UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Admin. Proc. File No. 3-20531

In the Matter of HORTER INVESTMENT MANAGEMENT, LLC and DREW K. HORTER, Respondents.	**RESPONDENTS' BRIEF ADDRESSING CIVIL PENALTIES AND OTHER REMEDIAL ACTIONS**

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Pursuant to the December 5, 2022 Order of Administrative Law Judge Foelak (the "ALJ"), Respondents Horter Investment Management, LLC and Drew K. Horter submit this brief addressing "(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 Sections 203(e) and 203(f)."

I. INTRODUCTION

Five years following the termination of Kimm Hannan ("Hannan") it should come as no surprise that Respondent Horter Investment Management, LLC ("HIM") no longer resembles the firm it was in 2017. HIM has nearly 85% *fewer* registered investment advisers and manages less than 20% of the assets under management than it did during the same time frame. Stated differently, the risk profile of HIM has changed dramatically, and as a consequence, the likelihood of future violations has also been materially reduced or eliminated. HIM has implemented substantial compliance and supervisory improvements and Respondent Drew K. Horter ("Horter") has materially reduced his daily supervisory responsibilities.

As reflected in the Offer of Settlement, HIM and Horter have accepted responsibility for any compliance program and supervisory deficiencies that may have enabled Hannan to further his conduct, but that does not mean that punishment should be without limits. Over the last five years, HIM and Horter have suffered tremendous economic, business, and reputational harm as a consequence of Hannan's actions. The Commission's desire to seek additional sanctions is little more than piling-on a business that continues to struggle for survival five years after the fact. There is a very real chance that further sanctions will have

the effect of a revocation on HIM and a bar on Horter, neither of which are sanctions that are being sought in this case or would otherwise be available in the context of this matter.

The purpose of sanctions is to protect the investing public and the integrity of the markets, not to punish respondents. The ALJ must consider the public interest as well as all surrounding factors and history of the Respondents. As set forth below, after a review of the facts involved in this matter and the various factors for the ALJ's consideration for the implementation of possible discipline, including protection of investors, and in light of the extraordinary compliance and supervisory measures taken by HIM and Horter, Respondents respectfully request that no further sanctions be issued in this matter.

II. FACTUAL BACKGROUND

Respondents recognize that they are precluded from challenging the validity of the facts set forth in the *Order Making Findings and Imposing a Cease-and-Desist Order Pursuant to Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940, and Ordering Continuation of Proceedings* (the "Cease and Desist Order") and those facts are to "be accepted as and deemed true by the hearing officer . . . ." [C&D Order at IV.] However, for completeness of the record and for the assistance of the ALJ in determining whether or not to impose discipline in this matter, Respondents present the following facts that supplement—and do not contradict—the Cease and Desist Order.

A. Background on Kimm Hannan and His Clients.

Prior to his registration with HIM in December 2014, Hannan's registration history reflected having been in the financial services industry for more than 40 years with no regulatory disciplinary history and only one customer complaint. [Long Aff.[1] at ¶ 3.] Hannan had also sold a successful investment advisory practice a year or two earlier. [*Id.* at ¶ 4.] Also prior to his registration with HIM, Hannan already had pre-existing investment relationships with Buddy and Gloria Scott, David and Anne Heinzman, Michael and Nannette Maletich, and John and Mary Ruth (collectively, the "Hannan Clients"), some for close to twenty years. [Woods Aff.[2] at ¶¶ 8, 14, 15, 17; Ex. B-2 at 20:14-25; Ex. B-3 at pp. 4, 5, 7.] Also prior to Hannan's registration with HIM, some of the Hannan Clients had already given Hannan approximately $175,000 for his investment use in his personal businesses. [*Id.* at ¶¶ 9, 16; Ex. B-2 at 28:7-24; Ex. B-3 at p. 5.]

As detailed in the Cease and Desist Order, Hannan solicited the Hannan Clients to invest in his various businesses. Each time the Hannan Clients wanted to transfer funds out of their Horter accounts, they completed Distribution Request forms.[3] [Vierling Dep.[4] at 50:17-56:25.] Those forms, which were signed by the Hannan Clients indicated the funds were to go to Hannan Properties, and the Hannan Clients were aware and wanted their funds to go to Hannan Properties. [*Id.*; Woods Aff. at ¶ 4, Ex. B-1.] Each time a

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[1] All references for "Long Aff." are to the Affidavit of Jason D. Long, attached hereto as **Exhibit A**. Exhibits to the Long Aff. are referred to herein as Ex. A-X.

[2] All references to "Woods Aff." are to the Affidavit of Nicole R. Woods, attached hereto as **Exhibit B.** Exhibits to the Woods Aff. are referred to herein as Ex. B-X.

[3] Buddy and Gloria Scott did not complete any Distribution Request forms because, although they were HIM clients, none of the funds provided to Hannan by the Scotts were from their HIM accounts or appeared on HIM account statements. [Long Aff. at ¶ 5.] As a consequence, it was impossible for HIM or Horter to know that the Scotts were transferring money to Hannan.

[4] All references to "Vierling Dep." are to the Deposition of Jessica Vierling, dated March 29, 2022 in this matter. True and accurate copies of all relevant pages are attached hereto as **Exhibit C.**

Distribution Request form was submitted, a HIM employee, Jessica Vierling, would contact the Hannan Client to confirm distribution of the funds per the Third-Party Distribution Procedure. Each time the Hannan Client confirmed the distribution. [Vierling Dep. at 58:19-61:14.] Although each of the distributions from a Hannan Client should have been written on the Distribution Log by Ms. Vierling, some of them were not entered, as a result of human error. [*Id.* at 67:15-69:13.] The distributions that were logged by Ms. Vierling were then reviewed by another HIM employee, who also did not notice the distributions were to Hannan Properties. [Hetzer Dep.[5] at 43:24-44:17; 59:6-18.] None of the Hannan Clients ever complained or objected to HIM regarding the distributions to Hannan. [Long Aff. at ¶ 6.] In fact, HIM never received a single complaint regarding Hannan from anyone, including the Hannan Clients, during the period of his registration with HIM. [*Id*. at ¶ 7.]

Although the Compliance Department was supposed to audit the Distribution Log, it did not do so. [Vierling Dep. at 69:9-11; Long Aff. at ¶¶ 8, 9.] When Compliance was made aware of the distribution to Hannan Properties from the Maletiches for $50,000 in March 2017, HIM put a hold on a pending Distribution Request. [Long Aff. at ¶ 10.] Instead of expressing concern about a distribution to Hannan for $50,000, Michael Maletich contacted HIM several times and demanded that it release the funds to Hannan. [Id. at ¶ 11.] Mr. Maletich became angry with HIM, asking Hannan via text message, "What right do they [*HIM*] have to refuse my request?" [Woods Aff. at ¶¶ 18, 19, Ex. B-4.] In the end, HIM did not process the request and prevented the $50,000 loss. [Long Aff. at ¶ 12.]

As stated in the Cease and Desist Order, "[f]rom a least November 2015 through at least March 2017, Hannan misappropriated $728,001 from [HIM] clients . . . ." [C&D

[5]All references to "Hetzer Dep." are to the Deposition of Kevin Hetzer, dated February 9, 2022 in this matter. True and accurate copies of all relevant pages are attached hereto as **Exhibit D.**

Order at ¶¶ 2, 20.] HIM entered into Confidential Settlement Agreements with the Hannan Clients.[6] [Long Aff. at ¶ 13; Woods Aff. at ¶¶ 10, 20.]

B. HIM Has Evolved as a Firm and Has Undergone Significant Changes Since the Facts Set Forth in the Cease and Desist Order.

HIM today is a very different firm than it was in 2014 when Hannan was hired, or even 2017 when Hannan was terminated. The firm itself is smaller, with 15 employees today compared with 41 employees in 2017. [Long Aff. at ¶¶ 15, 16.] In addition, HIM has significantly reduced the number of registered investment adviser representatives ("IARs"). As of December 31, 2014, HIM had 203 registered IARs. [Long Aff. at ¶ 17.] As of December 31, 2017, HIM had 220 registered IARs. [*Id.* at ¶ 18.] However, as of December 31, 2022, HIM has 35 total registered IARs, none of which are designated "high risk." [*Id.* at ¶ 19.] Similarly, as of 2014, HIM had $1.074 billion in assets under management ("AUM"). [*Id.* at ¶ 20.] As of 2017, HIM had $1.383 billion in AUM. [*Id.* at ¶ 21.] However, in December 2022, HIM has $260 million in AUM, less than 20% of the 2017 total. [*Id.* at ¶ 22.]

Although it is now a significantly smaller firm than it was, HIM has not lagged in its compliance efforts. HIM has spent hundreds of thousands of dollars implementing new compliance technology between 2017 and today. [Long Test.[7] at 43:10-44:9, 46:16-47:7; Long Aff. at ¶ 23.] In fact, Horter never declined a request for additional compliance resources for the HIM compliance department. [Roth Rep.[8] at 19; Long Aff. at ¶ 24.] New

[6] The Settlement Agreements with the Hannan Clients were produced to Staff as part of the investigatory document production. However, due to their confidential nature, the amounts of the settlements are not included herein and the agreements have not been attached hereto.

[7] All references to "Long Test." are to the investigative testimony of Jason D. Long. All relevant pages are attached hereto as **Exhibit E**.

[8] All references to "Roth Rep." are to the Expert Report of Lisa Roth, dated May 11, 2022 in this matter. A true and accurate copy of the Roth Rep. is attached hereto as **Exhibit F**.

technologies including Smarsh (for social media and email monitoring), Sweet Process (a cloud-based process documentation tool), BasisCode (a suite of regulatory compliance software, including tracking of outside business activities), Riskalyze (software platform for analyzing investment risk), Zephyr OnDemand (a reporting tool for comparing risk and performance of a client's portfolio), Black Diamond (cloud-based compliance solutions), and IAS (performance reporting and IAR tracking) were adopted and deployed. [Roth Rep. at 19; Long Aff. at ¶ 25.] HIM also retained Oyster Consulting, a third-party compliance consultant, from February 2015 through April 2018.[9] [Long Aff. at ¶ 26.]

In addition, HIM has engaged in ongoing enhancements of its policies and procedures and its compliance and supervisory structure. Although Horter is still the CEO and President of HIM, he no longer is responsible for day-to-day operations of HIM. [Horter Dep.[10] at 32:13-22.] Horter also is not the person with ultimate supervisory responsibility for HIM's IARs, this change being reflected in the IAR's ADV Part 2Bs. [*Id.* at 31:3-6; Long Aff. at ¶ 33.] As of February 2022, overall supervisory authority was vested in HIM's Compliance Committee (the "Compliance Committee"). [Long Aff. at ¶ 29.] The Committee is currently comprised of Jason Long (HIM's Chief Compliance Officer), Kevin Hetzer (HIM's Director of Operations) and Leslie Green and Patrick Hayes of Calfee Halter & Griswold—a compliance and supervisory firm to assist with policies and procedures, code of ethics, and the overall compliance department at HIM. [Horter Dep. at 21:19-22:1, 31:9-12; Long Aff. at ¶¶ 30, 31, Ex. A-2.] Importantly, Horter is <u>not</u> a member of the Compliance Committee. [Horter Dep. at 29:13-20; Long Aff. at ¶ 31.] The Compliance

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[9] It is worth noting that despite working with HIM during the relevant time frame, Oyster <u>also</u> failed to identify Hannan's conduct. [Long Aff. at ¶ 27.]

[10] All references to "Horter Dep." are to the Deposition of Drew K. Horter, dated May 25, 2022 in this matter. True and accurate copies of all relevant pages are attached hereto as **Exhibit G**.

Committee is now a permanent addition at HIM and is tasked with all compliance responsibilities, including a top-down review of each of HIM's policies and procedures. [Horter Dep. at 24:7-25:4.] The Compliance Committee is also responsible for supervising all of HIM's IARs and providing ongoing monitoring and oversight of HIM's compliance program, and has independent authority to discipline IARs, up to and including termination. [Horter Dep. at 30:6-9; Long Aff. at ¶ 32.]

HIM and the Compliance Committee instituted a Branch Office Supervisory Program ("BOSP") the procedures for which have been incorporated into HIM's policies and procedures. [*Id.* at 25:13-18; Long Aff. at ¶¶ 34-35, Ex. A-3.] Horter is not a member of nor does he participate in the BOSP. [*Id.* at 23:8-12.] The BOSP is a four-part supervisory program for HIM's IARs. [*Id.* at 25:19-26:6; Long Aff. at ¶¶ 34-35, Ex. A-3.] The policy first provides for ongoing testing and monitoring from HIM's home office, which includes email review, trading/suitability reviews, compliance certification reviews, marketing reviews, etc. [Long Aff. at ¶ 26.] The second part of the BOSP provides for a pre-onsite exam review, which allows HIM to conduct an enhanced review of the information collected prior to the onsite review. [*Id.* at ¶ 37.] A questionnaire includes requests for information such as client reviews and suitability determinations, disclosures and privacy policies, books and records, and client transactions. [*Id.* at ¶ 38.] The pre-onsite review then includes compliance testing review of marketing, data privacy, code of ethics, email, etc. [*Id.* at ¶ 39.]

The third part of the BOSP is the actual on-site review of the IAR, which can be broken into routine reviews (completed on a 2-3 year cycle) or a "for cause" review, which is determined by risk rating of the office or previous compliance/regulatory issues. [*Id.* at ¶

40.] The on-site review contains in-person interviews of the IAR and support staff, trading/suitability testing/client file review, and a marketing materials review. [*Id.* at ¶ 41.] The final part of the BOSP is ongoing IAR training, including annual compliance training and periodic adviser training throughout the year. [*Id.* at ¶ 42.]

Finally, separate and apart from the significant internal compliance changes made to HIM, counsel for HIM also retained third-party compliance consulting firm ACA Foreside ("Foreside")—one of the world's largest and most respected compliance consulting firms—to complete an all-encompassing review of HIM's compliance program and assessment of the firm. [*Id.* at 27:2-20; Woods Aff. at ¶¶ 23-24, Ex. B-5.] Foreside's scope of work included an assessment of HIM's compliance program, including onsite review and testing. The compliance assessment involved determining whether HIM's written compliance policies and procedures appropriately address regulatory requirements and to test whether HIM's business and compliance practices are being implemented consistent with regulatory requirements and HIM's policies and procedures. [*Id.* at ¶ 26.]

Foreside was provided and reviewed all requested data and conducted numerous interviews of HIM personnel as part of its compliance program review, paying special attention to supervision and marketing, as those issues had been previously identified by the United States Securities and Exchange Commission (the "Commission") in prior year exams. [*Id.* at ¶ 27.] Foreside completed its work in November 2022, and did not make any recommendations to HIM's compliance program, oversight, and/or supervision programs. [*Id.* at ¶ 28.]

Quite simply, HIM is a different firm than it was when Hannan was terminated in 2017 and Horter's role within HIM has changed dramatically from the information included

in the Cease and Desist Order. HIM and Horter have accepted responsibility for any compliance and supervision deficiencies and proactively transformed the firm and its compliance program.[11]

III. LEGAL ANALYSIS

A. Standards for Sanction Determination

The ALJ has a range of sanctions available under the Investment Advisors Act of 1940 (the "Advisers Act"), which are discussed below[12]. An important "purpose of sanctions is to serve as a deterrent against future violations by the individuals involved as for others in the securities industry." *In re Raymond James Fin. Svcs., et al.*, Rel. No. ID-296, 86 SEC Docket 604, 2005 WL 2237628, at *64 (Sept. 15, 2005) (initial decision became final on Nov. 21, 2005)[13]. Generally speaking, regardless of sanction, the Commission considers the following factors in determining which sanction is appropriate under the circumstances:

> [T]he egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979). The Commission also considers the "age of the violation" and the "degree of harm to investors and the marketplace resulting

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[11] Although not a party to the Cease and Desist Order and not involved in the actions set forth therein, HIM's affiliated advisor and registered mutual funds, Tactical Fund Advisors, LLC ("TFA") (which shares ownership, compliance, and executive structure with HIM) recently finished its first Commission examination, which resulted in no deficiencies. [Long Aff. at ¶¶ 43-46, Ex. A-4.] This outcome reflects a culture of compliance and controls in place to implement and effective compliance and supervision program.

[12] Although the Advisers Act permits the Commission to order disgorgement as a sanction (15 U.S.C. § 80b-3(k)(5)), the facts of this matter do not support disgorgement inasmuch as the Respondents realized no financial benefit from Hannan's conduct and none is alleged in the Cease and Desist Order. To the extent the Division includes disgorgement as a possible sanction in its briefing, Respondents reserve the right to address the potential sanction at that time.

[13] For ease of reference, copies of all authority cited herein and included on this Brief's Table of Authorities have been attached to the Affidavit of Nicole R. Woods as Exhibit B-6.

from the violation." *In re Marshall E. Melton*, Advisers Act Rel. No. 2151, 80 SEC Docket 3701, 2003 WL 21729839, at *2 (July 25, 2003). Importantly, however, "when the Commission chooses to order the most drastic remedies at its disposal, it has a greater burden to show with particularly the facts and policies that support those sanctions and why less severe action would not serve to protect investors." *Steadman*, 603 F.2d at 1137. "It would be a gross abuse of discretion to bar an investment adviser from the industry on the basis of isolated negligent violations." *Id.* at 1141.

The ALJ "must do more than say, in effect, [respondents] are bad and must be punished." *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1113 (D.C. Cir. 1988). Horter is the President, CEO, and majority owner of HIM. As was the case in *Blinder*, when the Commission's sanctions are affecting the "the livelihood of one commercial enterprise" and "the professional career of the firm's founder," the Commission is "not simply rendering a policy judgment; nor is it simply regulating the securities markets . . . ." *Id.* As such, "the Commission must craft [the sanction] with care." *Id.* (remanding matter to the Commission to determine appropriate sanction, especially in light of argument that respondents had "been singled out for disproportionately harsh treatment").

Importantly, sanctions <u>are not</u> compulsory under the Act. When a respondent engages in remedial action and cooperation, those act as mitigating factors for sanction decisions. For example, in the *HeadSpin* matter, "HeadSpin, through its former CEO Manish Lachwani, engaged in a fraudulent scheme to propel the Silicon Valley-based company's valuation to over $1 billion by falsely inflating its key financial metrics and doctoring internal sales records." *HeadSpin, Inc.*, SEC Litig. Release LR-25320 (Jan. 28,

2022)[14], referencing *SEC v. Headspin,* No. 5:22-cv-00576 (N.D. Cal.), filed Jan. 28, 2022. The Commission, however, announced no penalties against HeadSpin despite the fraud-based charges. *Id.* The Director of the Commission's Division of Enforcement stated, "[f]or companies wondering what types of remedial actions and cooperation might be credited by the Commission after a company uncovers fraud, this case offers an excellent example." *Remediation Helps Tech Company Avoid Penalties*, SEC Press Release No. 2022-14 (Jan. 28, 2022)[15]. Those examples included remediation, cooperation, improving its governance, and repaying harmed investors, "all of which were factors that counseled against the imposition of a penalty in [the HeadSpin] case." *Id.*

As in *HeadSpin*, Respondents here have completed extraordinary remediation and cooperation, repaid harmed investors, and improved its governance as detailed in Section II.B. above as well as discussed below. All of which leads to the conclusion that minimal, if any, penalties are appropriate in this matter.

B. Censure, Suspension, Revocation, or Bar.

The Cease and Desist Order finds that Respondents "failed reasonably to supervise, within the meaning of Sections 203(e)(6) and 203(f) of the Advisers Act." [C&D Order at ¶ 86.] For failure to supervise, Advisers Act Section 203(e) authorizes the ALJ to "censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any investment adviser . . . ." 15 U.S.C. § 80b-3(e). Section 203(f) similarly authorizes the ALJ to "censure or place limitations on the activities of any person . . . or suspend for a period not exceeding 12

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[14] https://www.sec.gov/litigation/litreleases/2022/lr25320.htm

[15] www.sec.gov/news/press-release/2022-14

months or bar any such person from being associated with an investment adviser . . . ." 15 U.S.C. § 80b-3(f).

As discussed above, if the Commission seeks "the most drastic remedies at its disposal," such as a bar or suspension, it must show why a "less severe action would not serve to protect investors." *Steadman*, 603 F.2d at 1137. Moreover, it is important to stress that a suspension, revocation, or bar may be ordered as a remedy, but not as a penalty. *Saad v. SEC*, 873 F.3d 297, 304 (D.C. Cir. 2017). Those severe types of sanctions are at risk of being punitive because they do not provide anything to any victims to make them whole or remedy their losses *Id.* Instead, suspensions, revocations, and bars should serve a prophylactic function of protecting investors and preserving the integrity of markets.

Following the *Steadman* factors, the ALJ should find that no sanction against the Respondents is appropriate under the facts of this matter. **First**, as shown by Respondents' consent to the Cease and Desist Order, they have accepted responsibility for their conduct[16]. *See*, *In re Eugene Terracciano*, SEC Rel. No. ID-1388, 2019 WL 5513382 (Oct. 22, 2019) (initial decision final Jan. 4, 2021) (noting that the respondent recognized the wrongful nature of his conduct as shown by the consent to the settlement order).

Second, the actions at issue here were isolated to Hannan. In fact, the Commission's 2018 examination of HIM was extraordinarily broad and resulted in a scorched-earth effort to uncover any possible violations by HIM and its associated persons. Part of that examination involved the gathering, review, and production of every single email to and from Horter, Jason Long, and Hannan (regardless of other sender or recipient) for a two-year period, resulting in a production of more than 53 GB of data and more than 192,000

[16] As stated in the Cease and Desist Order, Respondents neither admit nor deny the factual allegations.

pages. [Woods Aff. at ¶¶ 21-22.] Yet, despite the breadth and depth of the examination (and the fact that HIM had approximately 220 IARs at the end of 2017, including approximately 15 designated as high risk), the March 19, 2019 deficiency letter issued to HIM was almost entirely focused on Hannan, which was already known to Respondents. [Long Aff. at ¶¶ 14, 18; Ex. A-1.] No meaningful deficiencies were noted beyond what was already known.

Third, there are no allegations that Respondents' conduct involved fraud, deceit, or manipulation of any kind. Moreover, the Cease and Desist Order contains no allegations whatsoever that Respondents acted recklessly. Quite the opposite. HIM's third-party distribution policies changed when circumstances changed. HIM responded to a phishing incident by changing its policy and reacting to the risks at the time. [C&D Order at ¶ 48, Roth Rep. at 40-44.] At the time of Hannan's actions, the third-party distribution policy was not designed to root out the actions perpetuated by Hannan. [Roth Rep. at 44.] Instead, it was designed to confirm that clients were actually requesting the transfer of funds and wanted the funds to be transferred to the recipient listed on the form. When a risk became apparent, HIM adjusted policies and the policies worked. When the distributions of the Hannan Clients were finally discovered by HIM's compliance department[17], Hannan was terminated. [*Id.*; C&D Order at ¶¶ 25, 26.] None of the facts or findings set forth in the Cease and Desist Order state or support a finding of recklessness by Respondents.

Fourth, there is no likelihood of opportunities for future violations. As detailed above, Horter's role with HIM and HIM as a firm are completely different now than they were during the relevant period. Horter has no supervisory role, and HIM has implemented significant compliance changes and assessments. Quite simply, the allegations underlying

[17] Human error is not reckless, and no policy or procedure can eliminate that risk.

the Cease and Desist Order could not occur in today's HIM firm, especially given the drastically reduced number of IARs and the new BOSP.

Finally, Respondents have provided ample evidence of remediation and cooperation, including compliance assessments, an entire re-vamping of its compliance and supervisory structure, and repayment to the Hannan Clients.

Given the foregoing, Respondents respectfully request that no suspension, bar, or revocation be ordered. Previous matters before the SEC support such a finding; e.g.: *In re SFX Fin. Advisory Mgmt. Enters., Inc.*[18], Advisers Act Rel. No. 4116, 111 SEC Docket 6264, 2015 WL 3653814 (June 15, 2015). In *SFX*, the firm's president misappropriated at least $670,000 in assets from three client accounts for his own personal use. *Id.* at * 2. The Firm was alerted to the president's actions when a client complained that he could not use one of his credit cards. *Id.* The firm's policies "were not reasonably designed to prevent the person authorizing payments that [the firm] made from client accounts from circumventing secondary review of those payments." *Id.* As such, the president "was able to circumvent secondary review of the payments he authorized from client accounts." *Id.* The Commission instituted proceedings against the firm and the firm's Chief Compliance Officer for failure to supervise, and sanctions did not include <u>any</u> suspension, revocation, or bar. *Id.* at *4.

Respondents respectfully request that if the ALJ finds that a sanction is in the public interest, at most the AJL censure HIM and Horter. A censure is properly calibrated to punish Respondents for their misconduct and discourage future violations without the need

[18] Respondents are aware that settlement orders are not precedent for the ALJ or Commission. However, these citations are provided as examples of what sanctions the Commission found appropriate in those factual scenarios. Had the Commission required stricter sanctions, it could have sought them or litigated the matter.

for a suspension or bar. *See*, *In re Ascension Asset Mgmt., LLC, et al.*, SEC Rel. No. ID-1400, 2020 WL 1699565 (Apr. 3, 2020) (Foelak, J.) (initial decision final as of Jan. 1, 2021) (issuing censure and finding it was in the public interest).

Greater penalties are reserved for cases with a greater degree of scienter and where there was reckless conduct or actual knowledge. *See*, *In re Raymond James*, *supra*, 2005 WL 2237628 (issuing 90-day supervisory suspension to the CEO of the firm for allegations involving failure to supervise resulting in misappropriation of more than $16 million in investor funds where CEO relied on the compliance department and individual branch managers in carrying out his responsibilities); *In re Investment Placement Grp., et al.*, Advisers Act Rel. No. 3433, 102 SEC Docket 2621, 2011 WL 6541544 (Dec. 23, 2011) (consenting to a three-month supervisory suspension for firm's COO as a result of failure to supervise allegations with knowledge of problematic behavior by representative); *In re Jeffrey C. Young*, Advisers Act Rel. No. 2967, 97 SEC Docket 1791, 2009 WL 5125427 (Dec. 29, 2009) (consenting to a nine-month supervisory suspension of the vice president of supervision for failure to supervise a representative who executed unauthorized transactions, made unsuitable recommendations and churned customer's accounts where respondent had actual knowledge of wrongdoing); *In re Alexander R. Bastron*, Advisers Act Rel. No. 4362, 113 SEC Docket 4525, 2016 WL 1328925 (Apr. 5, 2016) (consenting to twelve-month supervisory suspension of IAR's direct supervisor arising from misappropriation of more than $300,000 in fees from 47 different clients); *c.f.*, *In re James T. Budden, et al.*, Advisers Act Rel. No. 4225, 112 SEC Docket 3701, 2015 WL 5935519 (Oct. 13, 2015) (consenting to two- and three-year supervisory bars for owners of firm arising from firm's CCO's fraudulent actions when owners knew of CCO's actions and failed to provide CCO with any training, funding,

or resources for his CCO role and provided no oversight whatsoever). These type of actions and violations are absent here and do not support such a sanction.

C. Civil Penalties

Advisers Act Section 203(i) authorizes the ALJ to impose monetary penalties for willful violation of Sections 203(e) or 203(f) if the penalty is within the public interest or for violation of 203(k). 15 U.S.C. § 80b-3(i)(1). To determine whether a penalty is in the public interest, the ALJ may consider (a) whether the actions of respondents involved "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement," (b) the harm to others caused by respondents' actions, (c) any unjust enrichment, (d) whether the person has been previously found by the Commission or other agency to have violated securities laws, (e) the need to deter respondents and others from committing similar acts, and (f) any other matters justice may require. 15 U.S.C. § 80b-3(i)(3)(A)-(F). "If the Commission applies the public interest factors listed in the Act and determines that some monetary penalty is warranted, the Commission must then decide which tier [of penalty] is appropriate." *ZPR Invest. Mgmt. Inc. v. SEC*, 861 F.3d 1239, 1256 (11th Cir. 2017).

The maximum amount of monetary penalty per act or omission is set forth in Section 203(i)(2). The First Tier is a maximum of $5,000 per natural person or $50,000 for firm; Second Tier is a maximum of $50,000 for a natural person or $250,000 for a firm if the respondents' actions involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and the Third Tier is a maximum of $100,000 for a natural person or $500,000 for a firm if the respondents' actions involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement <u>and</u> that act resulted in substantial losses. 18 U.S.C. § 80b-3(i)(2)(A)-(C).

Here, the public interest does not support a civil penalty against either HIM or Horter. **First**, the violations against Respondents do not involve fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, nor does the Cease & Desist Order (which the parties are bound by and which "shall be accepted as a deemed true by the hearing officer") contain any allegation the Respondents engaged in any of that type of behavior. In fact, the Cease & Desist Order does not describe Respondents' behavior as reckless in any way. Therefore, the first factor is not satisfied.

Second, there are no allegations that Respondents engaged in any conduct directly against the Hannan Clients that caused them harm. The Commission's arguments here are purely derivative. However, to the extent the ALJ concludes that the Hannan Clients were harmed by Respondents, the ALJ should also consider that Respondents made confidential settlement payments to the Hannan Clients. [Long Aff. at ¶ 13.] This factor does not weigh in favor of a civil penalty.

Third, neither Horter nor HIM were unjustly enriched by their actions as set forth in the Cease and Desist Order. In fact, quite the opposite. Respondents have settled claims with the Hannan Clients for significant amounts. Respondents have also suffered reputational harm stemming from Hannan incidents. Moreover, HIM has invested significant funds in its compliance structure and supervisory programs as a result of Hannan's actions. Most significantly, HIM's business has suffered tremendous economic loss with the departure of so many of its IARs and associated clients. This factor does not weigh in favor of a civil penalty.

Fourth, Respondents' history vis-à-vis security law violations does not warrant penalties. Horter has never been found by any regulatory agency, self-regulatory

organization, or court to have violated securities laws. His record reflects only a single client complaint from twenty-five years ago. HIM's record reflects a state consent order and a single cease-and-desist order from the Commission. The state consent order was from the Connecticut Department of Banking, dated December 18, 2019, and involved allegations of failure to supervise an IAR who was using an unlicensed solicitor and, unknown to HIM, paying a portion of his IAR commissions to the solicitor. *In re Horter Investment Management, LLC CRD No. 119880*, No. CO-19-14430-S, 2019 WL 7168076 (Conn. Dep't Banking Dec. 18, 2019). HIM agreed to a cease and desist order and payment of an administrative fine of $12,500. *Id.* at *3.

The Order from the Commission dated December 8, 2017, did not involve failure to supervise, but instead arose from misstatements made relating to F-Squared Investments.[19] Part of the settlement of that matter involved payment of a $250,000 civil penalty. *In re Horter Investment Management, LLC*, Advisers Act Rel. No. 4823, 118 SEC Docket 955, 2017 WL 6261511 (Dec. 8, 2017). However, as noted in that order, although not required to do so, HIM retained a compliance consultant (Oyster) from February 2015 through April 2018. [Long Aff. at ¶ 26.] Importantly, despite working with HIM during the relevant time frame, Oyster <u>also</u> failed to identify Hannan's conduct. [*Id.* at ¶ 27.] This factor does not weigh in favor of a civil penalty.

Fifth, a civil penalty is not required in order to deter Respondents from repeat behavior. As detailed *infra*, HIM is a different firm now and Horter has a vastly different

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[19] That matter was settled on a neither admit nor deny basis with HIM and was a result of a Commission enforcement sweep of advisors involved with F-Squared—a registered investment advisor that settled charges stemming from claims that it defrauded investors through false performance advertising about its flagship product. HIM was one of thirteen firms that accepted and relied upon claims by F-Squared Investments. *See*, *Investment Advisers Paying Penalties for Advertising False Performance Claims*, SEC Press Release No. 2016-167 (Aug. 25, 2016), https://www.sec.gov/news/press-release/2016-167.

role now than he did during the relevant time frame. Respondents have taken great pains and paid significant sums to revitalize and rebuild its compliance and supervisory structure. Penalizing Respondents will not deter similar behavior because that behavior has already been deterred. It may well have the opposite since firms may see little benefit in investing in compliance improvements only to be met with punitive financial penalties. This factor does not weigh in favor of a civil penalty.

As such, any civil penalty against Respondents is not in the public interest. However, even if the ALJ determines that a penalty is in the public interest, any penalty should be for a single violation rather than multiple acts or omissions. If allegations arise from a single course of action, the ALJ may issue a single civil penalty rather than numerous penalties. *See*, *In re Spring Hill Capital Markets, LLC*, Rel. No. ID-919, 112 SEC Docket 6264, 2015 WL 7730856 (Nov. 30, 2015) (considering multiple acts as course of action); *In re Natural Blue Resources, Inc., et al.*, SEC Rel. No. ID-863, 112 SEC Docket 1378, 2015 WL 4929878 (Aug. 18, 2015) (same). Hannan's conduct here clearly qualifies as a single course of action. Moreover, the penalty should be Tier One because Respondents' actions did not involve fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. *See, In re Retirement Sur. LLC, et al.*, SEC Rel. No. ID-1392, 2019 WL 7284955 (Dec. 20, 2019) (order first-tier civil penalties because respondents did not act with scienter, despite the fact "their actions leave much to be desired."); *c.f.*, *ZPR Invest.*, 861 F.3d at 1256-57 (upholding maximum second tier penalties because the respondents "repeatedly violated the antifraud provisions with scienter" and their misconduct was "especially serious because it involved attempts to promote their firm through false claims").

Respondents respectfully request that no civil penalties be ordered. However, if the ALJ orders penalties, they should be First Tier for a single violation.

D. Cease and Desist

If a person has violated any provision of Rule 203, the Advisers Act permits the ALJ to issue a cease and desist order from committing or causing any future violation of the same provision of the Advisers Act, rule, or regulation. 15 U.S.C. § 80b-3(k). However, despite a violation of the Advisers Act, if the ALJ finds that there is no risk of future violations, then a cease-and-desist order is unjustified. *In re Raymond James*, 2015 WL 2237628 at * 66 (finding that the record did not support an imposition of a cease-and-desist order because the risk of future violations was slight and therefore "not necessary for the future protection of public investors and capital markets"); *In re Ascension*, 2020 WL 1699565 at *7 (finding no need for cease-and-desist order for public interest).

Here, pursuant to Section 203(k) of the Advisers Act, the Commission has already ordered 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." [C&D Order at V.] No cease-and-desist was ordered against Horter. Because the risk of future violations of the same provisions are de minimis at best given the changes to HIM and Horter's role as previously discussed, no cease-and-desist order is necessary. Respondent Horter respectfully requests that the ALJ not issue any additional cease-and-desist orders.

IV. CONCLUSION

As set forth above, after a review of the facts involved in this matter and the various factors for the ALJ's consideration, including protection of investors, and in light of the

extraordinary compliance and supervisory measures taken by HIM and Horter, Respondents respectfully request that no sanctions be issued in this matter. If the ALJ finds that sanctions are appropriate, Respondents request that they be censured and a Tier One civil penalty be issued.

Dated: January 9, 2023

Respectfully submitted,

/s Matthew L. Fornshell

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Admin. Proc. File No. 3-20531

In the Matter of HORTER INVESTMENT MANAGEMENT, LLC and DREW K. HORTER, Respondents.	**CERTIFICATE OF SERVICE**

I hereby certify that I caused a true copy of the foregoing *Respondents' Brief Addressing Civil Penalties and Other Remedial Actions* on the following on this 9th day of January, 2023 via email as indicated below:

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Dated: January 9, 2023

/s Nicole R. Woods
Nicole R. Woods

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Admin. Proc. File No. 3-20531

In the Matter of HORTER INVESTMENT MANAGEMENT, LLC and DREW K. HORTER, Respondents.	**RESPONDENTS' INDEX OF EXHIBITS**

Exhibit	Description
A	Affidavit of Jason D. Long
A-1	Mar. 19, 2019 Deficiency Letter
A-2	Horter Investment Management, LLC ("HIM") Compliance Committee Charter
A-3	HIM's Branch Office Supervisory Program
A-4	Nov. 4, 2022 Examination letter for Tactical Fund Advisors, LLC
B	Affidavit of Nicole R. Woods
B-1	Distribution Forms
B-2	Excerpts from Deposition of Buddy Scott
B-3	Excerpts from Statement of Claim
B-4	Text message between Kimm Hannan and Michael Maletich
B-5	HIM's Master Service Agreement with Foreside
B-6	Copies of all authority used in Respondents' Brief
C	Excerpts from Deposition of Jessica Vierling
D	Excerpts from Deposition of Kevin Hetzer
E	Excerpts from Investigatory Testimony of Jason Long
F	Expert Report of Lisa Roth on behalf of Respondents
G	Excerpts from Deposition of Drew K. Horter

EXHIBIT A

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Admin. Proc. File No. 3-20531

In the Matter of HORTER INVESTMENT MANAGEMENT, LLC and DREW K. HORTER, Respondents.	**AFFIDAVIT OF JASON D. LONG IN SUPPORT OF RESPONDENTS' BRIEF ADDRESSING CIVIL PENALTIES AND OTHER REMEDIAL ACTIONS**

STATE OF OHIO :
: SS:
COUNTY OF HAMILTON :

Jason D. Long ("Affiant"), being first duly sworn according to law, deposes and says on the basis of personal knowledge:

1. I am over eighteen (18) years of age and have personal knowledge of and am competent to testify to the matters set forth in this affidavit and could testify competently and truthfully to the same if called as a witness and placed under oath.

2. I am the Chief Compliance Officer for Respondent Horter Investment Management, LLC ("HIM").

BACKGROUND ON KIMM HANNAN AND THIRD-PARTY DISTRIBUTIONS

3. Prior to his registration with HIM, Kimm Hannan's ("Hannan") registration history reflected having been in the financial services industry for more than forty (40) years with no regulatory disciplinary history and only one customer complaint.

4. Hannan had also sold a successful investment advisory practice a year or two prior to his registration with HIM.

5. Hannan clients Buddy and Gloria Scott held accounts with HIM. However, none of the funds provided to Hannan by the Scotts were from their HIM accounts or appears on HIM account statements.

6. None of Hannan's clients complained or objected to HIM regarding the distributions made from their accounts to Hannan Properties.

7. HIM never received a single complaint regarding Hannan from anyone during his registration with HIM.

8. When HIM was creating the Distribution Request Log as part of its Third-Party Distribution policy, I indicated the Log would be audited each month as part of the compliance program.

9. The compliance department did not audit the log as I indicated.

10. When compliance was made aware of the distribution to Hannan Properties from the Maletiches (Hannan clients) for $50,000, HIM put a hold on the pending distribution request.

11. Instead of expressing concern about a distribution to Hannan, Michael Maletich contacted HIM several times and demanded that it release the funds to Hannan.

12. HIM did not process the request.

13. HIM entered into confidential settlement agreements with the Hannan clients Buddy and Gloria Scott, David and Anne Heinzman, Michael and Nannette Maletich, and John and Mary Ruth.

14. Attached as **Exhibit A-1** is a true and accurate copy of the deficiency letter issued to HIM by the Commission on March 19, 2019.

CHANGES TO HIM AND HIM'S FOCUS ON COMPLIANCE

15. As of the date of this Affidavit, HIM has fifteen (15) employees.

16. In 2017, HIM had forty-one (41) employees.

17. As of December 31, 2014, HIM had two hundred three (203) registered investment advisor representatives ("IAR").

18. As of December 31, 2017, HIM had two hundred twenty (220) IARs, approximately fifteen (15) of which were designated as high-risk.

19. As of December 31, 2022, HIM has thirty-five (35) IARs, none of which are designated high-risk.

20. In 2014, HIM had $1.074 billion in assets under management ("AUM").

21. As of 2017, HIM had $1.383 billion in AUM.

22. As of December 2022, HIM has $260 million in AUM.

23. HIM has spent hundreds of thousands of dollars implementing new compliance technology between 2017 and today.

24. Drew K. Horter ("Horter"), HIM's President and CEO, never declined a request for additional compliance resources for the HIM compliance department.

25. New technologies that were adopted and deployed include Smarsh (for social media and email monitoring), Sweet Process (a cloud-based process documentation tool), BasisCode (a suite of regulatory compliance software, including tracking of outside business activities), Riskalyze (software platform for analyzing investment risk); Zephyr OnDemand

(a reporting tool for comparing risk and performance of a client's portfolio), Black Diamond (performance reporting tool), and IAS (performance reporting and IAR tracking).

26. HIM also retained Oyster Consulting ("Oyster"), a third-party compliance consultant, from February 2015 through April 2018.

27. Despite Oyster working closely with HIM during the relevant time frame, no one from Oyster detected any of Kimm Hannan's ("Hannan") conduct.

28. HIM has engaged in ongoing enhancements of its policies and procedures and its compliance and supervisory structure.

29. HIM created a Compliance Committee, which has overall supervisory authority of HIM's IARs.

30. A true and accurate copy of HIM's Compliance Committee Charter is attached hereto as **Exhibit A-2**.

31. HIM's Compliance Committee is comprised of myself, Kevin Hetzer (HIM's Director of Operations), and Leslie Green and Patrick Hayes of Calfee Halter & Griswold (a compliance and supervisory firm to assist with policies and procedures, code of ethics, and the overall compliance department at HIM). Mr. Hayes is a non-voting member of the Compliance Committee. Horter is not a member of the Compliance Committee.[1]

32. The Compliance Committee is responsible for supervising all of HIM's IARs and providing ongoing monitoring and oversight of HIM's compliance program.

33. Item 6 of the Form ADV Part 2B for each of HIM's IARs have been revised to reflect that HIM's Compliance Committee has primary responsibility for IAR supervision.

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[1] The Compliance Committee Charter lists Becky Hartsuck (Compliance Officer) of a member of the Compliance Committee. However, Ms. Hartsuck left HIM late 2022 and has not yet been replaced.

34. HIM and the Compliance Committee instituted a Branch Office Supervisory Program ("BOSP"), a four-part supervisory program for HIM's IARs.

35. A true and accurate copy of the BOSP Policy is attached hereto as **Exhibit A-3**.

36. The BOSP first provides for ongoing testing and monitoring from HIM's home office, which includes email review, trading/suitability reviews, compliance certification reviews, marketing reviews, etc.

37. The second part of the BOSP provides for a pre-onsite exam review, which allows HIM to conduct an enhanced review of the information collection prior to the onsite review.

38. A questionnaire includes requests for information such as client reviews and suitability determinations, disclosures and privacy policies, books and records, and client transactions.

39. The pre-onsite review then includes compliance testing review of marketing, data privacy, code of ethics, email, etc.

40. The third part of the BOSP is the actual on-site review of the IAR, which can be broken into routine reviews (completed on a 2-3 year cycle) or a "for cause" review, which is determined by risk rating of the office or previous compliance/regulatory issues.

41. The on-site review contains in-person interviews of the IAR and support staff, trading/suitability testing/client file review, and a marketing materials review.

42. The final part of the BOSP is ongoing IAR training, including annual compliance training and periodic adviser training throughout the year.

43. Tactical Fund Advisors, LLC ("TFA") is a registered investment advisor and is affiliated with HIM. TFA shares the same ownership, compliance, and executive structure as HIM.

44. I am the current Chief Compliance Officer for TFA.

45. TFA recently completed its first Commission examination.

46. As a result of that examination, on November 4, 2022, TFA received a notice that "no deficiencies came to the Staff's attention during the course of its examination." A true and accurate copy of the November 4, 2022 letter to TFA from Commission Staff is attached hereto as **Exhibit A-4**.

FURTHER THE AFFIANT SAYETH NAUGHT.

Jason D. Long
Jason D. Long

Sworn to and subscribed before me, a Notary Public, by Jason D. Long this 9TH day of January, 2023.

Patricia J. Hall
Notary Public

My commission expires: 2/10/2024

Patricia J. Hall
Notary Public, State of Ohio
My Commission Expires
February 10, 2024

4879-7717-0503.2

EXHIBIT A-1

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
175 W. JACKSON BOULEVARD, SUITE 1450
CHICAGO, IL 60604

CHICAGO
REGIONAL OFFICE

March 19, 2019

Delivery Via Secure E-mail

Drew Horter
Chief Executive Officer

Jason Long
Chief Compliance Officer
Horter Investment Management, LLC
11726 Seven Gables Rd
Symmes Township
Cincinnati, OH 45249

Re: Examination of Horter Investment Management, LLC
SEC File No. 801-67471

Dear Mr. Horter and Mr. Long,

The Staff conducted an examination of Horter Investment Management, LLC, which evaluated compliance with certain provisions of the federal securities laws or other applicable rules and regulations (together, "federal securities laws"). The examination identified the deficiencies and weaknesses in controls (together, "findings") that are described in Exhibit A, and which the Staff discussed during an exit interview on March 18, 2019, with Drew Horter, Registrant's Chief Executive Officer, Jason Long, Registrant's Chief Compliance Officer, and Matt Fornshell, Registrant's Counsel.

The Staff is bringing these findings to your attention for immediate corrective action, without regard to any other action(s) that may result from the examination. The findings are based on the Staff's examination and are not findings or conclusions of, or binding on, the Commission or any of its divisions or offices. You should not conclude that any of the firm's activities not discussed in Exhibit A are in full compliance with the federal securities laws. Nor should you conclude that Exhibit A sets forth an exhaustive list of the ways in which the firm's activities do not comply with the federal securities laws. Neither the Staff's findings or its communications during the course of the examination nor any remedial actions undertaken in response to such findings or communications foreclose the Commission from taking any action, including but not limited to an enforcement action, with respect to the firm.

The descriptions of the federal securities laws and related interpretations in Exhibit A may be paraphrased or abbreviated. Please visit our website at http://www.sec.gov/divisions.shtml for complete information related to these regulatory requirements.

Please respond in writing to each of the matters described in Exhibit A by April 18, 2019, describing any steps you have taken or intend to take with respect to each deficiency identified. Your response should be sent to John Ekdale at the address above. Thank you for your cooperation. If you have any questions, please contact John Ekdale at (312) 886-0846.

Sincerely,

John Ekdale
Lead Examiner

Emad Elsebaie
Assistant Regional Director

Attachment: Exhibit A

Exhibit A
Horter Investment Management, LLC
(SEC File No. 801-67471)

Deficiencies
The exam staff identified the following deficiencies during the examination:

I. Failure to Supervise

Section 206 of the Investment Advisers Act of 1940 ("Advisers Act") and Rule 206(4)-7 thereunder

Registrant failed to reasonably supervise investment adviser representative Kimm Hannan, who misappropriated client investments in a Ponzi-like scheme. Registrant did not have adequate policies and procedures in place to detect Mr. Hannan's activity, nor did it adequately address numerous red flags.

A. Relevant Law

Section 206 of the Advisers Act imposes a fiduciary duty on investment advisers.[1] As such, an adviser has an obligation to act in the best interest of its clients and to place their interests before its own. As fiduciaries, investment advisers have an affirmative duty of utmost good faith, and full and fair disclosure of all material facts and conflicts to clients, including a duty to avoid misleading them. An investment adviser's duties also include supervising the activities of all persons acting on its behalf.

Rule 206(4)-7 under the Advisers Act requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. Each adviser should 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. In addition, the Commission has enumerated issues that it expects an adviser to address in its policies and procedures to the extent that they are relevant to the adviser. These include the adviser's processes to safeguard client assets from conversion or inappropriate use by advisory personnel.[2]

Section 203(e)(6) of the Advisers Act authorizes the Commission to impose sanctions against an investment adviser if the investment adviser or any person associated with the investment adviser has failed reasonably to supervise, with a view to preventing violations of the securities laws, another person subject to his supervision who commits such a violation.

B. Examination Findings

Between November 2015 and March 2017, investment adviser representative Kimm Hannan borrowed approximately $1.65 million from Registrant's clients, effected through the sales of

[1] *See SEC v. Capital Gains Research Bureau, Inc.*

[2] *See Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2204 (Dec. 17, 2003).

promissory notes. These loans were ostensibly to be used to fund a start-up company that Mr. Hannan controlled, when in reality Mr. Hannan used at least some of the funds borrowed from clients to make interest payments to other clients. Ultimately, Mr. Hannan reported that he was unable to repay nearly $2 million in principal and interest owed to four of Registrant's clients.

Registrant did not effectively supervise Mr. Hannan, and its failure to address several red flags contributed to his ability to perpetuate the scheme. Registrant, for example, effected several fund transfers from client accounts into bank accounts of Hannan Properties, an entity controlled by Mr. Hannan. Hannan Properties was an outside business activity and had been reported as such when Mr. Hannan became affiliated with Registrant in 2014. Registrant, however, processed 16 cash distributions, transferring a total of $532,000 from client accounts into a bank account in the name of Hannan Properties between January 1, 2016 and March 16, 2017. Registrant did not have written policies and procedures to address its handling of third party wire transfer requests, and did not implement any such procedures until well after Mr. Hannan had been terminated. In practice, during the relevant time period, Mr. Hannan's distribution requests were reviewed by Registrant's trading supervisor who then confirmed the instructions with the client either verbally or via e-mail. No supervisory or compliance review was conducted to determine why client funds were being transferred into an account that was obviously controlled by Mr. Hannan.

Registrant became aware shortly after Mr. Hannan was hired that he had been terminated from his prior employer, LPL Financial, LLC, for, in part, accepting checks from clients payable to his DBA entity. Registrant's principals also became aware that Mr. Hannan was attempting to raise funds to launch a new company called HR Resources. E-mails reviewed by the Staff suggest that Mr. Hannan had solicited Registrant's involvement in the new company as early as October 2016, and had solicited direct investment from Drew Horter the following month. Still, these overtures did not cause Registrant to more closely supervise Mr. Hannan, or do anything to determine whether Mr. Hannan was soliciting investments from clients.

Further, Registrant's supervisory policies and procedures did not adequately address the risks inherent in its business model, which relies on a network of geographically dispersed independent contractors, generally operating from small DBA locations. The Staff has expressed similar concerns in the past, noting in a deficiency letter to Registrant dated December 18, 2014, that Registrant did not conduct supervisory inspections of its branch offices. A 2015 review of Registrant's compliance program conducted by Oyster Consulting noted that Registrant's supervision and compliance programs had not kept pace with its growth, and recommended that Registrant develop risk-based procedures to more closely supervise its IARs and branch offices. While Registrant eventually implemented a risk rating system for its IARs, it did nothing to enhance its supervision of those IARs determined to pose a higher risk. Indeed, Mr. Hannan was rated as a high risk IAR but was not subject to any enhanced supervision as a result. Similarly, Registrant did not conduct any branch office inspections until August 2017. Mr. Hannan's office was never subject to an onsite inspection.

C. Conclusion

Registrant's ineffective supervision is a recurrent, recidivist concern and enabled Mr. Hannan to sell promissory notes to Registrant's clients that he would ultimately not repay. Registrant should implement supervisory policies and procedures commensurate with the unique risks posed by its network of IARs, all of whom are independent contractors working from widely dispersed branch office locations. In its response, Registrant should describe the corrective actions that it intends to implement, and provide updated policies and procedures documenting said corrective action. In addition, we are requesting that Registrant inform us of the consideration it will give toward reimbursing clients affected by Mr. Hannan's activities.

II. Fee Billing

Section 206 of the Advisers Act of 1940 and Rule 206(4)-7 thereunder

Registrant overcharged certain clients for advisory fees and failed to implement adequate policies and procedures with respect to fee billing.

A. Relevant Law

Please see Section I above for descriptions of Section 206 and Rule 206(4)-7.

B. Examination Findings

1. Trust Company of America

The Staff's review found that certain clients of Registrant who use Trust Company of America ("TCA") for custody services were overbilled advisory fees due to incorrect valuations of assets held in their accounts. Registrant uses Hanlon Advisory Solutions' ("Hanlon") portfolio management software and engaged Hanlon for certain back-office operations, including data reconciling and fee billing. According to documents provided by Registrant, Hanlon experienced an internal conflicting process issue related to the pricing of certain assets in client portfolios. The result of this issue was that at least four clients were overbilled advisory fees due to incorrect asset valuations.

2. Jefferson National Life Insurance Company

The Staff's review also found that certain clients who have annuities with Jefferson National Life Insurance Company ("JNL") were overbilled advisory fees due to mispriced assets in subaccounts. As noted above, Registrant relies on Hanlon for its asset pricing and fee billing functions. Based on documents provided by Registrant, certain client accounts had a missing price file for assets in their accounts. Specifically, Hanlon's systems were unable to pull values for at least five assets as of December 31, 2017 and instead used stale values from September 30, 2017. This resulted in at least 12 client accounts being overbilled for advisory fees during this particular billing cycle.

3. Policies and Procedures

Due to the billing issues noted above, the Staff found that Registrant failed to implement adequate policies and procedures with respect to the valuation of securities and fee billing in client accounts. Registrant's Policies and Procedures Manual[3] ("Compliance Manual") states in Section 25 – Valuation of Securities the following:

> As a registered advisor and as a fiduciary to our advisory clients, Horter Investment Management, LLC, has adopted this policy which requires that all client portfolios and investments reflect current, fair and accurate market valuations.

This section goes on to state the following:

> Drew Horter will arrange for periodic and frequent reviews of valuations information from whatever source to promptly identify incorrect, stale, or mispriced securities. Any errors in pricing or valuations are to be resolved as promptly as possible, preferably upon a same day or next day basis, with re-pricing information obtained, reviewed and approved by the [sic] Drew Horter or the firm's Investment Committee.

The Staff's review noted numerous inaccurate valuations in client accounts as well as a lack of implementation of periodic reviews which would have noted these issues. Furthermore, when prompted with these valuation and fee billing issues, Registrant struggled to promptly resolve and reconcile the incorrect account valuations. Contrary to the procedures noted above, Registrant was solely reliant on Hanlon to resolve and reconcile the valuations and fee billing errors. Registrant demonstrated an inability to correctly value its own client accounts, which is further noted in subsequent findings.

C. Conclusion

Registrant's failure to accurately value assets in client accounts, accurately bill clients for advisory services, and follow its own written policies and procedures violates the requirements of Section 206 of the Advisers Act and Rule 206(4)-7 thereunder. Registrant should review its valuation and fee billing process and identify the steps it intends to take in response to this deficiency, including whether the firm intends to undertake a review of similarly-situated accounts to determine if those accounts have been impacted in a similar manner as described above, and whether the firm intends to reimburse clients. Registrant should provide documentation to support any corrective action taken, including documentation describing any review the firm has conducted of the accounts that were not reviewed by the Staff to determine if those accounts were impacted in a similar manner. Additionally, Registrant should provide documentation reflecting any reimbursements made to clients.

[3] Dated November 30, 2017.

III. Performance Advertising and Marketing

Section 206 of the Advisers Act and Rules 206(4)-1(a)(5), 206(4)-7, and 204-2(a)(16) thereunder

Registrant failed to maintain required books and records that form the basis, or demonstrate the calculation, of the historical performance reported on its managed portfolio fact sheets disseminated to existing and prospective clients. Registrant also failed to implement its policies and procedures to maintain required books and records that form the basis for the historical performance reported. Additionally, Registrant failed to disclose all material facts in certain portfolio fact sheets which were disseminated to existing and prospective clients.

A. Relevant Law

Section 206 of the Advisers Act and Rule 206(4)-1 thereunder govern the advertisements of investment advisers. Sections 206(1), 206(2), and 206(4) of the Advisers Act prohibit an investment adviser, directly or indirectly, from employing any device, scheme, or artifice to defraud any client or prospective client; from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; and from engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative. Rule 206(4)-1(a)(5) generally prohibits registrants or those required to be registered from using any advertisement that contains any untrue statement of a material fact or is otherwise false or misleading.

Rule 204-2(a)(16) requires that advisers retain all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons. Furthermore, in *Recordkeeping by Investment Advisers*, Advisers Act Release No. 1135 (October 20, 1988), the Commission set forth that advisers complying with Rule 204-2(a)(16) by retaining account statements must retain account statements for all accounts, whether or not a particular account statement is included in the computation of a performance figure. Rule 204-2(e)(3) requires that the records required by Rule 204-2(a)(16) be maintained and preserved for a period of not less than five years, the first two of which in the office of the adviser, after the end of the last fiscal year in which the adviser disseminates such communication.

B. Examination Findings

1. Support for Performance Advertisements

Registrant provides existing and prospective clients Fact Sheets produced quarterly for each of the portfolio strategies it recommends to its clients. The Fact Sheets provide the respective strategies' historical performance calculated by the third party money manager that manages

each strategy along with certain disclosures related thereto. The Staff's review revealed that Registrant failed to maintain all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance presented in the Fact Sheets.

Registrant informed the Staff that it asks each third party adviser to have their performance information audited and that it requests copies of the audits. Additionally, Registrant stated that in 2016, it retained Capital Market Consultants, Inc. ("CMC"), to provide ongoing due diligence of the third party money managers, as well as provide other research on their managed portfolio strategies. As part of its research, CMC produces quarterly performance reports on the third party money managers and their portfolio strategies. Registrant retains the performance reports provided by CMC. However, it does not appear that Registrant obtains, or retains, the underlying working papers, records, or other documents necessary to calculate the historical performance for each strategy. It also does not appear that Registrant obtains the original underlying records or documents used by each third party money manager to calculate the performance information presented in the Fact Sheets that Registrant provides to existing and prospective clients.

Furthermore, the Staff notes that Registrant's Compliance Manual states:

> The Chief Compliance Officer or designated compliance analyst is responsible for ensuring that the firm is properly maintaining copies of any performance materials and supporting documentation for the calculation of performance materials.

Registrant's failure to maintain all accounts, books, internal working papers, and any other documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return in the Fact Sheets violates Rule 204-2(a)(16) under the Advisers Act. Registrant also violated Rule 206(4)-7 under the Advisers Act by failing to implement its written policies and procedures as they relate to maintaining those documents.[4] Registrant should inform the Staff of the steps it intends to take in response to this deficiency and provide documentation of any corrective action(s) taken.

2. Fact Sheet disclosures

As mentioned above, Registrant provides existing and prospective clients Fact Sheets produced quarterly for each of the portfolio strategies it recommends to its clients. Registrant informed the Staff that, for certain strategies, it is responsible for implementing trades once it receives portfolio updates from the third party money manager. Additionally, page 5 of Registrant's

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[4] The staff notes that Registrant recently agreed to settle an Administrative Proceeding in which the Commission found violations of Sections 204(a), 206(2) and 206(4) of the Advisers Act and Rules 204-2(a)(16), 206(4)-1(a)(5) and 206(4)-7 thereunder relating to Registrant's advertising. *See In the Matter of Horter Investment Management*, *LLC*, Investment Advisers Act Rel. No. 4823 (Dec. 8, 2017).

March 31, 2017, ADV Part 2A, as well as its subsequent July 2, 2018 ADV Part 2A, discloses the following:

> In some circumstances, Horter has delegated trading authority to the Third-Party Money Manager. In other circumstances, Horter will place trades in the client's account according to trading instructions received from the Third-Party Money Manager.

The Staff's review revealed that Registrant failed to disclose in certain Fact Sheets that it implements trades in those particular strategies.[5] Additionally, as noted above, the performance information presented in the Fact Sheets is calculated by the third party money manager. For strategies where Registrant is responsible for implementing trades in client accounts, the Staff notes that the actual performance obtained by Registrant's clients could differ from the performance presented in the Fact Sheets. These differences may result from timing delays and execution quality, among other factors. Registrant has an obligation to disclose all material facts relating to any material differences between actual client performance and Fact Sheet performance disseminated to existing and prospective clients.

Registrant's failure to disclose all material facts in its performance marketing is a violation of Section 206 of the Advisers Act and Rule 206(4)-1(a)(5) thereunder. Registrant should amend its Fact Sheets and any other applicable marketing materials to ensure they disclose all material facts including, but not limited to, those highlighted in this deficiency. Registrant should inform the Staff of the steps it intends to take in response to this deficiency and should provide documentation of any corrective action(s) taken.

IV. Books and Records

Rules 204-2(a)(8) and 206(4)-7 under the Advisers Act

Registrant failed to maintain accurate books and records reflecting its list of client account asset values.

A. Relevant Law

Rule 204-2(a) requires a registered investment adviser to make and keep true, accurate, and current certain books and records, which include a list or other record of all accounts in which the adviser is vested with any discretionary power with respect to the funds, securities, or transactions of any client.

Please see Section I above for a description of Rule 206(4)-7.

[5] These strategies include: Alpha Investment Management- Bonds; Alpha Investment Management Mid-Cap; Kensington Analytics- Managed Income; Ocean Park Asset Management- High Yield Corporate Bonds; Potomac Advisors – EVO 1; Tactical Wealth Management- Government Bonds; W.E. Donoghue & Co – Power Dividend; W.E. Donoghue & Co – Power Dividend International; and, WST Capital Management- Credit Select Risk – Managed.

B. Examination Findings

Registrant failed to maintain an accurate list of client account values throughout the Examination Period. During the course of the examination, Registrant identified multiple accounting issues that affected the reported values in client accounts. As previously stated, Registrant relies on Hanlon to perform portfolio management functions including reconciling account values across applicable custodians. The Staff's review noted the following issues with respect to account valuations:

- A conflicting process issue at Hanlon that misstated client account values as of December 31, 2017 due to an internal server's inability to perform multiple valuation functions simultaneously. This issue affected at least 22 accounts.
- A closed account issue at TCA for certain of Registrant's client accounts that were closed in January 2018. According to Registrant, clients who elected to close accounts in the beginning of 2018 had the outgoing transfers reflected in December 2017 statements. This issue flowed through to client account values provided to the Staff by Registrant and affected at least 112 client accounts.
- An accounting issue where Hanlon did not reflect certain accounts as being opened due to the fact that the account had previously switched money managers and subsequently elected to return to the original manager. Accounts with this pattern did not have values reflected on the client list provided to the Staff.
- Incorrectly labeling certain proprietary accounts of Registrant as billable which caused the accounts to be listed incorrectly on the client account list provided to the Staff.
- As previously noted, accounts at JNL used stale pricing from a previous quarter for certain annuity subaccounts. This resulted in incorrect client account values as of December 31, 2017. Including accounts that were both under-billed and overbilled, the total population of affected accounts due to this issue was at least 119 accounts.

C. Conclusion

Registrant failed to maintain accurate books and records reflecting its list of advisory clients. On multiple occasions, Registrant produced to the Staff materially inaccurate client lists with an array of accounting issues noted above. Furthermore, Registrant's failure to provide an accurate client list caused a lengthy delay in the Staff's ability to examine for compliance with the Advisers Act. The Staff asks that Registrant's management review its record keeping practices to ensure that its list or other record of all client accounts in which Registrant is vested with any discretionary power with respect to the funds, securities or transactions of any client is true, accurate and current, as required by Rule 204-2(a)(8). Registrant's inability to correctly identify billable asset totals constitutes a violation of Rule 206(4)-7, as its policies and procedures do not adequately ensure accurate reporting of AUM on filings such as the Form ADV Part 1A, potentially in violation of Section 207 of the Act. Registrant should inform the Staff of the steps

it intends to take in response to this deficiency and provide documentation to support any corrective action(s) taken. Registrant should also inform the Staff of any errors in billing that may have occurred due to the discrepancies in billable assets identified above, and inform the Staff of any consideration it will give to making reimbursements as a result of any billing errors identified.

V. Policies and Procedures

Rule 206(4)-7 under the Advisers Act

Registrant failed to adopt and implement adequate policies and procedures surrounding the review and approval of money movements taking place in client accounts.

A. Relevant Law

Please see the descriptions of Rule 206(4)-7 under the Advisers Act in Section I and Section II, above.

B. Examination Findings

The Staff's review of Registrant's Compliance Manual found that it lacked adequate policies and procedures dictating how, on a firm-wide level, compliance would supervise and review money movements taking place in and out of client accounts. The Staff's review of Registrant's Compliance Manuals in effect between May 1, 2015 and November 30, 2017 revealed that there was a material lack of policies and procedures addressing the process by which Registrant processes money movements in client accounts[6] and reviews the movements from a compliance perspective for applicable red flags. Based on Registrant's document production, there appeared to be a supplement to the Compliance Manual[7] that addresses Registrant's workflow for processing third party distributions. This supplement summarizes Registrant's process for the time periods of pre-June 2016, June 2016 – October 2017, and post October 2017. However, the Staff's review identified the following issues with the supplement:

- The supplement was never incorporated into or referenced in Registrant's Compliance Manual.
- The review steps in the supplement for the majority of the Examination Period are inadequate due, in part, to a lack of formal compliance oversight.
- The supplement only addresses clients who use TCA for custody, and does not address the process for additional custodians used by Registrant's clients.

[6] Including both first and third party movements.

[7] Dated October 17, 2017.

C. Conclusion

Registrant failed to adopt and implement adequate policies and procedures with respect to the review of money movements in and out of client accounts which violates the requirements of Rule 206(4)-7 of the Advisers Act. Moreover, Registrant's failure to adopt and implement adequate policies and procedures with respect to money movements in client accounts allowed Mr. Hannan's scheme described in Section I to go undetected for over 18 months. The Staff asks Registrant to take steps to ensure that its policies and procedures are reasonably designed to prevent violations of the Advisers Act. The Staff asks Registrant to describe any changes made to its policies and procedures in response to this letter.

EXHIBIT A-2

Horter Investment Management
Compliance Committee Charter
Effective February 9, 2022

MEMBERS: Jason Long (Chair, CCO), Leslie Green (Calfee), Becky Hartsuck (Compliance Officer), Kevin Hetzer (Director of Operations)

NON-VOTING MEMBERS: Patrick Hayes (Counsel)

MISSION: The Horter Investment Management ("HIM") Compliance Committee monitors and reviews the policies and procedures put in place as well as recent activity to help mitigate against firm-wide compliance risks. Additionally, the Committee is responsible for the management of the HIM Branch Office Supervisory Program (BOSP) and the supervision of HIM IARs.

MEETINGS: The Compliance Committee will meet no less than quarterly and on an as-needed basis.

POWERS AND RESPONSIBILITIES: The Compliance Committee will provide ongoing monitoring and oversight of the firm's compliance program including:

- Administer and manage the HIM BOSP and supervision of IARs
- Review personal trading activity and Code of Ethics violations,
- Research analyst account reviews, custody issues, complaints, billing errors, and other areas deemed to be higher risk by the firm at the time.
- Responsible for identifying and addressing potential conflicts of interest.
- Responsible for the implementation and monitoring of HIM's complaint policy, practices, and recordkeeping.
- Oversight of its third-party IT service provider and is responsible for maintaining the HIM information security management system.
- Responsible for reviewing and providing oversight over the Firm's trading practices.
- Responsible for monitoring compliance with the trade error policy and reviewing all trade errors.
- Responsible for implementing and monitoring the policy for the preparation, presentation, review, and approval of performance information.
- Responsible for creating and developing the HIM Disaster Recover and Business Continuity Plan.
- Responsible for conducting and monitoring ongoing due diligence reviews for service providers.
- Responsible for the implementation and monitoring of HIM's advisory agreements and the corresponding delivery and recordkeeping.
- Responsible for the implementation and monitoring of the Firm's ERISA policy, practices, disclosures, and recordkeeping.
- Supports the Investment Committee by monitoring financial planning practices to provide reasonable assurance of adherence to state and federal law.
- Responsible for implementation and oversight of Firm's client billing practices
- Responsible for preparation and filing of the Firm's annual ADV filing and any interim updates as needed

EXHIBIT A-3

Horter Investment Management
Branch Office Supervision Program

Program Structure

4 Part Supervision

Supervision process encompasses 4 primary elements:

1. Ongoing testing/monitoring
2. Internal Review and/or Pre-onsite Branch Exam Review
3. Branch Exams/Onsite Visit – routine/for cause/risk based
    a. Routine Exams: 3yr cycle for low risk, 2yr cycle for moderate to high risk
        i. Risk rating should include specific factors
    b. For Cause: Materiality determination for required review. Can be targeted review.
    c. Pre-exam questionnaire, post-exam deficiency letter and interview
4. Training
    a. Annual Compliance Training Required
    b. Horter Adviser Training
        i. Required attendance at set number per year
        ii. Include compliance updates within each training
        iii. Reintroduction of "Compliance Corner" newsletter

Ongoing Testing

Internal, ongoing testing from home office should include the review of independent sales force. Testing should review appropriate sample sizes dependent on population size. Ongoing testing should include, but is not limited to:

1. Email Review
2. AML
3. Insider Trading
4. Marketing
5. Client Complaints
6. Data Privacy
7. Cybersecurity
8. Identify Theft Red Flags
9. Code of Ethics reviews
10. Disciplinary History Reviews
11. Trading/suitability reviews
12. Fee Billing
13. Compliance Certification Review (Basis Code?)
14. Social Media Review

Potential Deliverables: The committee should continue to develop and enhance the ongoing testing program based on the risks unique to Horter's network of geographically dispersed advisors.

Updates to Pre-Branch Audit Questionnaire

A review of the existing pre-audit branch exam questionnaire offered opportunities to enhance information collection prior to the onsite review.

Potential Deliverables: The committee should continue to develop and enhance the questionnaire as the program develops.

Pre-Branch Audit Office review

1. Individual IAR Review
    a. Form U4 and ADV 2B
    b. Client base and product concentration
    c. Individual IAR AUMs
2. Review of Pre-Branch Audit Questionnaire responses
3. Ongoing compliance testing review:
    a. Email Review
    b. AML
    c. Insider Trading
    d. Marketing
    e. Client Complaints
    f. Data Privacy
    g. Cybersecurity
    h. Identify Theft Red Flags
    i. Code of Ethics reviews
    j. Disciplinary History Reviews
    k. Trading/suitability reviews
    l. Compliance Certification Review (Basis Code?)
    m. Social Media Review
4. Training Reviews
    a. Up to date on initial/ongoing compliance and code of ethics training
    b. Attendance at required training sessions

Potential Deliverables: The committee should continue to develop the tools to aid in planning and coordinating the branch audits (for example, a Pre-Audit Checklist document).

Office On-Site/Remote Reviews

1. Review cycle broken into Routine (2/3-year cycle) vs. For Cause review
    a. For cause review can be based on risk rating of office based on high-risk areas of the business/product suite/client type, or can be based on previous compliance/regulatory issues.
    b. Consider inclusion of unannounced reviews
2. In-person interviews with IARs and Support staff
3. Trading/Suitability Testing/Client File Review
    a. Account Documentation Review
    b. Review trades against client objectives in client files
    c. Review documentation of client recommendations
4. Marketing Materials Review
    a. Sample review of printed and electronic materials distributed by IAR
    b. Look for DBAs/alternate names
    c. Use of Unapproved Marketing Materials
        i. Particular scrutiny around performance advertising

Potential Deliverables: The committee should continue to develop the tools to aid in conducting and documenting the on-site reviews (for example, on-site review document, IAR and support staff interview document, On-site audit checklist).

EXHIBIT A-4

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
175 W. JACKSON BOULEVARD, SUITE 1450
CHICAGO, IL 60604

DIVISION OF
EXAMINATIONS

November 4, 2022

DELIVERY VIA SECURE E-MAIL

Mr. Drew K. Horter
Chief Executive Officer
dhorter@tacticalfundadvisors.com

Mr. Jason D. Long
Chief Compliance Officer
11726 Seven Gables Road
Cincinnati, OH 45249
jlong@tacticalfundadvisors.com

Re: Examination of Tactical Fund Advisors, LLC ("Registrant")
SEC File No. 801-114248

Dear Mr. Horter and Mr. Long:

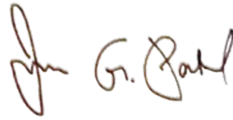
The staff of the U.S. Securities and Exchange Commission (the "Staff") completed an examination of Registrant, which evaluated compliance with certain provisions of the federal securities laws or other applicable rules and regulations (together, "federal securities laws") and no further action by Registrant is required.

The fact that the Staff has no written comments does not mean that all of Registrant's activities comply with the federal securities laws; rather only that no deficiencies came to the Staff's attention during the course of its examination. The Staff's decision to provide no written comments is based on the Staff's examination of Registrant and is not a finding or conclusion of, or binding on, the Commission or any of its divisions or offices. Furthermore, the Staff's decision does not foreclose the Commission from taking any action, including but not limited to an enforcement action, with respect to Registrant.

Thank you for your cooperation. If you have any questions, please contact Malinda Pileggi at (312) 886-0816.

Sincerely,

Malinda Pileggi
Staff Accountant



Jeson G. Patel
Assistant Regional Director

EXHIBIT B

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Admin. Proc. File No. 3-20531

In the Matter of HORTER INVESTMENT MANAGEMENT, LLC and DREW K. HORTER, Respondents.	**AFFIDAVIT OF NICOLE R. WOODS IN SUPPORT OF RESPONDENTS' BRIEF ADDRESSING CIVIL PENALTIES AND OTHER REMEDIAL ACTIONS**

STATE OF OHIO :
: ss
COUNTY OF FRANKLIN :

I, Nicole R. Woods, after being duly sworn according to law, do hereby voluntarily state the following:

1. I am competent to testify to and have personal knowledge of the matters set forth in this Affidavit.

2. I am an attorney licensed to practice in the State of Ohio. I am a partner at the firm of Ice Miller LLP ("IM"), with a business address of 250 West Street, Suite 700, Columbus, Ohio 43215.

3. IM represents Horter Investment Management, LLC ("HIM") and Drew K. Horter ("Horter"), the Respondents in the above-captioned proceeding.

4. Attached as **Exhibit B-1** are true and correct copies of the Distribution Forms for Anne Heinzman and David Heinzman, Michael and Nanette Maletich, and John and Mary Ruth, which were marked as Exhibits F, G, and H respectively to the deposition of Jessica Vierling taken on March 29, 2022 in the above-referenced proceeding. The Distribution Forms were produced by Respondents as part of its investigatory document production and bates numbered HORTER-SEC051716 through 51719 (Heinzmans), HORTER-SEC051739 through HORTER-SEC051751 (Maletiches), and HORTER-SEC051764 through HORTER-SEC051768 (Ruths)[1].

5. IM also previously represented HIM in an action captioned Buddy Scott, et al. v. Horter Investment Management, LLC, et al., Case No. 18-CV-194764, which was pending before the Common Pleas Court of Lorain County, Ohio (the "Scott Action").

6. The Scott Action involved HIM clients Buddy and Gloria Scott.

7. As part of the Scott Action, Buddy Scott was deposed on April 9, 2019. True and accurate copies of the relevant pages of Buddy Scott's deposition are attached hereto as **Exhibit B-2**.

8. Buddy Scott testified that he and his wife met and started working with Kimm Hannan ("Hannan") in November or December of 2013. *See*, Ex. B-2 at 20:14-25.

9. Buddy Scott also testified that he and his wife gave Hannan Properties, LLC ("Hannan Properties") $50,000 on or around November 13, 2014. *See*, Ex. B-2 at 28:7-24.

10. The Scott Action was resolved via settlement, and the matter was dismissed with prejudice on August 9, 2019.

[1] All Sensitive Personal Information has been redacted from the Distribution Forms pursuant to 17 CFR §§ 201.151(e). Complete and unredacted copies of the documents were produced by Respondents and used during the deposition.

11. IM also represented HIM in an arbitration captioned Michael Maletich, et al. v. Horter Investment Management, LLC, which was pending before a private arbitrator (the "Maletich Arbitration").

12. The Maletich Arbitration involved HIM clients Michael and Nanette Maletich, John and Mary Ruth, and Anne Heinzman and David Heinzman (the "Maletich Claimants").

13. As part of the Maletich Arbitration, the Maletich Claimants submitted a Statement of Claim to the Arbitrator. True and accurate copies of the relevant pages of the Statement of Claim are attached hereto as **Exhibit B-3**. The full and complete Statement of Claim was produced by Respondents to Staff of the Division of Enforcement as part of its investigatory document production at bates numbers HORTER-SEC046757 through HORTER-SEC046767.

14. The Statement of Claim alleged that Michael and Nanette Maletich met and started working with Hannan in 1998. *See*, Exhibit B-3 at p.4.

15. The Statement of Claim also indicated that John and Mary Ruth met and started working with Hannan in prior to Hannan's registration with HIM. *Id.* at p. 5.

16. At the time John and Mary Ruth opened their accounts with HIM, they had already loaded Hannan $125,000. *Id.*

17. The Statement Claim also indicated that Anne and David Heinzman met and started working with Hannan prior to his registration with HIM. *Id.* at p. 7.

18. As part of the discovery process in the Maletich Arbitration, the Maletiches produced a copy of a text message exchange between Michael Maletich and Hannan regarding the Maletiches' $50,000 disbursement request to Hannan Properties that was

stopped by HIM. Michael Maletich asked Hannan, "What right to they [*HIM*] have to refuse my request?"

19. A true and accurate copy of the text message exchange is attached hereto as **Exhibit B-4** and was previously produced by Respondents to Staff as part of the investigatory document production at bates number HORTER-SEC051753.

20. The Maletich Arbitration was resolved via settlement in October 2018.

21. As part of the Commission's examination of HIM beginning in January 2018 (SEC File No. 801-67471), Staff requested production of every email to and from the email boxes for Drew Horter, Jason Long, and Hannan (regardless of recipient) for the two year period of January 1, 2016 through December 31, 2017.

22. IM assisted HIM with that email production, which yielded more than fifty-three gigabytes (53 GB) of emails and attachments and were bates numbered HIM_SEC000001 through HIM_SEC192778.

23. On or around October 28, 2021, IM engaged the services of Foreside, n/k/a ACA Foreside ("Foreside"), a compliance consulting firm, to conduct an assessment of HIM's compliance program.

24. Attached as **Exhibit B-5** is a true and correct copy of the executed Foreside Master Service Agreement and accompanying Compliance Program Assessment Service Agreement. All terms related to fees paid to Foreside have been redacted.

25. Foreside's scope of work included an assessment of HIM's compliance program, including onsite review and testing.

26. The compliance program assessment involved determining whether HIM's written compliance policies and procedures appropriately addressed regulatory requirements

and to test whether HIM's compliance practices are being implemented consistent with regulatory requirements and HIM's policies and procedures.

27. Foreside was provided and reviewed all requested data and conducted numerous interviews of HIM personnel as part of its compliance program review, paying special attention to supervision and marketing, as those issues had been previously identified by the United States Securities and Exchange Commission in prior year exams.

28. Foreside completed its work in November 2022, and did not make any recommendations to HIM's compliance program, oversight, and/or supervision programs.

29. Attached as **Exhibit B-6** are true and correct copies of all authority relied upon in Horter's Brief Addressing Civil Penalties and Other Remedial Actions, which are listed in the Brief's Table of Authorities.

Nicole R. Woods

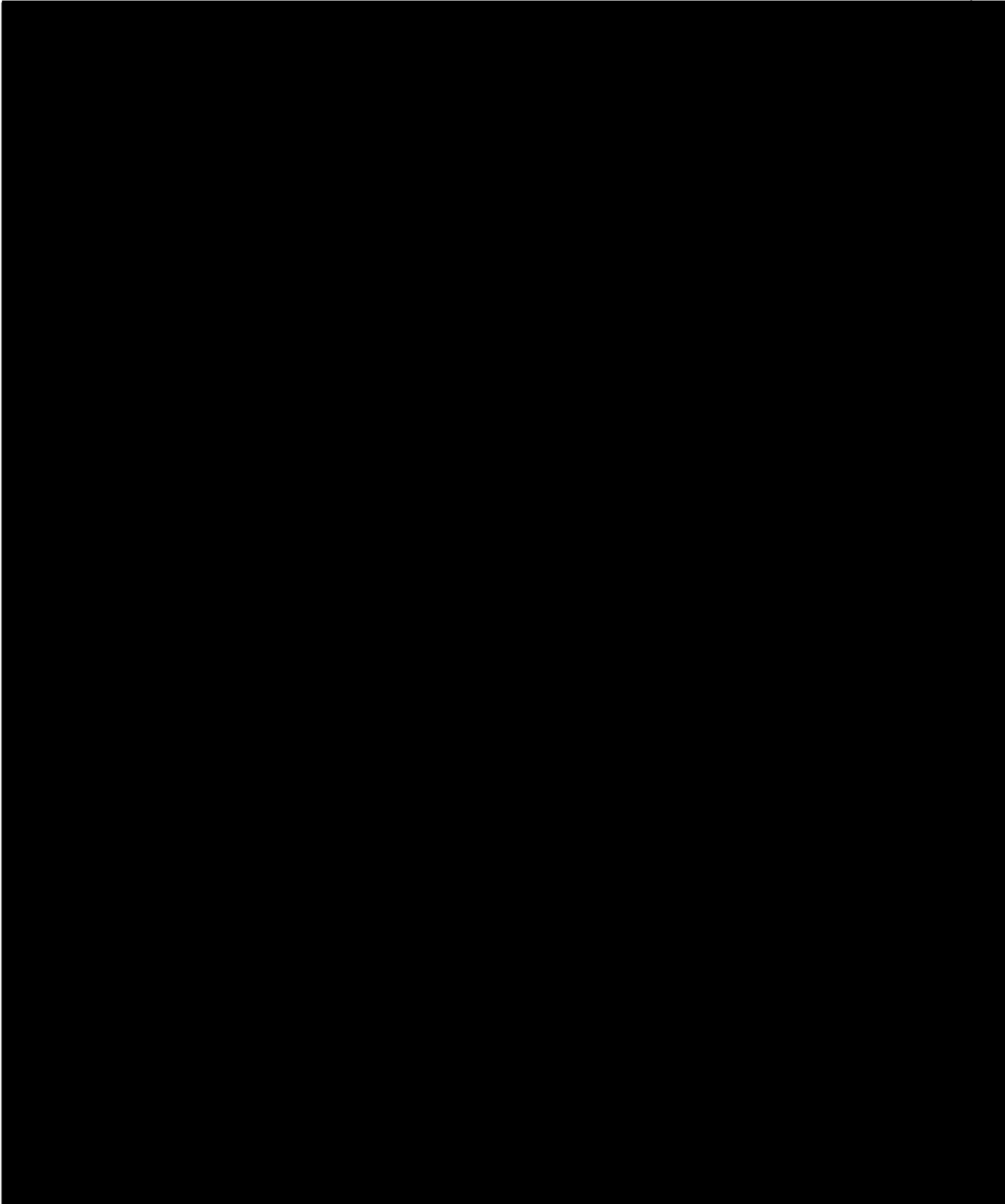
Sworn to and subscribed before me, a notary public, on this 9th day of January 2023.

Notary Public

ERIN M. LOVINS
Notary Public, State of Ohio
My Commission Expires
December 25, 2024

My commission expires 12-25-2024

EXHIBIT B-1



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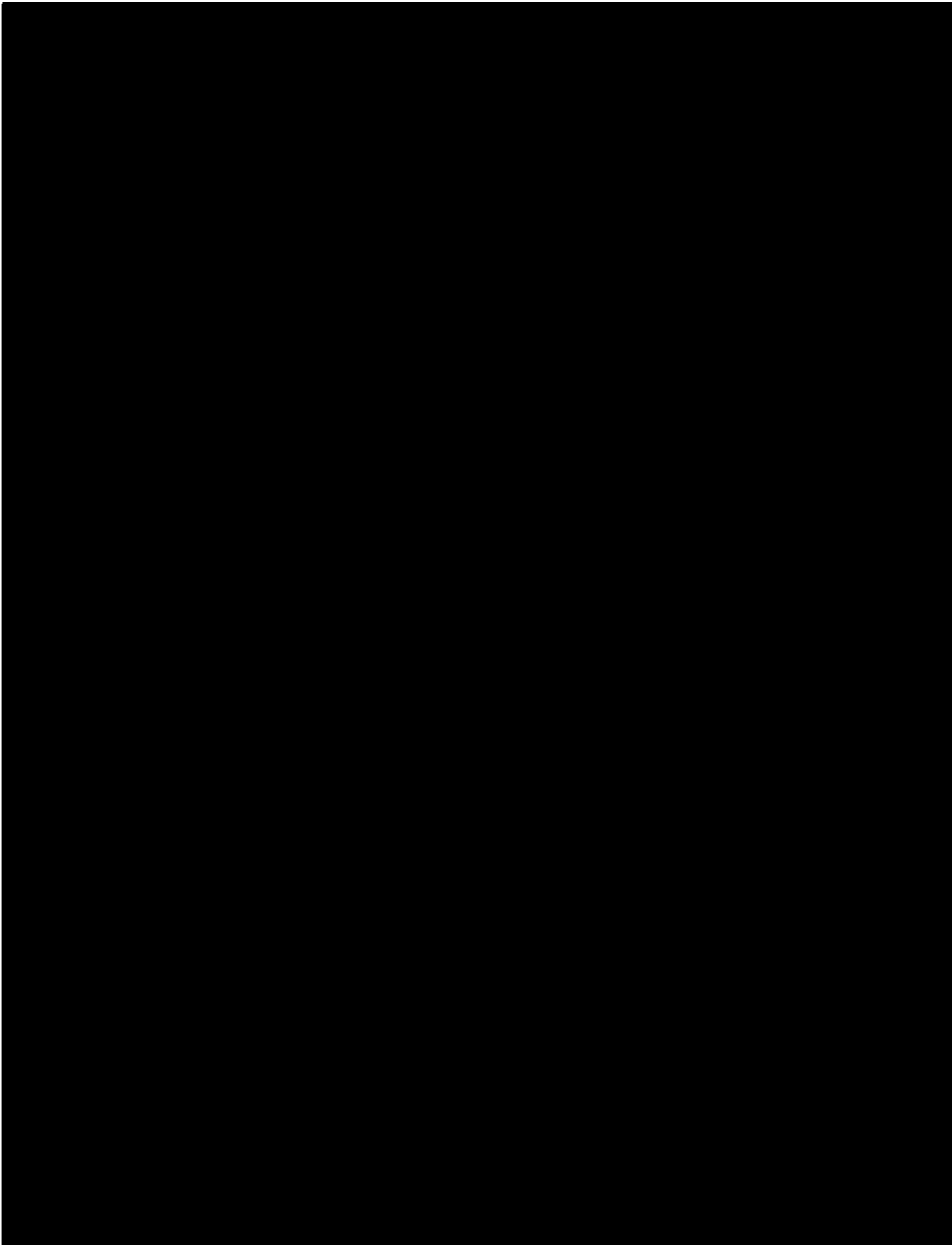

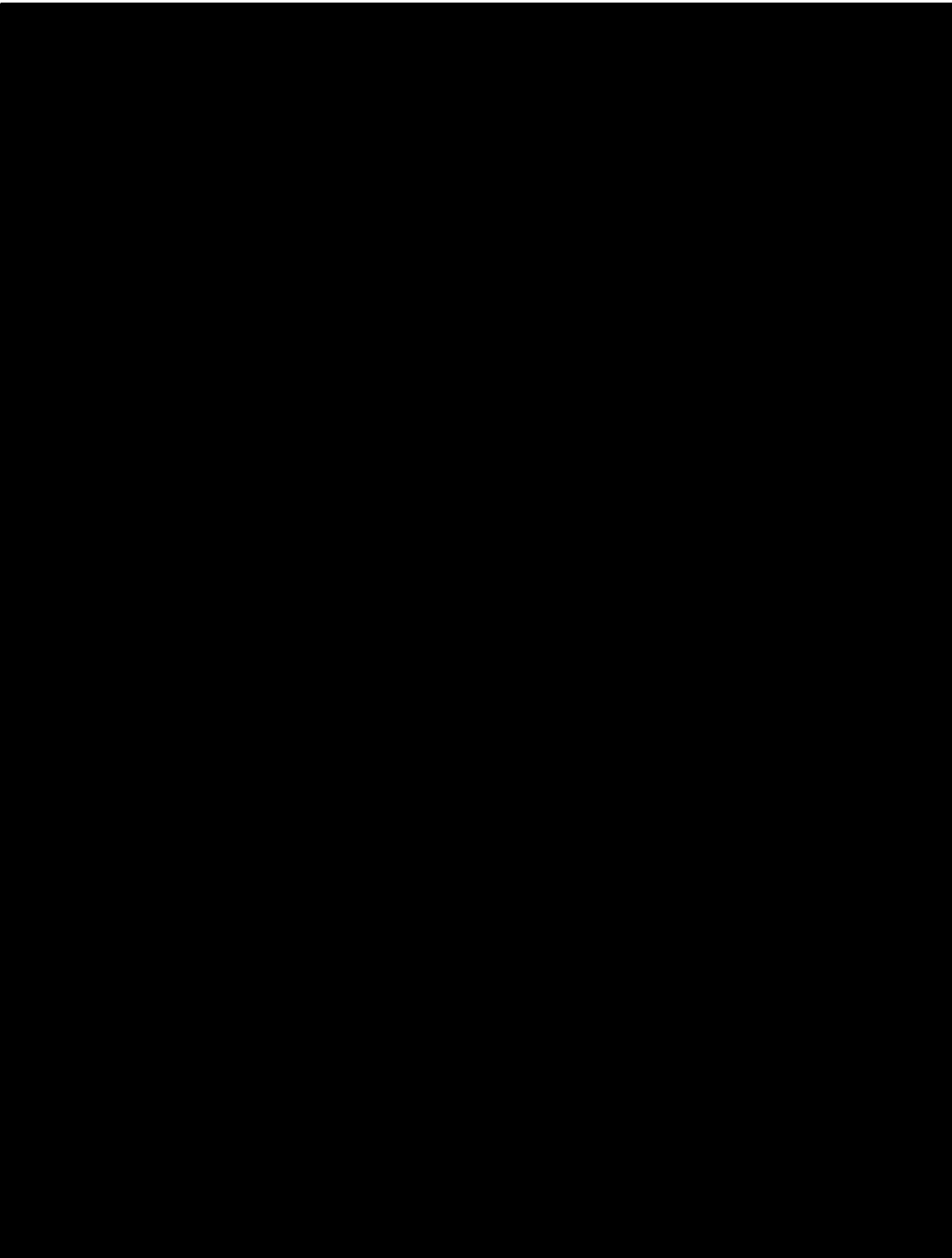

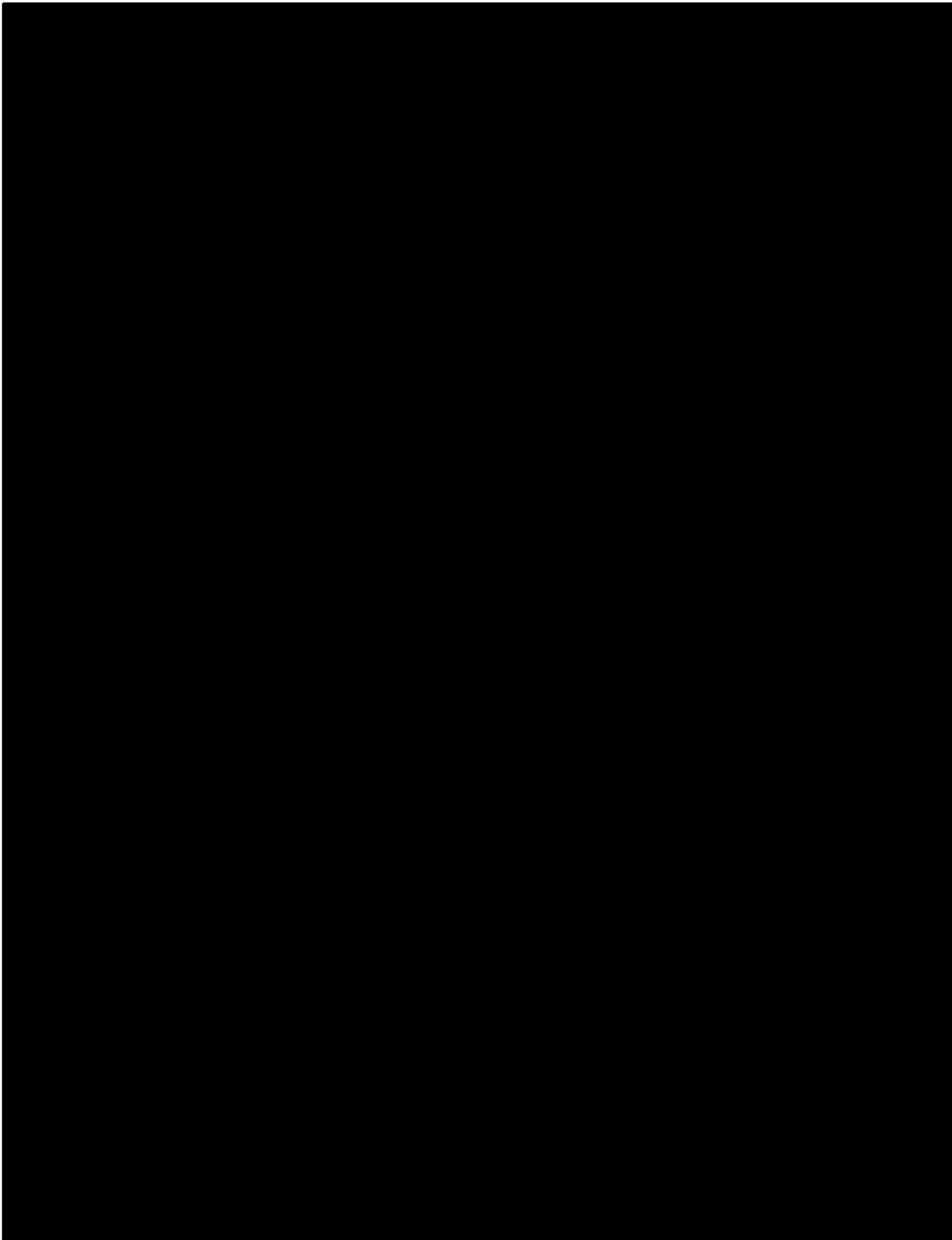

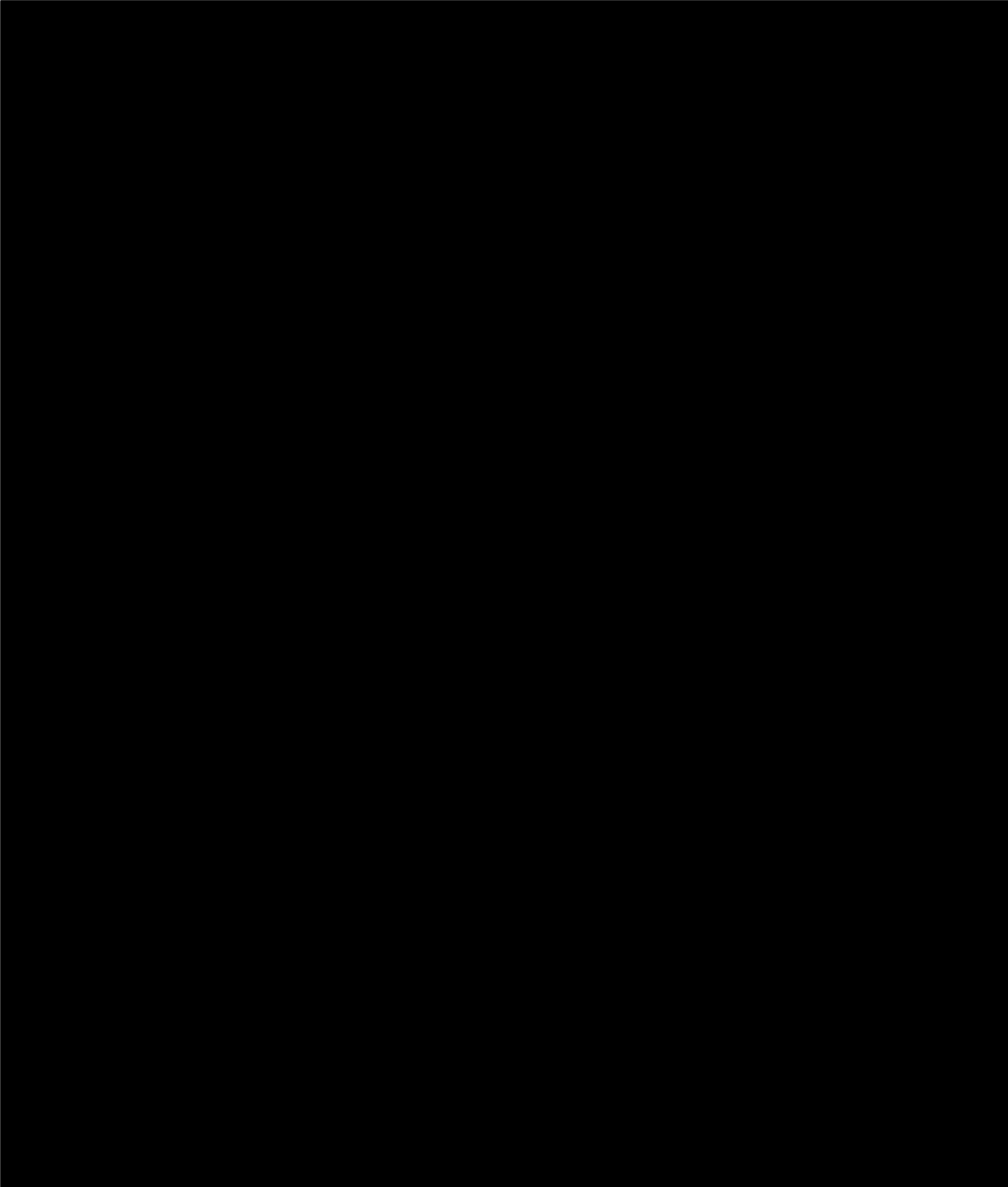

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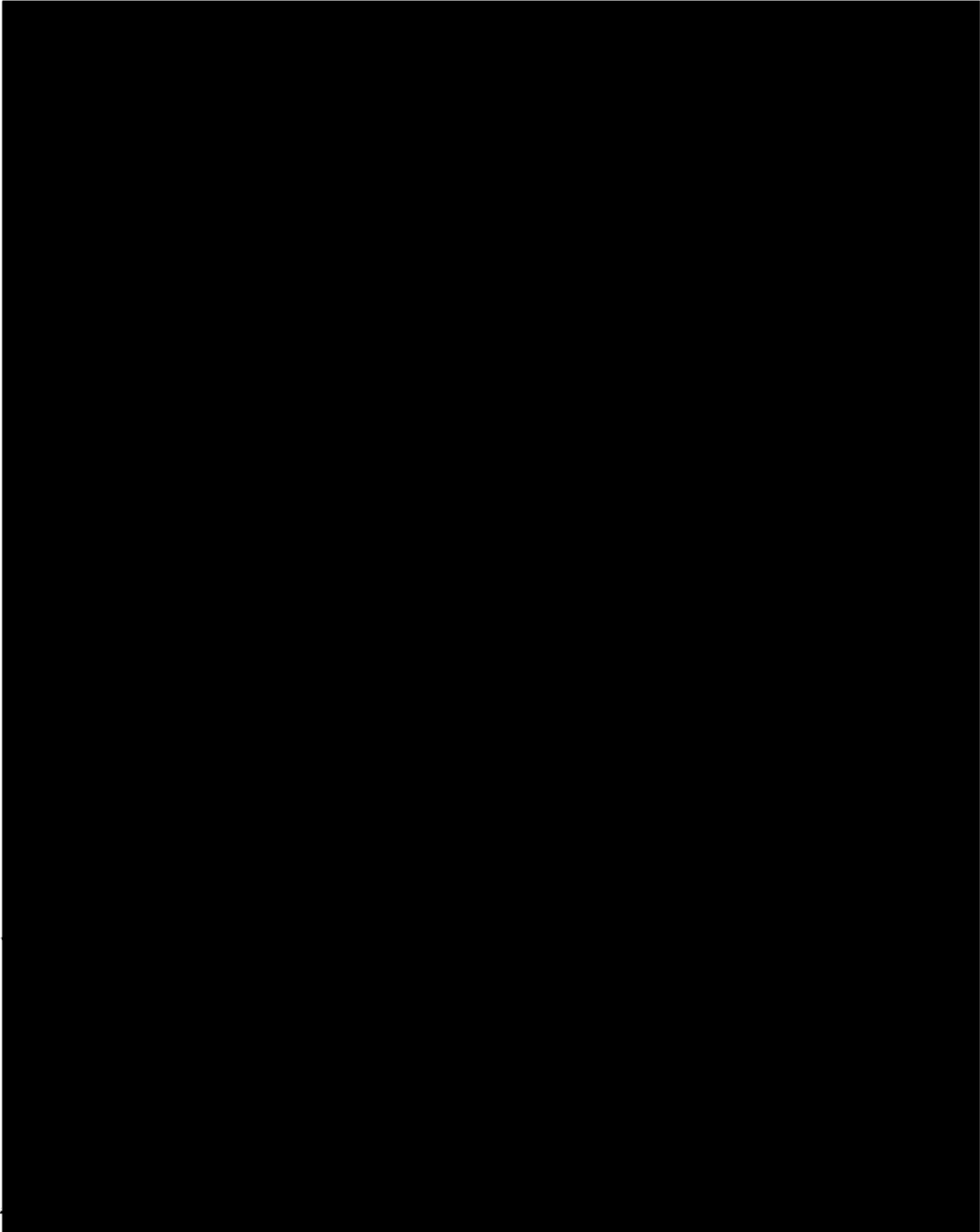
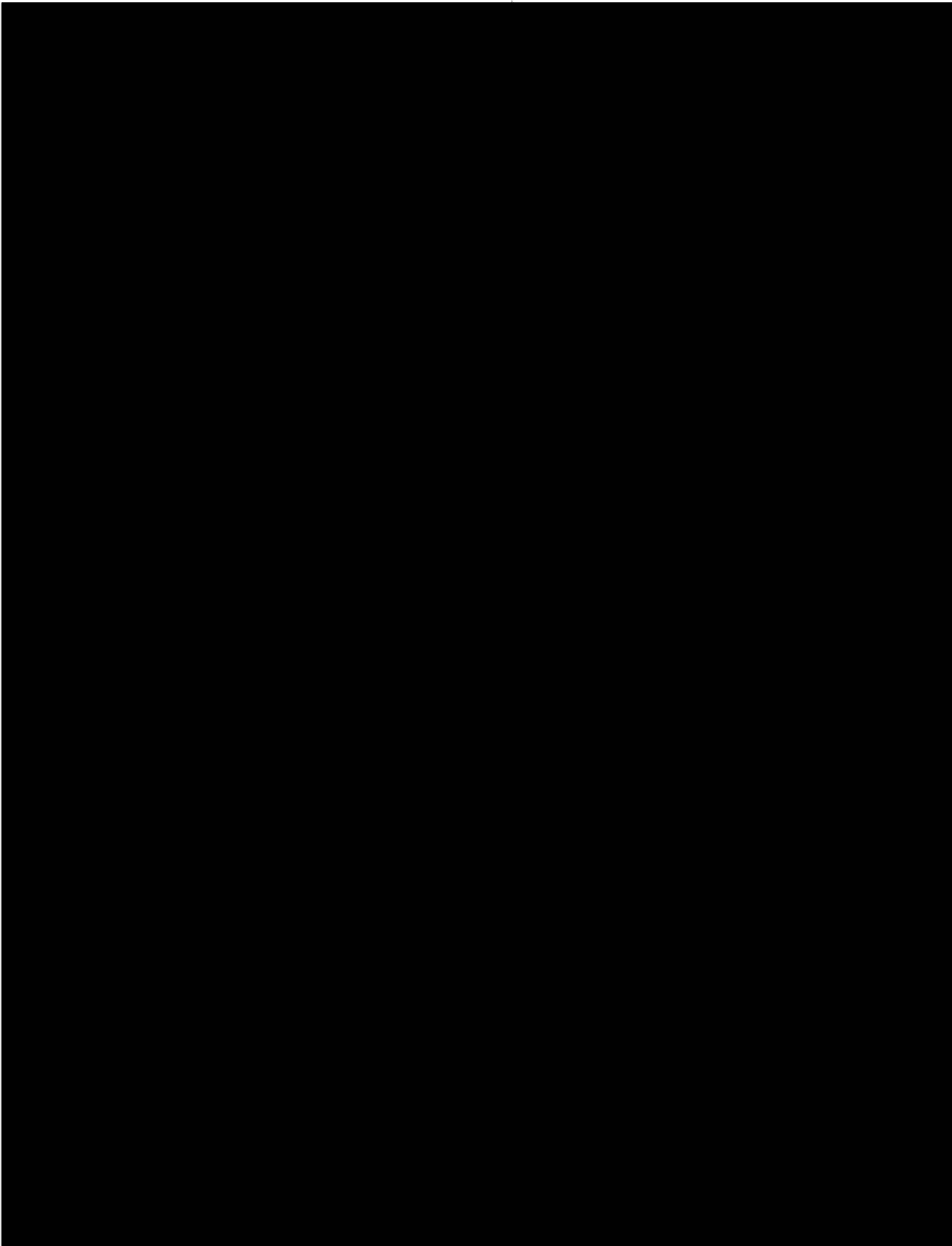
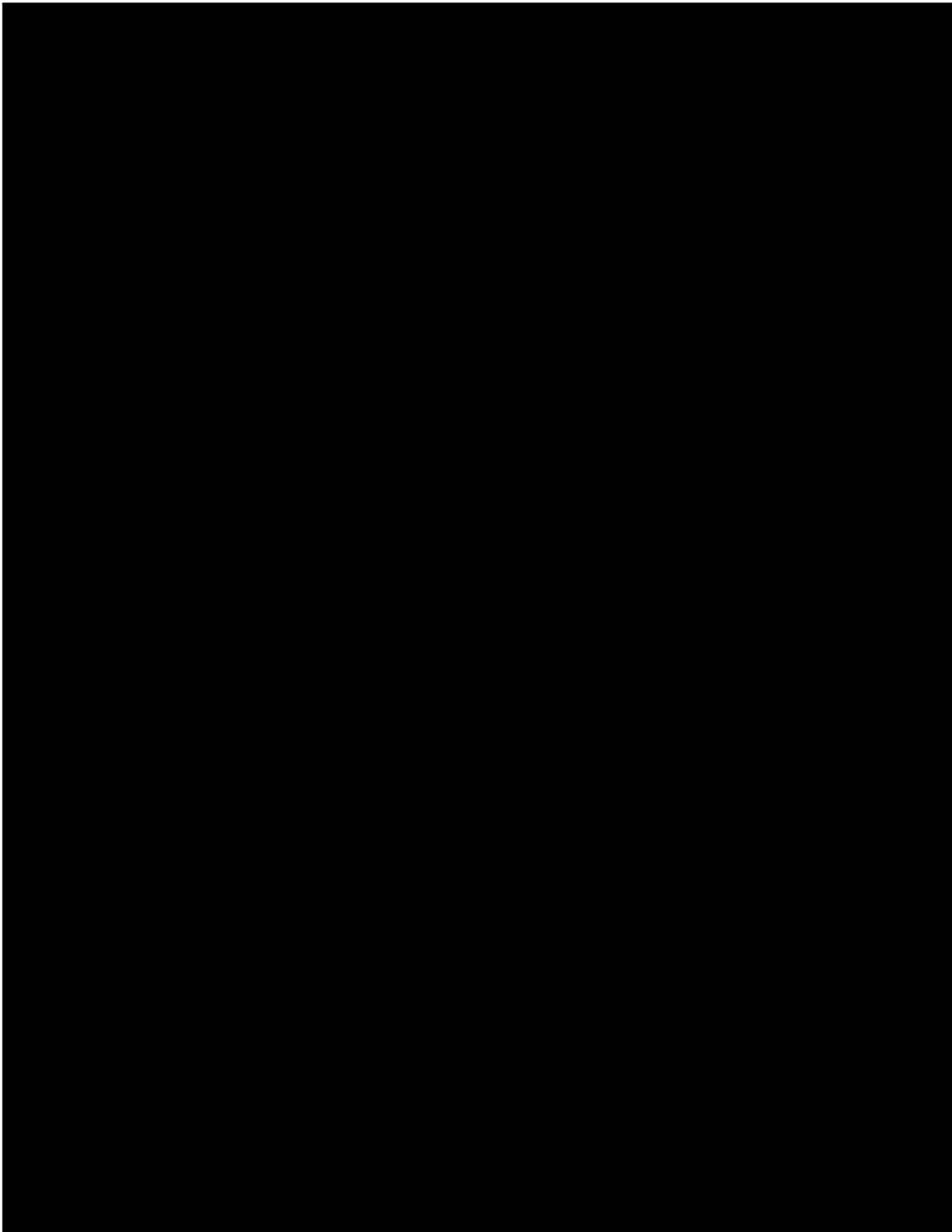
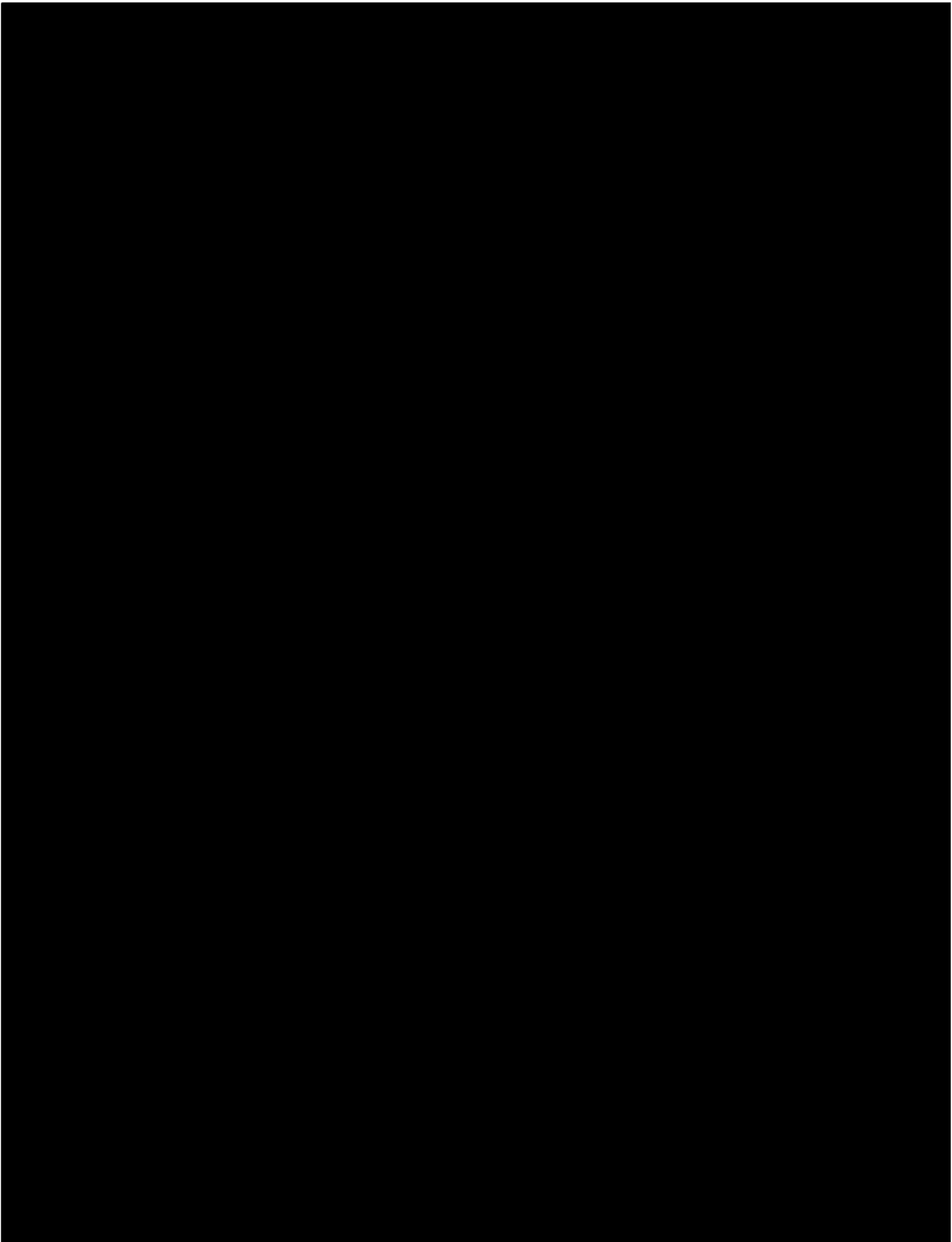
EXHIBIT L - HORTER MEDIATION POSITION STATEMENT

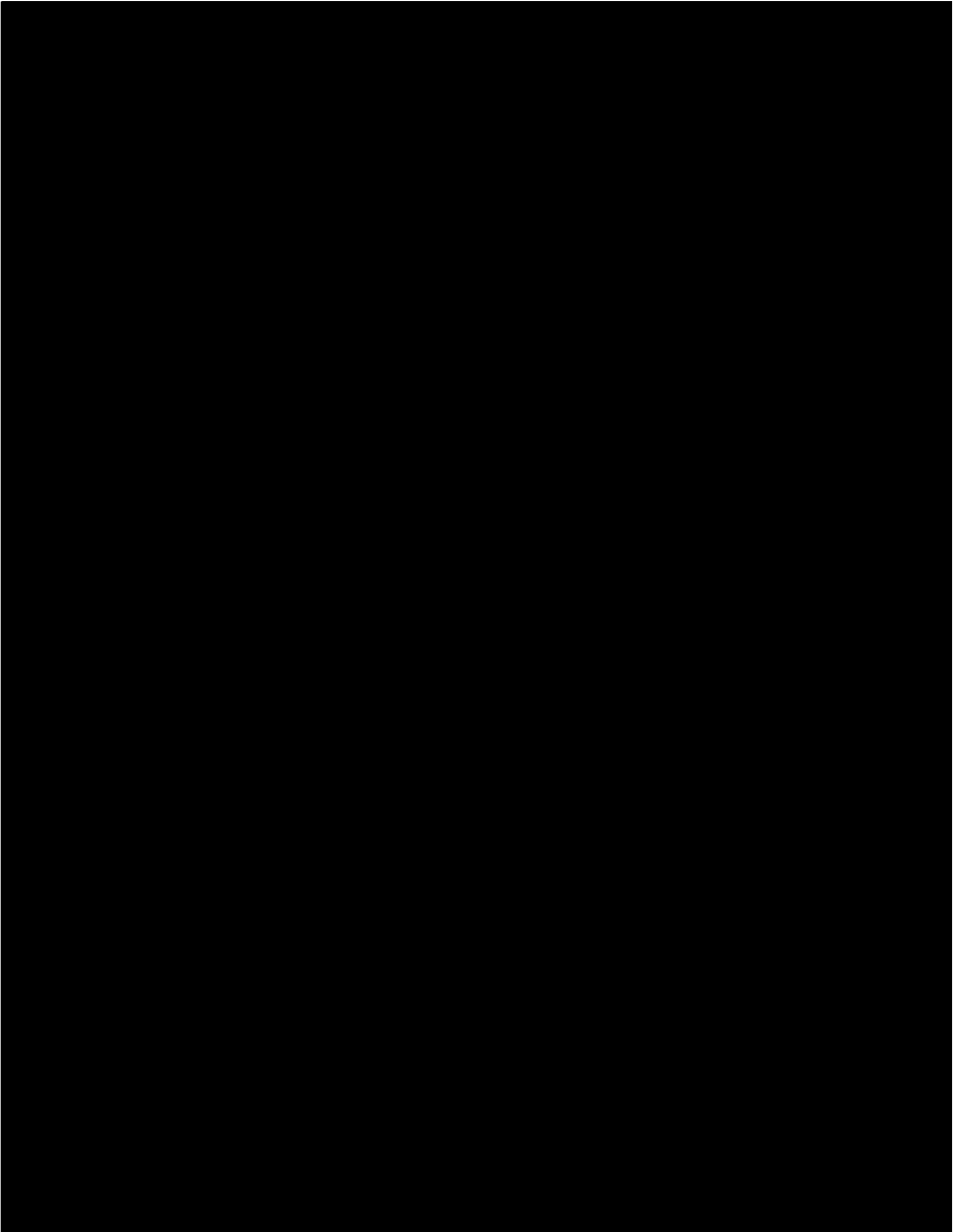


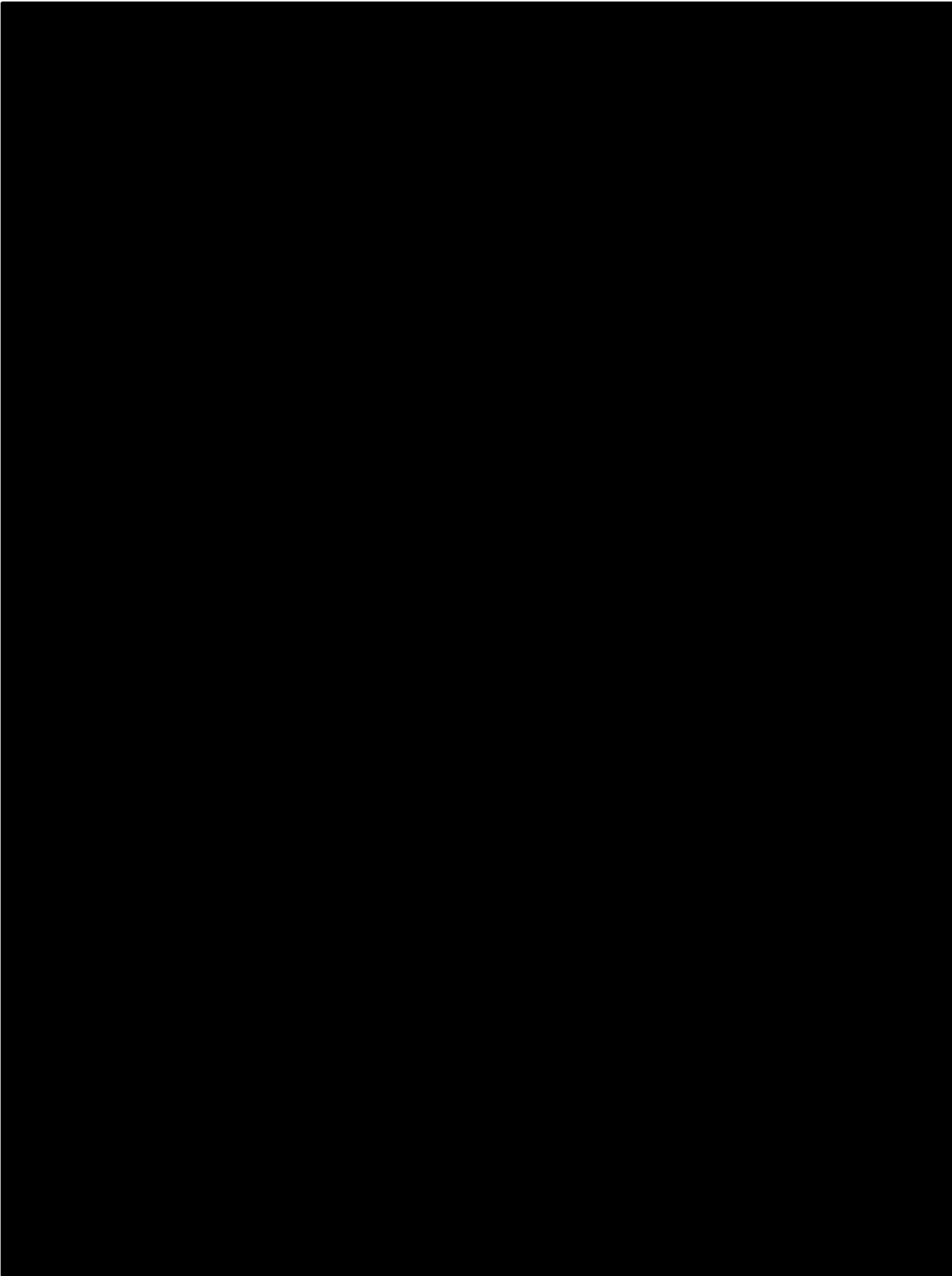
CONFIDENTIAL

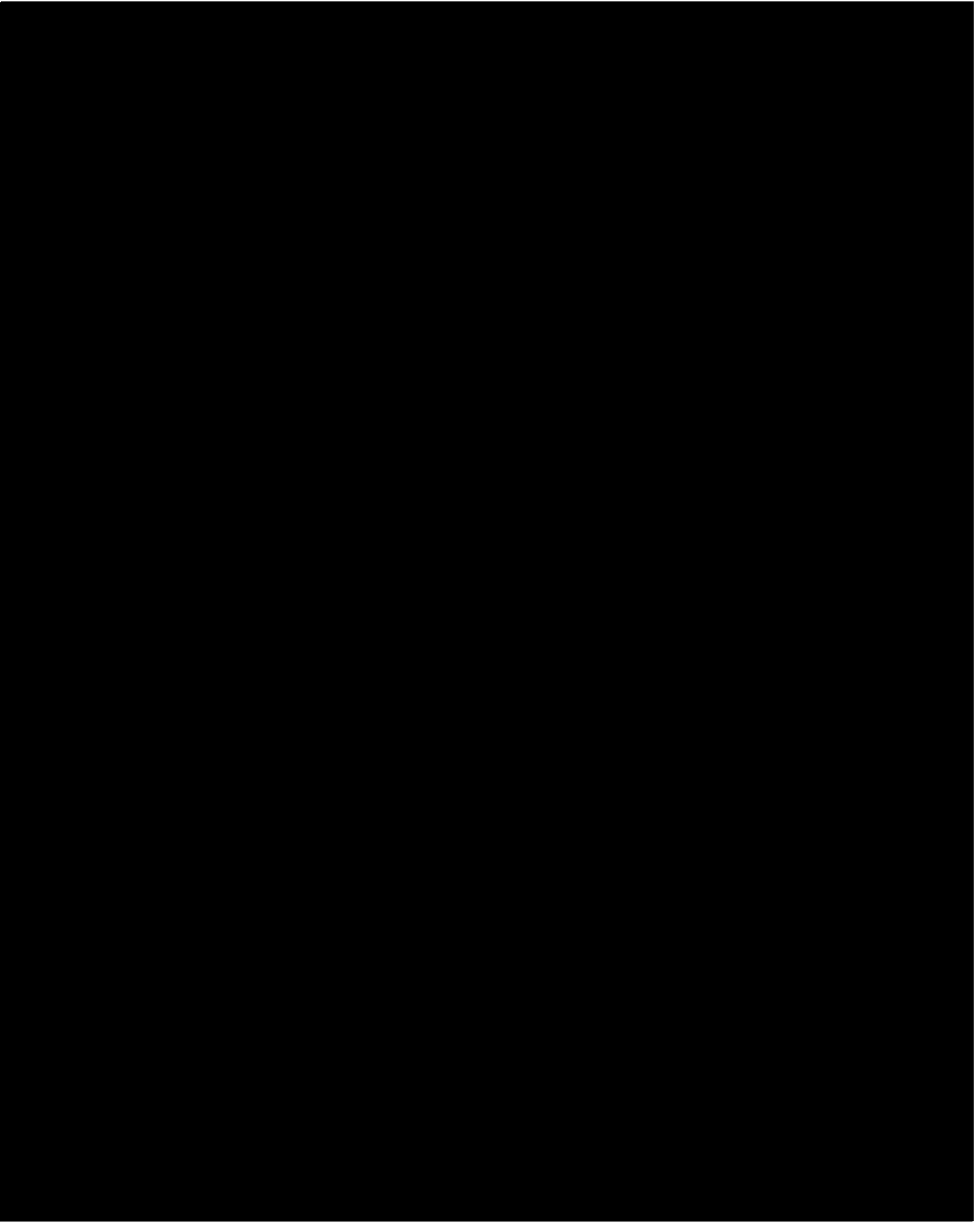


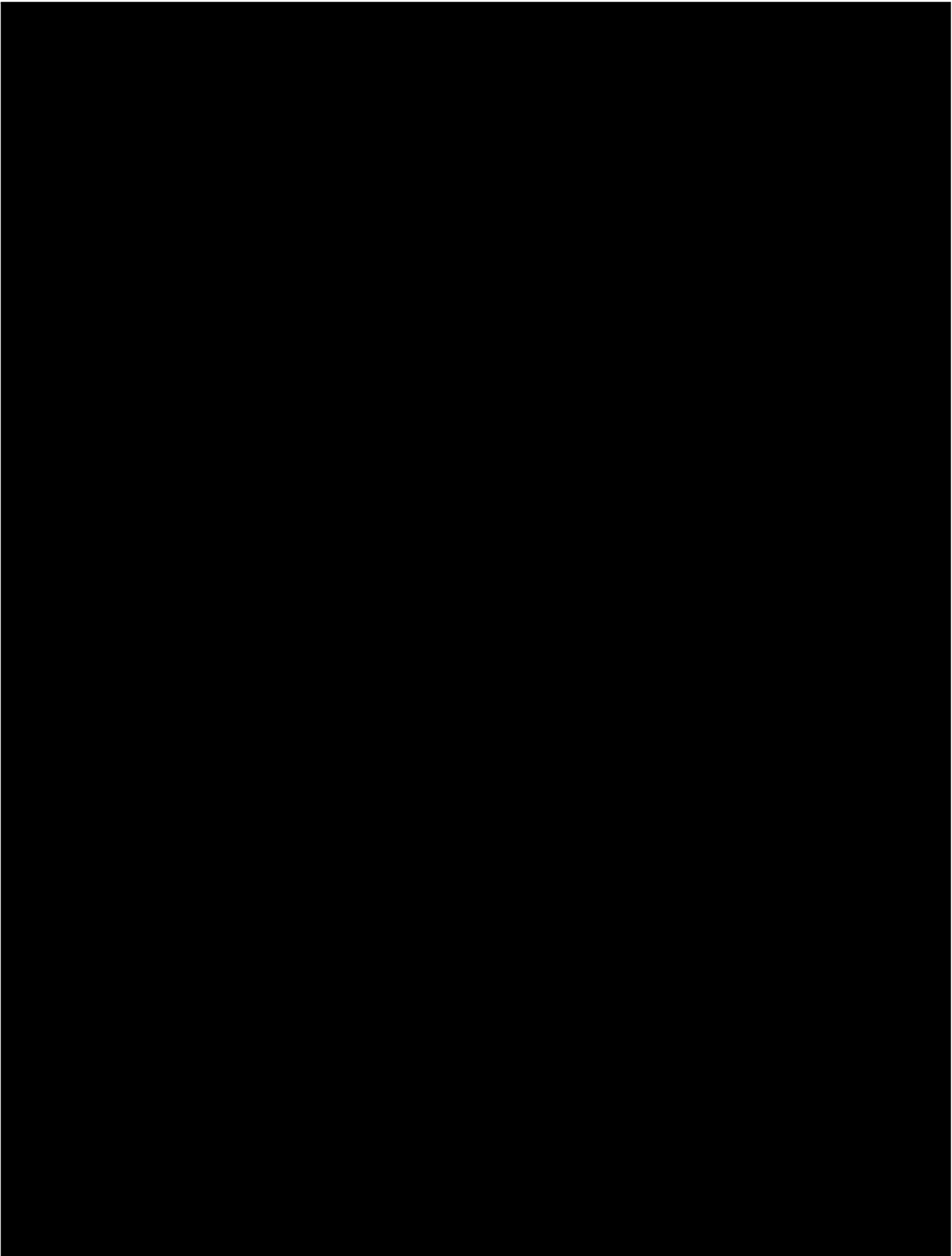


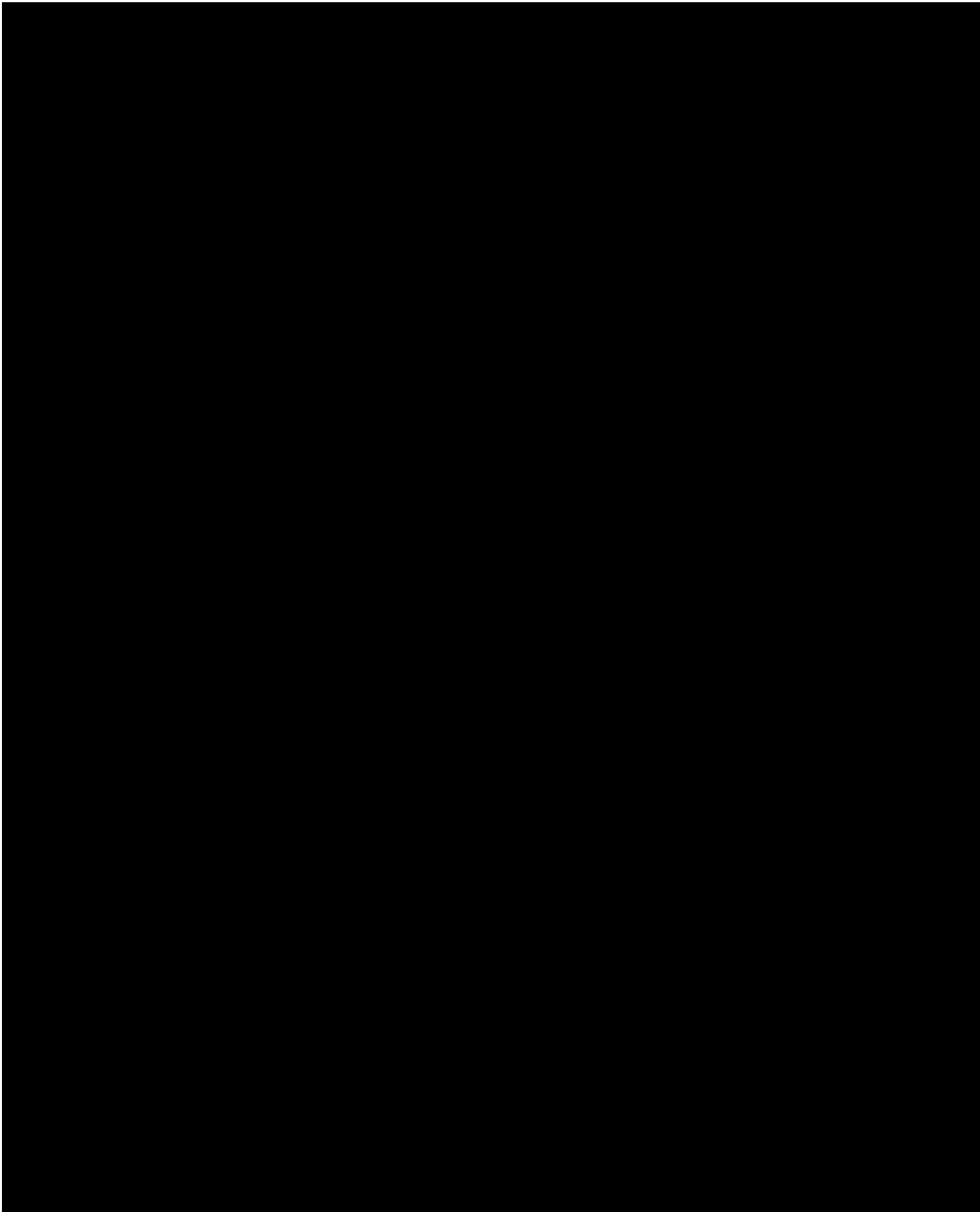


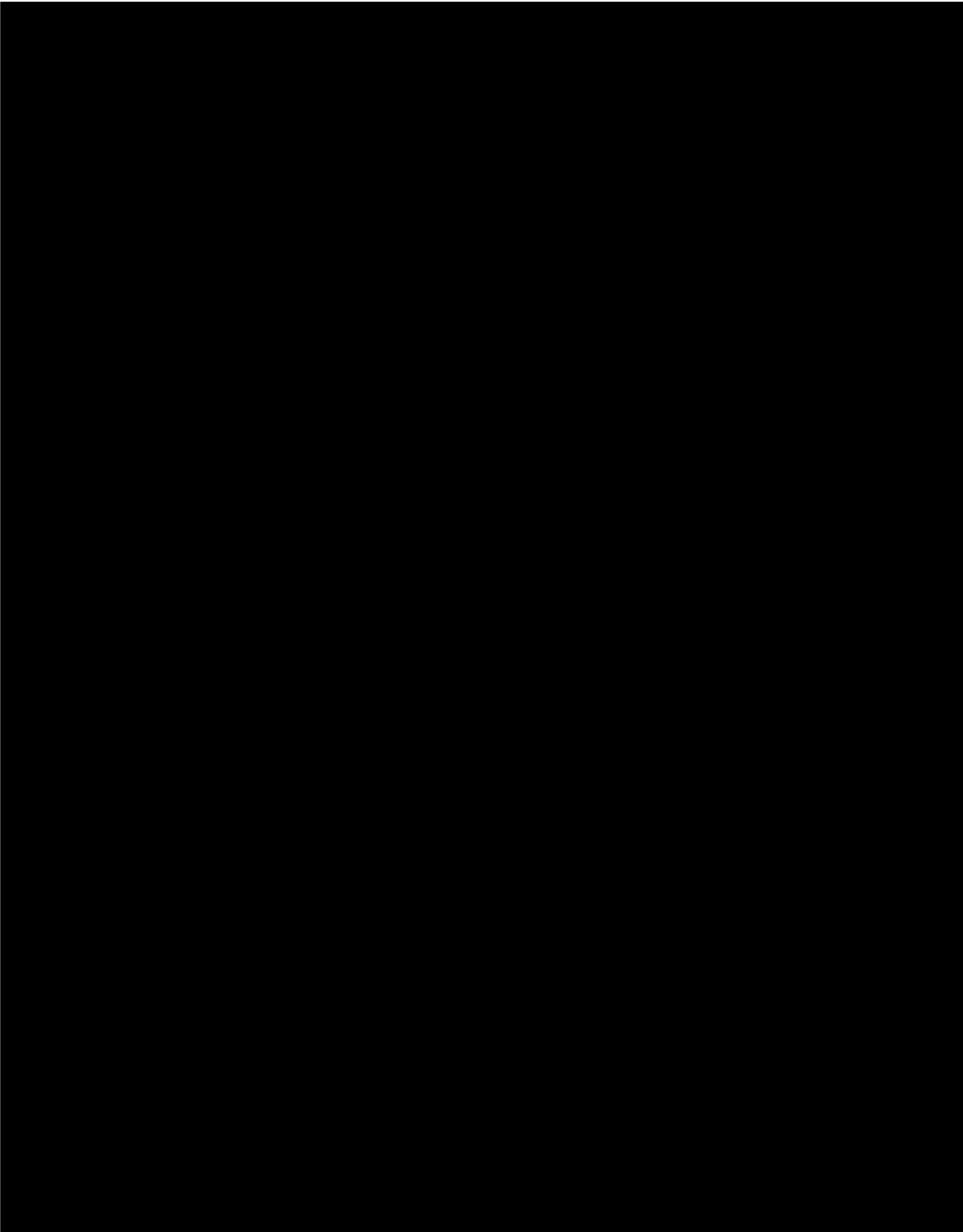












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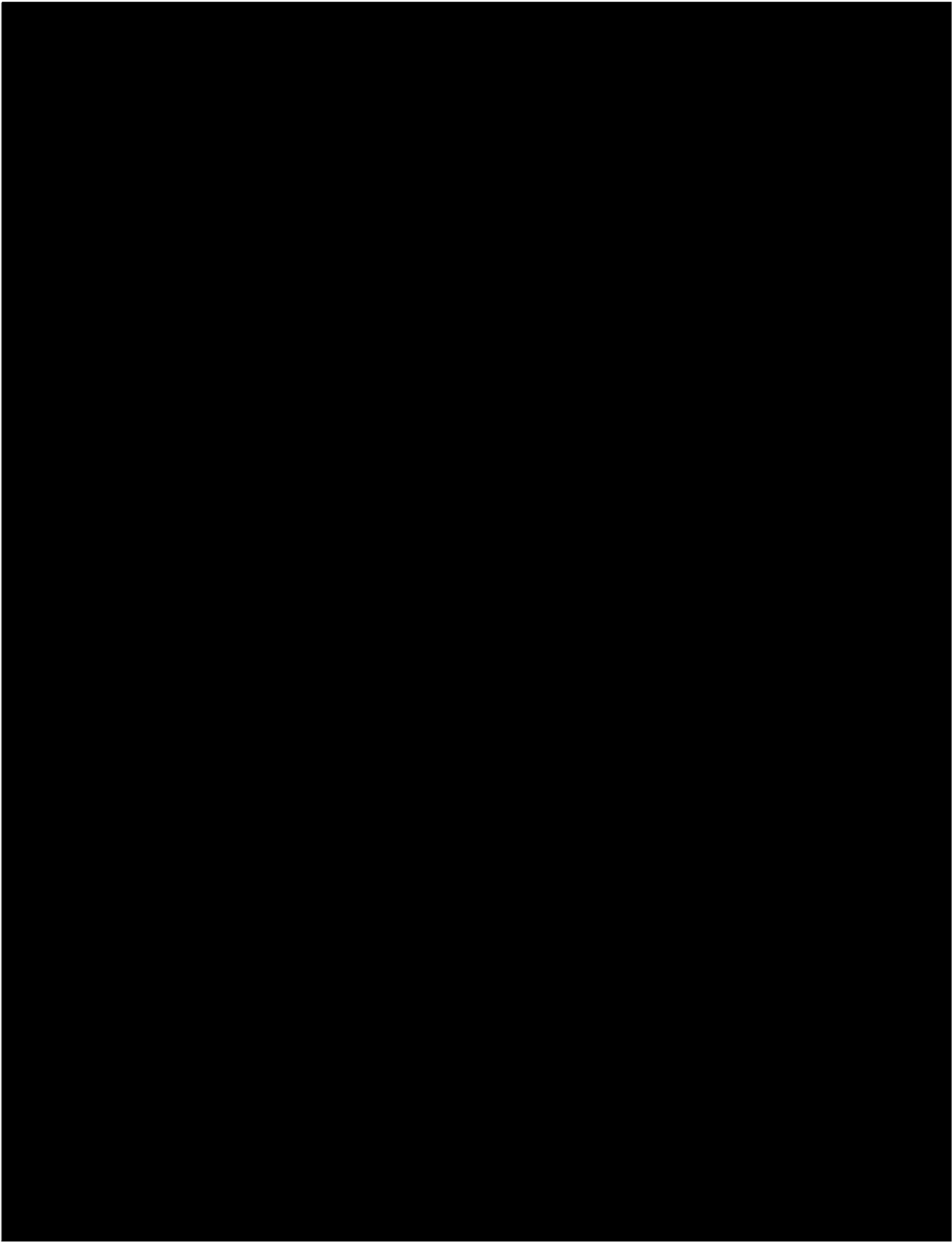

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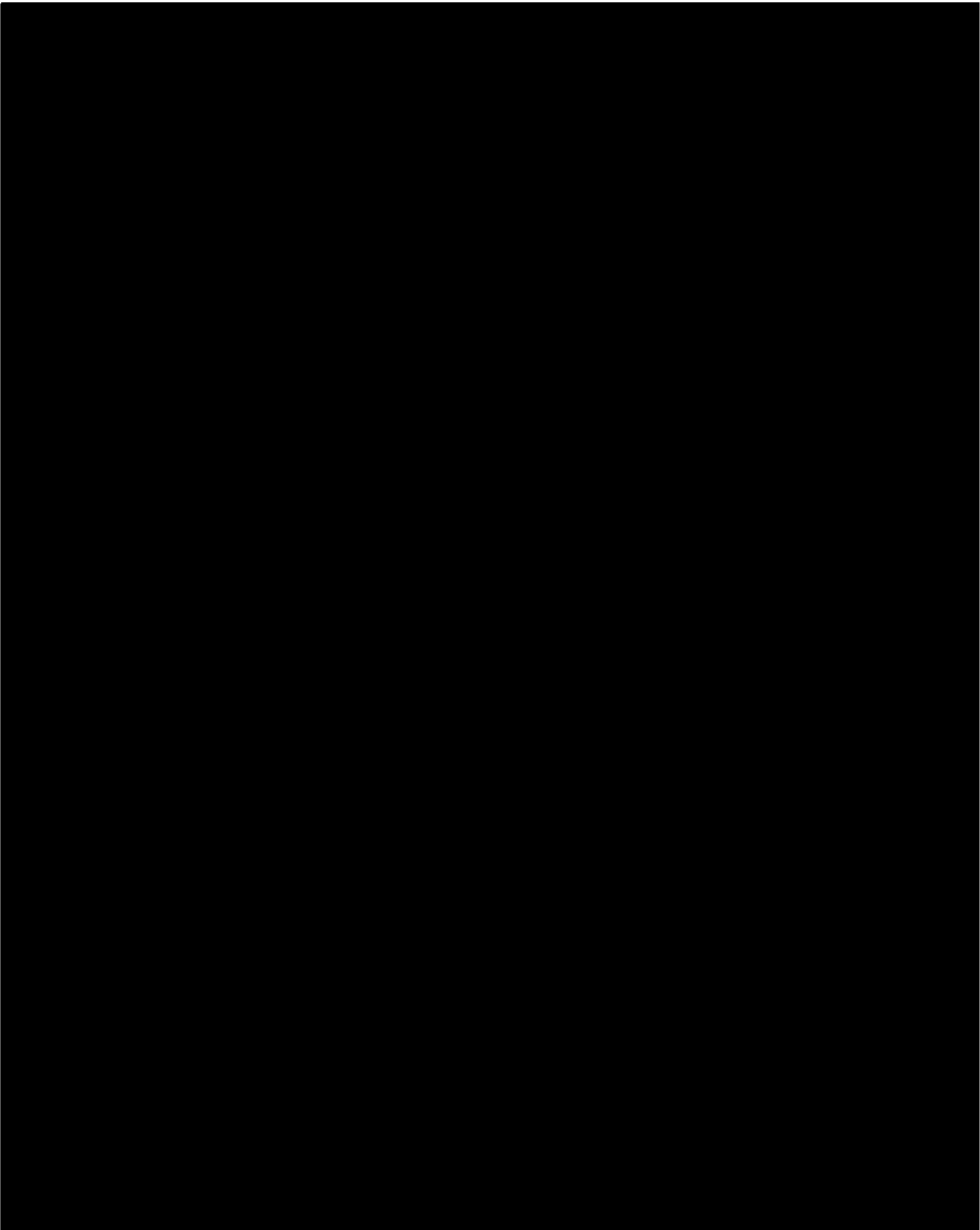

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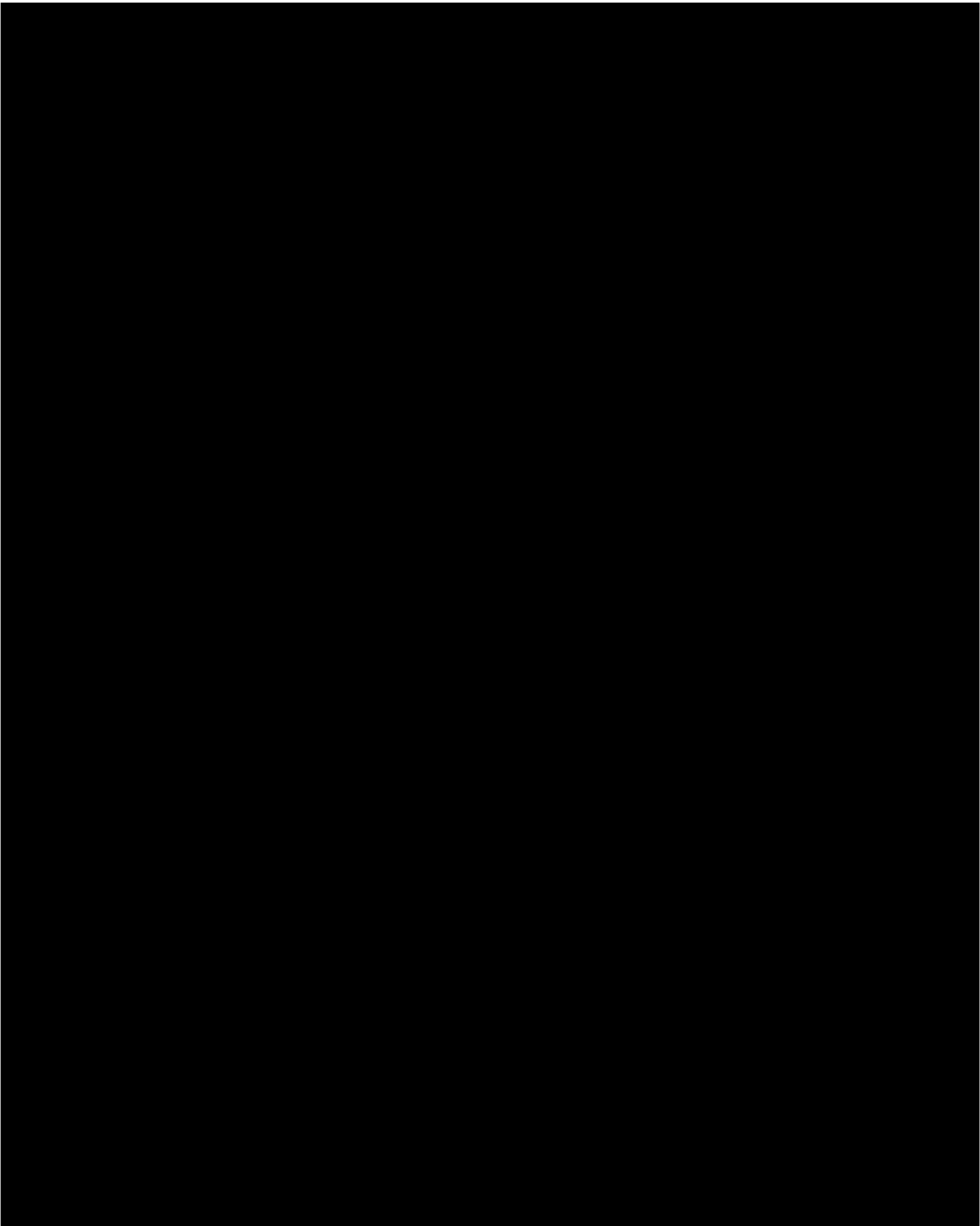
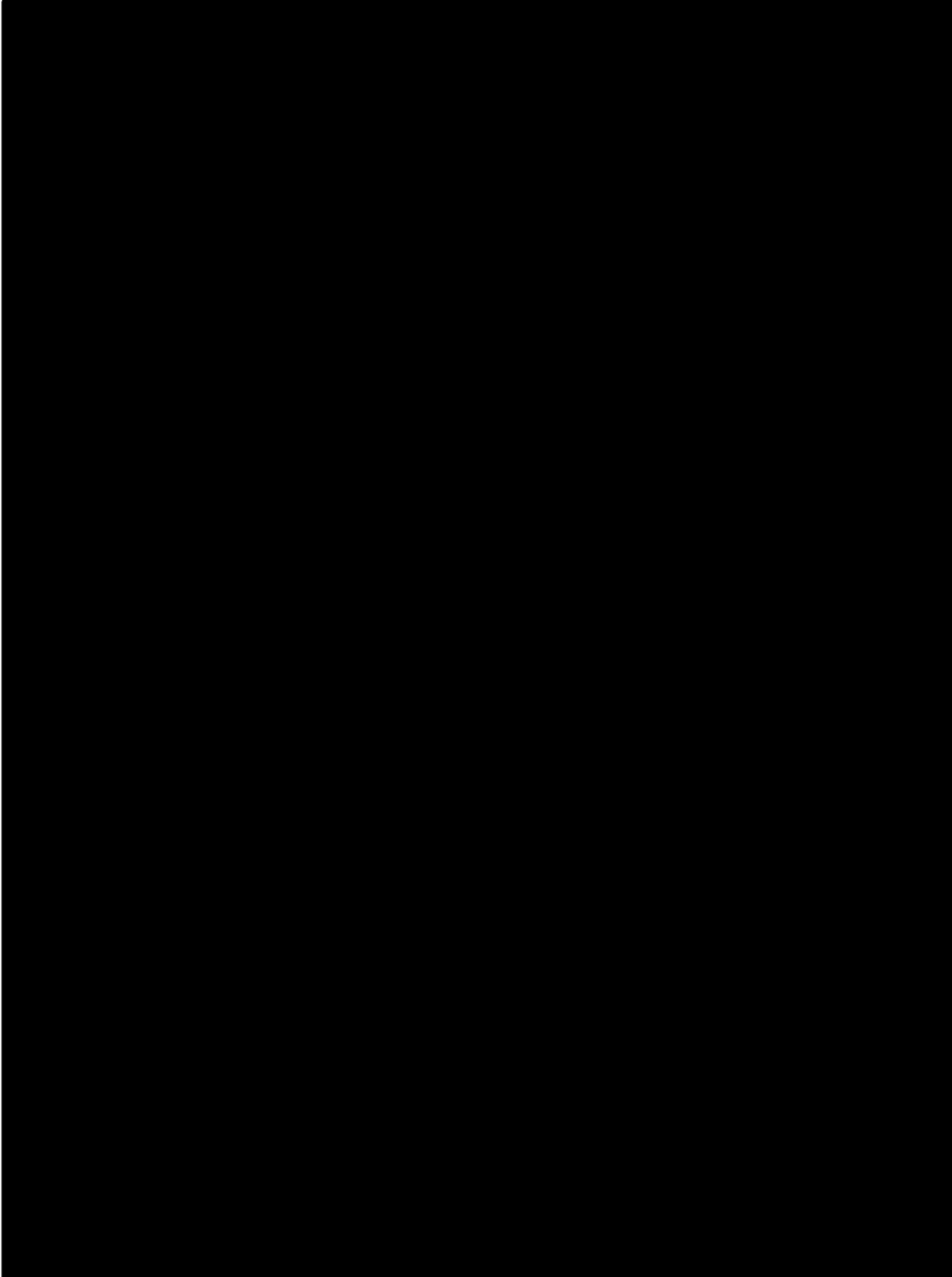
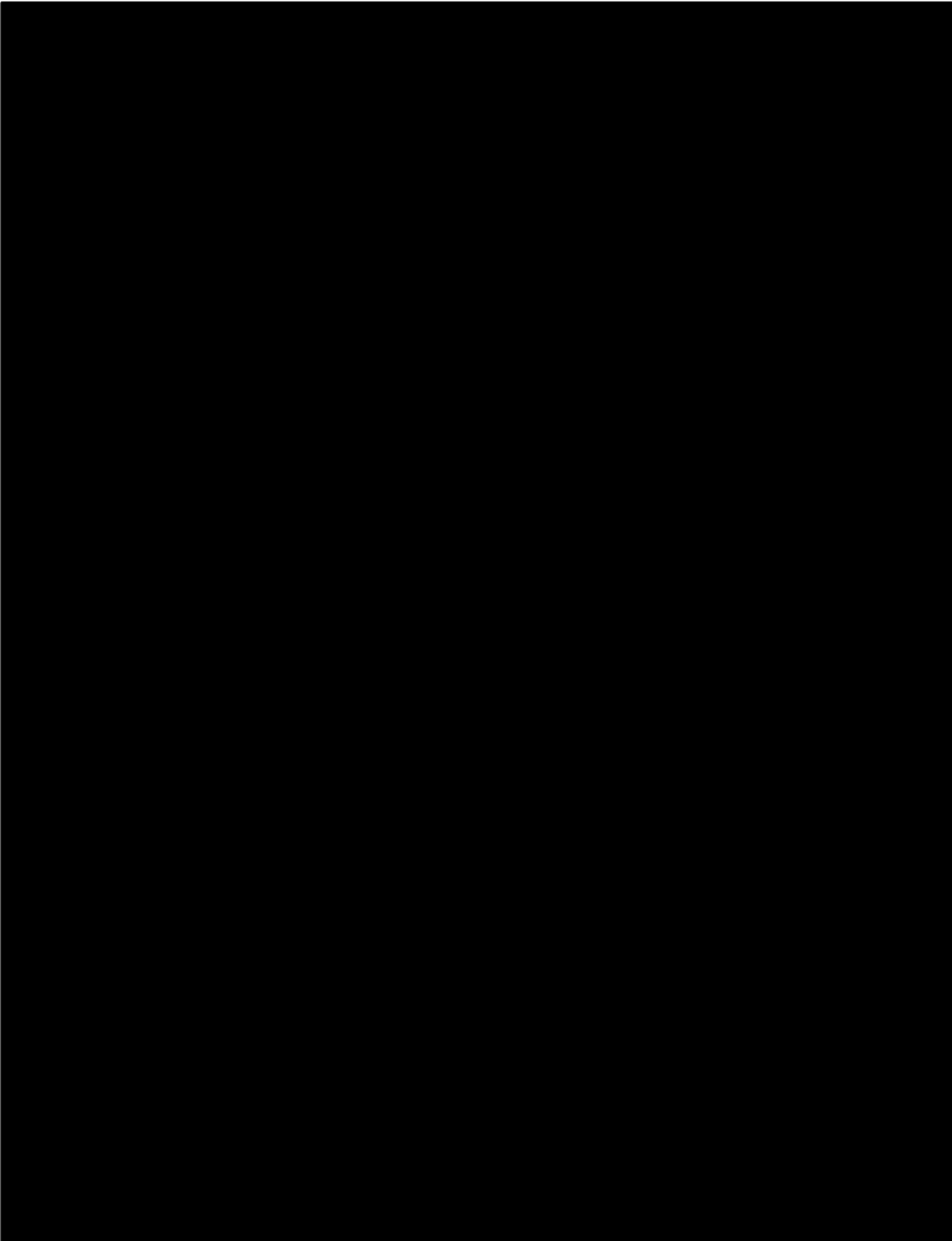
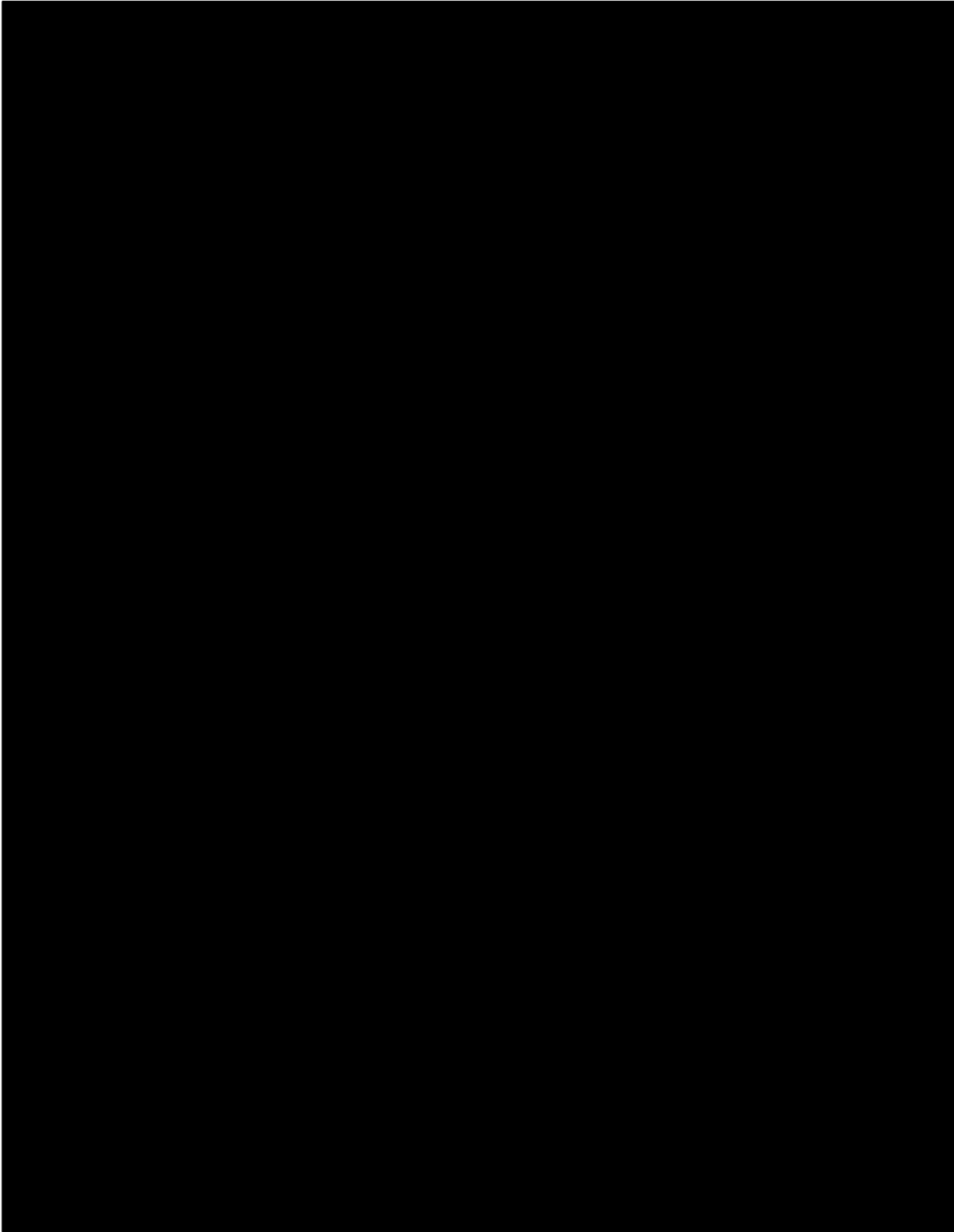


EXHIBIT O - HORTER MEDIATION POSITION STATEMENT







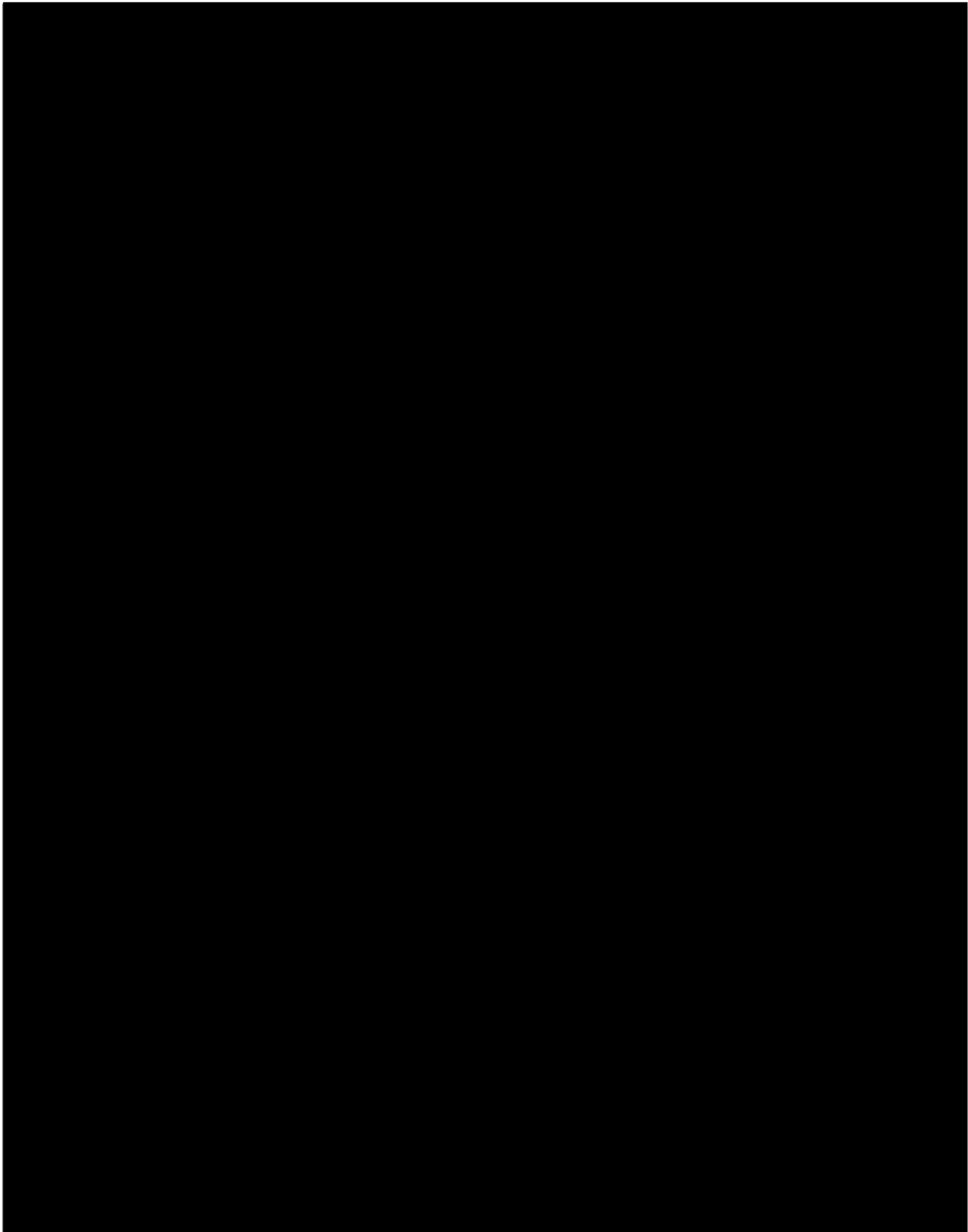


EXHIBIT B-2

1 IN THE COURT OF COMMON PLEAS
2 OF LORAIN COUNTY, OHIO
3 ~~~~~~~~~~~~~~~~~~~~
4
5 BUDDY SCOTT,
6
7 Plaintiff,
8
9 vs. Case No. 18CV194764
10
11 HORTER INVESTMENT MANAGEMENT, LLC, et al.,
12
13 Defendants.
14
15 ~~~~~~~~~~~~~~~~~~~~
16 Deposition of
17 BUDDY L. SCOTT
18
April 9, 2019
19 10:55 a.m.
20
Taken at:
21
Roderick Linton Belfance, LLP
22 50 South Main Street, 10th Floor
Akron, Ohio
23
24
25 Stephen J. DeBacco, RPR

1 A. No. I know nothing about
2 investments. I hire people to do my work.
3 Q. Do you recall how long you were
4 with Edward Jones before you cashed out
5 those --
6 A. Four or five years.
7 Q. Had you had any investments through
8 a 401(k) or any retirement account like that?
9 A. I believe he had a 401(k) account
10 set up through Edward Jones.
11 Q. Set up through Edward Jones?
12 A. I get an annuity from the
13 government, so I don't need a 401(k).
14 Q. So you attended this dinner that
15 Mr. Hannan put on. And I think you said it was
16 November or December of 2013?
17 A. October-November.
18 Q. October-November, I'm sorry.
19 When did you -- did you sign up
20 with Mr. Hannan?
21 A. Yes. The end of November or the
22 first part of December.
23 Q. And you said he was at Ameriprise
24 at that point?
25 A. He was with Ameriprise.

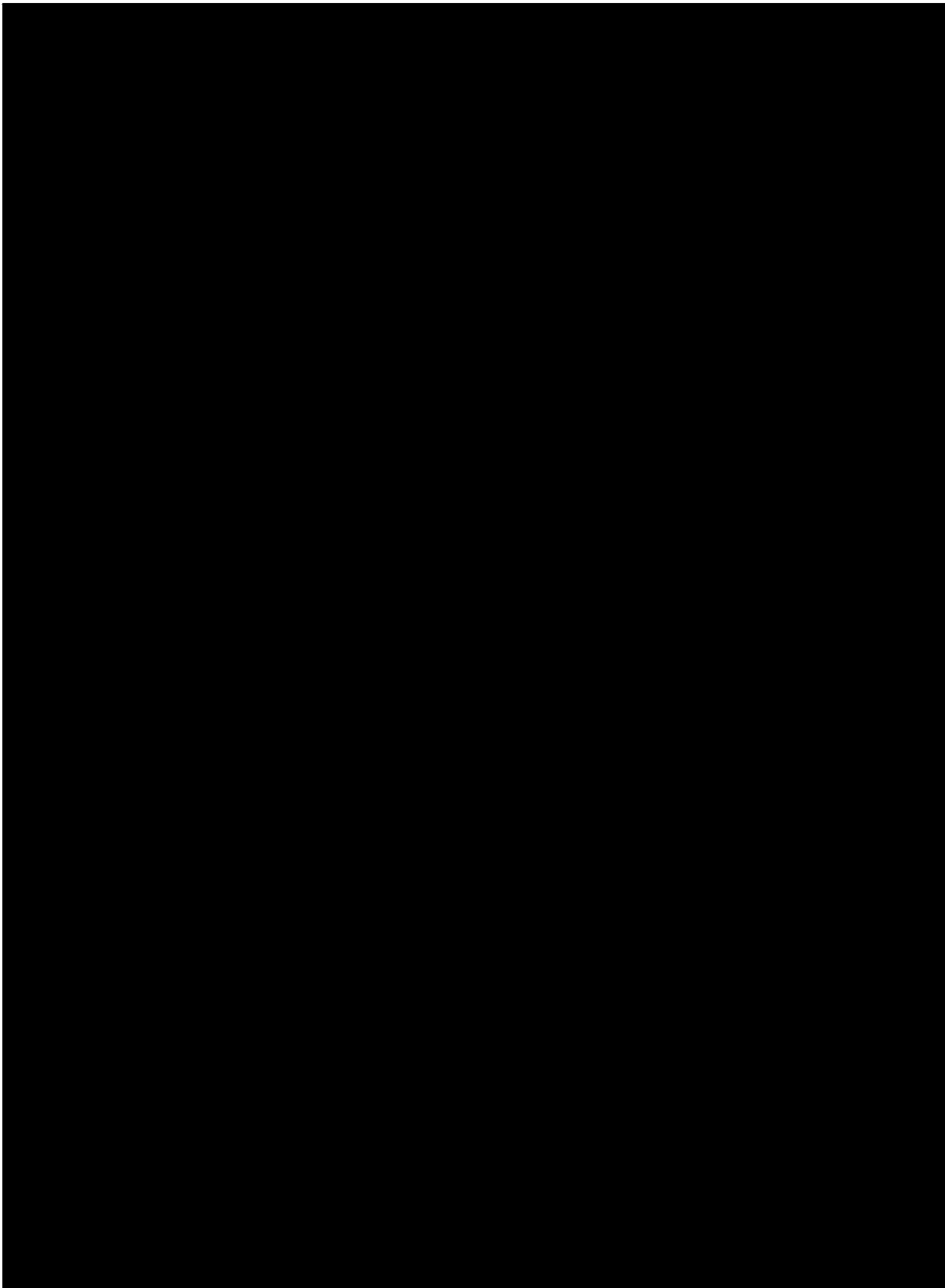
1 - - - - -
2 (Thereupon, Deposition Exhibit C,
3 Copy of Check No. 1013 Payable to
4 Hannan Properties, LLC, was marked
5 for purposes of identification.)
6 - - - - -
7 Q. So I have handed you what's marked
8 as Exhibit C, and I'll ask you, do you
9 recognize that?
10 A. Yes.
11 Q. Can you tell me what it is?
12 A. BG Scott Properties check made out
13 to Hannan Properties LLC for $50,000.
14 Q. It's dated November 13th of 2014?
15 A. Yes.
16 Q. Do you know what this check was
17 for?
18 A. No.
19 Q. But that's a check that you gave to
20 Kimm Hannan?
21 A. Yes.
22 Q. At the time -- and that is your
23 signature at the bottom of the check?
24 A. Yes.
25 Q. But you don't know why you gave it

1 REPORTER'S CERTIFICATE
2 The State of Ohio,)
3 SS:
4 County of Cuyahoga.)
5
6 I, Stephen J. DeBacco, a Notary
7 Public within and for the State of Ohio, duly
8 commissioned and qualified, do hereby certify
9 that the within named witness, BUDDY L. SCOTT,
10 was by me first duly sworn to testify the
11 truth, the whole truth and nothing but the
12 truth in the cause aforesaid; that the
13 testimony then given by the above-referenced
14 witness was by me reduced to stenotypy in the
15 presence of said witness; afterwards
16 transcribed, and that the foregoing is a true
17 and correct transcription of the testimony so
18 given by the above-referenced witness.
19 I do further certify that this
20 deposition was taken at the time and place in
21 the foregoing caption specified and was
22 completed without adjournment.
23
24
25

1 I do further certify that I am not
2 a relative, counsel or attorney for either
3 party, or otherwise interested in the event of
4 this action.
5 IN WITNESS WHEREOF, I have hereunto
6 set my hand and affixed my seal of office at
7 Cleveland, Ohio, on this 16th day of
8 April, 2019.
9
10
11
12

13
14 Stephen J. DeBacco, Notary Public
15 within and for the State of Ohio
16
17 My commission expires September 30, 2022.
18
19
20
21
22
23
24
25

EXHIBIT B-3



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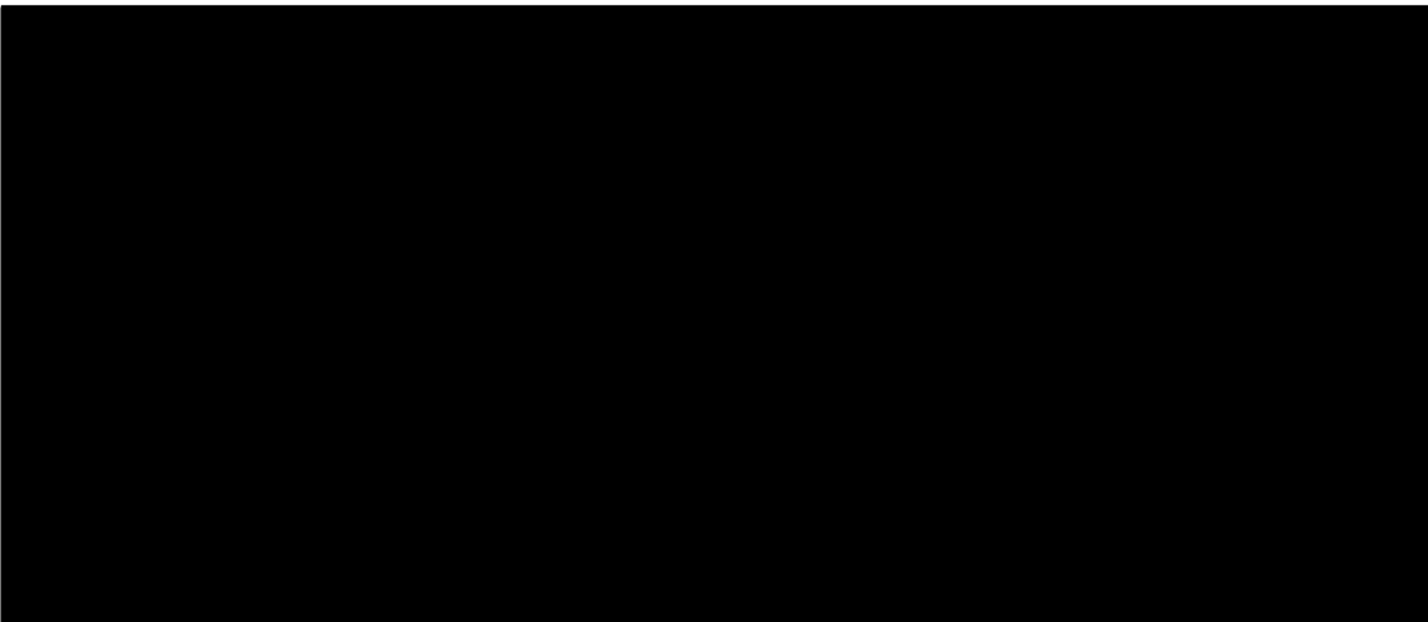

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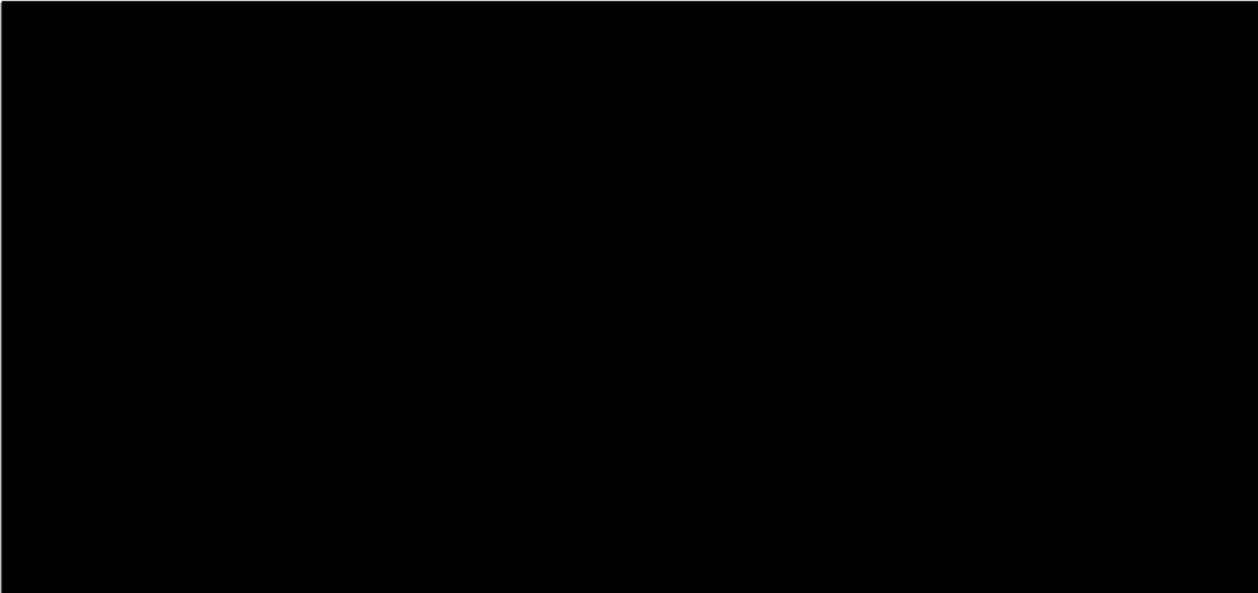
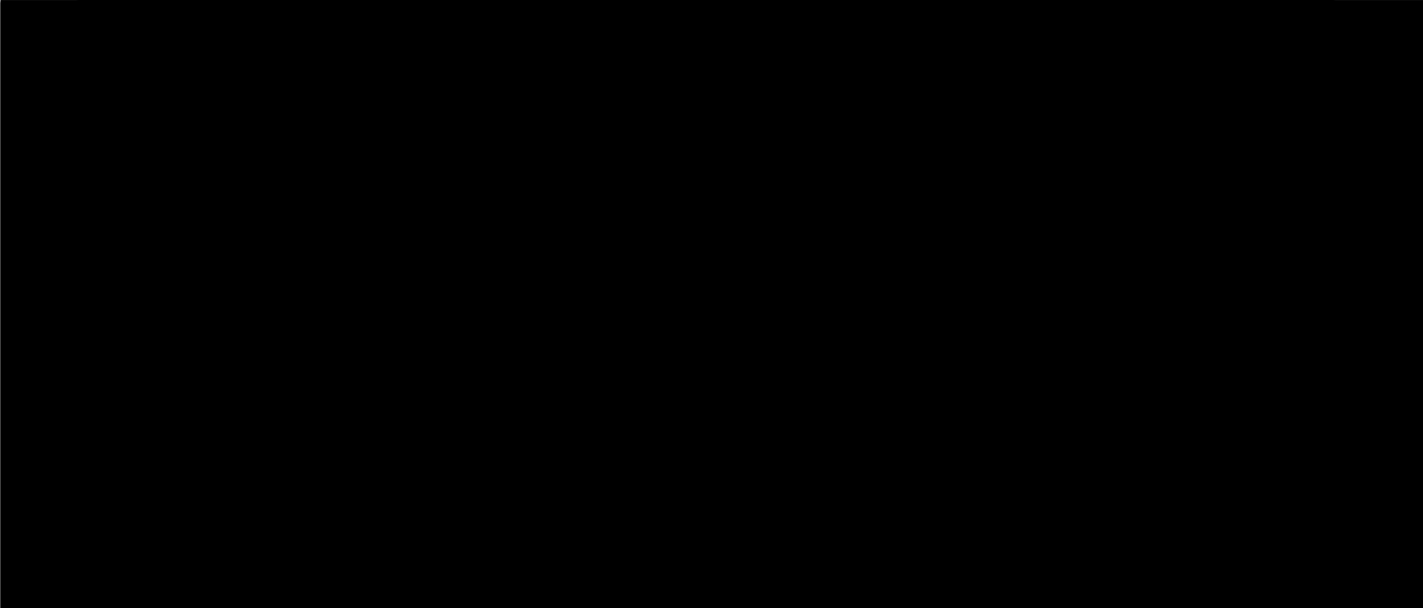
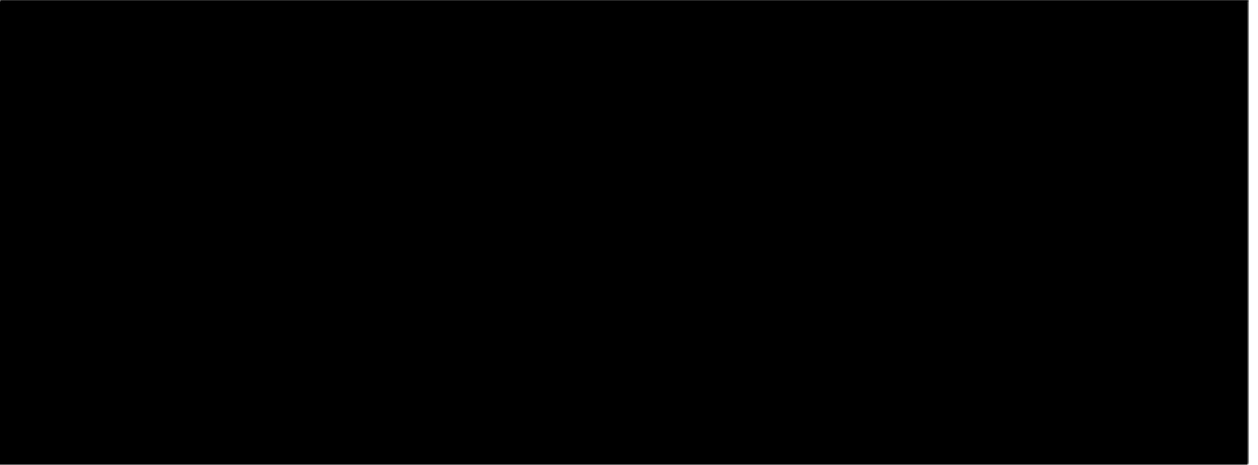
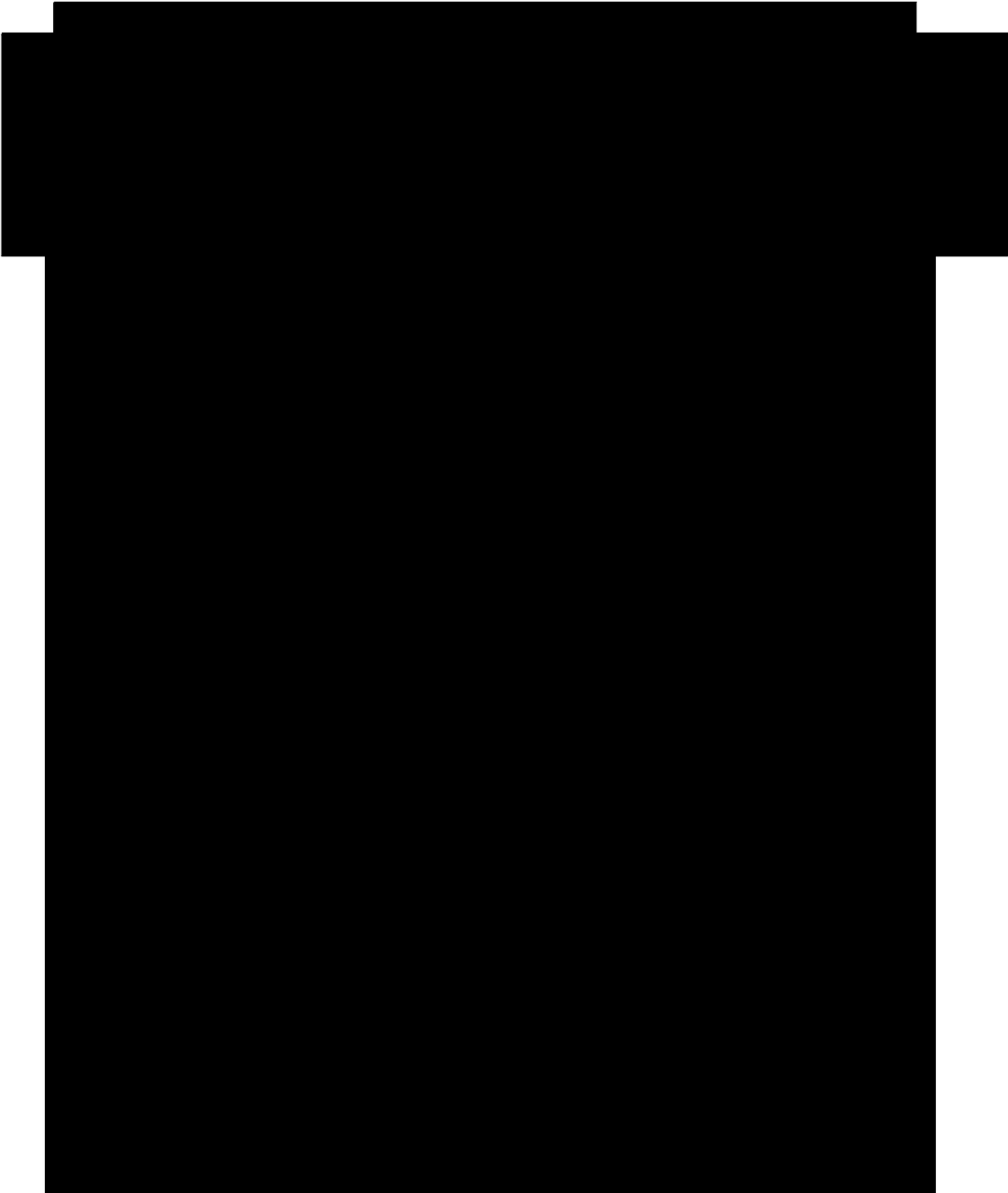








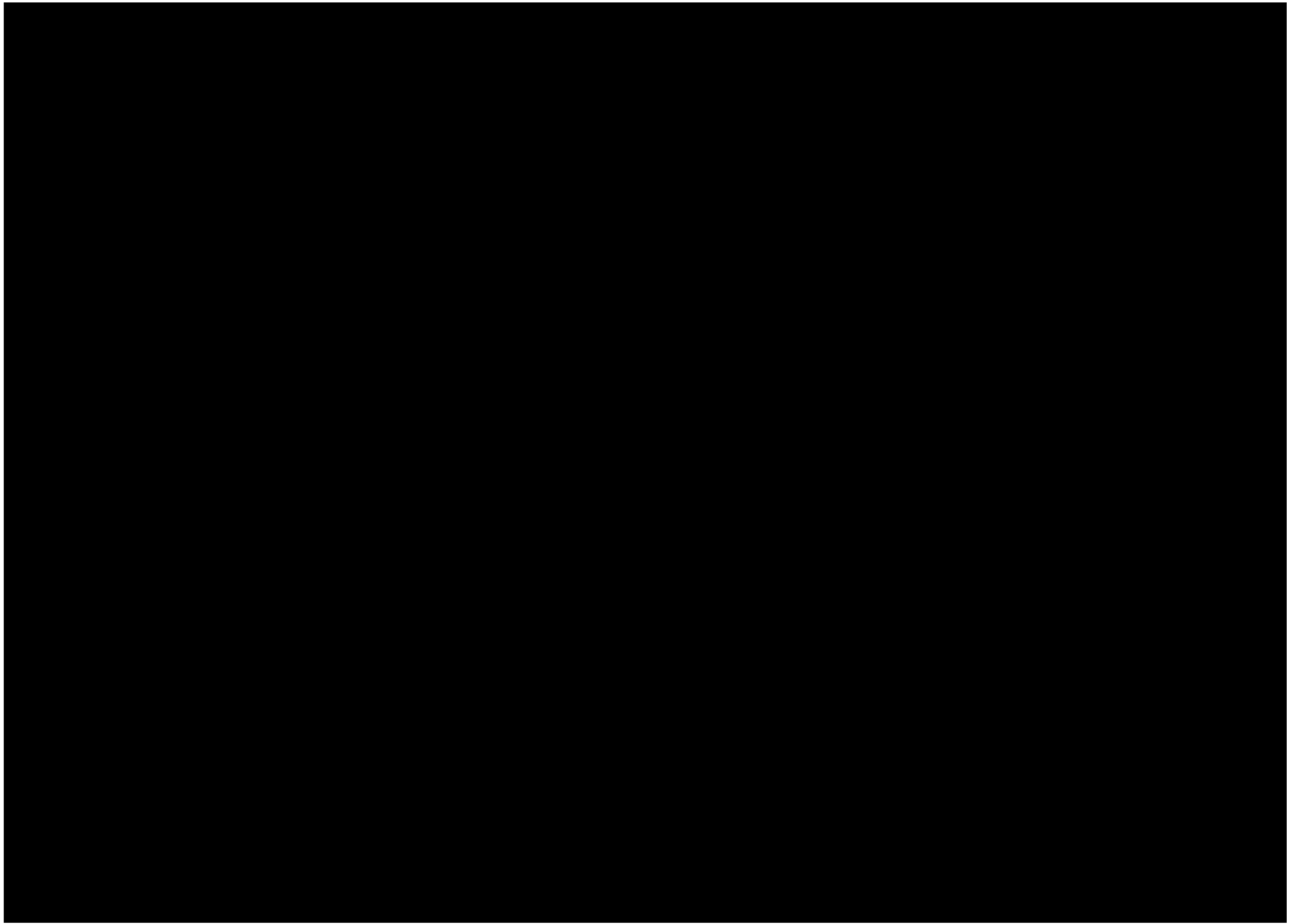
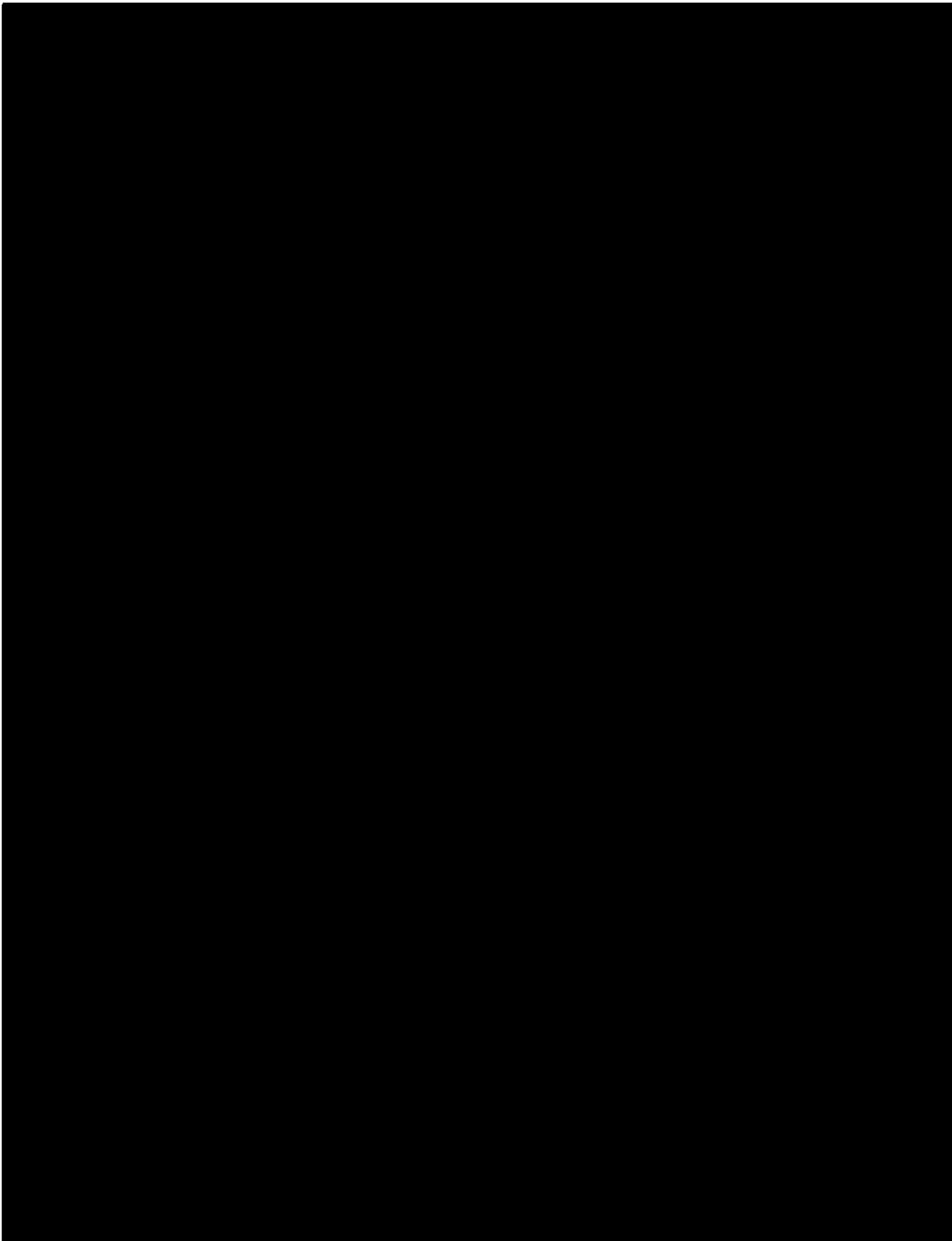


EXHIBIT B-4



MALETICH_002748

EXHIBIT M - HORTER MEDIATION POSITION STATEMENT

EXHIBIT B-5

Master Service Agreement

This Master Service Agreement ("MSA"), dated as of October 28, 2021, is entered into by and between Foreside Consulting Services, LLC, with its principal office at Three Canal Plaza, Suite 100, Portland, Maine 04101("Foreside"), Horter Investment Management, LLC (the "Company") with its principal office at 11726 Seven Gables Road, Symmes Township, Cincinnati, Ohio 45249 and Ice Miller LLP ("IM"), as counsel for Horter Investment Management, LLC with its principal office at 250 West Street, Suite 700, Columbus, Ohio 43215-7509, (the "Company" each a "Party" and together, the "Parties").

WHEREAS, Foreside assists and supports its clients with cost-effective professional services, including but not limited to consulting services, back-office support services, access to Technology, and outsourced business solutions. IM and Company wish to obtain certain services from Foreside, all as specified in one or more Service Agreements (as defined below).

WHEREAS, the Parties intend this MSA to govern the relationship between the Parties with respect to the Services set forth in one or more Service Agreements.

WHEREAS, the Parties hereby intend to execute one or more Service Agreements in connection with the provision of certain consulting and other related services provided by Foreside. Each Service Agreement shall be executed the Parties and shall be effective as of the effective date listed on such Service Agreement.

NOW, THEREFORE, the Parties hereto agree as follows:

SECTION 1. CERTAIN DEFINITIONS

(a) Any initially capitalized terms not defined in this Section 1 will have the meanings given to them where they first occur in this MSA.

(b) "Agreement" shall mean this MSA and each Service Agreement between the Parties.

(c) "Company Data" shall mean any and all information, documentation, or data provided to Foreside by Company or any agent or service provider of Company (Including IM) in connection with the provision of the Services.

(d) "Company Indemnitee" shall mean IM and the Company and each of their directors, officers, members, agents and employees.

(e) "Confidential Information" means any non-public or proprietary information that is treated confidential by a Party, including, without limitation, financial information, business practices and policies, know-how, trade secrets, market or sales information or plans, customer lists, business plans, and all provisions of this Agreement, and disclosed to other Party under this Agreement for the express purpose of the provision of Services. Confidential Information shall not include (i) information that is or becomes publicly known without breach of this Agreement by the Receiving Party, (ii) information that is disclosed to the Receiving Party by a third party not under an obligation confidentiality to the Disclosing Party of which the Receiving Party receiving the information should reasonably be aware, or (iii) information that is independently developed by a Party without reference to the other's Confidential Information.

(f) "Disclosing Party" means a party that discloses Confidential Information under this Agreement.

(g) "Foreside Indemnitee" shall mean Foreside, its affiliates and each of their respective directors, officers, members, agents, and employees.

(h) "Losses" shall mean any loss, liability, claim, damage or expense (including the reasonable cost of investigating or defending any alleged loss, liability, claim, damage or expense and reasonable counsel fees incurred in connection therewith).

(i) "Intellectual Property" shall mean, without limitation, any inventions, technological innovations, discoveries, designs, formulas, know-how, processes, business methods, patents, trademarks, service marks, copyrights, computer software, ideas, creations, writings, lectures, illustrations, photographs, motion pictures, scientific and mathematical models, improvements to all such property, and all recorded material defining, describing, or illustrating all such property, whether in hard copy or electronic form, and for the sake of clarity and only with respect to Foreside, all Technology.

(j) "Receiving Party" means a party that receives or acquires Confidential Information from the Disclosing Party under this Agreement.

(k) "Services" shall mean the services set forth in the applicable Service Agreement.

(l) "Service Agreement" shall mean each individual Service Agreement entered into in connection with the MSA.

(m) "Technology" means any or all technology, including but not limited to software, software or mobile applications, tools, application programming interfaces (APIs), connectors, programmable code, computer or web applications, programs, networks and equipment owned by Foreside.

SECTION 2. SERVICES

(a) Foreside will provide the Services in accordance with the terms of the applicable Service Agreement.

(b) Foreside will use commercially reasonable efforts in performing the Services, and shall endeavor to perform the Services in a manner consistent with that degree of care and skill ordinarily exercised by persons of the same profession performing under similar circumstances.

(c) To the extent that the Parties wish to add or remove one or more Services, each such Service will be added and/or removed, as the case may be, by executing an additional Service Agreement, or by terminating an existing Service Agreement in accordance with terms therein and herein.

SECTION 3. COMPANY DUTIES AND ACKNOWLEDGMENTS

(b) Company agrees to:

(i) Provide Foreside with all necessary documents, records and other information necessary and/or appropriate to enable Foreside to perform the Services, including any records or other information reasonably requested by Foreside. In addition, Company shall provide Foreside with any amendments to, or other changes in, such documents, records, and other information in a reasonable time prior to such amendments or changes becoming effective;

(ii) Respond promptly to any request by Foreside to provide direction or decisions that are reasonably necessary for Foreside to perform the Services;

(iii) Cooperate with Foreside (or Foreside's designee) in all matters relating to the Services, including obtaining any information reasonably requested by Foreside from the Company's service providers to assist Foreside (or Foreside's designee) in performing the Services;

(iv) Promptly notify Foreside in writing if the Company becomes aware or is notified of a visit, audit, examination, investigation (or potential investigation), or information request from a governmental, regulatory or self-regulatory agency with jurisdiction over the Company during the term of this Agreement.

After providing notice to Foreside, as set forth in Section 3(b)(iv), the Company agrees to promptly respond to and address such request for information, audit, or other similar action by a governmental, regulatory or self-regulatory agency.

(c) For the avoidance of doubt, the Company and IM acknowledge and agree that, unless specifically agreed to by Foreside under a Service Agreement, Foreside shall not be responsible for reviewing or verifying the accuracy of any Company Data provided hereunder.

(d) The Company and IM understand and agree that Foreside is not a law firm and that nothing contained in this Agreement shall be construed to create an attorney-client relationship between Foreside, and the Company or to require Foreside to render legal advice or otherwise engage in the practice of law in any jurisdiction. The Company assumes all responsibility for ensuring that the Company complies with all applicable laws, rules and regulations. The Company understands that Foreside does not provide substitute services for the services provided by a certified public accountant.

(e) Company an IM acknowledge and agree that Foreside may subcontract any or all of its functions or responsibilities pursuant to this Agreement, or utilize the services of certain software vendors, provided that any such subcontracting or use of software vendors shall not relieve Foreside of its responsibilities hereunder. The Company and IM agree to cooperate with any sub-contractor or vendor of Foreside in order for Foreside or such sub-contractor or vendor to provide the Services contemplated under any applicable Service Agreement.

SECTION 4. LIMITATION OF LIABILITY

(a) Foreside shall be under no duty to take any action under this Agreement except as specifically set forth in this Agreement or as may be specifically agreed to by Foreside in writing.

(b) The Company and IM agree that Foreside, and each Foreside Indemnitee shall not be liable to the Company or IM for any Losses arising out of or relating to this Agreement for an aggregate amount in excess of the fees paid to Foreside within the twelve (12) month period prior to such Loss under the Service Agreement under which such Loss arose. For the sake of clarity, the Company and IM agree that Foreside, and each Foreside Indemnitee, shall only be liable to the Company and/or IM for Losses directly attributable to a specific Service Agreement. The provisions of this paragraph shall apply regardless of the form of action, damage, claim, liability, cost, expense or loss, whether in contract, statute, tort (including, without limitation, negligence) or otherwise. This limitation of liability shall not apply to any Losses resulting from Foreside's gross negligence or willful misconduct in connection with Foreside's provision of Services to the Company and IM.

(c) Foreside shall not be liable to the Company, IM or any other person for:

(i) any Losses arising out of mistakes, errors or omissions in any Company Data;

(ii) any delay or failure by Foreside to perform the Services caused by any action or inaction of the Company; or

(iii) any action taken or failure to act in good faith or reasonable reliance upon:

I. the advice of the Company, or counsel to the Company; or

II. any oral or written instruction received by Foreside and reasonably believed in good faith by Foreside to be transmitted by the Company or IM.

(d) Each Party undertakes to perform such duties and only such duties as are expressly set forth herein, or expressly incorporated herein by reference, and no implied covenants or obligations shall be read into this Agreement against any Party to this Agreement.

(e) IN NO EVENT SHALL ANY PARTY, OR THEIR RESPECTIVE AFFILIATES, AGENTS, EMPLOYEES, OFFICERS, MEMBERS, OR DIRECTORS BE LIABLE FOR CONSEQUENTIAL, SPECIAL,

INDIRECT, INCIDENTAL, PUNITIVE OR EXEMPLARY DAMAGES, COSTS, EXPENSES OR LOSSES (INCLUDING, WITHOUT LIMITATION, LOST PROFITS AND OPPORTUNITY COSTS OR FINES), PROVIDED THAT THE FOREGOING LIMITATION SHALL NOT APPLY WITH RESPECT TO INDIRECT DAMAGES ARISING OUT OF OR RELATING TO THAT PARTY'S FRAUD OR WILLFUL MISCONDUCT.

SECTION 5. INDEMNIFICATION

(a) The Company agrees to indemnify and hold harmless each Foreside Indemnitee against any Losses arising out of or based upon (i) any action or inaction of Foreside taken in the performance of its duties and obligations under this Agreement so long as such action or inaction of Foreside was taken in accordance with this Agreement, (ii) the material breach of any obligation, representation or warranty under this Agreement by the Company, or (iii) Foreside's use of any Company Data in accordance with the terms and conditions of this Agreement.

(b) Foreside agrees to indemnify and hold harmless, the Company, and each Company Indemnitee, against any Losses arising out of or based upon the material breach of any obligation, representation or warranty under this Agreement by Foreside.

(c) In no case is (i) the indemnification provided by an indemnifying party to be deemed to protect against any liability the indemnified party would otherwise be subject to by reason of willful misfeasance, bad faith or gross negligence in the performance of its duties or by reason of its reckless disregard of its obligations and duties under this Agreement, or (ii) the indemnifying party to be liable with respect to any claim made against any indemnified party unless the indemnified party notifies the indemnifying party in writing of the claim within a reasonable time after the summons or other first written notification giving information of the nature of the claim shall have been served upon the indemnified party (or after the indemnified party shall have received notice of service on any designated agent).

(d) Notwithstanding the foregoing, failure to notify the indemnifying party of any claim shall not relieve the indemnifying party from any liability that it may have to the indemnified party against whom such action is brought, unless failure or delay to so notify the indemnifying party prejudices the indemnifying party's ability to defend against such claim. The indemnifying party shall be entitled to participate at its own expense in the defense or, if it so elects, to assume the defense of any suit brought to enforce the claim, but if the indemnifying party elects to assume the defense, the defense shall be conducted by counsel chosen by it and reasonably satisfactory to the indemnified party. In the event that the indemnifying party elects to assume the defense of any suit and retain counsel, the indemnified party shall bear the fees and expenses of any additional counsel retained by them. If the indemnifying party does not elect to assume the defense of any suit, it will reimburse the indemnified party for the reasonable fees and expenses of any counsel retained by them.

(e) No indemnified party shall settle any claim against it for which it intends to seek indemnification from the indemnifying party, under the terms of section 5(b) or 5(c) above, without prior written notice to and consent from the indemnifying party, which consent shall not be unreasonably withheld. No indemnified or indemnifying party shall settle any claim unless the settlement contains a full release of liability with respect to the other party in respect of such action.

SECTION 6. REPRESENTATIONS AND WARRANTIES

(a) Each Party represents and warrants to the other Party that:

(i) it is duly organized, validly existing, and in good standing under the laws of its jurisdiction of organization;

(ii) it is empowered under applicable laws and by its organizational documents to enter into this Agreement and perform its duties under this Agreement;

(iii) all requisite corporate or company proceedings have been taken to authorize it to enter into this Agreement and perform its duties under this Agreement;

(iv) this Agreement, when executed and delivered, will constitute a legal, valid and binding obligation, enforceable in accordance with its terms, subject to bankruptcy, insolvency, reorganization, moratorium and other laws of general application affecting the rights and remedies of creditors and secured parties;

(v) it has implemented, and shall maintain through the term of this Agreement, reasonably designed business continuity, data protection, and cybersecurity policies and procedures, including reasonably appropriate and documented administrative, technical and physical measures to protect Confidential Information against accidental or unlawful destruction, alteration, or unauthorized disclosure or access; and

(vi) it, at its own expense, shall maintain insurance coverage in full force and effect, in an amount necessary and appropriate with respect to its business.

(b) The Company represents and warrants to Foreside that with respect to Company Data:

(i) to the best of its knowledge and after reasonable investigation and due inquiry, all Company Data is and shall be true and correct at all times during the term of this Agreement;

(ii) the Company shall ensure the accuracy and completeness of all Company Data;

(iii) Foreside shall be entitled to rely upon and assume, without independent verification, the accuracy and completeness of all Company Data and shall have no obligation to verify the accuracy or completeness of any such Company Data (unless agreed otherwise by Foreside); and

(iv) Company agrees and understands that any inaccuracies in the Company Data are the sole responsibility of the Company and not Foreside.

SECTION 7. EFFECTIVENESS, DURATION, TERMINATION

(a) The MSA shall be effective as of the date first set forth above, or when Foreside began providing services to the Company, whichever is earlier ("MSA Effective Date"). The MSA shall remain in full force and effect unless terminated in accordance with Section 7 of the MSA. The termination of any or all Service Agreements shall not automatically terminate the MSA.

(b) The MSA may not be terminated by either Party unless and until all Service Agreements entered into in connection herewith have been terminated in accordance with their terms, at which time either Party may terminate the MSA with immediate effect.

SECTION 8. CONFIDENTIALITY

During the term of this Agreement, each Party may have access to Confidential Information relating to matters such as the other Party's business, procedures, personnel, and/or clients. The Receiving Party will protect the Disclosing Party's Confidential Information with at least the same degree of care the Receiving Party uses with respect to its own Confidential Information, and will not use the Disclosing Party's Confidential Information other than in connection with the Receiving Party's duties and obligations hereunder. The Receiving Party may not disclose the Disclosing Party's Confidential Information unless (i) such disclosure is required by law, regulation or legal process, or if required by any regulatory agency with jurisdiction over the Receiving Party; (ii) it is advised by counsel that it may incur liability for failure to make such disclosure; (iii) such disclosure is requested by the Disclosing Party, (iv) such disclosure is necessary to perform its duties and obligations under this Agreement, or (v) such disclosure is in response to a routine examination of the Receiving Party by a regulatory or self-regulatory agency with jurisdiction over the receiving party; provided that in the event of (i) or (ii) the Receiving Party shall give the Disclosing Party reasonable prior notice of such disclosure to the extent permitted by applicable law and shall reasonably cooperate with the Disclosing Party (at such other Disclosing Party's expense) in any efforts to prevent such disclosure.

SECTION 9. FORCE MAJEURE

Neither Party shall be responsible or liable for any failure or delay in the performance of its obligations under this Agreement arising out of or caused, directly or indirectly, by circumstances beyond its reasonable control including, without limitation, acts of civil or military authority, national emergencies, fire, mechanical breakdowns, flood or catastrophe, acts of God, insurrection, war, riots or failure of the mails, transportation, communication system or power supply.

SECTION 10. INTELLECTUAL PROPERTY

Ownership of all Intellectual Property used in connection with this Agreement will be determined as follows:

(a) Company retains and owns all right, title, and interest in and to all Company Data and any and all of its own Intellectual Property that it may provide to Foreside as Confidential Information during the term of this Agreement, and no ownership interest in any Company Data is transferred or conveyed to Foreside by virtue of this Agreement.

(b) Foreside retains and owns all right, title, and interest in and to all Foreside's Intellectual Property (i) provided to Company or IM as Confidential Information during the term of this Agreement, or (ii) used in connection with this Agreement, including but not limited to any Technology to which Company has access in connection with this Agreement. Company and IM agree that it shall not (i) reverse engineer, decompile, or otherwise attempt to derive source code from any Technology of Foreside, or any other technology platform or software application, to which the Company or IM has access in connection with this Agreement, (ii) reproduce, modify, or prepare derivative works of any Technology of Foreside, or any other technology platform or software application, to which Company and IM has access, or (iii) share, allow access to, rent, or lease any Technology of Foreside, or any other technology platform or software application to which Company has access in connection with this Agreement, or use Foreside's Technology as a standalone offering.

(c) Title to each Party's Confidential Information and Intellectual Property shall remain with the owning party. Neither party shall have any ownership rights to the other's Confidential Information or Intellectual Property but will have the right to use such information in accordance with the terms and conditions of this Agreement.

(d) Any work product, know-how, and other materials that are developed or prepared by Foreside under this Agreement in the course of performing the Services, shall be owned by Foreside, provided, however, that the Company or IM, respectively shall own all *final deliverables provided to the Company or IM by Foreside.*

SECTION 11. AMENDMENT

No amendment to this MSA or a Service Agreement shall be valid unless made in writing and executed by the Parties hereto.

SECTION 12. MISCELLANEOUS

(a) This Agreement shall be governed by, and the provisions of this Agreement shall be construed and interpreted under and in accordance with, the laws of the State of Delaware, without regard to the conflict of laws provisions thereof.

(b) During the term of this Agreement, and for a period of two (2) years from termination date of this Agreement, each Party agrees not to directly or indirectly solicit or hire any employee or agent of the other Party. If a Party breaches this Section 12(b), such Party shall promptly pay to the other Party, an amount equal to the annual compensation due to such employee or agent during the most recent 12 month period of employment, or $150,000, whichever is greater.

(c) If a dispute arises from this Agreement, or the breach thereof, and such dispute cannot be settled through direct discussions between the Parties, the Parties agree to settle the dispute exclusively by arbitration conducted by the American Arbitration Association in accordance with its Commercial Arbitration Rules, and judgment on the award rendered by the arbitrator(s) may be entered in any court having jurisdiction thereof. Any arbitration shall be governed by the laws of the State of Delaware. Except as may be required by law, neither Party may disclose the existence, content, or results of any arbitration hereunder without the prior written consent of the other Party.

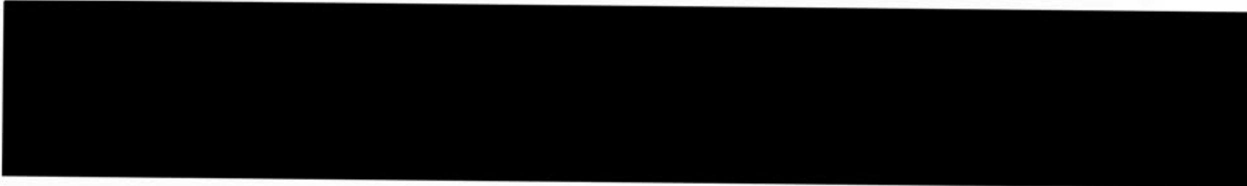
(d) If any part, term or provision of this Agreement is held to be illegal, in conflict with any law or otherwise invalid, the remaining portion or portions shall be considered severable and not be affected, and the rights and obligations of the Parties shall be construed and enforced as if this Agreement did not contain the particular part, term or provision held to be illegal or invalid.

(e) This Agreement shall be construed as if drafted jointly by both Foreside and Company and no presumptions shall arise favoring any Party by virtue of authorship of any provision of this Agreement.

(f) Section headings in this Agreement are included for convenience only and are not to be used to construe or interpret this Agreement.

(g) Any notice required or permitted to be given hereunder by either Party to the other shall be deemed sufficiently given if in writing and personally delivered or sent by facsimile, e-mail, or registered, certified or overnight mail, postage prepaid, addressed by the Party giving such notice to the other Party at the address furnished below unless and until modified by Foreside or Company, as the case may be. Notice shall be given to each Party at the following address, as amended from time to time:

(i) To Foreside:	**(ii) To IM and Company:**
FORESIDE CONSULTING SERVICES, LLC Three Canal Plaza, Suite 100 Portland, Maine 04101 Attn: Legal Department Phone: 207.553.7110 Fax: 207.553.7151 Email: legal@foreside.com	Ice Miller LLP Attn: Matthew L. Fornshell, Esq. 250 West Street, Suite 700 Columbus, OH 43215-7509Phone: (614) 462-1061 Fax: (614) 222-3692 Email: Matthew.Fornshell@icemiller.com **Horter Investment Management, LLC** **Attn: Drew Horter** **11726 Seven Gables Road** **Symmes Township** **Cincinnati, Ohio 45249** **Phone: (513) 984-9933** **Email: drew@him-ria.com**



(i) This Agreement has been negotiated and executed by the Parties in English. In the event any translation of this Agreement is prepared for convenience or any other purpose, the provisions of the English version shall prevail.

(j) Nothing herein shall be deemed to limit or restrict Foreside's right, or the right of any of Foreside's managers, officers or employees, to engage in any other business or to devote time and attention to the management

or other aspects of any other business, whether of a similar or dissimilar nature, or to render services of any kind to any other corporation, trust, firm, individual or association.

(k) The provisions of Sections 4,5,7,8, 10 and 12 shall survive any termination of this Agreement.

(l) Neither Party may assign its rights or obligations under this Agreement (in whole or in part) without the prior written consent of the other Party, such consent not to be unreasonably withheld, conditioned, or delayed; provided, however, that either Party may assign its rights and obligations hereunder (in whole, but not in part) without the other Party's consent to an entity acquiring all, or substantially all, of the assigning Party's assets or business or to an affiliate of the assigning Party so long as (i) the acquiring entity is able to comply with and fulfill the duties and obligations of the assigning Party under this Agreement, and (ii) the other Party to this Agreement is not adversely affected by such assignment. If a Party assigns its rights or obligations hereunder to an affiliate, the assigning Party or affiliate shall notify the other Party hereto of the change. Any purported assignment in violation of the provisions hereof shall be null and void. All terms and provisions of this Agreement shall be binding upon, inure to the benefit of and be enforceable by the respective successors and permitted assigns of the Parties hereto.

(m) This Agreement is for the sole benefit of the Parties hereto and their respective successors and permitted assigns and nothing herein, express or implied, is intended to or shall confer upon any other person or entity any legal or equitable right, benefit or remedy of any nature whatsoever under or by reason of the terms of this Agreement.

(n) This MSA sets forth the entire understanding between Foreside, IM and the Company with respect to the subject matter set forth in this MSA, and supersedes any and all prior or contemporaneous representations, discussions, negotiations, letters, proposals, agreements, and understandings between Foreside, IM and the Company with respect to the subject matter contained in the MSA, whether written or oral.

(o) This MSA may be executed in counterparts, each of which shall be deemed an original but all of which together shall constitute one and the same instrument.

[*Signature Page Follows*]

IN WITNESS WHEREOF, the Parties hereto have caused this MSA to be executed in their names and on their behalf by and through their duly authorized officers as of the date below. **For the sake of clarity, the Company, and IM represent and warrant to Foreside that it has reviewed and understands this MSA, including the limitation of liability and indemnification sections of this MSA.**

FORESIDE CONSULTING SERVICES, LLC

By: *Mark S. Alcaide*

Signature

Mark S. Alcaide

Printed Name

Vice President

Title

ICE MILLER LLP

By: [signature]

Signature

Matthew L. Fornshell

Printed Name

Partner 11/1/21

Title

Horter Investment Management, LLC

By: [signature]

Signature

DREW HORTER

Printed Name

CEO

Title

4824-1609-1391.1

Compliance Program Assessment
Service Agreement

The Company and IM wishes to obtain certain services from Foreside, all as specified below:

Services:

Foreside will provide an assessment of the Company's compliance program, by reviewing the following:

1. Registrations and regulatory filings
2. Form ADV responses and disclosures
3. Advisory agreements and fees
4. Compliance oversight and internal controls
5. Portfolio management
6. Trading practices
7. Code of ethics and insider trading
8. Conflicts of interest
9. Select client files (as requested by Foreside examiner)

Onsite Review and Testing:

The compliance assessment is designed to: (1) determine whether the Company's written compliance policies and procedures appropriately address regulatory requirements; and (2) test whether the Company's business and compliance practices are being implemented consistent with regulatory requirements and the Company's policies and procedures.

At the conclusion of the assessment, the reviewers will conduct an exit interview with IM and the Company summarizing any findings and recommendations.

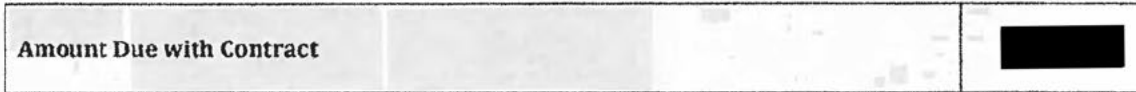
Reporting:

If requested by IM, after conclusion of the testing, a report documenting findings, observations, and recommendations will be delivered to IM. The compliance assessment report will include:

- A description of testing conducted
- Details of findings and recommendations to remediate issues
- Recommendations of any industry best practices
- Biographies of examination team

Fees and Expenses:

Description		Fee
Compliance Assessment Service	One-time fee.	[redacted]
Deposit	Invoiced when assessment is scheduled; applied toward assessment fee. Remainder will be invoiced upon completion of the assessment.	[redacted]



Amount Due with Contract

The Company shall also reimburse Foreside for reasonable out-of-pocket and ancillary expenses incurred in the provision of services pursuant to this Service Agreement. This Service Agreement (" Service Agreement") is dated October 28, 2021 and entered into by Horter Investment Management, LLC ("Company"), Ice Miller LLP ("IM"), (as counsel for the Company), and Foreside Consulting Services, LLC ("Foreside" and collectively the "Parties"), and shall be subject to and governed by the Master Services Agreement dated October 28, 2021 by and between Foreside, the Company and IM ("MSA"). Unless otherwise defined herein, all capitalized terms contained herein shall have the meanings assigned to them in the MSA.

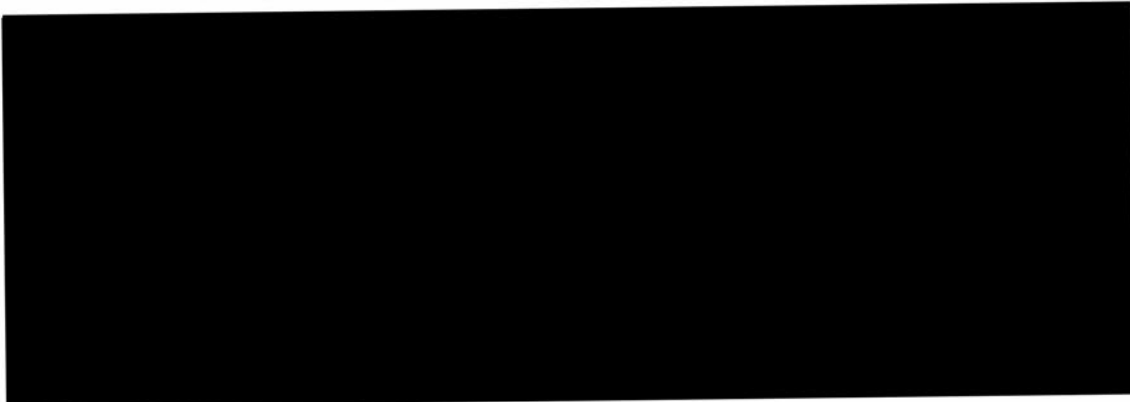
The Parties agree as follows:

1. This Service Agreement is subject to and governed by the MSA, and the terms and conditions of the MSA are hereby incorporated into this Service Agreement by reference.

2. Foreside shall perform the services ("Services") as set forth herein subject to the terms and conditions of this Service Agreement. To the extent that IM or Company requests services that are outside of the scope of the Services listed in this Service Agreement, the Company and Foreside agree that Foreside may provide such services, (at Foreside's sole discretion) at Foreside standard hourly rates.

3. Company shall pay the fees as set forth herein and reimburse the reasonable out of pocket expenses incurred by Foreside (collectively "Fees") in consideration for the Services. For the avoidance of doubt, the Company and Foreside agree that Company, and not IM, shall be solely responsible for payment of all invoices from Foreside provided hereunder.

4. Foreside reserves the right to delay the commencement of the Services until that time when Foreside receives the deposit and/or initial service/implementation fee, or suspend the continuation of the Services if there is a failure to pay any outstanding Fees or expenses until Foreside receives such outstanding Fees or expenses.



6. Either Party hereto may terminate this Service Agreement upon thirty (30) days written notice to the other party. Upon written notice to the other Party, each Party may terminate this Service Agreement if the other Party is in material breach of this Service Agreement. In such case, the Company shall be responsible for payment of any amounts due in connection with the Services performed up to and including the date of termination.

7. This Service Agreement shall be governed by the MSA and all terms, provisions, and agreements set forth in the MSA (except to the extent expressly modified herein) are hereby incorporated herein by reference with

the same force and effect as though fully set forth herein. To the extent that the terms set forth in this Service Agreement conflict with the MSA, the terms set forth in this Service Agreement shall control.

8. This Service Agreement sets forth the entire understanding between Foreside and the Company with respect to the Services contemplated herein, and supersedes any and all prior or contemporaneous representations, discussions, negotiations, letters, proposals, agreements, and understandings between Foreside and the Company with respect to the Services contained herein, whether written or oral.

(Signature Page to Follow)

IN WITNESS WHEREOF, the Parties hereto have caused this Service Agreement to be executed in their names and on their behalf by and through their duly authorized officers as of the date below. **By signing below, the Company, and IM represents and warrants to Foreside that it has reviewed this Service Agreement and the MSA, including but not limited to the limitation of liability and indemnification sections, and the Company agrees that this Service Agreement shall be subject to and governed by the MSA.**

FORESIDE CONSULTING SERVICES, LLC	**ICE MILLER LLP**
By: Mark S. Alcaide	By: [signature]
Signature	Signature
Mark S. Alcaide	Matthew L. Fornshell
Printed Name	Printed Name
Vice President	Partner
Title	Title
11.3.21	11/1/21
Date:	Date:

Horter Investment Management, LLC

By: [signature]

Signature

DREW HORTER

Printed Name

CEO

Title

EXHIBIT B-6

837 F.2d 1099
United States Court of Appeals,
District of Columbia Circuit.

BLINDER, ROBINSON & CO., INC., Petitioner,
v.
SECURITIES & EXCHANGE COMMISSION, Respondent.
Meyer BLINDER, Petitioner,
v.
SECURITIES & EXCHANGE COMMISSION, Respondent.

Nos. 87–1080, 87–1086.
|
Argued Nov. 3, 1987.
|
Decided Jan. 15, 1988.

Synopsis
Registered broker-dealer and its president and principal shareholder filed petition for review challenging Securities and Exchange Commission order imposing sanctions. The Court of Appeals, Starr, Circuit Judge, held that: (1) SEC did not violate due process when it initiated administrative proceeding against broker dealer after it had obtained substantial relief in civil enforcement action brought in District Court; (2) fact that broker's liability under securities laws did not justify exclusion of evidence relating to degree of petitioner's culpability in administrative sanctions proceeding; and (3) SEC could not adequately weigh factors necessary to determine appropriateness of sanctions without having full set of facts necessary for reasoned consideration.

Vacated and remanded.

Ruth Bader Ginsburg, Circuit Judge, filed concurring opinion.

***1100 **97** Petition for Review of an Order of the Securities and Exchange commission.

Attorneys and Law Firms

Arthur F. Mathews, with whom David M. Becker, Andrew B. Weissman, David D. Rosskam and Karen A. Getman, Washington, D.C., were on the brief, for petitioner Blinder, Robinson & Co., Inc.

Nathan Lewin, with whom Jonathan B. Sallet and Mary L. Lyons, Washington, D.C., were on the brief, for petitioner Meyer Blinder.

Jacob H. Stillman, Associate General Counsel, and Rosalind C. Cohen, Asst. General Counsel, S.E.C., with whom Daniel L. Goelzer, General Counsel, Paul Gonson, Sol., and Thomas L. Riesenberg, Senior Special Counsel, S.E.C., Washington, D.C., were on the brief, for respondent.

Before RUTH BADER GINSBURG and STARR, Circuit Judges, and GESELL, * District Judge, United States District Court for the District of Columbia.

* Sitting by designation pursuant to 28 U.S.C. § 292(a).

Opinion

Opinion for the Court filed by Circuit Judge STARR.

Concurring opinion filed by Circuit Judge RUTH BADER GINSBURG.

STARR, Circuit Judge:

These petitions for review challenge an order by the Securities and Exchange Commission imposing sanctions on a registered broker-dealer and its president and principal shareholder. The petitioners advance a number of contentions, both constitutional and nonconstitutional in nature. For the reasons that follow, we vacate the Commission's order and remand the case for further proceedings.

***1101 **98** I

This litigation pits the SEC against Blinder, Robinson & Co. (and its principal), a leading broker-dealer in the genre of securities known as “penny stocks.” The action arose out of an investigation into the actions of Blinder, Robinson and its president, Meyer Blinder, in underwriting an initial public offering of securities of American Leisure Corporation between December 1979 and March 1980. The purpose of the offering was to provide start-up funds for American Leisure's proposed casino project in Atlantic City. In the course of the offering, Blinder, Robinson took a variety of steps destined to be challenged by the SEC. In particular, the Commission assailed Blinder, Robinson's undisclosed purchase for its own

account of almost 1 million units of the 12–million unit offering;[1] a host of other violations were alleged as well, including violations of the antifraud provisions of both the Securities Act of 1933 and the Securities Exchange Act of 1934.

1 The American Leisure offering was on "all or none" terms. "All or none" transactions are ones in which funds paid for stocks by buyers are placed in escrow until a certain date; if the entire offering is not sold out by that date, the deal is cancelled, and the escrowed monies returned. The SEC thus viewed the company's buying for its own account as highly misleading, as it gave the impression that the offering was progressing successfully when it in fact was not.

Based on these allegations, the Commission brought a civil enforcement action pursuant to its statutory authority under section 20(b) of the 1933 Act, 15 U.S.C. § 77t(b) (1982), and section 21(d) of the 1934 Act, 15 U.S.C. § 78u(d), against both Blinder, Robinson and Meyer Blinder in the United States District Court for the District of Colorado. After a full trial, the district court entered findings of fact and conclusions of law, which are reported at 542 F.Supp. 468 (D.Colo.1982). The comprehensiveness of the district court's thorough and careful opinion renders it unnecessary for us to recanvass the underlying facts. It suffices for present purposes to observe that the district court in Colorado found that (1) both Blinder, Robinson and Meyer Blinder had violated the antifraud provisions of the securities laws, 15 U.S.C. 77q(a), 78j(b), 78*o*(c) and various rules promulgated thereunder, including Rule 10b–5; (2) the defendants had failed to establish a claimed defense of good-faith reliance on counsel and that, to the contrary, the firm had refused to follow the advice of counsel; and (3) comprehensive injunctive relief was appropriate, as articulated in nine specific subparagraphs set forth in 542 F.Supp. at 481–82.

Blinder, Robinson and Meyer Blinder took an appeal to the Tenth Circuit, which in due course affirmed entirely the district court's judgment. *SEC v. Blinder, Robinson & Co., et al.* [1983–1984 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 99,491 (10th Cir.1983). The Supreme Court thereafter denied certiorari. 469 U.S. 1108, 105 S.Ct. 783, 83 L.Ed.2d 777 (1985).

As the foregoing litigation was proceeding through the appellate process, the SEC instituted an *administrative* proceeding against Blinder, Robinson and its president pursuant to section 15(b)(4) of the 1934 Act, 15 U.S.C. 78*o*(b)(4). That provision authorizes the Commission to impose sanctions on broker-dealers if, after notice and hearing, it determines that sanctions are in "the public interest." The stated purpose of the proceeding was to determine what sanctions, if any, to impose on petitioners by virtue of their conduct during the American Leisure underwriting.[2] *See* Order for Public Proceedings and Notice of Hearing (June 27, 1984), *reprinted in* Joint Appendix (J.A.) at 30.

2 The order provided in pertinent part:

> [T]he Commission deems it necessary and appropriate in the public interest and for the protection of investors, that public proceedings be instituted to determine:
>
> ---
>
> B. What, if any, remedial action is appropriate in the public interest pursuant to Sections 15(b) and 19(h) of the Exchange Act.

J.A. at 34.

In due course, a hearing ensued before an Administrative Law Judge. At the outset, the ALJ determined that petitioners could not, under principles of issue and ***1102 **99** claim preclusion, introduce evidence as to any matters addressed in the district court's opinion. Blinder, Robinson describes its fruitless efforts in this respect as follows:

> First, petitioners sought to elicit testimony from Meyer Blinder concerning his reliance on counsel. Second, petitioners sought to introduce oral testimony from one of the principal attorneys concerning the advice to Meyer Blinder. When these requests were denied, petitioners sought to introduce into the record all evidence concerning reliance on counsel that had been before the District Court in the injunctive proceeding. This request, too, was denied.

Brief for Petitioner Blinder, Robinson & Co. at 7–8 (footnotes omitted.)

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Largely rejecting petitioners' claims that the firm had undertaken "substantial rehabilitative efforts to ensure that the American Leisure events would not be repeated," *id.* at 9, the ALJ concluded that sanctions should be imposed. Specifically, the ALJ ordered that Blinder, Robinson's registration be suspended for 45 days and that a two-year ban be imposed on Blinder, Robinson's underwriting activities; as to Meyer Blinder, the ALJ concluded that he should be suspended from association with any broker or dealer for a period of 90 days. The ALJ put it this way:

> In light of the egregiousness of the antifraud and antimanipulation violations found in the *American Leisure* injunction opinion ... coupled with the failures of Respondents to establish in the main their claims to fullsome rehabilatative [sic] actions and to a new and genuine dedication to compliance.... it is concluded that substantial sanctions ... are ... in the public interest, but that sanctions of the severity recommended by the [Enforcement] Division are not required in light of the mitigative factors found herein, including the remedial steps actually taken....

Initial Decision (Aug. 30, 1985), J.A. at 517–L.

Neither petitioners nor the SEC staff were enamored of the ALJ's decision. Both sides therefore appealed to the full Commission. In the order from which review is now sought, the SEC upheld the ALJ's decision and choice of sanctions as to Blinder, Robinson, but increased the sanctions imposed on Meyer Blinder individually, determining that he should be barred permanently from association with any broker or dealer (with the proviso that he could apply for reinstatement after two years). *See* Opinion of the Commission (Dec. 19, 1984), J.A. at 536. In a detailed opinion, the SEC made the following points, among others: (1) petitioners' claims of rehabilitation and reformation were unpersuasive, as evidenced by "wholly misleading" sales presentations and techniques still employed by the firm, J.A. at 547–48; (2) the firm's much vaunted personnel changes since the American Leisure imbroglio were entitled to "little weight," in view of key employees having been beguiled away from Blinder, Robinson by the enticing bid of a competing firm, as well as the tell-tale continuing presence of three high-ranking officers with disciplinary records, and, most importantly, of the firm's continued dominance by Meyer Blinder himself, *id.* at 549; and (3) the sanctions imposed by the Commission, while stringent, were necessary to guard against "any repetition of the blatant misconduct in which respondents engaged." *Id.* at 550.

The Commission expressly recognized the gravity of its decision:

> We recognize the serious effect of the sanctions we are imposing. But we are convinced that lesser sanctions will not suffice. Our action is designed to protect the public interest not only by restricting respondents' future activity in the securities business but also by deterring them from any repetition of their violative practices. The sanctions are a clear message to registrant, and to Blinder if and when he returns to the securities business, that any recurrence of misconduct will be dealt with severely. At the same time, the sanctions serve the important purpose of general deterrence, and should operate as a warning to any other participant in the securities industry ***1103 **100** who might be tempted to engage in similar misconduct.

Id. at 550 (citation omitted.) [3]

[3] The reference to Mr. Blinder's possible return to the securities business took into account the Commission's proviso that he could apply for reassociation after two years.

On New Year's Eve 1986, the Commission entered a stay with respect to the sanctions imposed on Blinder, Robinson. J.A. at 553–56. Applying the criteria articulated by this court, *see, e.g., Wisconsin Gas Co. v. FERC,* 758 F.2d 669, 673–74 (D.C.Cir.1985); *Washington Metro. Area Transit Comm'n v. Holiday Tours, Inc.,* 559 F.2d 841, 844 (D.C.Cir.1977), the Commission denied Meyer Blinder's request for stay. On

March 26, 1987, this court, over the opposition of the SEC, entered an order staying the entry of sanctions against Meyer Blinder. *See* Brief for Petitioner Blinder, Robinson & Co. at 10 n. 28.

II

Petitioners assert a variety of grounds for overturning the SEC's order. For ease of discussion, their contentions can be divided into two categories, those arising under the Constitution, and other, nonconstitutional, claims.

A

1. *Separation of Powers*

In their broadest line of attack, petitioners contend that the SEC lacked power under the Constitution to seek in federal district court the injunction that provided the foundation for the set of administrative sanctions that the Commission ultimately fashioned. In petitioners' view, an independent agency whose members are secure from removal at the President's will is constitutionally disabled from bringing law enforcement actions, a function entrusted to the Executive under Article II of the Constitution. We decline to entertain this aspect of petitioners' challenge, however, by virtue of the fact that petitioners have previously litigated (and lost) this very issue in the federal district court in Colorado, the appeal of which is currently pending in the Tenth Circuit.

The well-established policies underlying preclusion of relitigation are especially applicable here. The waste of judicial resources would be particularly stark were we to allow petitioners to have another day in court on this question. Two separate Courts of Appeals are being asked to resolve the very same issue, presented by the very same parties, on a single set of facts. We therefore defer to our colleagues in the Tenth Circuit, inasmuch as the issue was first presented, and has been initially resolved, in that circuit. *See Durfee v. Duke,* 375 U.S. 106, 84 S.Ct. 242, 11 L.Ed.2d 186 (1963) (when first court's jurisdiction is actually litigated, a subsequent court must give the first court's resolution preclusive effect); *Stoll v. Gottlieb,* 305 U.S. 165, 59 S.Ct. 134, 83 L.Ed. 104 (1938) (same).[4]

4 *Chicot County Drainage Comm'n v. Baxter State Bank,* 308 U.S. 371, 60 S.Ct. 317, 84 L.Ed. 329 (1940), cited by the SEC as support for applying the normal rules of preclusion in this case, is in our view a more difficult case than the present one. In *Chicot County,* the Supreme Court gave preclusive effect to a prior judgment, notwithstanding the fact that the prior court's jurisdiction had been based upon a statute later found to be unconstitutional. The case dealt with a bondholder's suit to recover the value of his defaulted bonds, even though in a prior bankruptcy proceeding a court had effected a reorganization plan (to which the party had notice) which disposed of the issuer's obligations; the constitutionality of the bankruptcy act, and therefore the court's jurisdiction, were not questioned in the first proceeding. The statute on which the bankruptcy proceeding had been founded was later found, in an unrelated case, to be unconstitutional. By contrast to *Chicot County,* in the present case, as in *Durfee v. Duke* and *Stoll v. Gottlieb,* the first court's jurisdictional power was contested and actually decided.

Petitioners suggest that relitigation is appropriate where, as here, the prior court's jurisdiction is at issue. Under those circumstances, petitioners argue, the court's resolution of the issue is open to collateral challenge, citing *Kalb v. Feuerstein,* 308 U.S. 433, 60 S.Ct. 343, 84 L.Ed. 370 (1940), and *United States v. U.S. Fidelity Co.,* 309 U.S. 506, 60 S.Ct. 653, 84 L.Ed. 894 (1940), in support of their position. We ***1104 **101** disagree. Properly read, both *Kalb* and *U.S. Fidelity* stand narrowly for the propositions that collateral attack is permitted only when the first court's proceeding "substantially infringe[d] the authority of another tribunal or agency of government," Restatement (Second) of Judgments § 12(2) (1982), or when it improperly trenched on sovereign immunity.[5] The present case is, in our view, unexceptional; having fully litigated (and lost) in Colorado, petitioners, have no persuasive claim to a second try.[6]

5 In *Kalb,* a state court had exercised jurisdiction over a foreclosure action, even though federal bankruptcy law vested exclusive jurisdiction in the federal courts. In *U.S. Fidelity,* a federal court had issued a judgment requiring certain Indian Nations to pay monies on disputed bonds, in contravention of their sovereign immunity. In both cases, the Supreme Court refused to give the judgments preclusive effect in subsequent suits.

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6 We note that the fact that a judgment is pending on appeal ordinarily does not detract from its finality (and therefore its preclusive effect) for purposes of subsequent litigation. *See* *Martin v. Malhoyt,* 830 F.2d 237, 265 (D.C.Cir.1987), and authorities cited therein.

For the foregoing reasons, we conclude that precedent supports, and sound policies informing the orderly administration of justice demand, our not entertaining petitioners' constitutional challenge to the SEC's civil enforcement power.

2. *Due Process*

In addition to petitioners' jointly advanced separation-of-powers argument, Meyer Blinder argues, separately, that the procedures employed by the SEC and its staff in this dispute run afoul of the Fifth Amendment's Due Process Clause. As Mr. Blinder sees it, the SEC's repairing first to federal court, vigorously litigating against him in that forum, and thereafter imposing Commission-spawned administrative sanctions on him cannot stand in the face of the bedrock constitutional requirement of procedural fairness. Here is the way Mr. Blinder summarizes his claim:

> Having prevailed on its contested lawsuit, the SEC now is seeking to exercise quasi-judicial discretion to decide how severely Mr. Blinder should be sanctioned for the conduct that was the subject of the lawsuit. If the Commission's proposed course is permitted, a plaintiff will have become a judge of its own claim.

Brief for Petitioner Meyer Blinder at 13.

Invoking a line of cases illustrated by the Supreme Court's decision in *In re Murchison,* 349 U.S. 133, 75 S.Ct. 623, 99 L.Ed. 942 (1955), which we shall discuss presently, Mr. Blinder maintains that the Constitution "does not permit ... a transformation of litigation roles" so as to permit a litigant to become a judge in its own case. Brief for Petitioner Meyer Blinder at 13. The infirmity in the SEC's procedures in this instance, Blinder complains, is exacerbated by three additional factors: first, the SEC chose in the first instance to eschew administrative procedures and to resort initially to federal district court, a forum which granted substantial relief to the Commission and which remains available for any agency request for further relief; second, the prejudice wreaked by the SEC's "doffing its litigator's hat" and "donning judicial robes" is especially "acute when the agency, as litigant, has considered and rejected a settlement offer," *id.* at 14; and third, the likelihood of injustice (and its appearance) is "aggravated when the agency continues to engage in active litigation with the party whom it is judging." *Id.*

We disagree with Mr. Blinder's analysis. In our view, his approach represents, upon reflection, not merely a narrow attack on the specific procedures employed in his case. Rather, Mr. Blinder's challenge, fairly viewed, represents nothing less than an assault on the constitutionality of a principal feature of the Administrative Procedure Act itself. That familiar statute, enacted by Congress over forty years ago, represents a comprehensive charter for the conduct and operation of modern administrative agencies. Among other things, the APA prohibits agency staff from combining prosecutorial and adjudicative functions in the same case. 5 U.S.C. § 554(d) (1982). *But it expressly exempts agency members from this prohibition of combined functions. Id.*

***1105** ****102** The permissibility of the APA-sanctioned regime under the Constitution has been strongly suggested (if indeed not settled) by the Supreme Court in the case of *Withrow v. Larkin,* 421 U.S. 35, 95 S.Ct. 1456, 43 L.Ed.2d 712 (1975). There, in recognizing the substantiality of arguments challenging the combination of functions or purposes in a single individual or body, the Court observed that "legislators and [commentators] have given much attention to whether and to what extent distinctive administrative functions should be performed by the same persons. No single answer has been reached. Indeed, the growth, variety, and complexity of the administrative process have made any one solution highly unlikely." *Id.* at 51, 95 S.Ct. at 1466. With this recognition of the problem, the Court, speaking through Justice White, went on to state:

> Congress has addressed the issue in several different ways, providing for varying degrees of separation from complete separation of functions to virtually none at all. For the generality of agencies, *Congress has been content with section 5 of*

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> *the [APA], which provides that no employee [may combine functions], but which also expressly exempts from this prohibition "the agency or a member or members of the body comprising the agency."*

Id. at 51–52, 95 S.Ct. at 1467 (citations and footnotes omitted) (emphasis added).

In its discussion of applicable precedent, the *Withrow* Court carefully distinguished Mr. Blinder's featured case, *In re Murchison.* At issue in *Murchison* was the constitutionality of a Michigan law authorizing a judge of any court of record in the State to act as a one-man grand jury. Faced with this unusual statute, the Supreme Court found a due process violation in Murchison's conviction before a judge who tried him for contempt arising out of his, Murchison's, testimony before the same judge acting as a one-man grand jury. The basic teaching of *Murchison* was this:

> A fair trial in a fair tribunal is a basic requirement of due process. Fairness of course requires an absence of actual bias in the trial of cases. But our system of law has always endeavored to prevent even the probability of unfairness. To this end no man can be a judge in his own case and no man is permitted to try cases where he has an interest in the outcome.

349 U.S. at 136, 75 S.Ct. at 625.

Interpreting this broad statement, the Court in *Withrow* expressly distinguished the situation of administrative agencies from the prototypical situation of a judge performing combined functions. "*Murchison* has not been understood," the *Withrow* Court stated, "to stand for the broad rule that the members of an administrative agency may not investigate the facts, institute proceedings, and then make the necessary adjudications." 421 U.S. at 53, 95 S.Ct. at 1467. Indeed, Justice White continued, "[t]he [*Murchison*] Court did not purport to question ... the Administrative Procedure Act." *Id.*

Withrow's qualification of *Murchison's* broad teaching is further illustrated by the Court's treatment of one factual twist in *Withrow* itself. The facts of *Withrow,* briefly stated, were these: one Dr. Larkin had obtained a license to practice medicine in Wisconsin from a state-created Examining Board, composed of practicing physicians. In due course, the Examining Board sent Dr. Larkin a notice that it would hold an investigative hearing, as authorized under state law, to determine whether he had engaged in certain proscribed acts. In the notice, the Board indicated that, based on the evidence to be presented at the investigative hearing, the Board would then decide what action to take, including possibly referring the matter for criminal prosecution or instituting license revocation proceedings.

Dr. Larkin promptly filed an action in federal district court challenging the Board's procedures as violative of the Due Process Clause under the *Murchison* line of authority. In the course of that litigation, the Board was enjoined by the trial court from going forward with its proposed hearing. Faced with that order, the Board went forward, albeit without a hearing, and ***1106 **103** issued formal findings of fact and conclusions of law that probable cause existed to believe Dr. Larkin had violated state law. The findings were then forwarded to the state prosecutor for possible prosecution.

In addressing this aspect of the Board's course of action, the *Withrow* Court flatly rejected the contention that this particular tack showed bias or prejudice on the part of the Board. The Court once again invoked the administrative agency model in language that bears directly on the question Mr. Blinder brings before us:

> It is also very typical for the members of administrative agencies to receive the results of investigations, to approve the filing of charges or formal complaints instituting enforcement proceedings, and then to participate in the ensuing hearings. *This mode of procedure does not violate the Administrative Procedure Act, and it does not violate due process of law.*

Id. at 56, 95 S.Ct. at 1469 (footnote omitted) (emphasis added).

Withrow v. Larkin thus stands as a formidable (if not insurmountable) barrier to Mr. Blinder's due process attack. Undaunted, Mr. Blinder seeks to avoid *Withrow's* pronouncements by suggesting its inapplicability where, as here, the agency chooses first to litigate in federal court, rather than instituting administrative proceedings. We are at a loss to discern a meaningful distinction in the suggested difference. Whether the adversarial proceeding is before an agency-designated ALJ or a federal district court judge, the relationship obviously remains one of adversariness between agency and opponent. Indeed, if anything the difference cuts against Mr. Blinder's position, because he was afforded the not insubstantial advantage of the neutral forum provided by an Article III court, with its attendant procedures and protections (including the rules of evidence and procedure) that may not obtain in an agency adjudication. [7]

7 Mr. Blinder suggests that when the SEC engages in highly publicized litigation of the sort that ensued in Colorado, the resultant placing of "institutional prestige" on the line impermissibly adds to the appearance, if not actuality, of injustice. We reject this argument as well. The concept of "institutional prestige" relied on by petitioners is in severe tension with fundamental premises of the administrative state. One of those premises is that *institutions* may competently perform diverse functions. At the agency level, our law assumes integrity in individual members, and requires direct evidence of bias, or some other personal interest, to overcome that assumption.

Nor does the fact that the Commission considered and rejected Mr. Blinder's offer of settlement alter our analysis. Offers of settlement are in the very nature of the litigation process; common experience tells us that neither consideration nor rejection of an offer of settlement contains within it the inherent likelihood of bias and prejudice. Settlement offers are rejected day in and day out for a multitude of reasons; but rejection of a settlement offer does not suggest prejudgment, much less bias, on the part of an administrative agency. If in *Withrow v. Larkin* the Examining Board's issuance of formal findings of fact and conclusions of law did not suffice to establish bias, then the SEC's rejection here of a settlement offer is even farther away from constitutionally forbidden territory.

Our conclusion in this respect is reinforced by (but by no means conditioned on) the fact that, as Mr. Blinder describes it, only one Commissioner who participated in the order imposing sanctions had participated in the earlier consideration and rejection of the settlement offer. It would be a strange rule indeed that inferred bias on such a tenuous basis, and then presumed that the bias spread contagion-like to infect Commissioners who were not even called upon to consider the settlement offer. To do so would manifest profound disrespect for Congress' deliberately structuring agencies as (typically) multi-member bodies, with staggered terms and with requirements that the President appoint a certain number of members from the political party other than his own. To give credence to Mr. Blinder's dark suspicion of bias notwithstanding this carefully crafted structure would flout what Justice White, in writing for the Court in *Withrow,* called "a ***1107 **104** presumption of honesty and integrity" on the part of those who serve in office. *Id.* at 47, 95 S.Ct. at 1464. [8]

8 Blinder's argument that the SEC must be biased as it continues in litigation with him is but another chapter of the same book. The foundation of his argument is flawed for the reasons already given in the text; the mere fact that litigation goes on hardly suggests that the Commissioners, with their broad ranging areas of responsibility over the wide world of securities markets, have succumbed to bias and prejudice against a single firm and its president.

In short, we believe that Mr. Blinder has failed to heed *Withrow*'s message that a due process challenge directed broadly to combinations of purposes or functions in the modern administrative state "assumes too much." *Id.* at 49, 95 S.Ct. at 1465. As in *Withrow* itself, acceptance of Mr. Blinder's broad due process attack would transmogrify the sensible holding of *Murchison,* [9] and in the process accede precisely to what the Supreme Court has twice warned against, namely a sweeping due process challenge that " 'would bring down too many procedures designed, and working well, for a governmental structure of great and growing complexity.' " *Id.* at 49–50, 95 S.Ct. at 1465–1466, *quoting Richardson v. Perales,* 402 U.S. 389, 410, 91 S.Ct. 1420, 1432, 28 L.Ed.2d 842 (1971).

9 We set aside as inapplicable those cases involving a possible financial interest on the part of a decisionmaker. *See, e.g., Gibson v. Berryhill,* 411 U.S. 564, 93 S.Ct. 1689, 36 L.Ed.2d 488 (1973) (which expressly reserved the issue subsequently addressed in *Withrow v. Larkin*). Indeed, the great

English case cited by Mr. Blinder, *Dr. Bonham's Case,* 8 Eng.Rep. 114a (Com.Pl.1610), involved just such a financial interest. There, in a memorable opinion by Lord Coke, the Royal College of Physicians was prevented from disciplining a doctor if the College had the right to receive any part of the fine. While edifying, *Dr. Bonham's* case and its progeny have no bearing on the issue before us.

Mr. Blinder argues, finally, that the district court in Colorado remains open for the SEC to seek any relief in addition to that which it previously sought and secured in that forum. This is, upon analysis, a policy argument, not one sounding in due process. This is particularly true in the circumstances of this case, where the SEC did not seek to obtain specific sanctions (save for injunctive relief) in district court against Mr. Blinder and his firm. The subsequent administrative proceeding therefore does not, fairly viewed, constitute a second bite at the apple for an agency that had failed to convince an Article III judge of the merits of a particular remedy. Instead, based upon the district court's judgment, the SEC subsequently initiated procedures expressly ordained by Congress in section 15(b)(4). This, we are satisfied, does not run afoul of any values of fundamental fairness embodied in the Due Process Clause. Indeed, to accept petitioners' broadside would do violence to the core value of flexibility (coupled with appropriate procedural protections) that has been the hallmark of the modern administrative process.

Indeed, a moment's reflection suggests that acceptance of Mr. Blinder's claim under the Due Process Clause would do considerable violence to Congress' purposes in establishing a specialized agency to regulate in the difficult and challenging world of financial markets and securities regulation. Ironically, the wisdom of Congress' handiwork is suggested by the brief of Mr. Blinder's own firm, whose words, we believe, aptly capture the considerations informing Congress' policy choice in this respect:

> While courts are best equipped to adjudicate whether statutory violations occurred, Congress believed the SEC's particular expertise would best enable it to choose among available administrative disciplinary sanctions and to discern the interests of the investing public.

Blinder, Robinson Brief at 43 (footnote omitted).

In sum, to accept Mr. Blinder's argument would be to work a revolution in administrative (not to mention constitutional) law, in the face of repeated cautionary signals from the Supreme Court. We decline the invitation to storm the barricades and, instead, content ourselves with following what seems to us the clear teaching of the Supreme Court that a fundamental aspect of the modern administrative state is not ***1108 **105** founded upon a violation of the Due Process Clause.

3. *Fourth Amendment*

Blinder, Robinson devotes a few pages of its brief to the proposition that the SEC's disciplinary sanctions are infected with an underlying Fourth Amendment violation and thus cannot stand. As we understand the point, Blinder, Robinson maintains that the Formal Order of Investigation which led to the initial district court proceeding was unconstitutionally broad. This order, employed by the staff over 17 months after its issuance as the basis for investigating the American Leisure offering, "constituted a broad warrant supposedly authorizing the SEC staff to undertake an investigation, with administrative subpoena power, of a virtually unlimited range of conduct by Blinder, Robinson over an open-ended period of time." Blinder, Robinson Brief at 35. Blinder, Robinson condemns the investigative order as a general grant of surveillance power over the entirety of the firm's activities for an indefinite period of time. This, Blinder, Robinson complains, cannot be countenanced under the Fourth Amendment.

So framed, the argument appears to be an attack on the validity of the Colorado district court injunctive proceeding. And indeed, so it is. As such, it is doomed to fail, for even if the 1978 Formal Order could be viewed somehow as constituting an intrusion for purposes of Fourth Amendment analysis, a proposition which we need not address and with which the Commission emphatically disagrees, we will not entertain this untimely collateral attack on the Colorado proceedings. Those proceedings provided the time and the place for advancing any such claims of illegality; it is simply too late in the day to litigate issues that could have been adjudicated in the courts of the Tenth Circuit. Indeed, the

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record in this hydra-headed litigation reflects that the issue was in fact litigated by Blinder, Robinson in a separate action brought against the Commission and its staff, seeking injunctive and other relief on account of asserted Fourth Amendment violations. That action, the procedural history of which is described in one of the Tenth Circuit's opinions in this litigation, *Blinder, Robinson & Co., Inc. v. SEC,* 748 F.2d 1415, 1417–18 (10th Cir.1984), indicates that twelve days before the SEC filed its complaint in federal district court in Denver, Blinder, Robinson and Mr. Blinder repaired to the same court in an attempted preemptive strike. That litigation ultimately ended with a whimper, namely an appellate determination of mootness, *see id.* at 1418–19. But in the process of resolving that branch of the litigation, the Tenth Circuit squarely rejected petitioners' efforts to litigate the question of the legality of evidence secured pursuant to subpoenas issued under authority of the 1978 Formal Order. The Tenth Circuit put it this way:

> At the trial [of the enforcement action] counsel for Blinder, Robinson did not object to the introduction of evidence obtained through the investigatory order. ...
>
> Even assuming that Blinder, Robinson's attorney's failure to object to the allegedly improper evidence was due solely to the negligence of their counsel rather than to deliberative litigation strategy, this would not constitute a sufficient showing to warrant the extraordinary relief sought.

Id. at 1420.

Those words were penned by our colleagues in the Tenth Circuit almost four years ago. In view of the passage of time, the attack before us is even more tenuous. Stubbornly, Blinder, Robinson maintains (1) that the disciplinary order under challenge in this case is rooted in the decision of the district court in Colorado, and (2) that the latter decision is illegitimately grounded in Fourth Amendment violations. But the foundation of the argument obviously rests on sand, for the Tenth Circuit has, as we have seen, upheld the district court's injunctive order and ruled that Blinder, Robinson can no longer litigate the question of the legality *vel non* of the evidence (or the lawfulness of the 1978 Formal Order itself). We scarcely need remind counsel that this issue litigated fully in the Rockies cannot now be raised on the Eastern Seaboard, ***1109 **106** and indeed that it was utterly inappropriate even to suggest as much.

B

1. *Issue Preclusion*

In addition to the previously discussed constitutional claims, petitioners contend that the Commission erred in upholding the ALJ's exclusion of evidence proffered by the broker-dealer with respect to the firm's reliance (through Meyer Blinder) on counsel. Specifically, as we alluded to in the factual narrative above, Blinder, Robinson sought in the administrative proceeding to adduce the following evidence before the ALJ: (1) testimony of Meyer Blinder concerning the advice given to him by counsel; (2) testimony from one of the principal attorneys concerning the advice given to Mr. Blinder; and (3) when those requests were denied, the introduction of all evidence concerning reliance on counsel that had been before the district court in the Colorado injunctive proceeding.

The requests were denied by the ALJ on grounds of issue preclusion, inasmuch as the issue concerning good faith reliance on counsel had been litigated in the federal district court and resolved adversely to petitioners. The SEC agreed with the ALJ's determination in this respect, stating that "[t]o allow the introduction of such evidence would permit the very relitigation that the doctrine of collateral estoppel is designed to prevent." J.A. at 541.

The SEC is wrong. The issue before the district court in Colorado was manifestly not the question before the SEC in the administrative proceeding. As is readily apparent, the SEC litigated in federal court the question of petitioners' *liability vel non* under the securities laws. Armed with the findings of fact (and the entry of broad injunctive relief) of the district court, the SEC then instituted an entirely different sort of proceeding, namely an administrative proceeding under section 15(b) of the 1934 Act. That proceeding was aimed at reaching a completely different determination than resolving the issue of liability, including the question of "good-faith reliance" on counsel. The precise question in the SEC proceeding was whether sanctions should be imposed "in the public interest." Blinder, Robinson makes the argument well:

> This "public interest" determination is separate from and in addition to the SEC's determination as to the existence of the disqualifying conditions necessary for the

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> imposition of any sanctions. As to sanctions, the *extent* to which petitioners sought the advice of counsel, the *clarity* of the advice, and petitioners' reasons for following or disregarding it, in whole or in part, are highly relevant, *even though the reliance on counsel may not have been sufficient to discharge petitioners from the underlying liability for statutory violations.*

Blinder, Robinson Brief at 39–40 (footnote omitted) (emphasis added).

It is important in this respect to draw a clear distinction between the issue before the district court in Colorado—whether Meyer Blinder relied on counsel so as to establish a good-faith defense to liability—and the obviously related, but nonetheless analytically distinct, matter of the circumstances surrounding the lawyer-client relationship. We are in no way suggesting that Meyer Blinder (and, through him, Blinder, Robinson) is at liberty to relitigate the factual question as to whether there was reliance on counsel. That issue has been conclusively decided against him. As the district court expressly found, counsel advised Mr. Blinder to sticker the prospectus, and he chose to reject that advice.

But saying that, and nothing more, is not to state the whole of what is germane to the SEC in exercising its judgment as to the nature and scope of sanctions that are appropriate in the public interest. Unless the SEC is to adopt a sanctioning regime whereby specific offenses call for certain specific sanctions, it seems inescapable that evidence relevant to a party's *degree* of culpability must be considered in deciding that issue. After all, that was the precise issue in the SEC's section 15(b)(4) proceeding: how culpable was Mr. Blinder? In the district court, the issue was quite different. ***1110 **107** The finding that Mr. Blinder did not rely on counsel's advice does not tell us about the circumstances surrounding the advice given and Meyer Blinder's rejection of it. Indeed, the district court's opinion did not even address the question in great detail.

In the SEC's administrative proceeding, however, questions of degree were singularly relevant. Mr. Blinder's proffer of evidence in that proceeding was not, and could not have been, directed to litigating the issue of reliance on counsel as relevant to establishing a good-faith defense; rather, it related to the wholly different matter of the entirety of the relationship with counsel (including, for example, why the advice was rejected; which attorney's advice was rejected; the precise nature of the various advice given, *e.g.,* was it absolute and unequivocal, or somewhat flexible in nature, or something else).[10] These latter points go to the question of possible mitigation, notwithstanding the definitively resolved issue of liability and the specific factual determination that Mr. Blinder did not rely on counsel's advice.[11]

10 That is to say, counsel might, hypothetically, provide the following sort of advice: "Course 'x' is beyond question permissible under the securities laws and applicable regulations; no other course is 100 percent clearly permitted. To be completely safe, you should follow Course 'x.' " On the other hand, counsel might advise as follows: "It's not overpowering, but a straight-faced argument can be made that Course 'z' is permissible under the securities laws and applicable regulations. I can't imagine that anyone would go to jail for it, but it's likely to be dicey. You're on much surer and safer ground with Course 'x.' I therefore strongly recommend Course 'x.' Why take chances?"
The foregoing are, of course, only two variations on the same theme. In both hypotheticals, counsel advised in favor of Course x, but each hypothetical carries with it its own peculiar set of nuances. Other themes, and manifold variations on each, are readily conceivable. These matters, it seems to us, can only be adequately appreciated and addressed by the expert agency if it has the full set of facts before it.

11 That possibly mitigating evidence exists is manifest. In determining that counsel's ultimate advice was to sticker the American Leisure prospectus, the district court stated, "[w]hile the evidence is conflicting, the more probable and credible testimony is" that counsel advised against the course of action ultimately chosen by petitioners. *See* 542 F.Supp. at 472. Even conceding that this establishes that Mr. Blinder was not presented with *conflicting* advice as to the proper course of conduct, it tells us nothing about the nature of the advice he did receive, and the circumstances surrounding its rejection. These are matters relating to possible mitigation, which

> cannot be foreclosed solely because the district court found that Mr. Blinder rejected counsel's advice. Mr. Blinder's conduct, his attitude, indeed, all of the relevant circumstances present in the rejection of counsel's advice, bear on the degree of sanctions that the SEC, as the expert agency, would reasonably deem to be in the public interest.

Indeed, the strength of petitioners' core argument, that the nature of the administrative proceeding required the SEC to consider evidence relating to Mr. Blinder's degree of culpability, is implicitly conceded by the Commission counsel. As the Commission indicates to us:

> Blinder, Robinson is correct that the district court's judgment is not preclusive as to the issue of what sanctions are required in the public interest.

SEC Brief at 28 n. 38 (citation omitted). Yet that is, in effect, precisely what the Commission held. It approved the ALJ's refusal even to consider evidence concerning the relationship(s) with counsel on the theory that to do so would permit relitigation of issues adjudicated in Denver.

That error is not cured, as the SEC lamely suggests, by permitting petitioners to introduce evidence going to other points, such as "their asserted reformation and cessation of deceptive sales techniques." *Id.* The logical fallacy of the SEC's argument is apparent. Admitting evidence on issues a, b and c obviously does not cure a tribunal's refusal to consider evidence on issue d, unless of course issue d is irrelevant to the question to be resolved. But in this instance that cannot be. The "public interest" standard is obviously very broad, requiring that the Commission consider the full range of factors bearing on the *judgment* about sanctions that the expert agency ultimately must render. In reaching that judgment, questions such as the precise nature and details of counsel's advice, and indeed, the totality of the circumstances surrounding the lawyer-client relationships in question, are undoubtedly relevant. ***1111 **108** Blinder, Robinson captures the point admirably:

> Precluding petitioners in administrative disciplinary proceedings from presenting all evidence relevant to the issue of sanctions—whether or not previously presented to a District Court —would do violence to the considered allocations of adjudicatory responsibilities.... The statutory obligation placed on the SEC to exercise *its* judgment is not satisfied simply by having the SEC adopt the findings of the District Court.

Blinder, Robinson Brief at 43–44.

We agree. To uphold the SEC's decision here would not only blink at its fundamental error in the treatment of petitioners' attempt to introduce evidence relating to the relationship with counsel, but would also do violence to Congress' intent that the SEC exercise its own judgment in these circumstances. In short, the SEC cannot turn a deaf ear to evidence that should, in reason, bear upon the judgment that the Commission is called upon to render. [12]

[12] Our holding in this respect should by no means be interpreted as forcing the SEC to engage in an open-ended inquiry without metes and bounds. It has not been argued to us, and we fail to see how it reasonably could be, that the matter of Blinder, Robinson's relationship with counsel was irrelevant to the choice of sanctions imposed under the securities laws. Be that as it may, nothing that we say should be taken to cabin the broad discretion that agencies such as the SEC enjoy in determining what evidence is germane to the determination of the "public interest."

2. *APA Challenge*

Both petitioners devote considerable energy to attacking the sanctions imposed by the SEC as arbitrarily severe. We have been provided with the following arguments in particular: (1) the SEC subjects over-the-counter firms to disproportionately unfavorable treatment in comparison to Big Board-member firms that similarly run afoul of statutory or regulatory rules and requirements; (2) the SEC, in violation of fundamental requirements of administrative law, failed sufficiently to justify the harsh sanctions visited on petitioners; and (3) the two-year suspension of the firm from

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all underwriting and private placement activities exceeds the maximum period of suspension authorized under section 15(b)(4) of the 1934 Act. Impressive decisional authority is summoned to buttress the first two points, including an opinion by the late Judge Friendly in *Arthur Lipper Corp. v. SEC,* 547 F.2d 171 (2d Cir.1976), *cert. denied,* 434 U.S. 1009, 98 S.Ct. 719, 54 L.Ed.2d 752 (1978), where the Second Circuit set forth a variety of factors to employ in evaluating sanctions imposed by the SEC, and an opinion by our colleagues in the Fifth Circuit in *Steadman v. SEC,* 603 F.2d 1126 (5th Cir.1979), *aff'd* 450 U.S. 91, 101 S.Ct. 999, 67 L.Ed.2d 69 (1981), where the court erected a daunting standard to justify permanent exclusion from the securities industry. ("[P]ermanent exclusion from the industry is 'without justification in fact' unless the Commission specifically articulates compelling reasons for such a sanction." *Id.* at 1140 (footnote omitted)).

The SEC invokes, in response, similarly impressive authority supporting the unquestioned proposition that the crafting of an appropriate remedy is peculiarly within the province of an expert agency, and can appropriately be judicially disturbed only where the remedy is "unwarranted in law or ... without justification in fact...." SEC Brief at 11, *quoting Butz v. Glover Livestock Comm'n Co.,* 411 U.S. 182, 185–86, 93 S.Ct. 1455, 1458, 36 L.Ed.2d 142 (1973). Commission counsel points to the detailed reasons articulated by the SEC in visiting such substantial sanctions on petitioners. The SEC summarizes its position this way:

> Given the district court's findings that petitioners engaged in an on-going series of deliberately fraudulent transactions that included a deceptive sales campaign, arranging non bona fide transactions to give the appearance that the [American Leisure] offering was sold out, misleading their own counsel and then ignoring counsel's advice, violating the escrow agreement, failing to return investors' money as required, and engaging in prohibited trading in the putative aftermarket, ***1112 **109** this conclusion [as to sanctions] should need no further explanation.

SEC Brief at 12.

In the course of recounting petitioners' manifold sins, Commission counsel suggests that the factors on which the *Lipper* court relied are not present here. Among those are the following:

> Unlike Mr. Lipper, petitioners [in this case] did not seek counsel's advice as to the totality of the conduct held to violate the securities laws; and, on the only issue that they did seek advice, their purchase of [American Leisure] securities, they rejected the advice they received.

Id. at 14 (citation omitted). By their own words, then, Commission counsel have indicated the relevance of petitioners' relationship with counsel. Petitioners have been weighed in the balance and found wanting, in part because of their disdain for (or failure to secure) counsel's advice. That failure, as the Commission sees it, plainly related to the conclusion that the American Leisure offering was "permeated with deliberate fraud." *Id.* at 12 (quoting J.A. at 546). But the obvious problem with the SEC's conclusions relating to Mr. Blinder's relationship with counsel is that they assume the Commission had before it the full record germane to determining whether factors such as those emphasized by the *Lipper* court were present. That assumption, for reasons already stated, is ill-founded by virtue of the refusal even to consider potentially relevant evidence.

In brief, we are persuaded that the fundamental principle of administrative law that an agency act in a non-arbitrary, non-capricious fashion is necessarily implicated by the SEC's refusal to permit evidence with respect to a salient factor. That is, in meting out sanctions, the Commission cannot adequately weigh the factors that it concedes should be considered without having before it the full set of facts necessary for reasoned consideration.

Thus, our analysis in this section of the opinion is inevitably affected by the Commission's error, discussed in the preceding section, in refusing to consider evidence relating to the relationship with counsel on grounds of issue preclusion. We will therefore not extend further the length of this opinion,

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which is obviously but another (albeit important) chapter in this long-lived litigation. Instead, we will put down our pen and remand the case to the Commission for further action consistent with this opinion. On remand, the SEC will, of course, be obliged to satisfy the strictures of the APA by articulating an adequate rationale for whatever decision it may reach.

In this regard, we would be less than candid if we did not flag for the Commission our concern that petitioners have mounted a non-frivolous claim that they have been singled out for disproportionately harsh treatment. Petitioners list a series of instances which, they contend, demonstrate that the SEC's hand comes down more heavily on smaller, newer firms than it does on old-line, or at least more established, houses with the "right sort" of exchange memberships. The allegation is thus not simply that penalties have differed from case to case. As the colloquies at oral argument suggested, each case in securities regulation, as elsewhere, is different. Those inevitable differences and gradations in fact can best be discerned and articulated by the Commissioners whose job it is to come to just these sorts of judgments.

But it does not exceed our appropriate function to indicate that we have seen warning signs. What is alleged here are not mere disparities, *see Butz v. Glover Livestock Comm'n Co.,* 411 U.S. 182, 187, 93 S.Ct. 1455, 1458, 36 L.Ed.2d 142 (1973), but rather an asserted *systemic pattern of disparate treatment,* resulting in predictably, disproportionately harsh sanctions being visited upon firms such as Blinder, Robinson. If the Commission believes that the alarms are false, then it should say so and explain why what might appear to be troubling systemic variances are in fact not such variances at all, or, alternatively, variances justified by the circumstances of this ***1113 **110** case.[13] Finally, we emphasize in this respect that the Commission's broad discretion in fashioning sanctions in the public interest cannot be strictly cabined according to some mechanical formula. Nothing that we say suggests in the slightest that the Commission does not enjoy wide latitude in fashioning appropriate sanctions; such latitude is inherent in the Commission's broad grant of power from Congress, and is confirmed by such teachings as the Supreme Court's decision in *Butz.*

13 For example, at oral argument, counsel for the Commission chose not to rely merely upon salutary principles of broad agency discretion. To the contrary, counsel stated that in typical cases involving larger, more established firms, such firms ordinarily took prompt, remedial action so as to remove offending officials or employees from the firm. That sort of admirable internal housecleaning, counsel suggested, is a far cry from this case, where, as we previously indicated, various key officials, not the least of whom is Mr. Blinder himself, continue to be involved in the operation of the firm.
Needless to say, we do not pass judgment on this contention, or other possible explanations for the sanction imposed here. It is obviously too late in the day to accept the *post hoc* explanations of counsel, especially where, as here, the Commission was content to rely on mere boilerplate as to the undoubted breadth of its discretion. *See* Opinion of the Commission at 16 n. 36, J.A. at 551.

A closing observation is in order: Nothing that we have said today should suggest any intent on our part to intrude into the domain of the previous litigation between these parties in the Tenth Circuit. Petitioners stand condemned for serious violations of the securities laws, and we have held today that it is entirely appropriate and lawful for the SEC to carry out its statutory responsibilities in crafting a suitable and appropriate sanction in response to those violations.

But the Commission must do more than say, in effect, petitioners are bad and must be punished. Petitioners do not stand alone; they are, alas, only two in a long line of enterprises and individuals who have seen fit to conduct themselves in violation of the law of the land. It is because of the SEC's experience in dealing with such unhappy matters that it has the sensitive function, ordained by Congress, of deciding petitioners' fate. In this setting, the Commission is not simply rendering a policy judgment; nor is it simply regulating the securities markets; it is, rather, singling out and directly affecting the livelihood of one commercial enterprise and terminating (possibly forever) the professional career of the firm's founder. Faced with a task of such gravity, the Commission must craft with care.[14]

14 It will be apparent to the discerning reader that we have not treated heretofore Blinder, Robinson's contention that the SEC ran afoul of the specific terms of section 15(b)(4) of the 1934 Act, 15 U.S.C. § 78*o* (b)(4), in imposing on Blinder, Robinson a suspension for a period of longer than one year.
The point need not long detain us. Section 15(b)(4) of the Securities Exchange Act, 15 U.S.C. §

78*o* (b)(4), authorizes the SEC to "censure, place limitations on the activities, functions or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer." Blinder, Robinson argues that it is "clear ... on the face of the statute" that this list of sanctions is in "ascending order of severity," Brief for Blinder, Robinson at 21 & n. 50, so that no "limitations" placed on a broker-dealer's activities may exceed twelve months. In support of a one-year maximum, Blinder, Robinson urges that the order of sanctions was changed in a late draft of the 1934 Act, moving the "place limitations" sanction up from the end of the list to its current position. *Id.*

We disagree. The statute itself indicates that Congress full well knows how to express a time restriction: the Commission, when it suspends the registration of a broker-dealer, may not do so for a "period exceeding twelve months." An analogous section of the 1934 Act, 15 U.S.C. § 78s(h)(1), which provides for disciplinary action against industry self-regulatory organizations, contains virtually the same sanctions as section 15(b)(4) in different order: twelve-month suspension, revocation, censure, imposition of limitations. We also observe that the SEC has consistently interpreted section 15(b)(4) to allow limitations of more than one year's duration. *See, e.g.,* Bruce Zimmerman, 46 S.E.C. 509, 513 (1976) (reversing imposition of indefinite limitations on nonstatutory grounds); Joseph H. Gasperini, 32 S.E.C. Dkt. 1842, 1844–45 (1985) (indefinite limitations).

III

For the foregoing reasons, the order of the Commission is vacated and the case is ***1114** ****111** remanded for further proceedings consistent with this opinion.

It is so ordered.

RUTH BADER GINSBURG, Circuit Judge, concurring:

I join most of the court's fine opinion, but write separately to express some misgivings about the last step my colleagues take. I question the propriety of any remand, particularly one missing well-defined "metes and bounds." *See* court's opinion at 1111 n. 12.

The distinction my colleagues draw between "reliance on counsel" and "relationship with counsel," *see* court's opinion at 1110, slips from my grasp. True, different *claims* were at stake in the Colorado district court and before the SEC, so no claim preclusion operates here. I agree too that a degree of reliance sufficient to count as a mitigating factor in an administrative sanctions determination may be insufficient to constitute a good-faith defense in an injunction proceeding.[1] But degree of reliance never enters into the calculus when there was no reliance at all. Every counsel consulted, the Colorado district court found as a matter of fact, advised against the course of action ultimately chosen by petitioners. *See* court's opinion at 1110 n. 11, citing the Colorado district court's fact finding reported in 542 F.Supp. at 472.[2] As the Colorado district court reiterated, petitioners directly received "the advice of the involved attorneys," and then, with "knowledge of the materiality of their conduct, and its potential consequences, they ignored counsel's advice." 542 F.Supp. at 476–77. *See also id.* at 481.

1 This is the sole force of the SEC's remark quoted in the court's opinion:

> Blinder, Robinson is correct that the district court's judgment is not preclusive as to the issue of what sanctions are required in the public interest.

Court's opinion at 1110, quoting SEC Brief at 28 n. 38.

2 The Colorado district court specifically found as fact, after evaluating conflicting evidence, that each counsel had advised Blinder, Robinson it was required by law to sticker the American Leisure prospectus so as to inform investors Blinder, Robinson was itself purchasing the securities it was underwriting. *See* 542 F.Supp. at 472. My colleagues' hypotheticals therefore strike me as inapposite. *See* court's opinion at 1110 n. 10. This was not an instance of counsel advising a client that certain conduct was permissible but dicey; it was a situation in which counsel advised Blinder, Robinson that stickering was *required, i.e.,* that not stickering the prospectus was *im* permissible. Blinder, Robinson did not reject advice that stickering was the better course of conduct; it rejected advice that stickering was the only permissible course of conduct. In that respect, the "precise nature of [each counsel's] advice," court's opinion at 1110, has already been litigated

and determined; issue preclusive effect is therefore warranted.

If Meyer Blinder is not at liberty to urge again that he relied at all on the advice of counsel, then it is difficult for me to comprehend how a "relationship with counsel" can aid his cause. *Arthur Lipper Corp. v. SEC,* 547 F.2d 171 (2d Cir.1976), *cert. denied,* 434 U.S. 1009, 98 S.Ct. 719, 54 L.Ed.2d 752 (1978), is indeed "[i]mpressive decisional authority," *see* court's opinion at 1111, but that case seems to me critically different from the one at hand. Judge Friendly held in *Arthur Lipper* that when securities law violators "act under the supervision of experienced ... counsel," 574 F.2d at 184, SEC sanctions should be mitigated. One who received and "specifically declined to follow" advice of counsel, however, as the Colorado court found Blinder did, 542 F.Supp. at 481, is not largely assisted by precedent sympathetic to a party who acted on counsel's advice. Seeking and then rejecting advice logically should aggravate, not mitigate, blameworthiness.

I note, further, that my colleagues appear to have entrusted to the Commission a comparative analysis obligation heavier than any that has gone before. *See, Butz v. Glover Livestock Comm'n Co.,* 411 U.S. 182, 187, 93 S.Ct. 1455, 1459, 36 L.Ed.2d 142 (1973) ("employment of a sanction within the authority of an administrative agency is ... not rendered invalid in a particular case because it is more severe than sanctions imposed in other cases").

In sum, before returning a case to an agency, I believe a reviewing court has an obligation to specify with great care and ***1115 **112** precision the "metes and bounds" for the remand. My colleagues say they do not mean to "forc[e] the SEC to engage in an open-ended inquiry." Court's opinion at 1111 n. 12. I am uneasy, however, about the less than tight instructions the court's opinion contains concerning 1) the limitations now placed on what petitioners and their able counsel may open up or delve into on remand, and 2) what the Commission must do to justify its sanctions. I fear the court's opinion may be read by petitioners to present not limitations as intended, but an opening to introduce anything and everything arguably "relating to the[ir] relationship with counsel." *See* court's opinion at 1110.

There is in the remand course ordered some risk of confusion,[3] and an opportunity to protract. I take it to be the view of all members of the panel that the Commission, while instructed to "craft with care," court's opinion at 1113, is also to be vigilant to guard against undue protraction and deferral of the final disposition of this case.

3 It should be recalled that petitioners' "fruitless efforts" before the ALJ were, according to petitioners' own description, to introduce evidence concerning Meyer Blinder's "reliance on counsel." *See* court's opinion at 1102 (quoting from Brief for Petitioner Blinder, Robinson & Co. at 7–8). I therefore underscore the court's definitive ruling that the issue whether there was reliance on counsel "has been conclusively decided against [Meyer Blinder]." *See* court's opinion at 1109.

All Citations

837 F.2d 1099, 267 U.S.App.D.C. 96, 56 USLW 2419, Fed. Sec. L. Rep. P 93,588

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Release No. 4362 (S.E.C. Release No.), Release No. 77528, Release No. 34-77528, Release No. IA - 4362, 113 S.E.C. Docket 4525, 2016 WL 1328925

S.E.C. Release No.
Securities Exchange Act of 1934
Investment Advisers Act of 1940

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF ALEXANDER R. BASTRON RESPONDENT.

Administrative Proceeding File No. 3-17196
April 5, 2016

ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS, PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

***1** The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act"), against Alexander R. Bastron ("Respondent" or ""Bastron").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds [1] that:

Summary

1. This failure to supervise case arises out of a fraudulent scheme by Richard P. Sandru ("Sandru"), the principal of an Office of Supervisory Jurisdiction ("OSJ") of and investment adviser representative associated with Cambridge Investment Research Advisors, Inc. ("CIRA"), to misappropriate investment advisory client funds. From at least December 2009 through March 2011, Sandru misappropriated at least $308,850 in purported financial planning fees from at least 47 advisory clients. [2] Bastron was a Regional Director at CIRA and was Sandru's direct supervisor from approximately December 2009 through early June 2010. From March 2010 to June 2010, Bastron failed reasonably to supervise Sandru with a view to preventing his violations of the federal securities laws by failing to implement a heightened supervision plan for Sandru.

Respondent

2. Alexander R. Bastron, age 32, resides in Lakewood, Colorado. Bastron was a Regional Director at CIRA from November 2009 until February 2014. As a Regional Director, Bastron supervised OSJ supervisors and certain other investment adviser representatives who reported directly to the home office. Bastron was also an associated person of Cambridge Investment Research, Inc., a registered broker-dealer. Bastron currently works in recruiting at CIRA and Cambridge Investment Research, Inc. Bastron supervised Sandru from approximately December 2009 through early June 2010.

Sandru's Violations of the Federal Securities Laws

***2** 3. From at least December 2009 through March 2011, while associated with CIRA, Sandru misappropriated at least $308,850 in purported "financial planning" fees from at least 47 advisory clients. In order to bill clients for financial planning services, CIRA representatives were required to complete and submit to CIRA's Compliance Department a Financial Planning Engagement form ("FPE"). The FPE indicated the type of services to be performed, the fee, and contained certain information about the client, including income and net worth. Sandru misappropriated the fees by forging the clients' signatures on or adding costs to the FPEs after the clients had already signed them and without his clients' knowledge or authorization. Sandru failed to provide the financial planning services described in the FPEs.

4. After Sandru either obtained or forged his clients' signatures on the FPEs, he faxed or sent the FPEs to CIRA. After the FPEs were reviewed and approved by CIRA's Compliance department, CIRA's corporate accounting office debited the financial planning fees from the client's account. CIRA then paid Sandru ninety-one percent of these financial planning fees as part of his compensation by directly depositing the funds into Sandru's account.

5. During the relevant period, the fees charged to clients for the purported financial planning services ranged from $500 to $5,000 per FPE. Sandru submitted at least 107 fraudulent FPEs to CIRA. Some clients were charged four or five times over several months for unauthorized and unperformed financial planning services. Some clients were charged as much as ten percent of the value of the assets that they held at CIRA as a result of the fraudulent FPEs. Sandru also reversed financial planning fees on numerous occasions, beginning as early as April 2010.

Background

6. Sandru began negotiating to join CIRA in the spring of 2009. In its background check of Sandru, CIRA found that Sandru had poor credit, including a home in foreclosure. For this reason, CIRA's Department of Advocacy and Supervision recommended that the hiring decision be presented to a special committee. CIRA ultimately decided to allow Sandru to associate with CIRA, and he started as a CIRA investment adviser representative on July 1, 2009.

7. Most CIRA investment adviser representatives are located in branch offices and are supervised directly by a field OSJ supervisor. OSJ principals and certain other investment adviser representatives (usually in solo offices), are supervised by Regional Directors in the Home Office. As the principal of a CIRA OSJ, Sandru's direct supervisors were Regional Directors.

8. In October 2009, Sandru's previous broker-dealer filed an amended Form U5 disclosing that Sandru had been terminated for attempting to settle a complaint directly with a customer. Shortly thereafter, CIRA was notified that FINRA was investigating the matter. As a result, CIRA decided to place Sandru on heightened supervision until the FINRA investigation was completed, with the understanding that Sandru would be terminated if he were suspended by FINRA.

***3** 9. CIRA's Compliance department drafted a heightened supervision or Protective Documentation Plan ("PDP") for Sandru in November 2009. Compliance sent the PDP to Sandru's first Regional Director and supervisor at CIRA, on November 5, 2009.

10. That Regional Director was supposed to sign the PDP, transmit a copy to Sandru, and return the signed PDP to Compliance. However, that supervisor did not perform these tasks and did not place Sandru under heightened supervision. The PDP was not recorded on the spreadsheet kept by Compliance listing the investment adviser representatives who were on heightened supervision, was not included in CIRA's Customer Relationship Management (CRM) system, and no one at CIRA followed up at that time to determine whether Sandru had been placed on heightened supervision.

Bastron's Supervision of Sandru

11. In December 2009, Bastron was assigned to supervise Sandru. At that time, Bastron was not informed that Sandru had poor credit, had been terminated by his previous broker-dealer for attempting to settle a complaint directly with a customer, was being investigated by FINRA, or was supposed to be under heightened supervision.

12. In February 2010, Bastron learned of the FINRA investigation when the State of Utah demanded that, because of the FINRA investigation, Sandru be put on heightened supervision in order to become licensed in Utah. However, Sandru withdrew his application to become licensed in Utah, and Sandru was not placed on heightened supervision at that time.

13. On March 8, 2010, Compliance reported to Bastron that Compliance had concerns about Sandru's financial planning engagements because Sandru was calling Compliance to get it to "push through" certain FPEs on an expedited basis and also that he was charging between $2500 and $5000 for "ongoing portfolio review," which amounts were higher than what was typically seen, and Compliance questioned the reasonableness of the fees. Compliance also informed Bastron about Sandru's credit problems. Later that same day, Compliance suggested that Bastron contact some of Sandru's financial planning clients as part of his heightened supervision of Sandru.

14. After discovering that Sandru was not currently under heightened supervision, on March 10, 2010, Compliance sent Bastron a new PDP. The PDP required Bastron to review and approve each new product application or order; review and approve each new investment adviser client agreement; review all incoming mail and outgoing correspondence weekly; review client account activity monthly; review outside business activities quarterly; contact at least five clients each quarter; review Sandru's credit report, financial statements and personal checking account after six months; and, after six months, prepare a memo regarding the nature and findings of his review for Compliance, which was to be considered along with the status of the FINRA inquiry to help determine the continuation of the PDP.

***4** 15. Bastron, however, never signed the PDP, never sent a copy to Sandru, never returned the PDP to Compliance and failed to implement any of the heightened supervisory procedures set forth in the PDP that were not part of his normal supervisory duties. Among other things, Bastron did not contact any of Sandru's clients.

16. On April 21, 2010, Compliance furnished Bastron with the names of sixteen of Sandru's financial planning clients that were the subject of a Compliance review into Sandru's financial planning activities. By April 21, 2010, thirteen of the sixteen clients had already been fraudulently billed by Sandru for financial planning services. Despite being furnished this list of clients, Bastron did not contact any of Sandru's clients. Had Bastron called five of the clients on the list and asked them about the financial planning fees, it is likely that Sandru's fraud would have been discovered at that time.

17. On June 7, 2010, FINRA sent Sandru a letter indicating that its investigation was concluding with no charges. Based on the letter, CIRA decided to terminate the heightened supervision, which, in fact, had never been implemented.

18. Sandru's fraudulent financial planning billing, which began in at least December 2009, continued until March 2011, resulting in client losses of at least $308,850. During the time that Bastron supervised Sandru, Sandru fraudulently billed 19 clients for $42,100 in financial planning services.

Violations

19. As a result of the conduct described above, Bastron failed reasonably to supervise Sandru, within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing Sandru's violations of Sections 206(1) and 206(2) of the Advisers Act.

Undertakings

20. Bastron undertakes to provide to the Commission within 30 days after the end of the 12-month suspension period described below, an affidavit that he has complied fully with the sanctions described in Section IV below.

IV.

In view of the foregoing, the Commission deems it in the public interest to impose the sanctions agreed to in Respondent Bastron's Offer.

Accordingly, pursuant to Section 203(f) of the Advisers Act and Section 15(b) of the Exchange Act, it is hereby ORDERED that:

A. Respondent be, and hereby is, suspended from association with any broker, dealer, investment adviser, municipal securities dealer or transfer agent in any supervisory capacity for a period of twelve months, effective on the second Monday following the entry of this Order.

B. Respondent shall, within 14 days of the entry of this Order, pay a civil money penalty in the amount of $20,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). Payments shall be deemed made on the date they are received by the Commission and shall be applied first to interest due, if any, which accrues pursuant to 31 U.S.C. § 3717. Prior to making the final payment set forth herein, Respondent shall contact the staff of the Commission for the amount due for the final payment. If Respondent fails to make any payment by the date agreed and/or in the amount agreed according to the schedule set forth above, all outstanding payments due hereunder, including post-order interest, minus any payments made, shall become due and payable immediately at the discretion of the staff of the Commission without further application. Payment must be made in one of the following ways:
***5** (1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or

(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center

Accounts Receivable Branch

HQ Bldg., Room 181, AMZ-341

6500 South MacArthur Boulevard

Oklahoma City, OK 73169

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Payments by check or money order must be accompanied by a cover letter identifying Alexander R. Bastron as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Timothy J. Warren, Associate Regional Director, Chicago Regional Office, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Boulevard Suite 900, Chicago, Illinois 60604.

C. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that in any Related Investor Action, he shall not argue that he is entitled to, nor shall he benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that he shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

D. Respondent shall comply with the undertakings enumerated in Section III above.

By the Commission.
Brent J. Fields
Secretary

1 The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

2 *See Richard P. Sandru*, Advisers Act Rel. No. 3646 (August 12, 2013).

Release No. 4362 (S.E.C. Release No.), Release No. 77528, Release No. 34-77528, Release No. IA - 4362, 113 S.E.C. Docket 4525, 2016 WL 1328925

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Release No. 1400 (S.E.C. Release No.), Release No. ID - 1400, 2020 WL 1699565

S.E.C. Release No.
Initial Decision

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF ASCENSION ASSET MANAGEMENT, LLC, AND GRENVILLE M. GOODER, JR.

Administrative Proceeding File No. 3-19024
April 3, 2020

***1** APPEARANCES:

Joshua E. Braunstein and Luke A.E. Pazicky for the Division of Enforcement, Securities and Exchange Commission [1]
Thomas J. McGonigle, Alexandra J. Marinzel, and Macauley B. Venora of Murphy & McGonigle, P.C., for Ascension Asset Management, LLC, and Grenville M. Gooder, Jr.

Before: Carol Fox Foelak, Administrative Law Judge

SUMMARY

This Initial Decision orders Ascension Asset Management, LLC, and Grenville M. Gooder, Jr., jointly and severally, to pay a civil penalty of $50,000 and censures them.

I. INTRODUCTION

A. Procedural Background

The Securities and Exchange Commission instituted this proceeding with an Order Instituting Proceedings (OIP) on March 7, 2019, pursuant to Section 203(e), (f), and (k) of the Investment Advisers Act of 1940 and Section 9(b) of the Investment Company Act of 1940. On May 7, 2019, the Commission ordered that a hearing be convened before an Administrative Law Judge on September 9, 2019. *Ascension Asset Mgmt., LLC*, Advisers Act Release No. 5230, 2019 SEC LEXIS 1055, at *2. In the interim, the parties filed motions for summary disposition pursuant to 17 C.F.R. § 201.250, on which the undersigned ruled on August 29, 2019, making various findings of fact and conclusions of law. *Ascension Asset Mgmt., LLC*, Admin. Proc. Rulings Release No. 6665, 2019 SEC LEXIS 2290 (Summary Disposition Order). The undersigned held a one-day hearing in Washington, D.C., on September 9, 2019, to take additional evidence on the appropriate sanction, if any. The Division of Enforcement called one witness from whom testimony was taken, Patrick Smith, and Respondents called one, Respondent Gooder, in their case. [2]

The findings and conclusions in this Initial Decision are based on the record. Official notice pursuant to 17 C.F.R. § 201.323 is taken of the Commission's public official records and of Financial Industry Regulatory Authority, Inc., records as well. *See Joseph S. Amundsen*, Exchange Act Release No. 69406, 2013 SEC LEXIS 1148, at *1 n.1 (Apr. 18, 2013), *pet. denied*, 575 F. App'x 1 (D.C. Cir. 2014). Preponderance of the evidence was applied as the standard of proof. *See Steadman v. SEC*, 450 U.S. 91, 96-104 (1981). Pursuant to the Administrative Procedure Act, 5 U.S.C. § 557(c), the following post-hearing pleadings were considered: (1) the Division's Post-Hearing Brief; (2) Respondents' Counter-Proposed Findings of Fact and Conclusions of Law and Post-Hearing Brief; and (3) the Division's Post-Hearing Reply Brief. All arguments and proposed findings and conclusions that are inconsistent with this Initial Decision were considered and rejected.

B. Allegations and Arguments of the Parties

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***2** This Division requests that: Ascension and Gooder be censured and be ordered to cease and desist from further violations, to retain an independent compliance monitor, and to pay a civil penalty. Respondents urge that sanctions are not appropriate in that Respondents have remediated the violations, having even engaged a compliance consultant before the commencement of the Commission's examination that led to this proceeding and implemented the consultant's recommendations, even exceeding legal requirements, for instance by having monthly reviews instead of annual reviews. Respondents note that there is no evidence of client losses or misappropriation of client funds.

C. Procedural Issues

As the Summary Disposition Order stated, Respondents challenged the proceeding on the grounds that: it violates their Seventh Amendment right to jury trial; the presiding Administrative Law Judge is barred from adjudicating it under the Appointments Clause because of improper appointment and unconstitutional removal protections; claims based on conduct occurring prior to March 7, 2014, are barred by the five-year statute of limitations; and the Commission was not authorized to adopt Advisers Act Rule 206(4)-7, one of the rules that Respondents are charged with violating. The Summary Disposition Order denied Respondents' request that the proceeding be dismissed on these grounds. Post-hearing, Respondents reiterate their arguments and request reconsideration. The conclusions set forth in the Summary Disposition Order rejecting these challenges are adopted and incorporated herein. Respondents' objections are preserved for review.

II. FINDINGS OF FACT

A. Previous Findings Incorporated

For purposes of this ID, the findings of fact set forth in the Summary Disposition Order (at *9-15) are deemed true and incorporated herein as follows:

Ascension, located in New York City, registered with the Commission as an investment adviser in June 2004. It provides asset allocation and portfolio management services to high net worth investors, trusts, foundations, and a pension plan, with regulatory assets under management of $152,456,779 as of December 31, 2017. Gooder, a Chartered Financial Analyst, founded Ascension in 2004 after working in the securities industry for about 40 years, including for several SEC-registered investment advisers. Ascension's sole owner and operator, he signed its Forms ADV.

Ascension has been a member since 2005 of the Investment Adviser Association (IAA), which advocates for and provides compliance and educational resources to SEC-registered investment advisory firms. However, Gooder did not read the organization's monthly compliance bulletins and did not attend its training events on compliance issues. Nor did he visit the Commission's website or contact Commission staff for guidance on any investment advisory compliance issues.

Until November 2015, Ascension did not adopt and implement written compliance policies and procedures or conduct annual reviews. Accordingly, Ascension did not have records of these things during that period. Since then, following the initiation of an examination by the Commission's Office of Compliance Inspections and Examinations (OCIE), Ascension has been in compliance with these requirements.

***3** From September 2005 until March 2016, Respondents designated in Ascension's Forms ADV David N. Platt and Patrick L. Smith as Ascension's Chief Compliance Officer (CCO) at different times.

From about 2005, Ascension was an investment adviser to a private fund, which by 2007 had approximately 40 shareholders who collectively invested approximately $4.4 million. Gooder and Platt jointly managed the private fund. From about March 2010 until November 2015, Ascension did not retain an independent accountant to perform an annual audit of the private fund and did not distribute audited financial statements to its investors, nor did it retain an independent public accountant to conduct

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an annual surprise examination to verify the fund's assets.[3] The assets were in the possession of an independent qualified custodian. Since November 2015 the fund has been dissolved.

In or about July 2012, Gooder was named sole trustee of an approximately $5.2 million trust account, and from then through at least December 2015, Ascension was the investment adviser to the trust and received a fee for managing it. The assets were in the possession of an independent qualified custodian. As sole trustee, Gooder had the authority to obtain possession of and to withdraw client funds or securities maintained with a custodian. Through at least December 2015, Ascension did not engage an independent public accountant to conduct an annual surprise examination to verify the trust's assets. Since at least 2016 Ascension did do so.

Respondents concede that Ascension had what they describe as "technical" custody of the assets.[4] Respondents admit that through 2015 Ascension had "technical" custody of assets in the private fund and of at least some of the trust's assets and thus made "mistaken" statements in Forms ADV and in Form ADV brochures through February 2015 that it did not have custody of client assets.

Platt, listed in several Ascension Forms ADV filed between September 2005 and February 2015 as the adviser's CCO, has known Gooder for many years and owned and operated an investment adviser from 1980 to 2017, when he retired from business. He allowed Gooder to list his name as a convenience; Platt was not acquainted with the responsibilities of a CCO, and the two did not discuss it. He did not set up a compliance file, adopt or implement any written compliance policies and procedures, perform an annual review, or take any other action as Ascension's CCO.

Smith, listed in Ascension's Form ADV filed February 10, 2011, as the adviser's CCO, became acquainted with Gooder when both were associated with another investment firm. In 2009, when Smith was considering leaving that firm, Gooder suggested that he start his own firm and offered him shared office space rent-free until he became established. Smith began to pay rent in 2011 but found that he could not sustain it, and both made other arrangements for office space toward the end of 2011.

***4** At most, Gooder mentioned only briefly to Smith that he was naming him CCO: Gooder recalls telling Smith that he was naming him CCO, without, however, discussing the duties and responsibilities involved.[5]

Prior to the OCIE examination, Respondents did not maintain any ledgers reflecting the adviser's assets, liabilities, reserves, capital, income, and expense accounts; rather, Gooder "ran Ascension Asset Management out of a checkbook." At year-end, he listed receipts and disbursements in different categories by hand on pieces of paper to provide to his accountant for tax purposes; he retained some of the papers.

Gooder did not read any IAA bulletins or Commission guidance regarding the custody rule that was published around the time of the 2010 amendment of the rule and did not have an understanding of the requirements of the rule.

B. Additional Findings of Fact

Evidence taken at the hearing focused on what sanctions, if any, are appropriate for the violations. In particular, Respondents introduced evidence to support their argument that their evidence of remediation obviated the need for any sanction and also argued that the evidence was insufficient to show ""willful" violations.

On November 2, 2015, OCIE notified Respondents of an impending examination, to start on December 1. Tr. 85-86; Resp. Ex. 2. Respondents immediately took steps that led to engaging compliance consultants on November 9 and 10. Tr. 86-89; Resp. Exs. 5, 7. The consultants immediately reviewed Ascension's operations, resulting in a compliance policies and procedures manual on November 25. Tr. 90-91; Div. Ex. 3. Respondents have taken a number of steps to remain in compliance. They engage in a monthly review with a compliance consultant or correctly appointed CCO to make sure that their operation is within the guidelines of the manual. Tr. 91-92, 97, 99. They engaged a PCAOB-registered accounting firm, Mazars, for surprise

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audits of the trust as of January 2016. Tr. 96, 111-13; Resp. Exs. 15-18. To assist with books and records, as of February 2016, Respondents hired a bookkeeper who prepares balance sheets, income statements, ledgers, and trial balances. Tr. 93, 114-16; Resp. Exs. 19-20. They responded to OCIE's June 16, 2016, deficiency letter on July 14, 2016. Div. Ex. 95; Resp. Ex. 4. As of and since that date, Ascension was in compliance with the custody rule and remediated the other deficiencies; currently it contracts with a consultant to be CCO. Tr. 95-99, 104-08, 118-19; Resp. Ex. 11.

Respondents spent over $100,000 on compliance - remediating the deficiencies and maintaining a compliance program - from November 2015 to date. [6] Tr. 119-20. Gooder now recognizes the importance of rules regulating investment advisers and intends to continue complying with them "enthusiastically" going forward. Tr. 120.

Ascension currently has assets under management of $160 million. Tr. 79. Most of the clients have been with Ascension or Gooder at his previous firm for ten to twenty years, some as long as forty years. Tr. 82. Ascension has lost no clients or assets under management as a result of the investigation and OIP, which were disclosed on Ascension's Forms ADV. Tr. 118.

III. CONCLUSIONS OF LAW

***5** As concluded in the Summary Disposition Order, Ascension willfully violated and Gooder caused Ascension's violations of Section 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-2 thereunder; Ascension violated and Gooder caused Ascension's violations of Section 204 of the Advisers Act and Rule 204-2 thereunder; and Ascension and Gooder willfully violated Section 207 of the Advisers Act. These conclusions are adopted and incorporated herein.

Respondents argue that their conduct was not reckless, but merely negligent, and thus cannot be "willful," citing *Robare Group v. SEC*, 922 F.3d 468, 480 (D.C. Cir. 2019). The conclusion in the Summary Disposition Order that the conduct was reckless will not be revisited. A fiduciary who had decades of industry experience and who owned and controlled Ascension, Gooder failed to remain informed about compliance requirements - never attending IAA training events, reading IAA bulletins, visiting the Commission's website or otherwise obtaining Commission guidance on investment advisory compliance issues - and designated Platt and Smith as figurehead CCOs who would not undertake any actual compliance responsibilities. This shows that Respondents' conduct was at least reckless, amounting to scienter, and therefore willful. *See id.* at 479. No new evidence has been introduced to revisit that conclusion.

IV. SANCTIONS

The Division requests cease-and-desist orders, an independent compliance monitor, a civil penalty, and censures. As discussed below, a $50,000 civil penalty and censures will be ordered.

A. Sanction Considerations

In determining sanctions, the Commission considers such factors as:

> 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.

Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979) (quoting *SEC v. Blatt*, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)), *aff'd on other grounds*, 450 U.S. 91 (1981). The Commission also considers the age of the violation and the degree of harm to investors

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and the marketplace resulting from the violation. *Marshall E. Melton*, Exchange Act Release No. 48228, 2003 SEC LEXIS 1767, at *4-5 (July 25, 2003). Additionally, the Commission considers the extent to which the sanction will have a deterrent effect. *Schield Mgmt. Co.*, Exchange Act Release No. 53201, 2006 SEC LEXIS 195, at *35 & n.46 (Jan. 31, 2006). As the Commission has often emphasized, the public interest determination extends to the public-at-large, the welfare of investors as a class, and standards of conduct in the securities business generally. *See Christopher A. Lowry*, Investment Company Act Release No. 2052, 2002 SEC LEXIS 2346, at *20 (Aug. 30, 2002), *pet. denied*, 340 F.3d 501 (8th Cir. 2003); *Arthur Lipper Corp.*, Exchange Act Release No. 11773, 1975 SEC LEXIS 527, at *52 (Oct. 24, 1975). The amount of a sanction depends on the facts of each case and the value of the sanction in preventing a recurrence. *See Leo Glassman*, Exchange Act Release No. 11929, 1975 SEC LEXIS 111, at *7 (Dec. 16, 1975).

B. <u>Cease and Desist</u>

***6** Advisers Act Section 203(k) authorizes the Commission to issue a cease-and-desist order against a person who "is violating, has violated, or is about to violate" any provision of the Advisers Act or rules thereunder or who "is, was, or would be a cause of the violation" and "in addition . . . require such person to comply, or take steps to effect compliance, with such provision . . . upon such terms and conditions and within such time as the Commission may specify." 15 U.S.C. § 80b-3(k)(1). Whether there is a reasonable likelihood of such violations in the future must be considered. *See KPMG Peat Marwick LLP*, Exchange Act Release No. 43862, 2001 SEC LEXIS 98, at *101 (Jan. 19, 2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002). Such a showing is "significantly less than that required for an injunction." *Id*. at *114. In determining whether a cease-and-desist order is appropriate, the Commission considers the *Steadman* factors quoted above, as well as the recency of the violation, the degree of harm to investors or the marketplace, and the combination of sanctions against the respondent. *See WHX Corp. v. SEC*, 362 F.3d 854, 859-61 (D.C. Cir. 2004); *KPMG*, 2001 SEC LEXIS 98, at *116.

The violations were recurrent for ten years but ended four years ago, followed by a period of affirmative compliance. Respondents have recognized the wrongful nature of their conduct and given assurances against future violations. They acknowledged the deficiencies in their past conduct in words and action. While the Division argues that they may revert to their previous misconduct unless subject to a cease-and-desist order and monitoring, Respondents' claim to "enthusiastically" embrace compliance is made more credible by their affirmative compliance since November 2015. Thus, a cease-and-desist order will not be issued, and consequently the Division's request that Ascension be ordered to retain an independent compliance monitor for three years will not be granted. [7] Further, while such monitors have been ordered in settled proceedings, the undersigned is unaware of any litigated case in which the Commission itself has ordered a respondent to retain a compliance monitor. [8]

C. <u>Civil Money Penalty</u>

The Division requests that Respondents be ordered to pay a second-tier penalty of $50,000. Sections 203(i) of the Advisers Act and 9(d) of the Investment Company Act authorize the Commission to impose civil money penalties for willful violations of those Acts or rules thereunder. In considering whether a penalty is in the public interest, the Commission may consider six factors: (1) fraud or deliberate or reckless disregard of a regulatory requirement; (2) harm to others; (3) unjust enrichment; (4) previous violations; (5) deterrence; and (6) such other matters as justice may require. *See* 15 U.S.C. §§ 80b-3(1)(3), 80a-9(d)(3); *see, e.g.*, *Anthony Fields, CPA*, Securities Act of 1933 Release No. 9727, 2015 SEC LEXIS 662, at *101-02 (Feb. 20, 2015).

***7** Harm to others and previous violations are absent from the instant case. While the Division argues that Smith was embarrassed by having to explain it to his employer, he did not suffer financial harm, there is no evidence of harm to Respondents' clients, and none was alleged. However, the violations involved a reckless disregard of a regulatory requirement and resulted in unjust enrichment. Respondents argue that there was no unjust enrichment because they received no additional moneys, while the Division points to the expenses that Respondents avoided for over ten years by not paying for compliance services, which cost them $100,000 during the four years after November 2015. The undersigned construes the savings as a form of unjust enrichment for the purpose of the penalty analysis. Deterrence also requires penalties for the violations.

Penalties in addition to the other sanctions ordered are in the public interest. Because Respondents' conduct was reckless, second-tier penalties are appropriate. 15 U.S.C. §§ 80b-3(i)(2)(B), 80a-9(d)(2)(B); *see SEC v. M&A W., Inc.*, 538 F.3d 1043, 1054 (9th Cir. 2008) ("[T]he imposition of second-tier penalties requires an assessment of scienter."). Pursuant to Sections 203(i)(2) of the Advisers Act and 9(d)(2) of the Investment Company Act, for each violative act or omission during the period of violation within the five-year statute of limitations through November 2, 2015, the maximum second-tier penalty for each violation for a natural person is $80,000 and for any other person is $400,000. 17 C.F.R. § 201.1001(a) & tbl. I. For violations after November 2, 2015, the maximum second-tier penalty for each violation for a natural person is $96,384 and for any other person is $481,920. 17 C.F.R. § 201.1001(b); Adjustments to Civil Monetary Penalty Amounts, 85 Fed. Reg. 1833, 1834 (Jan. 13, 2020).

The provisions, like most civil penalty statutes, leave the precise unit of violation undefined. *See* Colin S. Diver, *The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies*, 79 Colum. L. Rev. 1435, 1440-41 (1979).

The events at issue will be considered as one course of action, and the requested $50,000 penalty will be imposed jointly and severally on Ascension and Gooder. Combined with the other sanction ordered, this penalty is in the public interest.

D. Censure

Advisers Act Section 203(e) and (f) authorizes the Commission to censure an investment adviser or associated person who "has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under [the Advisers Act] . . . any statement which was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein." 15 U.S.C. § 80b-3(e)(1), (f). The statute also authorizes the Commission to censure an investment adviser or associated person who has willfully violated any provision of the Advisers Act or rules thereunder. *Id.* § 80b-3(e)(5), (f). The Division requests that Respondents be censured. In combination with the other sanction ordered, censures for Respondents' willful violations are in the public interest. The censures, like the civil penalty, are properly calibrated to punish Respondents for their misconduct and discourage future violations without a need for a cease-and-desist order or an independent monitor. *See Monetta Fin. Servs., Inc.*, Advisers Act Release No. 2438, 2005 SEC LEXIS 2491, at *7-8 (Oct. 4, 2005) (imposing censure and a civil monetary penalty but no cease-and-desist order after weighing the need for deterrence against mitigating factors).

V. RECORD CERTIFICATION

***8** Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), it is certified that the record includes the items set forth in the record index issued by the Secretary of the Commission on January 30, 2020.

VI. ORDER

IT IS ORDERED that, pursuant to Sections 203(i) of the Investment Advisers Act of 1940 and 9(d) of the Investment Company Act of 1940, Ascension Asset Management, LLC, and Grenville M. Gooder, Jr., jointly and severally, PAY A CIVIL MONEY PENALTY of $50,000.

IT IS FURTHER ORDERED that, pursuant to Section 203(e) and (f) of the Investment Advisers Act of 1940, Ascension Asset Management, LLC, IS CENSURED for violating Sections 206(4) and 207 of the Investment Advisers Act of 1940 and Rules 206(4)-7 and 206(4)-2 thereunder; and Grenville M. Gooder, Jr., IS CENSURED for violating Section 207 of the Investment Advisers Act of 1940.

Payment of civil penalties shall be made no later than twenty-one days following the day this Initial Decision becomes final, unless the Commission directs otherwise. Payment shall be made in one of the following ways: (1) transmitted electronically

to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) direct payments from a bank account via Pay.gov through the SEC website at http://www.sec.gov/ofm; or (3) by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order, payable to the Securities and Exchange Commission.

Any payment by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order shall include a cover letter identifying the Respondent[s] and Administrative Proceeding No. 3-19024, and shall be delivered to: Enterprise Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Blvd., Oklahoma City, Oklahoma 73169. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111(h) of the Commission's Rules of Practice, 17 C.F.R. § 201.111(h). If a motion to correct a manifest error of fact is filed by a party, then a party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

***9** Carol Fox Foelak
Administrative Law Judge

Served by email on all parties.

1 Nicholas A. Pilgrim, who previously appeared for the Division, withdrew his appearance on August 9, 2019, and left the Commission's employ on that date.

2 Citations to the transcript will be noted as "Tr. ___." Citations to exhibits offered by the Division and by Respondents will be noted as "Div. Ex. ___" and "Resp. Ex. ___," respectively.

3 These steps were required as of March 12, 2010. *See* Custody of Funds or Securities of Clients by Investment Advisers, 75 Fed. Reg. 1456 (Jan. 11, 2010) (amending Rule 206(4)-2, effective Mar. 12, 2010).

4 This appears to refer to the definition of custody in Rule 206(4)-2(d)(2): "*Custody* means holding, directly or indirectly, client funds or securities, *or having any authority to obtain possession of them* . . . includ [ing] . . . (ii) any arrangement . . . under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian." (second emphasis added; "*Custody*" is italicized in the original). The definition of custody was added in 2003 (then numbered as Rule 206(4)-2(c)(1)). *See* Custody of Funds or Securities of Clients by Investment Advisers, 68 Fed. Reg. 56692-93, 56701 (Oct. 1, 2003) (amending Rule 206(4)-2, effective Nov. 5, 2003).

5 Weighing all the evidence, including Smith's testimony at the hearing, this finding will not be disturbed. As noted in the Summary Disposition Order, Smith testified in a June 2019 deposition that Gooder never talked to him about being CCO and that he was unaware he had been listed as CCO in the February 2011 Form ADV until Commission staff showed him a copy in 2017. Smith reiterated this at the September 9, 2019, hearing. Tr. 46-49. He also testified that he had been under great financial stress, was working a second job seven nights a week, and was sleep deprived. Tr. 47, 53-56. In the June 2019 deposition he testified that for those reasons, his "recollection of [the 2011] time frame is very fuzzy at best."

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Tr. 56-57. Smith has been inconvenienced by the investigation of Respondents in that he had to explain it to his employer (and to travel to the hearing on his wedding anniversary) but has not been demoted or lost any salary. Tr. 49-50, 57.

6 This sum does not include fees spent responding to the investigation and in this proceeding. Tr. 120.

7 The Division also cites Advisers Act Section 203(e), which authorizes the Commission to "place limitations on the activities, functions, or operations" of an investment adviser if "in the public interest" in support of its request that an independent monitor be ordered. 15 U.S.C. § 80b-3(e). In light of the conclusion that the likelihood of future violation is low, it is not in the public interest to impose the expense of an independent monitor on Respondents.

8 There was one litigated case, which the Division cites, in which an administrative law judge ordered a compliance monitor, and based on the request of the parties to declare the decision final on an expedited basis, the Commission did so. *Ernst & Young LLP*, Initial Decision Release No. 249, 2004 SEC LEXIS 831, at *173-78, *182-83 (A.L.J. Apr. 16, 2004), *finality order*, Securities Act of 1933 Release No. 8413, 2004 SEC LEXIS 885 (Apr. 26, 2004).

Release No. 1400 (S.E.C. Release No.), Release No. ID - 1400, 2020 WL 1699565

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Release No. 1388 (S.E.C. Release No.), Release No. ID - 1388, 2019 WL 5513382

S.E.C. Release No.
Initial Decision

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF EUGENE TERRACCIANO

Administrative Proceeding File No. 3-18414
October 22, 2019

***1** APPEARANCES:
Nicholas Margida and Daniel J. Maher for the Division of Enforcement, Securities and Exchange Commission
Gregg J. Breitbart of Kaufman Dolowich & Voluck LLP, for Respondent Eugene Terracciano

BEFORE: Carol Fox Foelak, Administrative Law Judge

SUMMARY

This Initial Decision (ID) suspends Respondent Eugene Terracciano from the securities industry for twelve months.

I. INTRODUCTION

A. Procedural Background

The Securities and Exchange Commission instituted this proceeding with an Order Instituting Proceedings on March 28, 2018, pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, 203(f) of the Investment Advisers Act of 1940, and 9(b) of the Investment Company Act of 1940. On July 6, 2018, pursuant to Terracciano's offer of settlement, the Commission made various findings of fact and conclusions of law, imposed a cease-and-desist order and civil money penalty, and ordered additional proceedings to determine what, if any, "remedial action is appropriate in the public interest." *Eugene Terracciano,* Exchange Act Release No. 83604, 2018 SEC LEXIS 1663, at *20 (Settlement Order). The procedures for the additional proceedings were set with the agreement of the parties. *Eugene Terracciano,* Admin. Proc. Release Nos. 6139, 2018 SEC LEXIS 2733 (A.L.J. Oct. 3, 2018); 6343, 2018 SEC LEXIS 3261 (Nov. 19, 2018); 6458, 2019 SEC LEXIS 178 (A.L.J. Feb. 14, 2019). Accordingly, the Division of Enforcement filed a motion for sanctions, Respondent filed an opposition, and the Division filed a reply. A hearing session, at which Respondent testified, exhibits were admitted into evidence, and the parties presented oral arguments, was held on March 26, 2019. [1]

The findings and conclusions in this ID are based on the record. Official notice pursuant to 17 C.F.R. § 201.323 is taken of the Commission's public official records and of Financial Industry Regulatory Authority, Inc. (FINRA), records as well. *See Joseph S. Amundsen,* Exchange Act Release No. 69406, 2013 SEC LEXIS 1148, at *1 n.1 (Apr. 18, 20*l*3), *pet. denied,* 575 F. App'x 1 (D.C. Cir. 2014). Preponderance of the evidence was applied as the standard of proof. *See Steadman v. SEC,* 450 U.S. 91, 97-104 (1981). All arguments and proposed findings and conclusions that are inconsistent with this ID were considered and rejected.

B. Allegations and Arguments of the Parties

***2** The Division argues that Terracciano should be barred from the securities industry with the right to reapply after two years. Terracciano urges that a lesser sanction, such as a supervisory suspension in the range of twelve months, would be more appropriate in the public interest.

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II. FINDINGS OF FACT

For purposes of this ID and pursuant to the offer of settlement, the findings and facts set forth in the Settlement Order are deemed true and incorporated herein. As detailed in the Settlement Order, the proceeding involves anti-money laundering (AML) failures at Aegis Capital Corporation, a FINRA registered broker dealer and Commission registered investment adviser, by Terracciano, who was the firm's AML Compliance Officer (AML CO) from September 2013 to approximately September 2015. Despite red flags and even despite alerts from Aegis's clearing firm, Aegis failed to file Suspicious Activity Reports (SARs), as required by 31 C.F.R. § 1023.320, on hundreds of suspicious transactions during that period. At most, after being alerted by the clearing firm, Terracciano closed customer accounts after allowing their high-volume questionable transactions in low-priced securities to settle and after becoming aware that no one at Aegis was flagging such transactions despite their raising red flags spelled out in Aegis's written supervisory procedures. [2]

Terracciano was employed in the securities industry in a capacity requiring FINRA (or predecessor) registration starting in 1988. Resp. Ex. 1; Eugene William Terracciano BrokerCheck Report, *available at* http://brokercheck.finra.org (last visited Oct. 11, 2019). His first compliance-related position started in 1995. Tr. 19; Resp. Ex. 1; Terracciano BrokerCheck Report. His last such employment was with Merrill Lynch, Pierce, Fenner & Smith, with which he was registered from November 2015 to January 2017. Tr. 41-45; Resp. Ex. 1; Terracciano BrokerCheck Report. He was let go by Merrill as a result of the investigation that led to this proceeding. Tr. 42-45. He has been unemployed since January 2017. Tr. 17, 50. Since then, he has sought, fruitlessly, employment in the securities industry. Tr. 46-47. None of the positions for which he applied related to AML compliance. Tr. 46. He realizes that if he were barred from the securities industry, even with a right to reapply after a specific time, his career in the securities industry would be over, due to the disincentive to any firm to sponsor him for re-registration. [3] Tr. 49. If he were suspended for a fixed period, he would attempt to reenter the industry as a compliance officer. Tr. 50.

Terracciano initially joined Aegis as a director of compliance; when he was interviewed for the position, there was no mention of AML responsibilities. Tr. 22-23. Soon after his arrival at Aegis, he was asked by the Chief Compliance Officer to be AML CO, which he was reluctant to accept. Tr. 23-24. Eventually he yielded to the importunity of the Chief Compliance Officer, who promised support and training, which never materialized. Tr. 24-26, 31-32, 35-36. Terracciano knew that low-price securities, such as those for which SARs should have been filed, might be used in questionable ways. Tr. 53. Terracciano now realizes that actions that he thought sufficient at the time - closing accounts to stop the activity - were insufficient and not a substitute for filing SARs. Tr. 40. He would not now seek or accept a position with AML reporting responsibilities. Tr. 50. In view of the consequences that he experienced from unwillingly accepting the AML responsibilities at Aegis, his representation that he would not do so again is credible.

III. VIOLATIONS

***3** As stated in the Settlement Order, Terracciano willfully aided and abetted and caused violations by Aegis of Section 17(a) of the Exchange Act and Rule 17a-8 thereunder. Rule 17a-8 requires broker-dealers to comply with the reporting, recordkeeping, and record retention requirements of the Bank Secrecy Act, which include filing SARs, as required by 31 C.F.R. § 1023.320. 17 C.F.R. § 240.17a-8. Failing to file SARs, as required by 31 C.F.R. § 1023.320, is a violation of Exchange Act 17(a) and Rule 17a-8.

IV. SANCTION

The Division requests that Terracciano be barred from the securities industry with the right to reapply after two years, while Terracciano urges a lesser sanction, such as a twelvemonth supervisory suspension. A collateral suspension for a period of twelve months will be ordered. [4]

A. Sanction Considerations

The Commission determines sanctions pursuant to a public interest standard. *See*15 U.S.C. §§ 78***o***(b)(4)(E), 6(A)(i); 80a-9(b)(3); 80b-3(e)(6), (f). The Commission considers factors including:

> the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979) (quoting *SEC v. Blatt,* 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)), *aff'd on other grounds,*450 U.S. 91 (1981). The Commission also considers the age of the violation and the degree of harm to investors and the marketplace resulting from the violation. *Marshall E. Melton,* Advisers Act Release No. 2151, 2003 SEC LEXIS 1767, at *5 (July 25, 2003). Additionally, the Commission considers the extent to which the sanction will have a deterrent effect. *Schield Mgmt. Co.,* Exchange Act Release No. 53201, 2006 SEC LEXIS 195, at *35 &n.46 (Jan. 31, 2006).

B. Sanction

As shown by Terracciano's consent to the Settlement Order as well as his testimony at the hearing, he has recognized the wrongful nature of his conduct. His conduct was recurrent over a period of two years. The egregiousness was somewhat mitigated by his eventually closing accounts that engaged in suspicious transactions. Scienter is not an element of violation of Exchange Act Section 17(a) and rules. However, Terracciano's state of mind was at least negligent, if not reckless. His most recent occupation as a compliance officer in the securities industry, if he were allowed to continue it in the future, would present opportunities for future violations. This factor is mitigated by his credible representation that he would not accept a position involving AML responsibilities. The violation is relatively recent, having ended four years ago. It is not possible to quantify the *direct* harm to the marketplace, but, as the Commission has often emphasized, the public interest determination extends beyond consideration of the particular investors affected by a respondent's conduct to the public-at-large, the welfare of investors as a class, and standards of conduct in the securities business generally. *See Christopher A. Lowry,* Investment Company Act of 1940 Release No. 2052, 2002 SEC LEXIS 2346, at *20 (Aug. 30, 2002), *aff'd,*340 F.3d 501 (8th Cir. 2003); *Arthur Upper Corp.,* Exchange Act Release No. 11773, 1975 SEC LEXIS 527, at *52 (Oct. 24, 1975).[5] Weighing these factors in conjunction with the sanctions ordered in the Settlement Order, the sanction requested by the Division is too severe, but a limited supervisory suspension would not suffice.

***4** A limited supervisory suspension would permit Terracciano to work at a regulated entity under supervision and is insufficient as a sanction and as a deterrent. A "collateral" suspension from the industry is appropriate because record-keeping and reporting provisions apply in all elements of the securities industry, even if the violative conduct is limited to the professional capacity in which Terracciano was acting. *See John W. Lawton,* Advisers Act Release No. 3513, 2012 SEC LEXIS 3855, at *42-43 (Dec. 13, 2012), *vacated in part on other grounds,*Advisers Act Release No. 4402, 2016 SEC LEXIS 1926 (May 27, 2016).

V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), it is certified that the record includes the items set forth in the record index issued by the Secretary of the Commission on May 8, 2019.

VI. ORDER

IT IS ORDERED that, pursuant to Sections 15(b) of the Exchange Act and 203(f) of the Advisers Act, EUGENE TERRACCIANO IS SUSPENDED for a period of twelve months from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization and from participating in an offering of penny stock. [6]

IT IS FURTHER ORDERED that, pursuant to Section 9(b) of the Investment Company Act OF 1940, EUGENE TERRACCIANO IS PROHIBITED for a period of twelve months from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111(h) of the Commission's Rules of Practice, 17 C.F.R. § 201.111(h). If a motion to correct a manifest error of fact is filed by a party, then a party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

***5** Carol Fox Foelak
Administrative Law Judge

Footnotes

1 Citations to the transcript are noted as "Tr. __." Citations to exhibits offered by the Division and Respondent are noted as "Div. Ex. __" and "Resp. Ex. __," respectively.

2 The Settlement Order, 2018 SEC LEXIS 1663, at *708, noted that the written supervisory procedures specified these red flags:

i. There is a sudden spike in investor demand for, coupled with a rising price in, a thinly-traded or low-priced security;

ii. The issuer has been through several recent name changes, business combinations or recapitalizations, or the company's officers are also officers of numerous similar companies;

iii. The issuer's SEC filings are not current, are incomplete, or [are] nonexistent;

iv. The customer appears to be acting as an agent for an undisclosed principal, but declines or is reluctant, without legitimate commercial reasons, to provide information or is otherwise evasive regarding that person or entity;

v. The customer's account has wire transfers that have no apparent business purpose to or from a country identified as a money laundering risk or a bank secrecy haven; and

vi. The customer, for no apparent reason or in conjunction with other "red flags," engages in transactions involving certain types of securities, such as penny stocks … which although legitimate, have been used in connection with fraudulent schemes and money laundering activity.

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3 The Commission has stated that when it "issues an order pursuant to an administrative proceeding which specifically provides that an application for re-entry may be made after a certain time, the applicant may apply directly to the Commission … [and] the Commission upon a proper showing will generally act favorably upon the application." *Applications for Relief from Disqualification,* Exchange Act Release No. 11267, 1975 SEC LEXIS 2166, at *4-5 (Feb. 26, 1975); *see also*17 C.F.R. §§ 201.193(a)(2), 200.30-4(a)(5). The application must include supporting exhibits, including a written statement by the applicant's proposed employer with descriptions of the compliance and disciplinary history of the office and plan for supervising the applicant. 17 C.F.R. § 201.193(b)(4). Commission decisions describe the conditions in granting or denying such applications. *See, e.g., Brett Thomas Graham,* Exchange Act Release No. 84526, 2018 SEC LEXIS 3056 (Nov. 2, 2018); *Michael L. Silver,* Advisers Act Release No. 4691, 2017 SEC LEXIS 1246 (Apr. 26, 2017); *Matthew D. Sample,* Exchange Act Release No. 75893, 2015 SEC LEXIS 3793 (Sept. 10, 2015).

4 The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which became effective on July 22, 2010, provided collateral bars in each of the several statutes regulating different aspects of the securities industry. The conduct that led to the case against Respondents occurred after July 22, 2010. *See Bartko v. SEC,* 845 F.3d 1217 (D.C. Cir. 2017) (holding that a collateral bar cannot be imposed when the violative conduct on which a follow-on proceeding was based ended before the July 22, 2010, effective date of the Dodd-Frank Act). The same reasoning applies to suspensions.

5 The violation did not involve fraud, for which a severe sanction is required because opportunities for dishonesty recur constantly in the securities business. *See Vladimir Boris Bugarski,* Exchange Act Release No. 66842, 2012 SEC LEXIS 1267, at *18 n.26 (Apr. 20, 2012); *Richard C Spangler, Inc.,* Exchange Act Release No. 12104, 1976 SEC LEXIS 2418, at *34 (Feb. 12, 1976).

6 Thus, Terracciano will be suspended from acting as promoter, finder, consultant, or agent; or otherwise engaging in activities with a broker, dealer, or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock, pursuant to Exchange Act Section 15(b)(6)(A), (C).

Release No. 1388 (S.E.C. Release No.), Release No. ID - 1388, 2019 WL 5513382

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2019 WL 7168076 (Conn.Dept.Banking)

Department of Banking

State of Connecticut

IN THE MATTER OF: HORTER INVESTMENT MANAGEMENT, LLC CRD NO. 119880

No. CO-19-14430-S
December 18, 2019

CONSENT ORDER

I. PRELIMINARY STATEMENT

***1 WHEREAS**, the Banking Commissioner ("Commissioner") is charged with the administration of Chapter 672a of the General Statutes of Connecticut, the Connecticut Uniform Securities Act ("Act"), and Sections 36b-31-2 to 36b-31-33, inclusive, of the Regulations of Connecticut State Agencies ("Regulations") promulgated under the Act;

WHEREAS, Horter Investment Management, LLC ("Horter"), located at 11726 Seven Gables Road, Symmes Township, Cincinnati, Ohio 45249, has been an investment adviser registered with the Securities and Exchange Commission (SEC No. 801-67471) from January 12, 2007 to the present, and has filed the notice required by Section 36b-6(e) of the Act since August 25, 2009;

WHEREAS, Daniel Reens (CRD No. 6576660) ("Reens"), an individual residing in Newtown, Connecticut, was registered under the Act as an investment adviser agent of Horter from November 2, 2015 to October 22, 2019. From approximately January 2016 through August 2019, while an investment adviser agent of Horter, Reens was also associated with two entities unrelated to Horter: Safe Harbor Retirement LLC ("Safe Harbor Retirement"), a Connecticut limited liability company that has never been registered under the Act in any capacity, and Safe Harbour LLC (CRD No. 300265) ("Safe Harbour"), an investment adviser registered under the Act since September 27, 2019;

WHEREAS, Robert William Brinkman (CRD No. 1511170) ("Brinkman"), an individual residing in Easton, Connecticut, is the President and Chief Compliance Officer of Safe Harbour and has been a registered investment adviser agent of Safe Harbour since September 27, 2019. Brinkman was also during all relevant times the *de facto* control person of Safe Harbor Retirement. At no time was Brinkman an officer, director or employee of Horter or a person subject to Horter's supervision and control and is thus not a "supervised person" of Horter as defined in Section 202(a)(25) of the Investment Advisers Act of 1940;

WHEREAS, the Commissioner, through the Securities and Business Investments Division ("Division") of the Department of Banking, has conducted an investigation pursuant to Section 36b-26 of the Act into the activities of Horter, to determine whether it has violated, is violating or is about to violate provisions of the Act or Regulations ("Investigation");

WHEREAS, as a result of the Investigation, the Division alleges that from approximately January 2015 to approximately January 2019 Brinkman transacted business as an investment adviser agent of Horter absent registration under the Act. Specifically, 1) Brinkman solicited and referred investment advisory clients to Reens while Reens was an investment adviser agent of Horter; and 2) Reens, in turn and while under the supervision of Horter, paid a portion of the investment advisory fees he earned from Horter from the referred clients to Safe Harbor Retirement and, indirectly to Brinkman. In addition, as a result of the Investigation, the Division ascertained that on January 16, 2019, Horter paid Safe Harbor Retirement, an unregistered entity, $29,337.95 as a solicitation fee;

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***2** **WHEREAS**, Horter had an ongoing duty to supervise Reens during Reens' association with Horter;

WHEREAS, as a result of such Investigation, the Division believes that a basis exists under Section 36b-27 of the Act for the entry of an order to cease and desist and the imposition of a fine against Horter;

WHEREAS, Section 36b-31(a) of the Act provides, in relevant part, that "[t]he commissioner may from time to time make ... such ... orders as are necessary to carry out the provisions of sections 36b-2 to 36b-34, inclusive";

WHEREAS, Section 36b-31(b) of the Act provides, in relevant part, that "[n] o ... order may be made ... unless the commissioner finds that the action is necessary or appropriate in the public interest or for the protection of investors and consistent with the purposes fairly intended by the policy and provisions of sections 36b-2 to 36b-34, inclusive";

WHEREAS, an administrative proceeding initiated under Section 36b-27 of the Act would constitute a "contested case" within the meaning of Section 4-166(4) of the General Statutes of Connecticut;

WHEREAS, Section 4-177(c) of the General Statutes of Connecticut and Section 36a-1-55(a) of the Regulations provide that a contested case may be resolved by consent order, unless precluded by law;

WHEREAS, on September 27, 2019, the Commissioner entered a Consent Order against Safe Harbour and Brinkman, relating in part to Brinkman transacting business as an investment adviser agent of Horter while not registered under the Act (Docket No. CO-19-8416-S);

WHEREAS, on October 22, 2019, the Commissioner entered a Consent Order against Reens relating in part to his payment of a portion of the investment advisory fees he received from Horter to Safe Harbour Retirement (Docket No. CO-19-8537-S);

WHEREAS, Horter expressly consents to the Commissioner's jurisdiction under the Act and to the terms of this Consent Order;

WHEREAS, the Commissioner finds that the entry of this Consent Order is necessary or appropriate in the public interest or for the protection of investors and consistent with the purposes fairly intended by the policy and provisions of the Act;

AND WHEREAS, Horter, through its execution of this Consent Order, specifically assures the Commissioner that the violations alleged in this Consent Order shall not occur in the future.

II. CONSENT TO WAIVER OF PROCEDURAL RIGHTS

WHEREAS, Horter, through its execution of this Consent Order, voluntarily waives the following rights:
1. To be afforded notice and an opportunity for a hearing within the meaning of Section 36b-27 of the Act and Section 4-177(a) of the General Statutes of Connecticut;

2. To present evidence and argument and to otherwise avail itself of Section 36b-27 of the Act and. Section 4-177c(a) of the General Statutes of Connecticut;

3. To present its position in a hearing in which it is represented by counsel;

***3** 4. To have a written record of the hearing made and a written decision issued by a hearing officer; and

5. To seek judicial review of, or otherwise challenge or contest the matters described herein, including the validity of this Consent Order.

III. ACKNOWLEDGEMENT OF THE COMMISSIONER'S ALLEGATIONS

WHEREAS, Horter, through its execution of this Consent Order, and without admitting or denying the Commissioner's allegations, acknowledges the following allegations of the Commissioner:
1. Horter violated Section 36b-6(c)(3) of the Act by engaging an unregistered investment adviser agent; and

2. Horter failed to establish, enforce and maintain a system for supervising the activities of Reens that was reasonably designed to achieve compliance with applicable securities laws and regulations.

WHEREAS, the Commissioner would have the authority to enter findings of fact and conclusions of law after granting Horter an opportunity for a hearing;

AND WHEREAS, Horter acknowledges the possible consequences of an administrative hearing and voluntarily agrees to consent to the entry of the sanctions described below.

IV. CONSENT TO ENTRY OF SANCTIONS

WHEREAS, Horter, through its execution of this Consent Order, consents to the Commissioner's entry of an order imposing on it the following sanctions:
1. No later than the date this Consent Order is entered by the Commissioner, Horter shall remit to the department by cashier's check, certified check or money order made payable to "Treasurer, State of Connecticut" the sum of twelve thousand five hundred dollars ($12,500) as an administrative fine; and

2. Horter, its representatives, agents, affiliates, successors in interest and employees shall cease and desist from engaging in conduct constituting or which would constitute a violation of the Act or any regulation or order under the Act, either directly or through any person, organization or other device, including, without limitation, violating Section 36b-6(c)(3) of the Act.

V. CONSENT ORDER

NOW THEREFORE, the Commissioner enters the following:
1. The Sanctions set forth above be and are hereby entered;

2. Entry of this Consent Order by the Commissioner is without prejudice to the right of the Commissioner to take enforcement action against Horter and/or its affiliates and successors in interest based upon a violation of this Consent Order or the matters underlying its entry if the Commissioner determines that compliance with the terms herein is not being observed;

3. Nothing in this Consent Order shall be construed as limiting the Commissioner's ability to take enforcement action against Horter and/or its affiliates and successors in interest based upon evidence of which the Division was unaware on the date hereof relating to a violation of the Act or any regulation or order under the Act;

4. Horter shall not take any action or make or permit to be made any public statement, including in regulatory filings, any proceeding in any forum or otherwise, denying, directly or indirectly, any allegation referenced in this Consent Order or create the impression that this Consent Order is without factual basis;

***4** 5. Horter shall not take any position in any proceeding brought by or on behalf of the Commissioner, or to which the Commissioner is a party, that is inconsistent with any part of this Consent Order. Nothing in this provision affects Horter's

(i) testimonial obligations; or (ii) right to take a legal or factual position in litigation or other legal proceeding in which the Commissioner is not a party; and

6. This Consent Order shall become final when entered.

So ordered at Hartford, Connecticut, this 18th day of December 2019.

Jorge L. Perez
Banking Commissioner

CONSENT TO ENTRY OF ORDER

I, Drew K. Horter, state on behalf of Horter Investment Management, LLC ("Horter"), that I have read the foregoing Consent Order; that I know and fully understand its contents; that I am authorized to execute this Consent Order on behalf of Horter; that Horter agrees freely and without threat or coercion of any kind to comply with the terms and conditions stated herein; and that Horter consents to the entry of this Consent Order.

Horter Investment Management, LLC
Drew K. Horter
President

2019 WL 7168076 (Conn.Dept.Banking)

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Release No. 4823 (S.E.C. Release No.), Release No. IA - 4823, 118 S.E.C. Docket 955, 2017 WL 6261511

S.E.C. Release No.
Investment Advisers Act of 1940

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF HORTER INVESTMENT MANAGEMENT, LLC, RESPONDENT.

Administrative Proceeding File No. 3-18302
December 8, 2017

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 203(e) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

***1** The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against Horter Investment Management, LLC ("Respondent" or "Horter").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Respondent and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e) and 203(k) of the Advisers Act, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds [1] that:

Summary

1. This matter arises from misstatements made by registered investment adviser Horter to certain of its advisory clients concerning F-Squared Investments, Inc.'s ("F-Squared") materially inflated, and hypothetical and back-tested, performance track record for its AlphaSector strategy.

2. AlphaSector is a sector rotation strategy based on an algorithm that yields a signal indicating whether to buy or sell nine industry exchange-traded funds ("ETFs") that together made up the industries in the S&P 500 Index. Between January 2012 and November 2014, Horter offered the AlphaSector strategy to its clients. Horter's assets under management relating to F-Squared's AlphaSector strategy were approximately $56 million by September 2013.

3. From January 2012 to October 1, 2013, in reliance on F-Squared's false statements, Horter disseminated AlphaSector advertisements falsely stating: (a) assets had been invested in the AlphaSector strategy from April 2001 to September 2008;

and (b) the track record had significantly outperformed the S&P 500 Index from April 2001 to September 2008. In fact, no F-Squared or other client assets had tracked the strategy from April 2001 through September 2008. In addition, F-Squared miscalculated the historical performance of AlphaSector from April 2001 to September 2008 by incorrectly implementing signals in advance of when such signals actually could have occurred. Because of this inaccurate compilation of historical data by F-Squared, Horter advertised the AlphaSector strategy by using hypothetical and back-tested historical performance that was inflated substantially over what performance would have been if F-Squared had applied the signals accurately. As a result, Horter violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder by publishing, circulating, and distributing advertisements that contained untrue statements of material fact.

***2** 4. Horter also violated Sections 204(a) and 206(4) of the Advisers Act and Rules 204-2(a)(16) and 206(4)-7 thereunder by (i) failing to make and keep true, accurate and current records or documents necessary to form the basis for or demonstrate the calculation of the performance or rate of returns that it circulated and distributed, and (ii) failing to adopt and implement written policies and procedures regarding the accuracy of performance information it circulated in advertisements and the retention of books and records necessary to support the basis for such performance information.

Respondent

5. **Horter Investment Management, LLC** (SEC File No. 801-67471) is an investment adviser registered with the Commission since January 2007 and is headquartered in Cincinnati, Ohio. Horter had regulatory assets under management of more than $1 billion as reported in its Form ADV, dated September 13, 2017. [2]

Other Relevant Entity

6. **F-Squared Investments, Inc.** (SEC File No. 801-69937) was an investment adviser that was registered with the Commission from March 2009 until January 2016, and was headquartered in Wellesley, Massachusetts. In October 2008, F-Squared launched its first AlphaSector index. F-Squared sub-licensed its approximately 75 AlphaSector indexes to unaffiliated third parties who managed assets pursuant to these indexes. On December 22, 2014, the Commission instituted a settled fraud action against F-Squared in which F-Squared admitted, among other things, to making the materially false claims that (a) the signals that formed the basis of the AlphaSector index returns had been used to manage client assets from April 2001 to September 2008; and (b) the signals resulted in a track record that significantly outperformed the S&P 500 Index from April 2001 to September 2008. *See In the Matter of F-Squared Investments, Inc.*, Admin. Proceeding No. 3-16325 (Dec. 22, 2014).

Facts

7. In approximately August 2011, F-Squared introduced Horter to its AlphaSector strategies. Horter began considering whether it would enter into a model manager agreement with F-Squared whereby Horter would establish an investment product that followed FSquared's AlphaSector sector rotation strategy. F-Squared marketed AlphaSector to Horter as an ETF sector rotation strategy that was based on an algorithm that yields a "signal" indicating whether to buy or sell nine industry ETFs. [3] If the algorithm produced buy signals for three or fewer sector ETFs, the AlphaSector strategy provided for some or all of the assets to be invested in cash equivalents.

8. F-Squared described the strategy falsely to Horter by, among other things, representing that: (a) the AlphaSector strategy had been used to manage client assets from April 2001 to September 2008, often calling it a "live" track record; and (b) the track record had significantly outperformed the S&P 500 Index from April 2001 to September 2008. In reality, no assets tracked the strategy until 2008 and the back-tested track record was substantially overstated. F-Squared's AlphaSector sales and marketing materials, which it shared with Horter, claimed falsely that clients actually achieved these performance returns for the April 2001 to September 2008 time period.

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***3** 9. In September 2011, Horter entered into a model manager agreement allowing the firm to invest client assets pursuant to the AlphaSector Premium strategy. In December 2011, after reviewing the disclosures in F-Squared's AlphaSector marketing slide presentation, one Horter employee suspected that F-Squared's AlphaSector performance results from April 2001 to September 2008 were back-tested, as opposed to performance resulting from the "live" trading of actual assets. Horter took insufficient steps to determine whether F-Squared's buy or sell signals were generated or used in any trading decisions during the April 2001 through September 2008 period. As a result, Horter knew or should have known that it did not have a reasonable basis to believe that AlphaSector's advertising claims were accurate prior to recommending the AlphaSector strategy to clients.

Horter's Advertisements Contained Misstatements

10. Horter advertised the strategy by incorporating portions of F-Squared's advertisements, including claims concerning the live nature of the track record and the significant outperformance claim, into its own advertisements. Horter then disseminated these advertisements to its clients and prospective clients without having a reasonable basis to conclude that F-Squared's exceptional performance claims between 2001 and 2008 were the result of live trading. For example, from January 2012 through October 1, 2013, Horter, in advertising its own advisory services, disseminated AlphaSector performance advertisements for its own separately managed account strategies that failed to disclose the AlphaSector track record for the period April 2001 to September 2008 was hypothetical and back-tested. In fact, these Horter advertisements described the historical performance of AlphaSector as "not backtested." Horter's AlphaSector advertisements also substantially overstated the performance of the back-tested track record for the strategy during this period based on the false information provided by F-Squared. Horter advised clients to invest in the AlphaSector strategies based on their historical performance. In October 2013, F-Squared notified Horter that F-Squared was removing all performance track records for the time period April 2001 to September 2008. Horter removed the references in its advertising materials to any performance information of F-Squared for periods prior to September 2008. In November 2014, Horter suspended new sales of F-Squared products.

Horter Failed to Adopt and Implement Adequate Policies and Procedures

11. Horter was required to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. As an adviser that often relied on subadviser or other third-party-produced performance and marketing materials, both in hiring or retaining subadvisers and in marketing a subadviser to its own clients or prospective clients, Horter should have adopted and implemented policies and procedures reasonably designed to address the accuracy of such materials. However, Horter had no written policies and procedures for evaluating and monitoring the accuracy of such materials that it provided to other persons. As a result, Horter failed to adopt and implement reasonably designed written policies and procedures regarding the retention of books and records necessary to support the basis for performance information in advertisements directly or indirectly circulated or distributed by Horter.

Horter Failed to Maintain Adequate Books and Records

***4** 12. Horter was required to make and keep true, accurate and current records or documents necessary to form the basis for or demonstrate the calculation of the performance or rate of return that it circulated or distributed to ten or more persons. In marketing its own advisory services, Horter circulated and distributed the 2001-2008 historical performance of the AlphaSector strategy in client presentations and marketing materials and other communications to numerous clients, investors, and potential investors. However, Horter never made or kept records or documents sufficient to form the basis for or demonstrate the calculation of the historical performance or rate of return of the AlphaSector strategy.

Retention of a Compliance Consultant

13. In determining to accept Respondent's Offer, the Commission considered Horter's retention of a compliance consultant in February 2015. Among other things, Horter hired a compliance consultant to conduct a comprehensive review of Horter's written compliance policies and procedures addressing: (i) with respect to separately managed accounts, the publication, circulation,

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communication, or distribution of third-party marketing materials or materials that include third-party-produced performance information, and (ii) with respect to the initial and continuing due diligence into and retention of subadvisers, policies and procedures related to appropriate oversight of subadviser compliance with Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, as appropriate.

Violations

14. As a result of the conduct described above, Respondent willfully[4] violated Section 206(2) of the Advisers Act, which prohibits any investment adviser from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. A violation of Section 206(2) may rest on a finding of simple negligence. *SEC v. Steadman,* 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)). Proof of scienter is not required to establish a violation of Section 206(2) of the Advisers Act. *Id.*

15. As a result of the conduct described above, Respondent willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder, which makes it a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of Section 206(4) of the Advisers Act to, among other things, directly or indirectly publish, circulate, or distribute an advertisement which contains any untrue statement of material fact, or which is otherwise false or misleading. A violation of Section 206(4) and the rules thereunder does not require scienter. *Steadman*, 967 F.2d at 647.

***5** 16. As a result of the conduct described above, Respondent willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder by failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.

17. As a result of the conduct described above, Respondent willfully violated Section 204(a) of the Advisers Act and Rule 204-2(a)(16) thereunder. Section 204(a) of the Advisers Act requires investment advisers to make and keep certain records as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Rule 204-2 under the Advisers Act requires investment advisers registered or required to be registered to make and keep true, accurate and current various books and records relating to their investment advisory business, including all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Horter shall cease and desist from committing or causing any violations and any future violations of Sections 204(a), 206(2), and 206(4) of the Advisers Act and Rules 204-2(a)(16), 206(4)-1(a)(5), and 206(4)-7 thereunder.

B. Horter is censured.

C. Horter shall pay disgorgement of $482,595, prejudgment interest of $46,209, and a civil money penalty in the amount of $250,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Securities Exchange Act of 1934 Section 21F(g)(3), as follows: $194,701 within 10 days of the entry of this Order and the remaining $584,103 to be paid in three payments of $194,701 within 180 days, 270 days, and 360 days of the entry of this Order.

If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and 31 U.S.C. §3717. Payment must be made in one of the following ways:
(1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or

(3) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

***6** Enterprise Services Center

Accounts Receivable Branch

HQ Bldg., Room 181, AMZ-341

6500 South MacArthur Boulevard

Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Horter as the Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Corey A. Schuster, Assistant Director, Asset Management Unit, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549-5012.

D. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that in any Related Investor Action, it shall not argue that it is entitled to, nor shall it benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that it shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.
Brent J. Fields
Secretary

Footnotes

1 The findings herein are made pursuant to Respondent's Offer and are not binding on any other person or entity in this or any other proceeding.

2 Regulatory assets under management include the securities portfolios for which Horter provides continuous and regular supervisory or management services.

3 F-Squared created several AlphaSector strategies and sub-licensed approximately 75 AlphaSector indexes. The AlphaSector Premium index that is the subject of this matter is based on investments in U.S. equity ETFs. As with all indexes, the performance of the AlphaSector Premium Index is inherently hypothetical in the sense that the index does not purport to reflect the performance of any particular client or account. However, the AlphaSector Premium Index was advertised as being based on a strategy that had been in place since 2001 and therefore the performance of this index was advertised as ""not backtested" when in fact the performance *was* back-tested.

4 A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing."' Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting Hughes v. SEC, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts."' Id. (quoting Gearhart & Otis, Inc. v. SEC, 348 F.2d 798, 803 (D.C. Cir. 1965)).

Release No. 4823 (S.E.C. Release No.), Release No. IA - 4823, 118 S.E.C. Docket 955, 2017 WL 6261511

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Release No. 3433 (S.E.C. Release No.), Release No. 66055, Release No. 34-66055, Release No. IA - 3433, 102 S.E.C. Docket 2621, 2011 WL 6541544

S.E.C. Release No.
Securities Exchange Act of 1934
Investment Advisers Act of 1940

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF INVESTMENT PLACEMENT GROUP AND ADOLFO GONZALEZ-RUBIO, RESPONDENTS.

Administrative Proceeding File No. 3-14677
December 23, 2011

SUMMARY

The Securities and Exchange Commission (SEC) accepted an offer of settlement submitted by Investment Placement Group and Adolfo Gonzalez-Rubio. The Commission's complaint alleged, among other things, that IPG and Gonzalez-Rubio failed reasonably to supervise Aurelio Rodriguez. Rodriguez perpetrated a fraudulent interpositioning scheme involving a Mexican investment adviser, InvesTrust. Rodriguez's fraudulent scheme went undetected by IPG due to its failure to establish adequate policies and procedures and a system for implementing those policies and procedures which would reasonably be expected to prevent and detect interpositioning by its traders. As a result, IPG and Gonzalez-Rubio failed to prevent Rodriguez's willful violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 (17 CFR 240.10b-5) thereunder. The Commission ordered IPG be censured and pay a civil money penalty, and Gonzalez-Rubio be suspended from association in a supervisory capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal adviser, transfer agent, or nationally recognized statistical rating organization for a period of three months.

REGULATION
17 C.F.R.240.10b-5

ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e) AND 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940 , MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS

I.

***1** The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Sections 203(e) and 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Investment Placement Group ("IPG") and Adolfo Gonzalez-Rubio ("Gonzalez-Rubio") (collectively "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 15(b) of the Securities Exchange

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Act of 1934 and Sections 203(e) and 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds [1] that:

Summary

These proceedings arise out of the failure reasonably to supervise Aurelio Rodriguez ("Rodriguez"), a former registered representative and trader who engaged in a fraudulent interpositioning scheme. IPG was Rodriguez's employer, and Gonzalez-Rubio, then IPG's chief operating officer, was Rodriguez's direct supervisor. From approximately January through November 2008 ("relevant period"), while Rodriguez was associated with IPG, he perpetrated a fraudulent interpositioning scheme involving a Mexican investment adviser, InvesTrust, and utilizing a separate Mexican brokerage firm. Rodriguez, acting in concert with InvesTrust, violated Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by needlessly interposing the Mexican brokerage firm into securities transactions between IPG and InvesTrust's institutional clients, including four Mexican pension funds. As a result of Rodriguez's misconduct, the pension funds paid approximately $65 million more for certain credit-linked notes than they would have had the Mexican brokerage firm not been unnecessarily interposed as a "middleman." IPG and Rodriguez each received more than $6 million as a result of Rodriguez's fraudulent scheme.

***2** Rodriguez's fraudulent scheme went undetected by IPG due to its failure to establish adequate policies and procedures and a system for implementing those procedures which would reasonably be expected to prevent and detect interpositioning by its traders. During the relevant period, Gonzalez-Rubio was directly responsible for supervising Rodriguez and overseeing the trading room. Gonzalez-Rubio, however, delegated supervisory oversight of the trading to Rodriguez, which effectively allowed Rodriguez to supervise himself. Further, Gonzalez-Rubio failed to respond to red flags regarding Rodriguez's fraudulent scheme, including a dramatic rise in revenue resulting from the interpositioned transactions. As a result, IPG failed reasonably to supervise Rodriguez within the meaning of Section 15(b)(4)(E) of the Exchange Act and Section 203(e)(c) of the Advisers Act. As a result, Gonzalez-Rubio failed reasonably to supervise Rodriguez within the meaning of Section 15(b)(4)(E) as incorporated by Section 15(b)(6) of the Exchange Act and Section 203(e)(c) of the Advisers Act.

Respondents

1. **Investment Placement Group** is a California corporation with its principal place of business in San Diego, California. It has been registered with the Commission as a broker-dealer since 1991 and as an investment adviser from January 2006 until June 2010, when it withdrew its registration. IPG is owned, directly or indirectly through family trusts, by several individuals associated with the firm. In February 2010, IPG's owners registered a new entity called IPG Investment Advisors, LLC as an investment adviser with the Commission.

2. **Adolfo Gonzalez-Rubio**, age 49, resides in Coronado, California. He joined IPG in 1990 and has since held positions of increasing responsibility. During the relevant period, he was IPG's chief operating officer, directly responsible for supervising Rodriguez and overseeing the trading room. In 2009, Gonzalez-Rubio became IPG's chief executive officer, a position he currently holds. He currently owns 26% of the firm.

Other Relevant Person

3. **Aurelio Rodriguez**, age 42, formerly of Coronado, California, currently resides in Zapopan, Mexico. Rodriguez is not currently associated with a registered broker-dealer. Rodriguez was a registered representative with IPG from 1995 until November 12, 2010, when he resigned from the firm.

Background

4. In 2001, an IPG registered representative approached IPG with a proposal from InvesTrust. In exchange for placing institutional client trades through IPG and referring clients, InvesTrust would receive 70% of the markups that IPG earned from trading by InvesTrust's institutional clients. IPG agreed to the proposal and opened a separate proprietary trading account with its clearing firm ("IPG Proprietary Account") through which Rodriguez executed principal trades on behalf of IPG, with IPG acting as a counterparty to InvesTrust's institutional clients. The remaining 30% of the markups earned in the IPG Proprietary Account would be split evenly among the registered representative, IPG, and Rodriguez.

***3** 5. Between 2001 through 2007, InvesTrust invested primarily in Mexican government and corporate bonds and steadily increased the size and number of institutional trades it placed through IPG. Beginning in 2008, InvesTrust invested its pension fund clients in credit-linked notes, dramatically increasing the number trades it placed through IPG. By this time, InvesTrust had also increased its share of the markups generated from these trades to 75%, with the registered representative, IPG, and Rodriguez splitting the remaining 25% equally.

The Interpositioning Scheme

6. From January through November 2008, Rodriguez, acting in concert with InvesTrust, acquired ten different credit-linked notes in the IPG Proprietary Account. Rodriguez knew that the notes were slated for InvesTrust's pension fund clients. IPG, through Rodriguez, added a markup of roughly 1.5% to 4.5% to the purchase price, and then sold the notes to the Mexican brokerage firm. Within a day or so, IPG, through Rodriguez, repurchased the notes from the Mexican brokerage firm (at a slightly higher price), added another markup, and then sold the securities to InvesTrust's pension fund clients. In some instances, Rodriguez repeated the buy/sell pattern with the Mexican brokerage firm multiple times, driving up the price with each successive trade, before finally selling the notes to the pension funds at artificially inflated prices.

7. For each transaction, InvesTrust specified in advance the trade date, the amount of securities to be bought and sold by IPG and the Mexican brokerage firm, the successively higher prices to be paid (and thus the markup to be charged on each trade), and the final price to be paid by its pension fund clients. Rodriguez received the instructions for the fraudulent transactions from InvesTrust at his San Diego, California office. From there, he confirmed the order with the Mexican brokerage firm via e-mail and then submitted the principal trade electronically to IPG's U.S.-based clearing firm for processing.

8. Beginning in July 2008, the number of interpositioned trades between IPG and the Mexican brokerage firm increased as the pension funds purchased new credit-linked notes. The interpositioning scheme added about 12% to 14% to the cost of four new notes the pension funds purchased from IPG between July and November 2008.

Failure Reasonably to Supervise Rodriguez

9. IPG failed reasonably to supervise Rodriguez because it did not establish adequate policies and procedures and a system to implement the procedures which would reasonably be expected to prevent and detect Rodriguez's fraudulent interpositioning scheme. IPG's written supervisory procedures ("WSP") listed interpositioning as a prohibited activity but only summarily stated that "[a] trader may not interpose IPG or any account or any other dealer between a customer order and the best available market." Aside from this statement in the WSP, IPG failed to establish sufficient procedures for reviewing transactions in the IPG Proprietary Account, where Rodriguez executed the InvesTrust trades, to monitor for suspicious trading, such as interpositioning. If IPG had procedures that required periodic supervisory review of transactions in the IPG Proprietary Account, the firm could have reasonably discovered that Rodriguez was interposing the Mexican brokerage firm between IPG and the ultimate purchasers of the securities, thereby generating millions in improper markups.

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***4** 10. During the relevant period, Gonzalez-Rubio, IPG's chief operating officer, was directly responsible for supervising Rodriguez and overseeing the trading room. GonzalezRubio failed reasonably to supervise Rodriguez with a view towards preventing Rodriguez's antifraud violations because he unreasonably delegated oversight of activity in the IPG Proprietary Account to Rodriguez, which resulted in Rodriguez effectively supervising himself. Gonzalez-Rubio knew that no one except Rodriguez executed trades for InvesTrust. While in response to Gonzalez-Rubio's daily inquiries, Rodriguez repeatedly assured Gonzalez-Rubio verbally that everything was fine with InvesTrust, Gonzalez-Rubio did not independently review InvesTrust's overall trading activity in the IPG Proprietary Account. As a result, Rodriguez was able to use the IPG Proprietary Account to carry out the interpositioning scheme and charge additional markups without detection.

11. Gonzalez-Rubio also failed reasonably to supervise Rodriguez because he failed to respond to red flags that could have led to discovery of Rodriguez's misconduct. These red flags included: (a) a dramatic increase in IPG's 2008 revenues, 78% of which was derived from the additional markups that IPG earned from the interposed trades; and (b) Gonzalez-Rubio's discovery in August 2008 that InvesTrust had been receiving 70% of the markups in the IPG Proprietary Account generated from trades by InvesTrust's institutional clients; and (c) InvesTrust's insistence that its share of the markups be deposited directly into a foreign bank account held in name of a related Nevis-based entity, rather than into U.S. bank accounts, as had been its prior practice. Had Gonzalez-Rubio responded to these red flags, it is likely that he could have prevented and detected Rodriguez's antifraud violations.

Violations

12. As a result of the conduct described above, Rodriguez willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase, or sale of securities.

13. Section 15(b)(4)(E) of the Exchange Act allows for the imposition of a sanction against a broker or dealer who "has failed reasonably to supervise, with a view to preventing violations of the securities laws, another person who commits such a violation, if such other person is subject to his supervision." The Commission has emphasized that the "responsibility of broker-dealers to supervise their employees by means of effective, established procedures is a critical component in the federal investor protection scheme regulating the securities markets." See, e.g., Gilford Sec., Inc., et al., Securities Act Rel. No. 9264, 2011 SEC LEXIS 3419 (Sept. 30, 2011). Section 15(b)(6) incorporates by reference Section 15(b)(4)(E) and allows for the imposition of sanctions against persons associated with a broker or dealer for failing reasonably to supervise. Similarly, Sections 203(e) and 203(f) of the Advisers Act authorize the Commission to sanction an investment adviser or person associated with an investment adviser for failure to supervise. The Commission has repeatedly emphasized that the duty to supervise is a critical component of the federal regulatory scheme. See, e.g., Thomas C. Palmer and Aeneas Capital Mgmt., L.P., Advisers Act Rel. No. 1693, 2008 SEC LEXIS 1693 (July 23, 2008).

***5** 14. As a result of the conduct described above, IPG and Gonzalez-Rubio failed reasonably to supervise Rodriguez with a view to detecting and preventing Rodriguez's willful violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

IPG's Remedial Efforts

15. In determining to accept the Offers, the Commission considered remedial acts promptly taken by the Respondents and the cooperation afforded the Commission staff.

Undertakings

16. IPG has undertaken to review its policies, procedures, and systems regarding the detection and prevention of interpositioning violations. Within ninety days of the entry of this Order, unless otherwise extended by the staff of the Commission for good

cause shown, IPG shall submit a report to the Commission describing the review performed and the conclusions and changes made as a result of this review. Further, at the time that IPG submits the report, IPG shall certify to the Commission in writing that it has established procedures, and a system for applying such procedures, which are reasonably expected to prevent and detect, insofar as practicable, the violations described in this Order.

17. Gonzalez-Rubio has undertaken to provide to the Commission, within 15 days after the end of the three-month suspension period described below, an affidavit that he has complied fully with the sanctions described in Section IV below.

18. IPG undertakes to cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in this Order. In connection with such cooperation, IPG has undertaken:
a. To produce, without service of a notice or subpoena, any and all documents and other information reasonably requested by the Commission's staff, with a custodian declaration as to their authenticity, if requested;

b. To use its best efforts to cause IPG's current and former employees to be interviewed by the Commission's staff, at the option of the staff with representatives of other government agencies present, at such times and places as the staff reasonably may direct. Live interviews on one week's notice at the Commission's Los Angeles office, or at any U.S or state government office in San Diego, California, and telephone interviews on 72 hours notice, at the option of the staff, shall be deemed to be reasonable.

c. To use its best efforts to cause IPG's employees to appear and testify truthfully and completely without service of a notice or subpoena in such investigations, depositions, hearings or trials as may be reasonably requested by the Commission's staff; and

d. In connection with any interviews of IPG employees to be conducted pursuant to this undertaking, requests for such interviews may be provided by the Commission's staff to Sean T. Prosser, Morrison & Foerster LLP, 12531 High Bluff Drive, Suite 100, San Diego, CA 92130-2040, or such other counsel that may be substituted by IPG.

***6** In determining whether to accept the Offers, the Commission has considered IPG's undertakings.

19. IPG undertakes to certify, in writing, compliance with the undertaking(s) set forth above. The certification shall identify the undertaking(s), provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and IPG agrees to provide such evidence. The certification and supporting material shall be submitted to Michele Wein Layne, Associate Regional Director, Los Angeles Regional Office, Securities and Exchange Commission, 5670 Wilshire Boulevard, 11th Floor, Los Angeles, CA 90036, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of the undertakings.

IV.

In view of the foregoing, the Commission deems it appropriate, and in the public interest, to impose the sanctions agreed to in Respondents' Offers.

Accordingly, pursuant to Section 15(b) of the Exchange Act and Sections 203(e) and 203(f) of the Advisers Act, it is hereby ORDERED that:

A. Respondent IPG is censured.

B. Respondent IPG shall, within 30 days of the entry of this Order, pay a civil penalty in the amount of $260,000 to the United States Treasury. It is further ordered that Respondent IPG shall pay disgorgement of $3,572,015.56 and prejudgment interest of $240,012.37 to the United States Treasury. Payment shall be made in the following installments. Respondent IPG shall, within

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30 days of the entry of the Order, pay $1,000,000. The remaining balance of $2,812,027.93, plus post-judgment interest pursuant to SEC Rule of Practice 600, shall be paid in sixteen (16) equal installments. Each installment shall be due within ten (10) days after the end of the quarter for the sixteen (16) quarters following the entry of this Order.

C. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of disgorgement, prejudgment interest, and civil penalties, plus any additional interest accrued pursuant to SEC Rule of Practice 600 or pursuant to 31 U.S.C. §3717, shall be due and payable immediately, without further application. Payment shall be: (A) made by wire transfer, United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Securities and Exchange Commission, Office of Financial Management, 100 F St., NE, Stop 6042, Washington, DC 20549; and (D) submitted under cover letter that identifies IPG as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Michele Wein Layne, Associate Regional Director, Securities and Exchange Commission, 5670 Wilshire Blvd., Suite 1100, Los Angeles, CA 90036.

***7** D. Respondent IPG shall comply with the undertakings enumerated in Section III, Paragraphs 16 and 19, above.

E. Respondent Gonzalez-Rubio be, and hereby is, suspended from association in a supervisory capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal adviser, transfer agent, or nationally recognized statistical rating organization for a period of three (3) months, effective on the second Monday following the entry of this Order.

F. Respondent Gonzalez-Rubio shall comply with the undertaking enumerated in Section III, Paragraph 17, above.

By the Commission.
Elizabeth M. Murphy
Secretary

1 The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

Release No. 3433 (S.E.C. Release No.), Release No. 66055, Release No. 34-66055, Release No. IA - 3433, 102 S.E.C. Docket 2621, 2011 WL 6541544

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Release No. 4225 (S.E.C. Release No.), Release No. IA - 4225, 112 S.E.C. Docket 3701, 2015 WL 5935519

S.E.C. Release No.
Investment Advisers Act of 1940

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF JAMES T. BUDDEN AND ALEXANDER W. BUDDEN, RESPONDENTS.

Administrative Proceeding File No. 3-16892
October 13, 2015

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER

I.

***1** The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") against James T. Budden ("J. Budden") and Alexander W. Budden ("A. Budden") (collectively, "“Respondents").

II.

In anticipation of the institution of these proceedings, Respondents each have submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds [1] that:

SUMMARY

Respondents failed reasonably to supervise Douglas E. Cowgill ("Cowgill"), the former Chief Compliance Officer ("CCO") of Professional Investment Management, Inc. ("PIM"), an investment adviser registered with the Commission, within the meaning of Sections 203(e)(6) and 203(f) of the Advisers Act, with a view to preventing and detecting Cowgill's violations of the federal securities laws. Cowgill violated several antifraud provisions of the federal securities laws by misappropriating more than $840,000 in client assets. Respondents also caused [2] PIM to violate Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder (the "Compliance Rule"). J. Budden further caused PIM to violate Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder (the "“Custody Rule").

RESPONDENTS

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1. **James T. Budden**, age 73, is a former 50.2% shareholder of PIM. J. Budden was the President and a Director of PIM from approximately 1973 through approximately July 22, 2013, the date he sold all of his interest in PIM to Cowgill. While associated with PIM, J. Budden supervised several employees, including Cowgill. J. Budden resides in Columbus, Ohio.

***2** 2. **Alexander W. Budden**, age 68, is a former 48.7% shareholder of PIM. A. Budden was the Vice President and Secretary and a Director of PIM from approximately April 1981 through approximately July 22, 2013, the date he sold all of his interest in PIM to Cowgill. While associated with PIM, A. Budden supervised several employees, including Cowgill. A. Budden resides in Cleveland, Ohio.

OTHER RELEVANT PARTIES

3. **Professional Investment Management, Inc.** is an Ohio corporation with its principal place of business in Columbus, Ohio. At all times relevant to this proceeding, PIM was owned by J. Budden (50.2%), A. Budden (48.7%), and Cowgill (1.1%). PIM was registered with the Commission as an investment adviser from 1978 through September 30, 2013. PIM reregistered with the Commission on June 24, 2014. PIM provides third-party administration services and investment advisory services to approximately fifteen retirement plan clients (which consist of approximately 325 participants who, in turn, own approximately 425 individual retirement accounts that PIM advises), and also provides investment advisory services to approximately twenty-five individual clients for their own (non-retirement plan) accounts. PIM has approximately $120 million of regulatory assets under management, and has custody of client assets through three omnibus accounts. PIM has been operating under the control of a courtappointed receiver since on or about May 15, 2014.

4. **Douglas E. Cowgill**, age 60, began working for PIM in July 1981. Cowgill became the sole owner and President of PIM on or about July 22, 2013, when he purchased all of Respondents' interest in PIM. Cowgill remained the President of PIM until on or about May 15, 2014, when a court-appointed receiver took control of PIM. Cowgill resides in Columbus, Ohio.

5. The Commission filed suit against Cowgill and PIM in the United States District Court for the Southern District of Ohio on April 29, 2014 in *Securities and Exchange Commission v. Douglas E. Cowgill, et al.,* Case No. 2:14-CV-396, alleging that Cowgill and PIM violated the antifraud provisions of the U.S. securities laws by hiding a shortfall of more than $700,000 in client assets by sending false account statements to clients, and that PIM violated, and Cowgill aided and abetted and caused PIM's violations of, the registration provisions of the Advisers Act, and the Custody Rule. The Commission filed an Amended Complaint on August 7, 2014 that included additional counts against Cowgill and PIM. On August 21, 2014, the Court entered a Judgment by Consent against Cowgill as to all counts asserted in the Amended Complaint and permanently restrained and enjoined Cowgill from violating and/or aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder, Sections 203(a), 204(a), 206(1), (2), and (4), and 207 of the Advisers Act, and Rules 204-2, 206(4)-2, and 206(4)-7 thereunder.

***3** 6. On September 8, 2014, the Commission entered an order barring Cowgill from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

7. On July 2, 2015, a Grand Jury sitting in the United States District Court for the Southern District of Ohio indicted Cowgill in *United States v. Cowgill,* Case No. 2:15-CR-160, on thirteen counts of wire fraud, five counts of engaging in monetary transactions in property derived from specified unlawful activity, two counts of theft or embezzlement from an employee benefit plan counts, and one count of perjury. Each of these counts stemmed from the conduct alleged in the Commission's civil lawsuit against Cowgill. Cowgill's criminal matter is ongoing.

FACTS

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Failure to Supervise Cowgill

8. At all times from July 1981 through approximately July 22, 2013, Cowgill reported to Respondents and Respondents were Cowgill's supervisors. For instance, Respondents promoted Cowgill from Accounting Clerk to Vice President and Treasurer in 1983, and designated Cowgill as PIM's CCO on or about September 28, 2004.

9. As explained above, the United States District Court for the Southern District of Ohio entered an order on August 21, 2014 in *Securities and Exchange Commission v. Douglas E. Cowgill, et al.* that permanently restrained and enjoined Cowgill from violating and/or aiding and abetting violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 203(a), 204(a), 206(1), (2), and (4), and 207 of the Advisers Act, and Rules 204-2, 206(4)-2, and 206(4)-7 thereunder.

10. Respondents failed to adopt or implement any policies or procedures regarding their supervision of Cowgill. In fact, Respondents merely assumed, without ever confirming, that Cowgill performed his responsibilities in compliance with the federal securities laws. [3]

Violations of the Compliance Rule

11. After Respondents designated Cowgill as PIM's CCO, they never provided any funding, training, or resources to support Cowgill in the CCO role.

12. Respondents, as the majority owners of PIM and as required by the Compliance Rule, participated in annual compliance reviews with Cowgill in 2004, 2006, and 2007. [4] Respondents knew or should have known that Cowgill stopped performing compliance reviews after 2007, but took no steps to ensure that Cowgill or anyone else at PIM resumed conducting compliance reviews at least annually after 2007.

13. Respondents took no steps to ensure that PIM was complying with the federal securities laws after 2007, and did nothing after 2007 to ensure that Cowgill carried out his responsibilities as PIM's CCO.

14. Respondents did not ensure that PIM established policies or procedures to prevent client assets from being misappropriated via checks or wire transfers or to ensure that client statements were reviewed for accuracy. No such policies or procedures were ever established at PIM. During the period 2008 through 2013, Cowgill secretly wrote numerous checks and initiated numerous wire transfers from PIM's client asset-holding bank account and sent false account statements to PIM's clients to hide his misappropriation of client assets.

Violations of the Custody Rule

***4** 15. At all relevant times, PIM maintained client funds in an omnibus checking account held on an agency basis at Custodian 1, and client securities in two omnibus accounts held on an agency basis at Custodian 2 and Custodian 3. All client funds were initially deposited into the omnibus checking account held at Custodian 1. PIM then transferred these client funds for investment to various firms, including Custodians 2 and 3. PIM had custody of all of the client assets held at Custodian 1, 2, and 3 because it had the authority to obtain possession of these assets.

16. Each year from 1999 to 2009, J. Budden had, as required by the Custody Rule, engaged an independent accountant on behalf of PIM to conduct annual surprise examinations to verify all client assets of which PIM had custody and required the accountant to file Form ADV-E with the Commission within a prescribed amount of time. J. Budden delegated that responsibility to Cowgill during the summer of 2009 after J. Budden had engaged the accountant in May 2009 to perform the 2009 annual surprise examination. J. Budden continued to supervise Cowgill during this time period, but did not follow up with Cowgill to ensure that Cowgill had fulfilled this responsibility.

17. J. Budden knew from past experience that, in order to comply with the Custody Rule, PIM was obligated to, among other things, require the accountant to file Form ADV-E with the Commission. Cowgill failed to require PIM's accountant to file Form ADV-E with the Commission in connection with the 2009 surprise examination, and J. Budden did nothing to ensure that that Cowgill had done so. J. Budden did nothing to confirm that Form ADV-E had been filed with the Commission or that PIM had complied with the Custody Rule in 2009. PIM violated the Custody Rule in 2009 by failing to ensure that the accounting firm filed with the Commission Form ADV-E.

18. Cowgill engaged these same accountants in 2010 and again in 2011 to perform annual surprise examinations in accordance with the Custody Rule. Cowgill did not cooperate with the accounting firm, and, ultimately, the accounting firm did not complete either of these annual surprise examinations. J. Budden did nothing to confirm that these annual surprise examinations had been completed, that Form ADV-E had been filed with the Commission in connection with either of these annual surprise examinations, or that PIM had complied with the Custody Rule in 2010 and 2011. PIM violated the Custody Rule in 2010 and 2011 by failing to have annual surprise examinations completed in each of those years.

19. Cowgill did not engage any accountants in 2012 to perform an annual surprise examination in accordance with the Custody Rule. J. Budden did nothing to confirm that Cowgill had engaged an accountant to complete the annual surprise examination in 2012, that the annual surprise examination had been completed, that Form ADV-E had been filed with the Commission in connection with the annual surprise examination, or that PIM had complied with the Custody Rule in 2012. PIM violated the Custody Rule in 2012 by failing to have an annual surprise examination completed that year.

***5** 20. In 2013, J. Budden realized that he had not seen any accountants at PIM for "some time," and sought to learn the status of PIM's compliance with the Custody Rule. Respondents spoke with the principal of the accounting firm that historically had completed annual surprise examinations for PIM. Respondents learned that the accounting firm was terminating its relationship with PIM because, among other reasons, Cowgill had not sufficiently cooperated with the accounting firm in 2010 and 2011 to enable it to complete the annual surprise exams during those two years as required by the Custody Rule. Respondents further learned that Cowgill had not engaged the accounting firm to perform any work on behalf of PIM since 2011.

21. In July 2013, Respondents spoke with an attorney to determine how to address PIM's delinquent ADV-E filings.

22. However, neither Respondent took any disciplinary action against Cowgill.

23. Instead, on July 22, 2013, each Respondent executed a stock purchase agreement in which they each agreed to sell all of their interest in PIM to Cowgill.

24. Respondents both knew at the time of the sale that PIM was not in compliance with the federal securities laws, including specifically, the Compliance Rule and the Custody Rule.

25. As a result of the conduct described above, Respondents failed reasonably to supervise Cowgill within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing and detecting Cowgill's violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 203(a), 204(a), 206(1), (2), and (4), and 207 of the Advisers Act and Rules 204-2, 206(4)-2, and 206(4)-7 thereunder.

26. As a result of the conduct described above, Respondents caused PIM's violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require, among other things, that a registered investment adviser adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser and its supervised persons, and review, no less frequently than annually, the adequacy of such policies and procedures.

27. As a result of the conduct described above, J. Budden caused PIM's violation of Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, which require, among other things, that a registered investment adviser have client assets over which it has

custody verified by an independent public accountant at least once a year without prior notice to the investment adviser and that the investment adviser require the accountant to file Form ADV-E with the Commission within a prescribed amount of time.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in each Respondent's Offer.

Accordingly, pursuant to Sections 203(f) and 203(k) of the Advisers Act, it is hereby ORDERED that:

Respondent J. Budden

***6** A. Respondent J. Budden cease and desist from committing or causing any violations and any future violations of Section 206(4) of the Advisers Act and Rules 206(4)-2 and 206(4)-7 thereunder.

B. Respondent J. Budden be, and hereby is:

> barred from association in a supervisory or compliance capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization

with the right to apply for reentry after three (3) years to the appropriate selfregulatory organization, or if there is none, to the Commission.

C. Any reapplication for association by Respondent J. Budden will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against Respondent J. Budden, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

D. Respondent J. Budden shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $125,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Payment must be made in one of the following ways:
(1) Respondent J. Budden may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondent J. Budden may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or

(3) Respondent J. Budden may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center

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Accounts Receivable Branch

HQ Bldg., Room 181, AMZ-341

6500 South MacArthur Boulevard

Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Respondent J. Budden as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Paul Montoya, Assistant Director, Division of Enforcement, Securities and Exchange Commission, Chicago Regional Office, 175 West Jackson Boulevard, Suite 900, Chicago, IL 60604-2908.

Respondent A. Budden

***7** E. Respondent A. Budden cease and desist from committing or causing any violations and any future violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

F. Respondent A. Budden be, and hereby is:

> barred from association in a supervisory or compliance capacity with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization

with the right to apply for reentry after two (2) years to the appropriate selfregulatory organization, or if there is none, to the Commission.

G. Any reapplication for association by Respondent A. Budden will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against Respondent A. Budden, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

H. Respondent A. Budden shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of $75,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Payment must be made in one of the following ways:
(1) Respondent A. Budden may transmit payment electronically to the Commission, which will provide detailed ACH transfer/ Fedwire instructions upon request;

(2) Respondent A. Budden may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or

(3) Respondent A. Budden may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

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Enterprise Services Center

Accounts Receivable Branch

HQ Bldg., Room 181, AMZ-341

6500 South MacArthur Boulevard

Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Respondent A. Budden as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Paul Montoya, Assistant Director, Division of Enforcement, Securities and Exchange Commission, Chicago Regional Office, 175 West Jackson Boulevard, Suite 900, Chicago, IL 60604-2908.

***8** I. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, a Fair Fund is created for the penalties referenced in paragraphs IV.D and IV.H, above. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against any Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondents, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.
Brent J. Fields
Secretary

1 The findings herein are made pursuant to each Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

2 "Negligence is sufficient to establish 'causing' liability …, at least in cases in which a person is alleged to 'cause' a primarily violation that does not require scienter." *KPMG Peat Marwick, LLP*, Rel. No. 43862, 2001 WL 47245, *19 (Jan. 19, 2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002).

3 "Liability for failure to supervise may be imposed when a supervisor fails 'to learn of improprieties when diligent application of supervisory procedures would have uncovered them.'" *In the Matter of Stephen Jay Mermelstein*, Advisers Act Rel. No. 2961 (Dec. 14, 2009).

4 PIM did not conduct an annual compliance review in 2005.

Release No. 4225 (S.E.C. Release No.), Release No. IA - 4225, 112 S.E.C. Docket 3701, 2015 WL 5935519

End of Document

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Release No. 2967 (S.E.C. Release No.), Release No. 61247, Release No. 34-61247, Release No. IA - 2967, 97 S.E.C. Docket 1791, 2009 WL 5125427

S.E.C. Release No.
Securities Exchange Act of 1934
Investment Advisers Act of 1940

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF JEFFREY C. YOUNG, RESPONDENT.

Administrative Proceeding File No. 3-13731
December 29, 2009

SUMMARY

The Securities and Exchange Commission (SEC) instituted proceedings against Jeffrey C. Young (the Defendant).The SEC complaint alleged that the Defendant failed to supervise Harold Jaschke in violation of federal securities laws, specifically Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940. The SEC accepted the Defendant's Offer of Settlement and imposed a bar from association with any dealer, broker, or investment adviser in a supervisory capacity for 9 months and a civil monetary penalty.

REGULATION
17 C.F.R.

ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940

I.

***1** The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 (“Exchange Act”) and Section 203(f) of the Investment Advisers Act of 1940 (“Advisers Act”) against Jeffrey C. Young (“Young” or “Respondent”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative Proceedings, Making Findings, and Imposing Remedial Sanctions Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940 (“Order”), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds [1] that:

Summary

These proceedings arise out of Young's failure to supervise Harold Jaschke, a registered representative who, between May 2006 and March 2008, executed unauthorized transactions, made unsuitable recommendations, and churned his customers' accounts. During this time, Jaschke was associated with First Allied Securities, Inc. ("First Allied"), a registered broker-dealer for which Young was the vice president of supervision. Jaschke violated Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by engaging in an unauthorized high risk, short term Treasury bond trading strategy on behalf of his customers. Jaschke's customers, the City of Kissimmee ("COK") and the Tohopekaliga Water Authority ("Toho") (collectively, the "Municipalities"), were required by ordinance to invest their funds in order to provide for safety of capital, liquidity of funds, and investment income, in that order of importance, and were prohibited specifically from using the proceeds of repurchase agreements and reverse repurchase agreements for the purpose of making investments. Despite being aware of the ordinances, Jaschke engaged in a high risk trading strategy and leveraged the Municipalities' accounts in violation of the ordinances. In addition, Jaschke lied to the Municipalities to conceal the risky nature of the investments, his use of leverage, and large unrealized losses the accounts experienced as a result of his misconduct.

***2** Young failed reasonably to supervise Jaschke because he failed to respond adequately to "red flags" relating to Jaschke and failed to take reasonable steps to ensure that First Allied's procedures regarding suitability were followed. Young received notices generated by Bear, Stearns Securities Corp. ("Bear Stearns"), First Allied's clearing broker, that highlighted declining equity and high turnover in the Municipalities' accounts. However, Young did not contact the Municipalities to discuss the account activity. In addition, Young was aware that Jaschke claimed that the Bear Stearns account statements were inaccurate and that Jaschke provided the Municipalities with his own trading spreadsheets. While Young himself did not understand Jaschke's spreadsheets and, in fact, questioned the accuracy of the information contained therein, Young did not ensure that the spreadsheets were accurate, despite knowing that they were being provided to the Municipalities. Finally, Young failed to follow First Allied's procedures regarding suitability determinations. As a result, Young failed reasonably to supervise Jaschke within the meaning of Section (15)(b)(6)(A) of the Exchange Act which incorporates by reference Section 15(b)(4)(E) and Section 203(e)(6) of the Advisers Act.

Respondent

1. **Jeffrey C. Young ("Young")**, age 45, resides in San Diego, California. Young has been associated with First Allied since 1997. From 2000 to August 2009, he was vice president of supervision. He is currently vice president of special projects.

Other Relevant Entities and Persons

2. **First Allied Securities, Inc. ("First Allied")** is a New York corporation with its principal place of business in San Diego, California. Since 1993, First Allied has been registered with the Commission as a broker-dealer, and, since 1994, as an investment adviser. First Allied licenses over 900 independent contractor representatives and maintains approximately 600 branch offices nationwide. First Allied is solely owned by FAS Holdings Inc., which in turn is solely owned by Advanced Equities Financial Corp.

3. **Harold H. Jaschke ("Jaschke"),** age 48, resides in Houston, Texas. Jaschke was associated with First Allied as a registered representative from June 2005 until August 2008, at which time First Allied terminated its association with Jaschke.

Background

4. Jaschke recommended that the Municipalities engage in a trading strategy involving long-term, zero-coupon United States Treasury Bonds, also known as "STRIPS" (which stands for Separate Trading of Registered Interest and Principal of Securities). Jaschke's strategy involved buying and selling the same STRIPS within a matter of days, and sometimes within the same day,

to take advantage of short term changes in the price of STRIPS. In addition to simply short-term trading in STRIPS, Jaschke used repurchase agreements, or "repos," to finance purchases of STRIPS for the Municipalities. Repos are agreements in which a seller of securities agrees to buy the securities back from the purchaser at a specified price at a designated future date. In other words, repos are a type of short- term loan, which in this case were collateralized by STRIPS. The use of repos significantly increased the risks to which Jaschke's customers were exposed, as repos effectively allowed the accounts to borrow large amounts of money in order to hold larger positions of STRIPS. As a result of Jaschke's trading strategy, between May 2006 and June 2007, COK's account value declined 56% and Toho's account value declined 58%, an aggregate unrealized loss of more than $47 million. The Municipalities closed their accounts in March 2008 at a profit.

***3** 5. The individuals responsible for making investment decisions on behalf of the Municipalities relied upon Jaschke for information regarding their investments in STRIPS. They also relied on Jaschke to ensure that any investing they engaged in complied with their investment policies, which were substantially identical, and codified in municipal ordinances. The ordinances stated, among other things, that the Municipalities' funds were to be invested to provide safety of capital, liquidity of funds, and investment income, in that order of importance. The ordinances, while allowing for the use of repos for liquidity, also specifically prohibited using repos for the purpose of making investments. Despite these restrictions, Jaschke engaged in risky trading and used repos in a manner that directly violated the terms of the Municipalities' investment ordinances.

Jaschke's Material Misrepresentations and Omissions

6. Jaschke lied to the Municipalities regarding his use of leverage in their accounts. In fall 2006, the STRIPS market fell, causing Jaschke to significantly leverage the Municipalities' accounts to allow him to continue his trading strategy. This, in turn, caused the percentage of equity in the Municipalities' accounts to drop below Bear Stearns' equity threshold. As a result, the accounts began receiving house calls that required an infusion of cash to meet the required equity percentage. House calls could be satisfied by either wiring cash into the account, or by selling off securities.

7. Jaschke lied to the Municipalities about the house calls' existence. He instructed his customers to ignore communications on First Allied letterhead regarding the need to make deposits to cover the house calls. When Jaschke needed additional funds wired into one of the accounts to satisfy a house call, he contacted his customers purporting to offer them new STRIPS "investments," which typically involved an investment of a fixed amount that would be returned shortly with a specific rate of return. However, instead of investing his customers' funds as promised, Jaschke simply used the "investment" funds to meet house calls, then returned the funds plus the rate of return when the accounts no longer needed the cash to meet the required equity threshold. If the Municipalities weren't interested in making these "investments," or if Jaschke chose not to approach them, he would simply direct First Allied's margin clerks to sell securities to cover the calls without ever disclosing either the house call or the sale to his customers (although the Municipalities did receive trade confirmations).

8. Jaschke also lied to the Municipalities regarding their account activity and performance. Between December 2006 and June 2007, the Municipalities' accounts continuously lost value, and experienced extremely large, unrealized losses by the summer of 2007 when the STRIPS market rapidly declined. Jaschke never disclosed the unrealized losses to his customers. Although the Municipalities received account statements from Bear Stearns, Jaschke instructed them to ignore those statements. For example, when one customer noticed that Toho's account statement showed losses in December 2006, Jaschke told him that the statements were inaccurate due to problems with Bear Stearns' systems, and instructed him to instead rely on spreadsheets Jaschke had prepared. On at least one of Jaschke's spreadsheets, the market value of Toho's STRIPS was overstated by approximately $25 million.

***4** 9. In late summer 2007, COK's and Toho's auditors began reviewing the Municipalities' investment activity and identified the unrealized losses. Jaschke blamed the losses on Bear Stearns and falsely claimed that the accounts had mistakenly been treated as margin accounts and were wrongfully liquidated, at a loss, to cover margin calls. In reality, Bear Stearns neither liquidated the Municipalities' accounts, nor directed anyone at First Allied to do so. Instead, the losses resulted from Jaschke's

trading in the accounts while the STRIPS market suffered a dramatic decline, and Jaschke simply lied to deflect attention from his unauthorized activities.

Jaschke's Unauthorized Trading

10. Between May 2006 and March 2008, Jaschke engaged in several different types of unauthorized trading in the Municipalities' accounts. Despite the fact that the Municipalities held non- discretionary accounts with First Allied, Jaschke conducted hundreds of short-term STRIPS transactions in the Municipalities' accounts without the full knowledge or authorization of his customers.

11. Additionally, Jaschke's use of repos was unauthorized. Jaschke led the Municipalities to believe that the repos were used only to facilitate the transfer of funds between the Municipalities and First Allied, and would not be used to leverage the Municipalities' investment portfolios. Despite his statements to his customers, Jaschke continually used repos to highly leverage both accounts.

12. Finally, Jaschke conducted unauthorized transactions to hide the numerous house calls the Municipalities received. Jaschke engaged in unauthorized sales of securities to meet some house calls, and lied to his customers about non-existent investment opportunities in order to secure funds to satisfy other house calls.

Jaschke's Unsuitable Recommendations

13. Jaschke's trading strategy was unsuitable for the Municipalities in light of their investment ordinances and their conservative investment objectives. Their investment ordinances prioritized safety of capital above all else, and specifically prohibited using repos for the purpose of making investments. Jaschke was aware of, and had copies of, the Municipalities' investment ordinances, and the accounts were listed as having low or moderate risk tolerances within First Allied's internal account-tracking system. Nevertheless, Jaschke embarked on a risky trading strategy that involved short-term trading, a practice described as “trading” in First Allied's written definitions of investment objectives, which was not appropriate for customers with a low investment risk tolerance. Additionally, Jaschke used repos to invest in STRIPS, a practice he knew was specifically prohibited by the Municipalities' investment ordinances.

Jaschke's Churning

14. Between May 2006 and March 2008, although COK's and Toho's accounts were set up as non- discretionary, Jaschke engaged in unauthorized trading and/or in effect had complete discretion over the accounts at all relevant times. Jaschke excessively traded the Municipalities' accounts for his own gain in disregard of his customers' interest.

Young's Failure to Supervise Jaschke

***5** 15. Young failed reasonably to supervise Jaschke. Young was the vice president of supervision and the head of First Allied's supervision department, a role that required him to oversee and train other supervisors regarding compliance with First Allied's policies and procedures. While Young was not Jaschke's direct supervisor, he became actively involved in supervising Jaschke in September 2006 and thereafter began making significant supervisory decisions regarding Jaschke's handling of the Municipalities' accounts. Young also had the powers traditionally associated with a supervisor, including the ability to discipline and fire Jaschke.

Young Failed to Respond Reasonably to Red Flags

16. Young was first notified of abnormal trading in the Municipalities' accounts in September 2006 when automated account surveillance reports, or “exception reports,” generated by Bear Stearns were escalated to him. The exception reports showed turnover rates of 17 for COK and 21 for Toho, and indicated the possibility of churning in the accounts. [2] When a valid exception

report was generated, First Allied's general practice was to send its customers a "negative response letter," i.e., no response is required. The negative response letter informed the customer of the type of activity shown on the exception report and provided the customer with the contact information for the regional supervisor responsible for the account in the event the customer had questions.

17. However, when Young received the September 2006 exception reports for the Municipalities, he did not send them negative response letters. Young was concerned because institutional (rather than retail) customers were involved, and he had had little experience dealing with such customers and was unsure whether to send out the typical negative response letter or whether to take some other action. Because he believed, based on representations from Jaschke, that the Municipalities were sophisticated and that the trading in the accounts was occurring at their direction, Young worried that he would appear to be uninformed if First Allied were to send the customers negative response letters, since he assumed that they and Jaschke understood the activity in the accounts better than he did. Bear Stearns generated additional exception reports in December 2006 indicating turnover ratios of 301 for COK and 106 for Toho, and highlighting the fact that COK's account had underperformed the S&P by 40%. Young did not send negative response letters to the Municipalities with respect to these reports as well. Young's responses to the exception reports were inadequate, as they did not result in prompt follow up on red flags regarding churning and suitability.

18. Over the next few months, as the Municipalities' account equity continued to drop, Young became increasingly concerned about the activity in both accounts. In response, Young had numerous conversations with Jaschke, during which Jaschke provided various excuses for the volatile account activity, including the falsehood that Bear Stearns' automated system did not know how to treat repos, which supposedly caused the exception reports and inaccurate account statements to be generated. Young failed adequately to question the veracity of Jaschke's often detailed and convoluted explanations, partly because he did not understand Jaschke's complex underlying trading strategy.

***6** 19. Furthermore, Young asked Jaschke to provide him copies of the spreadsheets Jaschke supposedly kept to reconcile the account activity due to the purported complexity of Bear Stearns' account statements. After several initial delays, Jaschke finally produced the spreadsheets, but Young did not fully understand them. Young was told by Jaschke that Jaschke was providing these same spreadsheets to the Municipalities and, although concerned about their accuracy, Young did not take any other steps to ensure that the Municipalities were receiving accurate account information from Jaschke. Young's failure to respond to red flags regarding the accuracy of information provided to the customers by Jaschke was unreasonable, particularly given that he was also aware of other red flags regarding the same accounts.

Young Failed to Assess Suitability in Accordance With Firm Policies

20. Despite the fact that he considered the Municipalities to be institutional investors, Young did not adequately assess the suitability of Jaschke's trading based on the firm's institutional investor suitability guidelines, which required consideration of the customer's ability to evaluate investment risk independently, and the extent to which the customer was exercising independent judgment regarding the transaction.

21. Additionally, First Allied's written supervisory procedures required Young to conduct reviews of exception reports. However, he failed to verify the accuracy of Jaschke's responses to the exception reports generated in September and December 2006. In February 2007, Jaschke submitted his responses to the December 2006 exception reports, falsely stating that the risk tolerance for the Municipalities was "high." Young knew that this was a change from prior account records he had reviewed. Those records were from 2003, and Young had asked Jaschke to have the Municipalities submit updated account documentation. However, Young did not check the firm's records to see if they had actually been updated, and did not check to see if any new paperwork had actually been submitted by the Municipalities. In fact, the Municipalities' account information was never changed within the firm's records and always showed a low or moderate risk tolerance because the Municipalities, by the terms of their investment ordinances, were required to engage only in conservative trading. If Young had checked the firm's internal systems, he would have seen that the Municipalities were listed as having low or moderate risk tolerances, and likely could have detected or prevented Jaschke's fraud.

22. Young's failure to follow the firm's established procedures was especially unreasonable because he was the head of First Allied's supervision department and was responsible for overseeing and training other supervisors regarding compliance with the firm's policies and procedures.

Legal Analysis

23. As a result of the conduct described above, Jaschke violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

***7** 24. Section 15(b)(4)(E) of the Exchange Act requires broker-dealers reasonably to supervise persons subject to their supervision, with a view toward preventing violations of the federal securities laws. See, e.g., Dean Witter Reynolds, Inc., Exchange Act Rel. No. 46578 (October 1, 2002). The Commission has emphasized that the "responsibility of broker-dealers to supervise their employees by means of effective, established procedures is a critical component in the federal investor protection scheme regulating the securities markets." Id. Section 15(b)(4)(E) of the Exchange Act provides for the imposition of a sanction against a broker or dealer who "has failed reasonably to supervise, with a view to preventing violations of the securities laws, another person who commits such a violation, if such other person is subject to his supervision." Section 15(b)(6)(A)(i) incorporates by reference Section 15(b)(4)(E) and provides for the imposition of sanctions against persons associated with a broker-dealer. Similarly, Section 203(f) of the Advisers Act, incorporating by reference Section 203(e)(6) of the Advisers Act, authorizes the Commission to sanction a person who is associated, or at the time of the alleged misconduct was associated, with an investment adviser for failing reasonably to supervise, with a view to preventing violations of the federal securities law, another person who commits such a violation, if that person is subject to the person's supervision.

25. As a result of the conduct described above, Young failed reasonably to supervise Jaschke within the meaning of Section 15(b)(4)(E) of the Exchange Act, and within the meaning of Section 203(f) of the Advisers Act, when he failed to supervise Jaschke with a view to preventing and detecting his violations of the federal securities laws.

IV.

In view of the foregoing, the Commission deems it appropriate, and in the public interest, to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Section 15(b) of the Exchange Act and Section 203(f) of the Advisers Act, it is hereby ORDERED that:

A. Respondent Young be, and hereby is, suspended from association in a supervisory capacity with any broker, dealer or investment adviser for a period of nine (9) months.

B. IT IS FURTHER ORDERED that Respondent shall, within one year of the entry of this Order, pay a civil money penalty in the amount of $25,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Young as a Respondent in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Michele Wein Layne, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., Suite 1100, Los Angeles, CA 90036.

***8** By the Commission.
Elizabeth M. Murphy

Secretary

1 The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

2 A turnover rate measures the turnover in an account, which is the number of times during a given period that the securities are replaced by new securities, by dividing the total cost of purchases made during a given period by the average amount invested during that period. A turnover rate that exceeds six is presumptive of churning. Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 767 F.2d 1498, 1502 (11th Cir. 1985); In the Matter of Al Rizek, 1998 SEC LEXIS 905, at 52.

Release No. 2967 (S.E.C. Release No.), Release No. 61247, Release No. 34-61247, Release No. IA - 2967, 97 S.E.C. Docket 1791, 2009 WL 5125427

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Release No. 2151 (S.E.C. Release No.), Release No. IA - 2151, 80 S.E.C. Docket 2258, 2003 WL 21729839

S.E.C. Release No.
Investment Advisers Act of 1940
Securities Exchange Act of 1934

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF MARSHALL E. MELTON AND ASSET MANAGEMENT & RESEARCH, INC.
Greensboro, North Carolina

Administrative Proceeding File No. 3-9865
July 25, 2003

SUMMARY

Marshall E. Melton and Asset Management & Research, Inc. (AMR) appeal from a decision of an administrative law judge, which found that Melton and AMR misused funds, and were subsequently enjoined from violating antifraud provisions. The law judge concluded that Melton should be barred from association with any investment adviser, among others. The Securities and Exchange Commission determined that it would be in the public interest to revoke the registration of, or suspend or bar from participation in the securities industry, or prohibit from participation in an offering of penny stock, a respondent who is enjoined from violating the antifraud provisions.'

REGULATION
17 C.F.R.275
Appeal filed: August 3, 2000
Briefing completed: November 29, 2000
***1** APPEARANCES:
J. Anthony Penry, of Ellis & Winters LLP, for Marshall E. Melton and Asset Management & Research, Inc.
Edward G. Sullivan and Michael E. Mashburn, for the Division of Enforcement.

OPINION OF THE COMMISSION

INVESTMENT ADVISER PROCEEDINGS BROKER-DEALER PROCEEDINGS

Grounds for Remedial Action

Consent Injunction

Misuse of Investor Funds

Registered investment adviser and its president, who was also associated with a registered broker-dealer, were permanently enjoined, with their consent, from violating antifraud provisions of the securities laws. In addition, president repeatedly misused investor funds. Held, it is in the public interest to revoke investment adviser's registration and to bar president from association with any investment adviser, broker, dealer, member of a national securities exchange, and member of a registered securities association.

I.

Marshall E. Melton and Asset Management & Research, Inc. ("AMR"), a registered investment adviser, appeal from the decision of an administrative law judge. Melton is AMR's president and sole shareholder, and also was associated with a registered broker-dealer. The law judge found that, on May 4, 1998, Melton and AMR, with their consent and without admitting or denying the allegations in the injunctive complaint, were permanently enjoined from violating antifraud provisions of the securities laws. [1] He further determined, on the basis of the evidence adduced below, that Melton had repeatedly misused funds invested in Melton's companies. The law judge concluded that Melton should be barred from association with any investment adviser, broker, dealer, member of a national securities exchange, and member of a registered securities association, and that AMY's registration should be revoked. We base our findings on an independent review of the record, except for those findings of the law judge that are not challenged on review.

II.

The Investment Advisers Act of 1940 and the Securities Exchange Act of 1934 empower us to discipline investment advisers, broker-dealers, and their associated persons who have been enjoined from any conduct or practice in connection with activity in such capacities, or in connection with the purchase or sale of any security. Such an injunction has been entered against Respondents, and we must therefore determine what remedial action is appropriate in the public interest. [2]

In this case, we must assess the disciplinary consequences of a consent antifraud injunction. Because this issue arises in our administrative disciplinary proceedings, it involves both our responsibility to protect the investing public and our responsibility to secure the just, speedy, and inexpensive determination of actions before the agency. The issue has arisen and been resolved in a number of our cases over the years.

***2** We set forth immediately below, and apply to this case, our traditional policy in this area. However, because this case has presented us with the opportunity to review and reconsider that traditional approach, we also announce, in Section V below, a refined and expanded policy. The new approach shall apply to disciplinary proceedings involving consent injunctions -- and, in particular, antifraud injunctions -- that are both agreed to and entered by a court after issuance of this opinion. In discussing the refined and expanded policy, we provide guidance to our Enforcement Division and to all other parties as to the type of showing that will warrant remedial action in such cases.

The Commission's determination that a remedial, disciplinary sanction is in the public interest is based on the particular circumstances and entire record of the case. The Commission considers a range of factors relevant to that determination, including: the seriousness of the violation; the isolated or recurrent nature of the violation; the respondent's state of mind; the sincerity of the respondent's assurances against future violations; the respondent's recognition of the wrongful nature of the misconduct; the respondent's opportunity to commit future violations; the age of the violation; and the degree of harm to investors and the marketplace resulting from the violation. [3]

Traditionally, in disciplinary proceedings based on an injunction, the Commission has considered the circumstances surrounding the injunctive action in making the public interest determination. In cases in which the injunctive complaint was settled by consent, as here, we have considered the allegations in that complaint.

The complaint is clearly relevant. [4] The Advisers Act and the Exchange Act make no exception for consent injunctions. Such injunctions typically do not include any findings of fact. Thus, as we have stated in a number of decisions, we have adopted the policy in administrative proceedings based on consent injunctions that the injunctive allegations may be given considerable weight in assessing the public interest. [5]

For example, we addressed this issue many years ago in Kaye, Real & Company, 36 S.E.C. 373 (1955). There, id. at 375, the Commission stated that:

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> We think that the hearing examiner properly rejected registrant's proffers seeking to disprove the facts upon which the injunctions were based. Under Section 15(b) of the Act, the mere issuance of the injunctions, the validity of which has not been attacked, furnishes a statutory basis for revocation if we find such action to be in the public interest. We are of the view that, whether or not the decrees are res judicata, we need not litigate the factual assertions made in the injunctive proceedings in here resolving the issue of public interest, but may give consideration to the fact that registrant has been twice enjoined from engaging in fraudulent and improper conduct in connection with the purchase and sale of securities. We also take into account the circumstances under which these injunctions were obtained. We have also considered the other circumstances urged in mitigation, but they are not in our opinion sufficient to overcome the fraudulent activities presented in the injunction proceedings.

***3** More recently, in Samuel O. Forson, 53 S.E.C. 31, 32 (1997), the Commission stated that:

> We have previously pointed out that the allegations in an injunctive complaint settled by consent may be given considerable weight in assessing the public interest in a subsequent proceeding. Forson complains that certain of the allegations against him have never been adjudicated. However, having consented to entry of an injunction based on those allegations, Forson may not question them now in an action based on that injunction.

Thus, the Commission has concluded that a consent injunction, "no less than one issued after trial upon a determination of the allegations, may furnish the sole basis for remedial action … if such action is in the public interest."[6] Indeed, the mere existence of an injunction may support revocation of registration or a bar from participation in the securities industry where the nature of the acts enjoined and the circumstances indicate that such is in the public interest.[7] The Commission has also had occasion in past cases based on injunctions to evaluate evidence independently adduced at the disciplinary hearing.[8]

The foregoing discussion demonstrates that the Respondents in this case had ample notice of the Commission's traditional policy described above prior to the time they consented to the injunction at issue. As the Supreme Court has stated, "Adjudicated cases may and do … serve as vehicles for the formulation of agency policies, which are applied and announced therein …. They generally provide a guide to action that the agency may be expected to take in future cases."[9]

III.

In accordance with our traditional policy, we properly may take into account the allegations underlying the injunction to which Respondents consented when considering their arguments that a revocation and bar are not necessary in the public interest.

Our assessment of those allegations and Respondents' arguments leads us to consider that revocation and a bar are appropriate here. Moreover, in this proceeding, additional evidence was adduced. This evidence substantiates some of the allegations in the complaint,[10] reveals additional instances of misconduct by Melton, and reinforces our conclusion as to the appropriateness of those sanctions.

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Respondents object to the admission of part of that evidence, the preliminary report of the court-appointed receiver for Melton's companies. They further contend that, in any event, the report should not be given any weight. These objections are without merit. We have previously held that a "receiver's reports are competent evidence, to be accorded their natural and probable weight, taking into account their reliability." [11]

We turn now to an examination of the allegations in the injunctive complaint and the other evidence adduced in this proceeding.

A. The Injunctive Complaint

***4** The complaint in the injunctive action at issue included the following allegations. From about mid-1994 through late 1996, AMR and Melton violated the securities laws' antifraud provisions by making material misrepresentations to investors in connection with the private placement of securities in three limited liability companies controlled by Melton - Westview Capital, L.C., Trading Partners, L.C. ("TP"), and Trading Partners II, L.C. ("TP II"). [12]

AMR, through Melton, made material misstatements to induce its clients to invest their funds in Melton's companies. Contrary to his representations to investors, Melton commingled monies among the companies, and used investors' funds to operate other entities that he controlled. He told investors to disregard warning language in the offering memoranda, giving them false assurances that their investments were safe and conservative.

Among other things, Melton falsely told prospective Westview investors that AMR had $75 million under management, and that Westview would get a percentage of AMR's commissions and fees so that investors would receive a return of 75% to 80% of their initial $50,000 investment in the first year. Melton showed prospective TP investors documents indicating that, based on its performance during the preceding eleven months, TP would return 1.5%-2% monthly. The documents did not disclose the unrealized losses that TP was carrying on its books. Melton persuaded one couple to margin stock and invest $500,000 of the borrowed proceeds in TP and TP II. He falsely assured the couple that their stock would be safe since the profits from their investments would be sufficient to cover their margin interest, eventually to pay the debt, and also to provide them with income.

B. Hearinq Evidence

The following evidence of Melton's misuse of funds invested in his companies was adduced at the hearing.

1. Westview

Interests in Westview, which Melton admittedly controlled, were offered to the public through a private placement memorandum ("PPM") dated June 10, 1994. The company's stated objectives were (1) to invest in securities or other investments; (2) to obtain commissions from the sale of insurance and/or securities; and (3) to act as a promoter of other investment entities. The offering, totaling $5,000,000, consisted of 50 investment units at $100,000 per unit. However, Westview was able to raise only about $2,250,000.

a. In September 1995, Rug Crafters, L.C., a start-up company in which Melton had a 10% interest, asked Westview for a loan to pay for new machinery it had ordered. Westview did not have the money to make the loan, and Melton asked his wife, Sydney Melton, to advance the money. Sydney Melton loaned Rug Crafters $100,000. The Meltons were in the process of building a luxury home, and needed the money back quickly. However, Rug Crafters did not have the funds to repay the loan.

On January 17, 1996, an investor purchased a $300,000 interest in Westview. Melton promptly transferred $105,000 of that amount to Rug Crafters. Immedately thereafter, on January 23, Rug Crafters wired Sydney Melton $104,373, repaying her loan in full with interest. Rug Crafters then executed an unsecured note in favor of Westview for $105,000, a note that was not paid. Melton admitted that "it could be inferred" that money from a Westview investor was used to repay a loan made by his wife.

***5** Respondents argue that Westview's loan to Rug Crafters was an appropriate investment of the type described in the PPM. We make no findings with respect to the propriety of Westview lending money to Rug Crafters. However, there was no justification for the undisclosed use of investor funds for the personal benefit of Melton and his wife.

b. Westview was organized in 1994. Prior to that time, in 1993, two individuals, Phillip Fagg and Melton Jewell, had each loaned $100,000 to another company controlled by Melton, Westview Capital, Inc. ("WCI"). The loans made to WCI by Fagg and Jewell were repaid from funds invested in Westview.

Respondents point out that the Westview PPM stated that $200,000 of the offering proceeds would be used for "Debt Payoff," and that a "Financial Forecast" attached to the PPM described two promissory notes for $100,000 each that Westview was scheduled to repay by August 1994. However, the PPM did not disclose that the debts it described were not the obligations of Westview but those of WCI, another company controlled by Melton.

Respondents concede that Fagg's and Jewell's loans were made to WCI, not Westview, but contend that WCI was a predecessor of Westview, that the loans were used to pay Westview's operating expenses during its start-up period, and that, when Westview was organized, "all business was converted from [WCI] to Westview." The record is devoid of any evidence to support these claims. In fact, the receiver testified that WCI was not the predecessor of Westview, and that WCI and Westview were maintained as separate companies.

2. TP and TP II

TP was organized to engage in the day trading of securities. Its PPM, dated February 14, 1995, offered investors 200 units at $25,000 per unit for a total offering of $5,000,000. TP managed to raise only a little more than $2 million. TP II was formed to engage in covered call writing and intermediate term investing. The PPM for TP II, dated May 31, 1995, offered 400 units at $25,000 per unit for a total offering of $10,000,000. TP II was even less successful than TP, raising less than $1 million.

Melton argues that he did not control TP or TP II. He asserts, among other things, that neither he nor AMR had check writing or check signing authority for those companies, and that neither he nor AMR had any ownership interest in TP. [13]

As noted, the injunctive complaint charged that Melton controlled TP and TP II. Having consented to an injunction based on that allegation, Melton may not challenge it here. [14] Moreover, other evidence in the record establishes that Melton controlled both companies. Melton was admittedly the promoter of both TP and TP II, and they were both located at his business address. Melton's brother, Kenneth Melton ("K. Melton"), who was employed at the same address by Falcon Financial Management, Inc., another company controlled by Melton, was the purported manager of both TP and TP II. However, according to the receiver for Melton's companies, K. Melton gave deposition testimony to the effect that he really did not run TP or TP II, and that both of those companies were in fact run by Melton. [15] We further note that AMR, controlled by Melton, served as investment adviser to both TP and TP II and made all of their investment and trading decisions. Moreover, the companies' money managers were all AMR employees.

***6** a. The PPM for TP stated that "[a]ssuming cash from Profits is available, the Managing Member intends to make distributions in an amount to be determined at his sole discretion." TP's Operating Agreement defined "profits" as net profits to be determined for each fiscal year by TP's accountants in accordance with generally accepted accounting principles. During 1995 and 1996, TP was losing money and had significant unrealized losses. Nevertheless, it distributed about $190,000 to investors.

In an effort to justify these payments, Respondents point to another section of the TP PPM that authorized distributions to investors from cash flow if three prior allocations were satisfied. These were (1) the payment of all currently due debts and obligations (other than debts to investors); (2) the establishment of and addition to necessary reserves; and (3) the payment of any debts or obligations owed to investors. The record does not show that these priorities were satisfied prior to the investor distributions in question.

Melton admitted that he told TP investors that TP intended to make periodic distributions of trading profits. [16] He further admitted that investors believed that TP's distributions would be based on actual trading profits. Melton testified, however, that, in any given month, if there was a positive amount remaining after monthly expenses were deducted from sales proceeds, it was distributed to investors.

b. The TP PPM stated that Renaissance Investors, Inc., another Melton-controlled company, was to receive 19% of TP's net income, payable monthly, as an "incentive fee." As noted above, TP was losing money in 1995 and 1996. Its 1995 federal tax return reported a loss of about $90,000, and its profit and loss statement for the year ending December 31, 1996 reflected a loss of $726,000. Yet TP paid Renaissance $20,362 in 1995 and $13,273 in 1996. When questioned about these payments, Melton stated, "I don't know exactly the accounting behind it."

c. TP's PPM also provided that Stormpeak, Inc., yet another Melton-owned company, would receive a "set up fee" of "3% of the offering to a maximum of $150,000." TP raised only $2,041,510 of the $5 million offering, entitling Stormpeak to a fee of $61,245. However, Stormpeak was paid $139,960, or $78,715 more than the amount to which it was entitled.

Respondents argue that it was intended that Stormpeak receive $150,000 regardless of the amount raised. However, that claim runs counter to the language of the PPM, which contemplates that $150,000 (3% of $5,000,000) would be paid to Stormpeak only if the entire offering was sold.

d. The PPM for TP II provided that a "set up and consulting fee of up to $300,000," representing "up to three percent of the funds raised by the Offering," would be paid to Stormpeak II, Inc., another Melton company. The PPM stated that the fee would be paid at a rate of $50,000 for every $1 million of the offering sold.

***7** On August 24, 1995, TP II wired $200,000 to Sydney Melton's brokerage account. Melton claimed that this money was an advance payment on the fee owed by TP II to Stormpeak II, and that it was wired to his wife to expedite payment since he probably needed the money for the house he was building. However, since TP II raised less than $1 million, Stormpeak II was not entitled to any fee.

IV.

Respondents argue that the bar imposed on Melton is excessive. [17] They assert, among other things, that Melton has no prior record of misconduct. They also emphasize that, while a jury in an investor lawsuit found Melton liable to investors in Westview, it declined to assess punitive damages and found Melton not liable to investors in TP and TP II. [18]

As we have noted, Respondents are subject to an injunction enjoining them from violating the antifraud provisions of the securities laws. Moreover, Melton engaged in additional egregious misconduct over an extended period of time.

AMR and Melton made material misrepresentations to investors. In addition, Melton caused Westview to pay debts it did not owe and to repay a risky loan made by his wife to another company. Melton also caused TP and TP II to pay his companies substantial fees when no fee or a lesser fee was due. We agree with the law judge that Respondents' conduct evidences "more than mere recklessness and indifference." There is ample evidence of deliberate deception coupled with the deliberate misuse of investor funds.

Melton and AMR exhibited a disturbing disregard for the standards that govern the securities industry. We consider that it is fully warranted to bar Melton from association with any investment adviser, broker, dealer, member of a national securities exchange, and member of a registered securities association, and to revoke AMR's registration as an investment adviser. We consider that our action is appropriate to protect the public from further harm at their hands.

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V.

We hereby take this opportunity to refine and expand, for future cases, our policy for administrative disciplinary proceedings based on consent injunctions -- and, in particular, antifraud injunctions -- that are both agreed to and entered by a court in Commission enforcement actions after issuance of this opinion. The policy reflects our view of the meaning that a settlement in a Commission injunctive action will have for a disciplinary proceeding against the same party. It also reflects our view of the seriousness of violations of the antifraud provisions of the federal securities laws. Because the new approach applies by its own terms prospectively, we make no attempt to compare and contrast it with our traditional policy. Nothing we say in this section of the opinion has any bearing on the terms or application of the traditional approach.

An injunction, by its very nature, is predicated on conduct that would or does violate laws, rules, or regulations. The Commission may seek an injunction "[w]henever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation" of securities laws, rules, or regulations. [19] The fact that a securities professional has engaged, or was about to engage, in such a violation clearly can create a need to discipline the person in the public interest. Congress made a basic public interest determination about the seriousness of an injunction when it specified an injunction as one of the grounds upon which the Commission can take disciplinary action against securities professionals under Advisers Act Sections 203(e) (4) and 203(f) and Exchange Act Sections 15(b)(4)(C) and 15(b)(6)(A)(iii). [20]

***8** We believe that an antifraud injunction can, in the first instance, indicate the appropriateness in the public interest of revocation of registration or a suspension or bar from participation in the securities industry. Of course, respondents have the opportunity to demonstrate that, notwithstanding the antifraud injunction, the public interest does not support revocation, suspension, or a bar.

As noted, the Advisers Act and Exchange Act draw no distinction between injunctions entered after litigation or by consent. [21] We do not believe that the statutes require the Enforcement Division to prove the allegations of an injunctive complaint in a follow-on administrative proceeding before any disciplinary action can be taken. If the contrary were true, then in the many cases involving willful misconduct, a disciplinary action under Section 15(b)(4)(C) based on an injunction would become indistinguishable from one under Section 15(b)(4)(D) based on a willful violation. The injunction would make no difference and have no force in the disciplinary proceeding. We do not believe that Congress, having made an injunction a ground for commencing the proceeding, intended for the parties to conduct the proceeding as if the injunction had never been entered, disregarding the allegations underlying the injunction.

We will rely on the factual allegations of the injunctive complaint in determining the appropriate remedial action in the public interest, taking into account what those allegations reflect about the seriousness of the underlying misconduct and the relative culpability of the respondent. In this connection, we will not permit a respondent to contest the factual allegations of the injunctive complaint. Consent injunctions are entered in actions, and pursuant to settlements, authorized by the Commission. By Commission Rule 202.5(e), 17 C.F.R. § 202.5(e), we will not accept, in any enforcement action, any settlement in which the defendant denies committing the violations:

> The Commission has adopted the policy that in any civil lawsuit brought by it or in any administrative proceeding of an accusatory nature pending before it, it is important to avoid creating, or permitting to be created, an impression that a decree is being entered or a sanction imposed, when the conduct alleged did not, in fact, occur. Accordingly, it hereby announces its policy not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings. In this regard, the Commission believes that a refusal to admit the allegations is equivalent to a denial, unless the defendant or respondent states that he neither admits nor denies the allegations.

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Having refused to be party to a settlement in which the defendant denies the Commission's allegations of wrongdoing, we should not countenance those same denials, after a person settles with the Commission, in a later proceeding before this agency. Furthermore, it would be illogical and a waste of resources for us not to rely on the factual allegations of the injunctive complaint in a civil action settled on consent in determining the appropriate remedial action in the public interest.

***9** For purposes of consent injunctions that are agreed to and entered by a court after issuance of this opinion, we will construe the "neither admit nor deny" language as precluding a person who has consented to an injunction in a Commission enforcement action from denying the factual allegations of the injunctive complaint in a follow-on proceeding before this agency. Defendants in Commission injunctive actions must understand that, if the Commission institutes an administrative proceeding against them based on an injunction to which they consented after issuance of this opinion, they may not dispute the factual allegations of the injunctive complaint in the administrative proceeding. Moreover, those allegations potentially can be dispositive of what remedial action is appropriate in the public interest. [22]

Under the refined and expanded policy, the Commission's determination whether a remedial disciplinary sanction is in the public interest is based on consideration of the particular circumstances and entire record of the case and on the range of traditional factors referred to in Section II above. The record would include any evidence adduced with respect to those factors. In considering the factors, we recognize that conduct that violates the antifraud provisions of the federal securities laws is especially serious and subject to the severest of sanctions under the securities laws.

The fact that a person has been "permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction" from violating the antifraud provisions has especially serious implications for the public interest. Based on our experience enforcing the federal securities laws, we believe that ordinarily, and in the absence of evidence to the contrary, it will be in the public interest to revoke the registration of, or suspend or bar from participation in the securities industry, or prohibit from participation in an offering of penny stock, a respondent who is enjoined from violating the antifraud provisions.

****

An appropriate order will issue. [23]

By the Commission (Chairman DONALDSON and Commissioners GLASSMAN, GOLDSCHMID, and ATKINS);
Commissioner CAMPOS not participating.
Jonathan G. Katz
Secretary

1 SEC v. Marshall E. Melton, et el., Civil Action File No. 2:97-CV-00151 (M.D.N.C.), 1998 WL 234162. Respondents were enjoined from violating Section 17(a) of the Securities Act (15 U.S.C. § 77q(a)), Section 10(b) of the Securities Exchange Act and Exchange Act Rule 10b-5 (15 U.S.C. § 78j (b) and 17 C.F.R. § 240.10b-5), and Section 206 of the Investment Advisers Act (15 U.S.C. § 80b-6). AMR was ordered to disgorge $188,243, and Melton ordered to disgorge $352,021, plus prejudgment interest. However, payment was waived due to their inability to pay.

2 See Sections 203(e)(4) and 203(f) of the Advisers Act (15 U.S.C. §§ 80b-3(e)(4) and (f)) and Sections 15(b)(4)(C) and 15(b)(6)(A)(iii) of the Exchange Act (15 U.S.C. §§ 780(b)(4)(C) and (b)(6)(A)(iii)).

3 See, e.g., KMPG Peat Marwick LLP, Exchange Act Release No. 43862 (Jan. 19, 2001), 74 SEC Docket 384, 436, motion for reconsideration denied, Exchange Act Release No. 44050 (Mar. 8, 2001), 74 SEC Docket 1351, petition denied, 289 F.3d 109 (D.C. Cir. 2002); Joseph J. Barbato, 53 S.E.C. 1259, 1281 n.31 (1999); Donald T. Sheldon, 51 S.E.C. 59, 86 (1992), aff'd, 45 F.3d 1515 (11th Cir. 1995).

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4 Rule 320 of our Rules of Practice provides that "the hearing officer may receive relevant evidence."

5 See, e.g., Seaboard Investment Advisers, Inc., Investment Advisers Act Release No. 1918 (Jan. 10, 2001), 74 SEC Docket 201, 206; Samuel O. Forson, 53 S.E.C. 31, 32 (1997); Richard J. Puccio, 52 S.E.C. 1041, 1042 (1996); Charles Phillip Elliott, 50 S.E.C. 1273, 1277 (1992), aff'd, 36 F.3d 86 (11th Cir. 1994) (per curiam).

6 Cortlandt Investing Corp., 44 S.E.C. 45, 53 (1969); accord Balbrook Securities Corp., 42 S.E.C. 496, 498 (1965).

7 See, e.g., Balbrook, 42 S.E.C. at 498; Dunhill Securities Corp, 44 S.E.C. 1, 3 (1969).

8 See Michael J. Markowski, Securities Exchange Act Release No. 44086 (Mar. 20, 2001), 74 SEC Docket 1537, 1543, aff'd, No. 01-1181 (D.C. Cir. 2002); Seaboard, 74 SEC Docket at 206; Charles Phillip Elliott, 50 S.E.C. at 1277; Dunhill, 44 S.E.C. at 2.

9 NLRB v. Wyman-Gordon Co., 394 U.S. 759, 765-766 (1969).

10 That evidence deals with the complaint's allegations with respect to the repayment to Melton's wife from funds invested in one of Melton's companies of a loan she made to another concern; the distributions made to investors by one of Melton's companies despite the company's losses; and the transfer by another Melton company of $200,000 of investors' funds to Melton's wife.

11 Charles Phillip Elliott, 50 S.E.C. at 1278.

12 The three offerings raised a total of about $5,334,000 from 29 investors.

13 Melton also points to the fact that a state court jury in an investor lawsuit found that he was not liable for damages to investors in TP and TP II. Respondents concede that we are not bound by the jury's verdict (which did find Melton liable for damages to investors in Westview). Moreover, there is no evidence in the record as to the basis for the jury's determination.

14 See Samuel O. Forson, supra.

15 Although the receiver's testimony regarding K. Melton was hearsay, it is well established that hearsay may be admitted as evidence and, in appropriate cases, may form the sole basis for findings of fact. Vladislav Steven Zubkis, 53 S.E.C, 794, 800 n.6 (1998); Henry E. Vail, 52 S.E.C. 339, 341, aff'd, 101 F.3d 37 (5th Cir. 1996). The law judge found the receiver to be "a fully credible witness," and relied on his testimony in this regard. We find no reason to disagree with that assessment.

16 This admission is contained in Melton's answer to the injunctive complaint which Melton attached to his answer to the order for proceedings herein, thereby incorporating it as part of his answer.

17 AMR is no longer conducting business. On September 24, 1996, the Securities Division of the Office of the Secretary of State of North Carolina suspended its license as a registered investment adviser until AMR complies with North Carolina's net capital requirements. The suspension is apparently still in effect.

18 See n.13, supra.

19 See Section 21(d)(1) of the Exchange Act (15 U.S.C. 78u(d)(1)); see also Section 209(d) of the Advisers Act (15 U.S.C. 80b-9(d)).

20 Indeed, Congress made even a further public interest determination of its own as to certain securities professionals. Under Section 9(a) of the Investment Company Act (15 U.S.C. § 80a-9(a)), persons who, based on any misconduct, are enjoined from, among other things, engaging in any practice in connection with the purchase or sale of a security,

are automatically disqualified from serving as an employee, officer, director, member of an advisory board, investment adviser, or depositor of a registered investment company or as a principal underwriter for any registered open-end company, registered unit investment trust, or registered face-amount certificate company.

21 As explained in SEC v. Clifton, 700 F.2d 744, 748 (D.C. Cir. 1983) (citations omitted):
Because of its limited resources, the SEC has traditionally entered into consent decrees to settle most of its injunctive actions. Indeed, as the government pointed out at oral argument, over 90% of the SEC's cases are resolved by such decrees. While it gives up a number of advantages when it proceeds by injunction rather than by litigation, including the filing of findings of fact and court opinions clearly setting forth the reasons for the result in a particular case, the SEC is thus able to conserve its own and judicial resources ….

22 Of course, a defendant that settles a Commission injunctive action remains free to “seek and receive concessions concerning the violations to be alleged in the complaint, the language and factual allegations in the complaint,” and, by settling disciplinary matters at the same time as the injunctive action, “the collateral, administrative consequences of the consent decree.” See Clifton, 700 F.2d at 748.

23 We have considered all of the parties' contentions. We reject or sustain them to the extent that they are inconsistent or in accord with the views expressed herein.

In the Matter of MARSHALL E. MELTON and ASSET MANAGEMENT & RESEARCH, INC. Greensboro, North Carolina

ORDER IMPOSING REMEDIAL SANCTIONS

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

ORDERED that Marshall E. Melton be, and he hereby is, barred from association with any investment adviser, broker, dealer, member of a national securities exchange and member of a registered securities association; and it is further

ORDERED that the registration of Asset Management & Research, Inc. as an investment adviser be, and it hereby is, revoked.

By the Commission.
Jonathan G. Katz
Secretary
By: J. Lynn Taylor
Assistant Secretary

Release No. 2151 (S.E.C. Release No.), Release No. IA - 2151, 80 S.E.C. Docket 2258, 2003 WL 21729839

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Release No. 863 (S.E.C. Release No.), 112 S.E.C. Docket 1378, Release No. ID - 863, 2015 WL 4929878

S.E.C. Release No.
Initial Decision

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF NATURAL BLUE RESOURCES, INC., JAMES E. COHEN, AND JOSEPH A. CORAZZI

Administrative Proceeding File No. 3-15974
August 18, 2015

***1** APPEARANCES:
Rua M. Kelly, Mayeti Gametchu, and Thomas J. Rappaport for the Division of Enforcement, Securities and Exchange Commission
Maranda E. Fritz and Eli B. Richlin of Thompson Hine LLP for James E. Cohen
Joseph A. Corazzi, *pro se*

BEFORE: Carol Fox Foelak, Administrative Law Judge

INITIAL DECISION AS TO JAMES E. COHEN and JOSEPH A. CORAZZI [1]

SUMMARY

This Initial Decision concludes that James E. Cohen (Cohen) and Joseph A. Corazzi (Corazzi) (collectively, Respondents) violated Sections 17(a)(1) and 17(a)(3) of the Securities Act of 1933 (Securities Act). The Initial Decision orders Respondents to cease and desist from further violations, imposes officer and director bars, and orders Cohen and Corazzi each to pay a civil money penalty of $75,000.

I. INTRODUCTION

A. Procedural Background

The Securities and Exchange Commission (Commission) instituted this proceeding with an Order Instituting Proceedings (OIP) on July 16, 2014, pursuant to Section 8A of the Securities Act and Sections 15(b) and 21C of the Securities Exchange Act of 1934 (Exchange Act). The undersigned held a seven-day hearing in Washington, D.C., on February 9-13 and 18-19, 2015. The Division of Enforcement (Division) called eleven witnesses from whom testimony was taken, including one expert. Cohen called two witnesses in his own case. Neither Cohen nor Corazzi was called by the Division, and neither testified in his own case. [2] Numerous exhibits were admitted into evidence. [3]

The findings and conclusions in this Initial Decision are based on the record and public official records regarding Respondents of which official notice has been taken, pursuant to 17 C.F.R. § 201.323. Preponderance of the evidence was applied as the standard of proof. *See Steadman v. SEC,* 450 U.S. 91, 96-104 (1981). Pursuant to the Administrative Procedure Act, 5 U.S.C. § 557(c), the following post-hearing pleadings were considered: (1) the Division's Post-Hearing Brief and Proposed Findings of Fact and Conclusions of Law; (2) Cohen's Post-Hearing Submission; (3) the Division's Post-Hearing Reply Brief; and (4) Cohen's Responses to the Division's Post-Hearing Brief and Proposed Findings of Fact and Conclusions of Law. Corazzi did not file his own post-hearing submission but, rather, adopted the legal and factual arguments of Cohen's filings and renewed his request for review of the denial of his motion for continuance. [4] All arguments and proposed findings and conclusions that are inconsistent with this Initial Decision were considered and rejected.

B. Allegations and Arguments of the Parties

***2** This proceeding concerns Respondents' relationship with Natural Blue Resources, Inc. (Natural Blue). The OIP alleges that Respondents orchestrated a fraudulent scheme to control the operation and management of Natural Blue as *de facto* officers, while calling themselves outside "consultants," so as to conceal their past disciplinary histories from Natural Blue investors.

The Division of Enforcement (Division) is seeking cease-and-desist orders, disgorgement, civil monetary penalties, and officer and director bars against Respondents. Respondents argue that the charges are unproven and no sanctions should be imposed.

II. FINDINGS OF FACT

A. Relevant Individuals and Entities

1. Natural Blue Resources, Inc.

Natural Blue was a publicly traded Delaware corporation created in July 2009 through the reverse merger[5] of Natural Blue Resources, Inc., a privately held Nevada corporation (Natural Blue Nevada) into Datameg Corporation (Datameg), a publicly traded Delaware corporation. Div. Ex. 300 ¶ 1. Natural Blue's purported mission was to create, acquire, or otherwise invest in environmentally friendly companies. *Id.* An early initiative undertaken by Natural Blue was to locate, purify, and sell water recovered from underground aquifers in New Mexico and elsewhere, where water resources are depleting. *Id.*

In or about March 2009, Natural Blue Nevada offered certain individuals and entities the opportunity to purchase its shares of stock at a cost of $.0001 or $.0002 per share. *Id.* ¶ 2. On or about April 14, 2009, Natural Blue Nevada commenced the offer and sale of additional shares through a private placement. *Id.* ¶ 3. In connection with the merger between Natural Blue Nevada and Datameg, holders of the initial shares of stock were able to exchange them, at the same ratio, for Natural Blue's publicly traded shares. *Id.* ¶ 4.

Beginning on July 24, 2009, Natural Blue's common stock traded under the symbol "NTUR" on the Over-the-Counter Bulletin Board (OTCBB). *Id.* ¶ 5. After it was removed from the OTCBB, its stock was quoted on OTC Link (formerly Pink Sheets). *Id.*

2. James E. Cohen

Cohen, of Windermere, Florida, held the title of "consultant" to Natural Blue. Cohen Answer ¶ 2. Cohen had been a registered representative for various broker-dealers from 1979 to 1997. Div. Ex. 300 ¶ 39. His disciplinary record includes a 1984 settlement, in which the Commission's settlement order found that he violated Securities Act Section 17(a)(1)-(3) and Exchange Act Section 10(b) and Rule 10b-5 while associated with a broker-dealer in 1981 and suspended him from association with any broker or dealer for thirty days. *Richard Nager*, Exchange Act Release No. 21179, 1984 SEC LEXIS 1047 (July 27, 1984).[6] On March 30, 1999, the National Association of Securities Dealers (NASD) accepted a Letter of Acceptance, Waiver and Consent, signed by Cohen, which resulted in a $200,000 fine, censure, and bar from association with any NASD member firm in any capacity. Div. Ex. 300 ¶ 40. On April 5, 2004, Cohen was convicted, on his plea of guilty, of attempted enterprise corruption and attempted grand larceny in the first degree under New York State law; he was sentenced to one to three years of incarceration and ordered to pay $545,000 in restitution. *Id.* ¶¶ 41-43.

3. Joseph A. Corazzi

***3** Corazzi, of Albuquerque, New Mexico, held the title of "consultant" to Natural Blue. Corazzi Answer ¶ 15. From 1990 to 1999, Corazzi was Chairman and Chief Executive Officer (CEO) of Las Vegas Entertainment Network, Inc., a public company whose securities were registered with the Commission. Div. Ex. 300 ¶ 45. On October 8, 2002, the Commission filed a complaint

against Las Vegas Entertainment Network, Inc., Corazzi, and others, in the United States District Court for the Central District of California, alleging violations of Sections 10(b), 13(a), and 14(a) of the Exchange Act and Rules 10b-5, 12b-20, 13a-13, and 14a-9 thereunder. *Id.* ¶ 46. On October 25, 2002, the United States District Court for the Central District of California entered a final judgment by consent against Corazzi, permanently enjoining him from violating Sections 10(b), 13(a), and 14(a) of the Exchange Act and Rules 10b-5, 12b-20, 13a-13, and 14a-9 thereunder, imposing a civil penalty of $75,000, and barring him permanently from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act. *Id.* ¶¶ 46-47.

4. Toney Anaya

Toney Anaya (Anaya) of Santa Fe, New Mexico, held several prominent positions throughout his career, including Governor of New Mexico, New Mexico Attorney General, Chief of Staff for the New Mexico Governor, and Assistant District Attorney for the First Judicial District in New Mexico. Tr. 783-89; Div. Ex. 269. Since 1986, Anaya has primarily focused on the private practice of law. Tr. 783-85; Div. Ex. 269 at 2. Anaya assisted the President of Mexico with the passage of the North American Free Trade Agreement, and in 2009 and 2010 he oversaw the implementation of federal stimulus funding in New Mexico under then-Governor Bill Richardson. Tr. 784; Div. Ex. 269 at 2. Anaya has served on various advisory boards and Boards of Directors (Boards). Tr. 992-993, 996, 998-1001; Div. Ex. 269 at 2. From March 2009 to August 2009, Anaya was CEO and a member of the Board of Natural Blue Nevada, and from August 2009 to January 2011, he was CEO and a member of the Board of Natural Blue. Div. Ex. 300 ¶ 1.

On May 2, 2014, Anaya entered into a cooperation agreement with the Division. Div. Exs. 295, 300 ¶ 36. On July 16, 2014, the Commission accepted an offer of settlement from Anaya, finding that Anaya willfully violated Section 17(a)(2) of the Securities Act by failing to disclose Cohen and Corazzi's disciplinary histories and control over Natural Blue in its filings with the Commission. Tr. 785-86; Div. Ex. 286 at 2, 5. The Commission issued a cease-and-desist order, barred Anaya from participating in a penny stock offering for five years, and directed that additional proceedings take place to determine what, if any, civil penalties against Anaya are in the public interest. Div. Ex. 286 at 5-6; Div. Ex. 300 ¶ 36. Those proceedings are pending. *Toney Anaya*, Admin. Proc. File No. 3-15973.

5. Paul Pelosi, Jr.

***4** Paul Pelosi, Jr. (Pelosi), is a real estate broker and resides in San Francisco, California. Tr. 472. He is the son of Congresswoman Nancy Pelosi, current Minority Leader of the U.S. House of Representatives (House) and former Speaker of the House. Tr. 484. Pelosi received undergraduate and law degrees from Georgetown University and has worked in the securities industry since 1996. Tr. 473; Div. Ex. 269 at 6. He has served on the Boards of several publicly traded companies, was President of the City of San Francisco's Commission on the Environment, and served as an advisor to the director of the NASA Ames Research Center. Tr. 473, 522-23, 541; Div. Ex. 269 at 6. From August 24, 2009, to January 10, 2010, Pelosi served as President and Board member of Natural Blue. Tr. 474, 479; Div. Ex. 300 ¶¶ 8, 10.

6. Blue Earth Solutions, Inc.

Blue Earth Solutions, Inc. (Blue Earth), was a Nevada corporation organized in March 2006 and primarily engaged in the business of recycling polystyrene foam. Div. Ex. 300 ¶ 20. It filed periodic reports with the Commission pursuant to Section 15(d) of the Exchange Act, and its securities were quoted on the OTCBB. *Id.* During the relevant time, Cohen's wife, Patricia Cohen, was the CEO, a Board member, and largest shareholder, and Respondent Cohen's son, James Cohen, Jr. (Cohen Jr.), was the company's Vice President of Sales and a Board member. *Id.* ¶ 21.

7. JEC Corp.

JEC Corp. was a Nevada corporation organized in May 2002. Div. Ex. 300 ¶ 22. JEC Corp. was owned by Patricia Cohen, and Cohen was its President. *Id.* Cohen and Corazzi entered into consulting agreements with Natural Blue through JEC Corp. *Id.* ¶¶ 24-25.

B. Creation of Natural Blue Nevada

Cohen and Corazzi's business relationship began over ten years ago. Tr. 51-52, 797-99. Although Cohen and Corazzi lost contact for several years, they reestablished contact to found Natural Blue Nevada in 2008. Tr. 393, 797-98. They planned for Natural Blue Nevada to become public since its inception. Tr. 481; Div. Exs. 9-10. To that end, in the second half of 2008, Cohen contacted Leonard Tocci (Tocci), head of American Marketing and Sales (AMS), a plastics company, to express interest in a business transaction between AMS and Natural Blue Nevada that would allow Natural Blue Nevada to become public. Tr. 38-39, 45, 276-77, 37475. James Murphy (Murphy), head of Datameg, AMS's parent company, subsequently called Cohen and the two discussed a potential business transaction between Datameg and Natural Blue Nevada. Tr. 40-45.

1. Cohen and Corazzi Recruit Anaya to be CEO of Natural Blue Nevada/Natural Blue

In about 2007, Corazzi, whom Anaya did not recall previously meeting, approached Anaya and represented himself as a longtime acquaintance and political supporter. Tr. 787-88, 791, 795. At Corazzi's recommendation, Anaya invested $60,000 in a high-yield investment program of which Corazzi was a principal. Tr. 788; Div. Ex. 8. Corazzi provided Anaya with a Commodity Trading Advisor Disclosure Document disclosing Corazzi's bar from serving as an officer or director of a public company, which Corazzi claimed was “of no real consequence.” Tr. 788-92; Div. Ex. 8 at 5. Anaya ultimately recouped the principal of his investment, but no income from it. Tr. 792. Later, Anaya provided Corazzi with an additional $60,000 for a real estate investment, which he never recovered. Tr. 793-95.

***5** In early 2009, Corazzi called Anaya and explained that Corazzi and Cohen had formed a private company focusing on green energy projects, Natural Blue Nevada, which would soon become public through a reverse merger with a public company, Datameg. Tr. 796-99, 806-11. Corazzi praised Cohen as “one of the best he had met in terms of being able to develop businesses.” Tr. 798-99. Cohen joined the call and along with Corazzi, told Anaya that Pelosi, who was then serving on the Board of Blue Earth (of which Cohen's wife was CEO), would be involved in the management of Natural Blue. Tr. 474, 799-801, 961; Div. Ex. 300 ¶ 21. Cohen and Corazzi told Anaya they wanted him to serve as Natural Blue's CEO and Chairman of its Board. Tr. 800-01, 961. Neither Pelosi nor Anaya, who were not acquainted, had any prior experience as officers of public companies. Tr. 473, 531, 785. However, Anaya had access to aquifers and Pelosi had “relationships and experience with technology companies that knew how to clean water.” Tr. 477. Corazzi explained to Anaya that this arrangement “would be a way that [Corazzi] would be able to help repay the funds that [Anaya] had lost” earlier, and that Anaya was particularly well suited to be CEO and Chairman because of his reputation. Tr. 80204. Corazzi and Cohen offered Anaya a monthly salary of $10,000 and a percentage of shares in the company, which Anaya accepted. Tr. 803, 854. It was understood by all that Anaya's role as CEO and Chairman would be a part-time position, because Anaya could not afford to leave his law practice for the salary that would be provided by Natural Blue. Tr. 802-03.

2. Initial Operations of Natural Blue Nevada

Natural Blue Nevada filed Articles of Incorporation in the Office of the Secretary of State of Nevada on March 2, 2009. Div. Ex. 9 at 1. On March 6, 2009, the Articles of Incorporation were adopted and Anaya was formally elected CEO, Chairman of the Board, and Treasurer, and Pelosi was elected President, Chief Operating Officer (COO), and Secretary. *Id.* at 2. Anaya devoted approximately two hours a day to managing Natural Blue Nevada. Tr. 821.

C. Creation of Natural Blue through Reverse Merger

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As previously noted, Cohen contacted Tocci, head of AMS, and Murphy, head of Datameg, in 2008 to express interest in a potential business transaction that would enable Natural Blue Nevada to become public. Tr. 38-39, 45, 375. In early 2009, Murphy and Cohen met at Blue Earth's office in Clermont, Florida, to discuss water extraction in New Mexico. Tr. 40-44. Corazzi participated in the meeting by phone. Tr. 42. Cohen proposed that Natural Blue Nevada reverse merge with Datameg, which would result in Natural Blue becoming a public company, and for Blue Earth to acquire AMS. Tr. 44-45, 53-54, 56. Cohen hoped that Natural Blue would eventually acquire Blue Earth. Tr. 133. Cohen and Corazzi told Murphy that Anaya and Pelosi would be involved in Natural Blue, which was significant to Murphy because Anaya and Pelosi's reputations “lent credibility” to the plan. Tr. 46-47, 51.

***6** On March 6, 2009, the Natural Blue Nevada Board resolved that Cohen “investigate and report alternatives to the Board for the corporation concerning funding and becoming a reporting public company.” Tr. 454; Div. Ex. 9 at 2. At that time, however, Cohen was already in the drafting stages of the reverse merger term sheet with Datameg. Div. Ex. 69 at 3 (attorney's invoice to Natural Blue Nevada reflecting a March 3, 2009, entry for a “[t]elephone conference with Cohen and Murphy re revisions and further revisions … to term sheet”). Upon Cohen's reporting on alternatives, the Natural Blue Nevada Board intended that the articles be amended to adjust the capital structure to reflect the following ownership:

- Toney Anaya - 24%

- Paul Pelosi, Jr. - 21%

- James Cohen, Sr., or designees - 20%

- Other Organizational Shares - 35%

Tr. 854, 1066-67; Div. Ex. 9 at 2. On March 17, 2009, the Natural Blue Nevada Board “authorize[d] and direct[ed] Mr. Cohen to proceed with the negotiation and drafting of a nonbinding term sheet with Datameg.” Div. Ex. 10 at 2. At a March 31, 2009, Board meeting, Cohen presented a proposed nonbinding term sheet with Datameg. Tr. 821; Cohen Ex. 1. Anaya signed the transaction term sheet on April 1, 2009. Tr. 1069; Cohen Ex. 2.

Around the same time, Cohen asked Datameg's attorney, Paul Vuksich (Vuksich), if he could simultaneously represent Datameg and Natural Blue Nevada in the reverse merger. Tr. 289, 387; Div. Ex. 20 at 1. On April 28, 2009, Vuksich wrote a letter to Natural Blue Nevada's and Datameg's Boards, noting that “[as] I have discussed with James Cohen, Sr., I have been asked to immediately begin providing corporate counsel legal services to Natural Blue.” Div. Ex. 20 at 1. In that letter, Vuksich sought written consent from both Datameg and Natural Blue Nevada to undertake simultaneous representation of both companies in the transaction. Tr. 290-91, 1107-08; Div. Ex. 20 at 1-2. Murphy and Anaya provided their consent to the dual representation. Tr. 291; Div. Ex. 20 at 3-4.

Pelosi performed due diligence on Datameg, which included reviewing Datameg's books and records and meeting with Vuksich to discuss the transaction. Tr. 482, 551-53; Cohen Ex. 32. Although Pelosi had some concerns with “over-the-counter stocks trading at five cents, [because] they tend to have challenges,” he ultimately favored the reverse merger going forward. Tr. 483, 551-52. Anaya did not voice any opinion regarding the reverse merger with Datameg because he saw it as an “accomplished fact.” Tr. 814. Vuksich was surprised to learn that Anaya “didn't seem to have a good grasp of corporate formalities” and was unaware “of the intricacies of how corporations and the documentation … had to be put together.” Tr. 362, 457.

***7** The reverse merger was approved by Natural Blue Nevada and Datameg shareholders and on July 24, 2009, the public company Natural Blue was formed. Tr. 45, 54, 57, 122-23, 149. As part of the transaction, existing shareholders had their percentage of ownership reduced. Tr. 158-59; Cohen Ex. 60. Ownership of Natural Blue for relevant individuals and entities at issue became the following:

Natural Blue Shares	Percent Owned	Shareholder Name(s) on Certificate

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9,010,049	18.281%	Toney Anaya
8,125,133	16.486%	Paul Pelosi, Jr.
1,991,060	4.040%	Alyse P. Cohen [7]
1,991,060	4.040%	James Cohen, Jr.
1,970,948	3.999%	JEC Family Ltd [8]
1,882,457	3.820%	Patricia Cohen
1,810,054	3.673%	CA Capital Associates LLC [9]
518,480	1.052%	Paul Vuksich
804,469	1.632%	James Murphy

7 Alyse P. Cohen is affiliated with Cohen; the Division presented evidence of this, and Cohen did not present evidence to contradict it. Tr. 1395.

8 JEC Family Ltd is affiliated with Cohen; the Division presented evidence of this, and Cohen did not present evidence to contradict it. Tr. 1395-96.

9 CA Capital Associates LLC is affiliated with Corazzi; the Division presented evidence of this, and neither Cohen nor Corazzi presented evidence to contradict it. Tr. 1396; Div. Ex. 253 at 3.

***8** Cohen Ex. 55 at 4-5.

D. Selection of Natural Blue Officers, Directors, Employees, and Professional Service Providers

1. Selection of Officers and Directors

During the initial call in which they recruited Anaya, Cohen and Corazzi made clear to Anaya that they had already selected the Board. Tr. 800-01, 822-23. Anaya understood from early discussions with Cohen and Corazzi that "[Cohen and Corazzi] had formed [Natural Blue], that they were selecting the Board of Directors, [and] that they were designating Paul Pelosi as president and me as CEO." Tr. 805.

Cohen took the lead in identifying Natural Blue's initial Board members, whom shareholders ultimately approved via consent in lieu of meeting. Tr. 822-23, 960-61, 1119-21; Cohen Ex. 55. The initial Board consisted of Anaya, Pelosi, Samir Burshan (Burshan), Daryl Kim (Kim), and Murphy. Cohen Ex. 55. Burshan "had an ongoing relationship, business and personal," with Cohen and was a Board member of Blue Earth. Tr. 490, 1120. Kim was an acquaintance of Cohen's who lived in Orlando, Florida. Tr. 490. Two later Board members, Paul Whitford and John McCall, also came at the recommendation of Corazzi and Cohen. Tr. 1122-23; Cohen Ex. 186. Anaya did not object to the composition of the Board as recommended by Cohen. Tr. 1121; Cohen Ex. 186.

Similarly, Cohen identified Natural Blue's officers, whom the Board approved at its first meeting: Anaya (CEO), Pelosi (President), Vuksich (Secretary and General Counsel), and Walter Cruickshank (Cruickshank) (Treasurer and CFO). Tr. 961, 1020, 1119-21, 1136; Div. Ex. 24. At the time Cohen recommended Cruickshank to be Natural Blue's Treasurer and CFO, Cruickshank was the controller for Blue Earth, where he had been hired by Cohen in 2008. Tr. 823-24, 1588, 1602-03, 1606.

Cruickshank only learned that he was the CFO when he was congratulated by others on the position. Tr. 1607-08. When Cruickshank asked Cohen about it, Cohen explained that Natural Blue "is a startup company" and that "it is not going to be that much work." Tr. 1608. Cruickshank was not offered any additional compensation to serve as the CFO of Natural Blue beyond what Blue Earth was already paying him, but was promised by Cohen and Anaya later on that he would be paid for his additional work. Tr. 1608-09. Other than what Cohen and Corazzi told Anaya, Anaya did not know anything else about Cruickshank's background and neither approved of nor disputed Cohen and Corazzi's selection. Tr. 824-25. In sum, Cohen and Corazzi selected individuals to become officers and directors, and Anaya approved the selections.

2. Selection of Attorneys

Following Vuksich's later resignation as General Counsel of Natural Blue, Cohen recommended that Natural Blue hire Jeffrey Decker (Decker), a Florida attorney at the BakerHostetler law firm, who had been recommended to him by Natural Blue's audit firm. Tr. 463, 570, 870, 1509. Cohen told Anaya he wanted to have counsel that was "closer physically to where [Cohen] was, as opposed to Mr. Vuksich, who [had been] across the country in California." Tr. 832-33. Anaya subsequently interviewed Decker and hired him in October 2009 to provide legal services. Tr. 1182-84, 1509-10, 1512; Div. Ex. 36; Div. Ex. 300 ¶ 11. BakerHostetler's engagement letter stated that the firm had run a conflicts check within its database for five individuals: Anaya, Pelosi, Burshan, Cohen, and Corazzi, as well as three companies: Natural Blue, Datameg, and Blue Earth. Div. Ex. 36 at 1.

***9** After Decker resigned in May 2010, attorney Steve Rountree was hired at Corazzi's recommendation, and provided legal services to Natural Blue from April 2010 to May 2011. Tr. 1125, 1184-85; Div. Ex. 300 ¶ 11.

3. Selection of Auditors

Cohen recommended that Natural Blue hire Florida audit firm Cross, Fernandez & Riley (Cross), and Anaya accepted the recommendation. Tr. 570, 832. In the fall of 2009, Paul Horowitz (Horowitz), a Certified Public Accountant (CPA) at Cross, met Cohen and Cruickshank in Clermont, Florida, at Blue Earth's office, and the firm was engaged to provide services for Natural Blue as well as Blue Earth. Tr. 566, 569-71, 602.

Cross resigned in April 2010, and Natural Blue hired audit firm Silberstein Ungar PLLC (Silberstein) at Cohen's recommendation. Tr. 573, 1264-65.

4. Selection of Other Employees

At Cohen's recommendation, Natural Blue hired Bill McPherson, a bookkeeper at Blue Earth, to assist with information technology and to provide bookkeeping services to support Cruickshank in his role as CFO. Tr. 825-26, 931-32, 1604.

E. First Natural Blue Board Meeting

Vuksich prepared materials for Natural Blue's first Board meeting and shipped them to Cohen at Blue Earth's office in Clermont, Florida. Tr. 41-42, 312-13. On July 30, 2009, two days before the Board meeting, Cohen emailed Vuksich asking if he had "any word relating to my ability to be on the Board without public disclosure." Div. Ex. 24; Div. Ex. 299 at 2. Vuksich replied that although Cohen's "crimes are known on the message boards[,]" it was his legal opinion that Cohen's "service on the board need not disclose [his] criminal matters from over 5 years ago." Div. Ex. 299 at 2. Vuksich did not inform Anaya of Cohen's disciplinary history, but instead "treated [it] as a private communication." Tr. 433.

When Vuksich arrived in Orlando to attend the Board meeting, Cohen and Corazzi picked him up and took him on a tour of a recycling facility and Blue Earth's offices. Tr. 326-28. Vuksich had dinner with Cohen, Corazzi, Anaya, Pelosi, Murphy, Cruickshank, and Patricia Cohen. Tr. 330-31, 845. Prior to this trip, Vuksich had only spoken to Anaya on the phone. Tr. 333.

On August 1, 2009, the first Board meeting was held in Orlando, Florida, at the offices of Prism One, a technology company headed by Burshan, and shareholders formally consented to the election of Anaya, Pelosi, Murphy, Burshan, and Kim as Board members. Tr. 61, 833-34; Div. Ex. 24; Cohen Ex. 55. Anaya, Pelosi, Vuksich, and Cruickshank were elected officers of Natural Blue. Div. Ex. 24 at 2. Cohen, Corazzi, and Cohen Jr. were present at the Board meeting. Div. Ex. 24 at 1.

During the meeting, Cohen advised the Board that Natural Blue had acquired EcoWave, LLC (EcoWave), a company specializing in converting water debris to fertilizer. Tr. 489-90, 847-49; Div. Ex. 24 at 1; Cohen Ex. 432. After the meeting, Anaya asked Vuksich to prepare a "summary of obligations of Board Members to their corporate entity as well as to the company's investors," which Vuksich did. Tr. 437; Cohen Ex. 59 at 1.

F. Natural Blue's Acquisition of EcoWave LLC

***10** Cohen first learned of EcoWave through Board member Kim, who had connections to EcoWave's plant in Seoul, South Korea. Tr. 490, 849. Anaya had not discussed the acquisition of EcoWave with anyone prior to the August 1, 2009, Board meeting. Tr. 850; Div. Ex. 24 at 1. Although Anaya recalled that during the first Board meeting Cohen "recommended [EcoWave] … as a good investment opportunity for the … company to pursue" and provided a "fairly elaborate presentation with PowerPoint and handouts," Board minutes reflect that Natural Blue had already acquired EcoWave at that point. Tr. 849-50; Div. Ex. 24 at 1. Anaya felt positive about EcoWave and recalled that Pelosi was also in favor of the transaction because the water business proved challenging and Natural Blue was accruing many bills. Tr. 488-90, 555, 1129.

Initially, Board members Kim and Burshan were in charge of EcoWave. Tr. 1129. Following conflict between Cohen and Burshan, Burshan resigned and Anaya hired Cohen Jr. to manage EcoWave. Tr. 826, 1129.

G. Natural Blue Executes Consulting Agreements with Cohen and Corazzi

Cohen and Corazzi had planned to travel to West Virginia in November 2009 to meet investors and raise capital for Natural Blue. Tr. 857-58. On November 19, 2009, shortly before the fundraising trip was to occur, Anaya emailed Pelosi, Murphy, and Kim that the four of them needed to talk about "an urgent matter" regarding consulting agreements with Cohen and Corazzi. Cohen Ex. 89. Anaya urged Pelosi, Murphy, and Kim to convene because he had received a phone call from Corazzi informing him that Cohen was refusing to fly to West Virginia "unless [Natural Blue] had a formal [consulting] contract with him." Tr. 858-59. Corazzi emailed Anaya a proposed consulting contract which Corazzi said "absolutely had to be … agreed to or else the money … wasn't going to be pursued." Tr. 858.

Murphy and Pelosi raised objections to the consulting agreements on a two-hour Board phone call, because they felt that the agreements favored Respondents at Natural Blue's expense. Tr. 85-88, 195-96, 201, 503-05, 859; Div. Ex. 50; Cohen Ex. 85. However, Anaya strongly urged the Board to approve the contracts. Tr. 859. The Board ultimately approved the contracts and Natural Blue entered into an Engagement and Advisory Fee Agreement with JEC Corp. (owned by Patricia Cohen), pursuant to which JEC Corp. would represent Natural Blue in connection with certain prospective mergers and acquisitions and would use its best efforts to effectuate those transactions. Tr. 859; Div. Ex. 43 at 2; Div. Ex. 300 ¶¶ 20, 24. The agreement specified that JEC Corp.'s services to Natural Blue would be provided through Cohen and Corazzi. Div. Ex. 43 at 1; Div. Ex. 300 ¶ 24. Natural Blue also entered into an Advisory and Management Fee Agreement with JEC Corp., pursuant to which JEC Corp. would organize and manage a new Natural Blue subsidiary called Natural Blue Steel, Inc. (NBS). Tr. 859; Div. Ex. 44; Div. Ex. 300 ¶ 24-25. That agreement similarly specified that JEC Corp.'s services to Natural Blue would be provided through Cohen and Corazzi. Div. Ex. 44 at 1; Div. Ex. 300 ¶ 25. Although Pelosi had ultimately voted to approve the consulting agreements, he later emailed Anaya that he disagreed with the contracts. Tr. 866-67; Div. Ex. 50.

***11** In total, Corazzi received $251,720 in payments from Natural Blue, while Cohen received $189,188, including reimbursements of expenses, which were not otherwise broken out. Tr. 1388-89; Div. Ex. 253. Natural Blue paid a total sum of $377,410 to officers and employees of Natural Blue in compensation. Div. Ex. 253.

H. Anaya's Control Over Natural Blue

When Anaya joined Natural Blue as Chairman and CEO, he understood that it was his responsibility to make "the material decisions with respect to the activities of the corporation." Tr. 1012. Anaya understood that Pelosi would be in charge of "the day-to-day operations as president" and expected that his own "role as chief executive officer of Natural Blue would be similar to that as chief executive officer of the State of New Mexico, in that [he] would be overseeing the various activities" of the company. Tr. 1015, 1057-58. As Governor, Anaya relied on the knowledge of his staff and their expertise in particular areas to make decisions, and his practice as Chairman and CEO of Natural Blue was similar. Tr. 403, 1011-12; Cohen Exs. 22, 31.

In his initial interactions with Anaya, Vuksich was surprised to learn that Anaya was not well-acquainted with Natural Blue's financials or corporate formalities. Tr. 362, 457. Nevertheless, he regarded Anaya as "the individual who ultimately had to make decisions on behalf of [Natural Blue]," and would consult Anaya regarding "anything significant … no matter who had given [him] inputs, [he] would go to him if it was — had to be approved." Tr. 389-90; Cohen Ex. 19. To Vuksich it was clear that Anaya was diligent in reviewing the material he sent him and "responded as the chief executive officer of the company." Tr. 395, 406-07. Similarly, during the time Decker served as legal counsel for Natural Blue, he had ongoing contact with Anaya and considered him "capable of serving as CEO or an executive role," despite his "obvious[]" lack of experience with financial reporting. Tr. 1513, 1537.

Anaya delegated many tasks to, and heavily relied on, Cohen and Corazzi. For example, Anaya relied on Corazzi to handle all communications and press releases and to manage the Natural Blue website. Tr. 885-87, 959; Div. Ex. 65; Cohen Ex. 230. Cohen and Corazzi frequently directed Anaya's decisions as CEO, and Anaya "deferred to [Cohen and Corazzi] a lot on most stuff." Tr. 218. For example, on September 30, 2010, Cohen emailed Anaya, directing him that "it is time to send a letter to shareholders from you[.] I would suggest you address the time that has [passed] and that we are finally rounding the corner with the beginning our first demo project." Div. Ex. 124. The next day, Anaya forwarded the email to Corazzi, asking him for "any thoughts on how [to] draft [the] letter." *Id.* Pelosi testified that Anaya would often send him items with a note that Cohen and Corazzi had "signed off" on them, without giving Pelosi or other Board members sufficient information to review before executing the decision. Tr. 560-61.

***12** Anaya soon became frustrated with the prominent role Cohen and Corazzi occupied in the management of Natural Blue. "Cohen was constantly interacting, interfacing, interfering with employees, with Board members, giving direction to employees, trying to direct Board members in their carrying out of their responsibilities." Tr. 1144. Cohen and Corazzi routinely dealt with Natural Blue's attorneys without Anaya being present on a host of issues, including acquisitions and financial matters. Tr. 870, 1515-16, 1543; Div. Ex. 78. Cohen was more than merely an "activist shareholder," "[he] was trying to run the company as the founder of the company, the person who selected the Board members, the person who selected the staff." Tr. 1144-45. Anaya considered that Cohen's decisions were brought to the Board "basically [for] ratification," and that Cohen "was not expressing his opinion as a shareholder." Tr. 1144-45. Cohen was present, either in person or by telephone, at all or most of the Natural Blue Board meetings. Tr. 479-80, 1520.

By August 2009, Anaya felt unable to carry out the role of CEO because Cohen "was making a lot of decisions and he was helping direct the operation of the company, to the point where [Anaya] expressed to Mr. Corazzi that [Anaya] needed to step down, that [Anaya] simply could not operate as a figurehead [because] … Cohen was just meddling too much in the day-to-day operations." Tr. 843, 1133-39. Anaya told Corazzi that he could not be "CEO in name only." Tr. 1137. However, Cohen assured Anaya he would allow both Anaya and Pelosi to perform the roles they had assumed, and Anaya agreed not resign. Tr. 844, 1139. For Anaya, "there were a lot of specific incidents that ultimately cumulatively led [him] to believe [that he] would never really be able to play the role of chairman and CEO [because] … Mr. Cohen … founded the company, the initial company, and

… he selected the officers [and] … he brought his son, James Cohen, Jr. on to the payroll ….” Tr. 852. As a result, from Anaya's perspective, Cohen “was running the company” and acting as President and/or CEO. Tr. 856, 1146. Also, Anaya “never knew what [he] wasn't being told” by Cohen and Corazzi. Tr. 1033; Div. Ex. 83 (April 29, 2010, email from Cohen to Corazzi saying “lets not let Toney know we sent [the term sheet] already.”).

In late April or early May 2010, Anaya learned that Cohen and Corazzi had purchased a building (the Hoover building) which had originally been identified by a consultant for Natural Blue, but which Cohen and Corazzi purchased on behalf of their own, separate company, without first offering it to Natural Blue. Tr. 902-04. Cohen admitted to Anaya that this event had transpired but blamed Corazzi. Tr. 903-05. Furious, Anaya temporarily suspended Cohen and Corazzi's contracts, with the Board's support. Tr. 903-04, 1030-31.

***13** On August 22, 2010, Anaya emailed Corazzi, noting that he was “tired of the tirades like you just tried to lay on me” and that Anaya “could get no more than two words in before you would attack me with vulgarities and insults.” Cohen Ex. 260 at 2. Anaya explained that “week after week, I have received absolutely no details from you — EVER — regarding the status of the steel deals.” *Id.* Anaya noted that “if the shit hits the fan, it is me and me alone that will be on the firing line with the SEC and/or disgruntled shareholders. You can try and walk away as merely a ‘consultant.”' *Id.*

On September 16, 2010, Anaya explained to Cohen that he was unable to “effectively manage [Natural Blue] for whatever length of time I may be here with you constantly second-guessing me on even trivial stuff and demanding I call you first on things.” Div. Ex. 111. Anaya felt that he was “made to fail [because] … [CEO] decisions were basically taken out of my hands primarily by James Cohen, Sr., because I could never get access to the financial reports, the data that I would need to fully analyze what was going on.” Tr. 1014.

Anaya's frustration continued and on September 20, 2010, Anaya emailed Cohen explaining that the “principal issue” he had with Cohen was “what authority you think you should have over me and the Board regarding management decisions … management decisions need to be left to the CEO — whomever that may be — with direction from the Board.” Tr. 953-54; Div. Ex. 115. That same day, Anaya corresponded by email with Corazzi about Respondents' consulting agreements. Tr. 957-58; Div. Ex. 116. Anaya explained to Corazzi that “Bob [Hunt] called me concerned that he was not getting to run the company as we had agreed; but, instead your email suggests that the three of you [Cohen, Corazzi and Hunt] run the company (i.e., he is an ‘equal’ and not ‘President.’).'D' Div. Ex. 116.

Anaya and Respondents also clashed when Cohen and Corazzi recommended that only 10% of revenue from subsidiary NBS flow up to Natural Blue. Tr. 963. On September 21, 2010, Anaya explained to Corazzi that “[i]t is sheer lunacy to have a consulting firm dictate, through me, to the parent company that owns 100% of the subsidiary what it can and cannot do with revenues flowing in. That is neither smart and probably not legal for me to do ….” Div. Ex. 119. Anaya emphasized to Corazzi that he did not “want to give up legal authority of [Natural Blue] to [Cohen,] who claims to ‘only’ be a ‘consultant’ when it suits him; and, to be the ‘founder’ when convenient to him.” Tr. 965-66; Div. Ex. 116.

***14** Despite his frustration, Anaya did not resign from Natural Blue in September 2010 because he felt there was “still some hope of piecing things … together with the [NBS] Division.” Tr. 957.

I. Pelosi's Departure from Natural Blue

In August 2009, shortly after Natural Blue went public, Pelosi began a full-time job at a securities firm because he felt that his expertise in water business technology was not needed at Natural Blue. Tr. 507, 510. Pelosi acknowledged that as a result of this job, he was not in a position to run the day-to-day operations of Natural Blue. Tr. 510. At the time, Anaya was not aware that Pelosi had taken on a full-time job. Tr. 990. Although Pelosi kept his title of President, he testified that he was unable to reach Anaya for the next four months, despite various efforts. Tr. 508-09.

In late 2009, Cohen told Pelosi that the Natural Blue shareholders were unhappy with Pelosi's performance and that they had the "votes to vote [Pelosi] off" the Board. Tr. 223, 508. In December 2009, Cohen and Corazzi emailed Board members a "Written Consent of the Stockholders in Lieu of a Meeting," soliciting a signature to remove Pelosi. Div. Exs. 59, 264. On January 7, 2010, Pelosi emailed Cohen, noting that "the information that 27 million shares have been voted in favor of my resignation suggests current shareholders believe that my reduced role in the company is in [their] interest." Cohen Ex. 106. Pelosi realized that "it just wasn't in the cards," and rather than be fired, resigned as President and Board member, effective January 11, 2010. Tr. 509, 1027; Div. Ex. 300 ¶¶ 8, 10; Cohen Ex. 107 at 2.

On April 26, 2010, Pelosi emailed Anaya and Decker that he had received a ""very confusing call" from Cohen in which Cohen threatened Pelosi and "said he was taking back [Pelosi's] shares in Natural Blue." Div. Ex. 80. Pelosi asked Anaya and Decker for clarification on whether "[Cohen] has any role with the company" because "[o]n many board calls I asked for this clarification and Chairman Toney represented that Jim Cohen was part of the company management …." Div. Ex. 80. Pelosi testified that he was frustrated that Anaya did not simply give him his stock certificate and instead directed him to talk to Cohen. Tr. 517.

J. Investor Recruitment

Cohen was responsible for soliciting investors for Natural Blue, with assistance from Corazzi, and was the main contact for addressing "shareholder questions [and] financial matters." Tr. 76, 823, 888, 1240; Div. Ex. 37. Cohen responded to investor emails and represented to investors that he "handle[d] communications for the company." Div. Ex. 34.

***15** It was uncommon for Anaya to attend investor meetings. Tr. 889. When Anaya inquired about investor meetings, he encountered resistance from Cohen and Corazzi, who did not want to discuss any details. Tr. 889. Cohen took custody of the stock certificates received from Natural Blue's transfer agent, and Corazzi directed Anaya to ensure the stock certificates were issued to investors. Tr. 1610-11; Div. Ex. 89.

On November 20, 2009, Cohen and Corazzi gave a presentation in Richlands, Virginia, to a group of fifteen investors. Tr. 230-31. They distributed pamphlets and told the audience that "the value of the [Natural Blue] stock could be in the range of 15 to 20 dollars" and that "anticipated revenues in 2010 would be somewhere between 200 million and 400 million dollars." Tr. 231-32. Respondents discussed Natural Blue's subsidiaries at great length and represented that NBS had procured contracts in the range of $60 million in value. Tr. 231. They also described Anaya and Pelosi's management roles at Natural Blue, despite the fact that at that time Pelosi had already taken on another full-time job. Tr. 233-34, 507-10. One of the audience members, Joseph Robinson, a 77 year old retired civil engineer, "was excited to see that [Anaya and Pelosi] were involved in Natural Blue." Tr. 234. From the presentation, Robinson had the "impression [] that [Cohen and Corazzi] were both involved in the day-to-day operations of Natural Blue Resources and their subsidiary companies." Tr. 233, 243. Robinson felt that there was an opportunity to "make a lot of money" and subsequently invested a total of $137,900 in Natural Blue in 2009 and 2010. Tr. 234-35. During this time, Robinson spoke often with Cohen and on occasion with Corazzi, but never met anyone else involved in Natural Blue's management. Tr. 236-38. At the end of 2010, Cohen stopped returning Robinson's calls, and Robinson never recovered any of his investment. Tr. 235. Robinson was not aware of Cohen and Corazzi's disciplinary histories when he invested in Natural Blue; had he been aware, he would never have invested. Tr. 236-37.

Another investor, Elizabeth Flaherty, an operations manager at AMS, invested between eight and nine thousand dollars in Natural Blue in 2009 or 2010 after she learned that Tocci, head of AMS, was investing in Natural Blue and that Anaya and Pelosi were involved in its management. Tr. 753-54. Flaherty spoke to Cohen many times on the phone in her capacity as an AMS employee and was under the impression that Cohen and Corazzi were "running" Natural Blue. Tr. 754-58, 761. She was not aware of Cohen and Corazzi's disciplinary histories when she invested and would never have invested had she known. Tr. 758-59. Flaherty lost all of her investment in Natural Blue. Tr. 759, 761.

In April 2010, Cohen, Corazzi, and Anaya met with a venture capital firm in New York City in an effort to raise capital. Tr. 887-90. Although Anaya attempted to obtain details about the meeting beforehand, he was "led to believe by Mr. Corazzi that it

was such a sensitive meeting that if [Anaya] inquired too much or tried to reach out to him directly, [Anaya] could mess up the deal." Tr. 890. Corazzi took the lead in making the presentation. Tr. 893. During a break in the presentation, Cohen confessed to Anaya that he had been in jail. Tr. 895. Anaya and Cohen did not have any further conversations about it and Anaya did not mention it to anyone but Steve Rountree, Natural Blue's attorney at the time. Tr. 895-96.

K. Control over Natural Blue's Books and Records, Disbursements of Payments, and Preparation of Financial Statements

1. Books and Records

***16** Following Natural Blue's first Board meeting, Vuksich discussed Natural Blue's balance sheet liabilities with Anaya and realized that Anaya "was not apprised of the nature of the liabilities of Datameg that had been taken on [by Natural Blue] in the reverse merger." Tr. 338. Vuksich was surprised that Anaya did not know about the liabilities because he had assumed that "discussions of liabilities that went on between Mr. Murphy and Mr. Cohen would go straight back to Mr. Anaya." Tr. 345. Once Anaya learned about Datameg's liabilities, he called an "emergency" meeting to discuss the liabilities and had a heated exchange with Corazzi, upset that he had not been told about the debts Natural Blue had taken on. Tr. 350, 439; Div. Ex. 69 at 41.

Vuksich held custody of Natural Blue Nevada's books and records, which he transferred to Cruickshank when Cruickshank became CFO of Natural Blue. Tr. 340-41. Natural Blue's accounting records were stored on Natural Blue's server and hardcopy financial records were kept under Cruickshank's control in Clermont, Florida, in office space Natural Blue shared with Blue Earth. Tr. 41-42, 931, 1606, 1615.

Anaya did not have access to Natural Blue's financial records in Clermont, Florida, and suggested many times moving Natural Blue's operations, including the bookkeeping, to New Mexico to allow Anaya to "immediately assume control" and "better manage the company and its wholly-owned subsidiaries." Tr. 831, 934; Div. Exs. 109, 112; Cohen Ex. 149 at 2; Cohen Ex. 161 at 2. Anaya believed that Cohen directed both Cruickshank and McPherson to deliberately withhold financial documents from him. Tr. 1034-36, 1271. However, Cruickshank did not recall Cohen ever asking him not to send materials to Anaya, and could not recall whether or not Cohen had access to the passwords needed to access Natural Blue's financial records online. Tr. 1599, 1610.

When Cruickshank resigned as CFO of Natural Blue in August 2010, Anaya planned to fire McPherson and hire Anaya's daughter, Kristina Bibb, to replace him as bookkeeper. Tr. 943, 1588; Div. Ex. 300 ¶ 9; Cohen Ex. 11. In September 2010, Anaya contacted Cruickshank for help with putting together a budget for Natural Blue, but Cruickshank declined and informed Anaya that he would be suing Natural Blue and Blue Earth for money owed for his work while CFO. Tr. 941; Div. Ex. 109 at 3-4; Div. Ex. 112. When Cohen found out about the call and Anaya's plan to hire his daughter, he was furious and berated Anaya for having reached out to Cruickshank and for considering hiring his daughter as a bookkeeper. Tr. 943; Div. Ex. 111. Anaya sensed from the conversation that Cohen was upset that Anaya "was finding a way to take control of the financial records of the company and, with that, that [Anaya] was finding a way to take control of the company." Tr. 944; Div. Ex. 111. Anaya was never able to "get the bookkeeping under [his] control." Tr. 831; Div. Ex. 55.

2. SEC Filings

***17** Natural Blue's CFO was generally responsible for preparing Natural Blue's securities filings, in collaboration with several others. Tr. 869. During his term as CFO, Cruickshank prepared the financial statements using the general ledger of Natural Blue's reporting system. Tr. 1593. After receiving the attorney's approval, Cruickshank recalled distributing the draft filing to "all the management and/or who they designated it to be distributed to," to ultimately be approved by Anaya and the Board. Tr. 1593. However, drafts of securities filings typically came to Anaya from Corazzi, and Anaya, Cohen, Corazzi, Natural Blue's General Counsel, and its outside auditing firm reviewed them and provided feedback. Tr. 869-70, 910-11, 1254-56; Div. Ex. 95.

Anaya submitted every public filing to Cohen and Corazzi for review, unless he knew the filing originated with either Cohen or Corazzi or had already been approved by them. Tr. 1088; Div. Exs. 95, 98, 267.

Cruickshank recalled an occasion when Corazzi called him regarding “when [Natural Blue was] filing the 10-K's or Q's'D' and Corazzi began “ranting and raving about [what Cruickshank] had to get [] done and screaming and hollering at [Cruickshank].” Tr. 1615. Cruickshank felt uncomfortable because Corazzi “wasn't an officer, as far as [he] knew,” and therefore questioned whether Corazzi had “authorization to call [him] like that.” Tr. 1616.

Decker, Natural Blue's attorney from October 2009 to May 2010, assisted with the preparation and correction of Natural Blue's public filings during that time. Tr. 1521-22; Div. Ex. 300 ¶ 11. Decker worked with Cruickshank with respect to accounting issues and recalled that Cruickshank would not prepare complex 8-Ks. Tr. 1523-25. Decker routinely communicated with Cohen and Corazzi, who, he understood, were authorized to contact him directly without Anaya's involvement. Tr. 870, 1543; Div. Ex. 78. However, Decker did not “recall having a lot of discussions or any discussions with [Cohen] on the totality of the 10-K under any circumstances.” Tr. 1540-41. Decker testified that Anaya had the ultimate say as to whether to file a document or not. Tr. 1525; Cohen Exs. 117, 139.

Natural Blue's Form 10-K for 2009 was filed with the Commission on April 2, 2010, and Forms 10-Q for the first three quarters of 2010 were filed, respectively, on May 14, 2010, August 13, 2010, and November 22, 2010. Div. Ex. 300 ¶ 26. Natural Blue's Form 10-K for the year ended December 31, 2009, states that in November 2009, Natural Blue entered into a Management Agreement and an Advisory Agreement with JEC Corp. *Id.* at ¶ 27; Div. Ex. 75 at 32. It states that JEC Corp. “is owned by one of our shareholders and the shareholder is related to one of our consultants.” Div. Ex. 75 at 32; Div. Ex. 300 ¶ 27. The Form 10-K itself does not specifically identify either Cohen or Corazzi or disclose their disciplinary histories. Div. Ex. 75 at 32. However, included as exhibits to the 10-K are both the Management Agreement and the Advisory Agreement that the company entered into with JEC Corp. *Id.* at Exs. 10.1, 10.2. These agreements list Cohen as “Chairman & CEO” of JEC Corp., and he executed both agreements. *Id.* Decker testified that he chose not to list Cohen or Corazzi in the securities filings because he did not feel that their responsibilities made them executive officers under the disclosure rules. Tr. 1538. Anaya approved and signed the 2009 Form 10-K as Natural Blue's CEO. Div. Ex. 300 ¶ 27.

***18** Natural Blue's Form 10-Q filings for the first three quarterly periods of 2010 contained the same disclosure about the Management Agreement and the Advisory Agreement with JEC Corp. Div. Exs. 84, 97, 134, 194; Div. Ex. 300 ¶ 28. As Natural Blue's CEO, Anaya approved and signed all these filings. Div. Ex. 300 ¶¶ 27, 30. Anaya felt comfortable signing the Sarbanes-Oxley certification based on what had been represented to him by Cruickshank, Corazzi, Cohen, the auditors, and legal counsel. Tr. 1016.

Anaya testified that Cruickshank resigned as CFO of Natural Blue because Cruickshank was not comfortable working with Cohen and was concerned about ““getting himself into trouble.” Tr. 933. However, Cruickshank denied ever telling Anaya that he was resigning because he was tired of dealing with Cohen or that he did not want to get in trouble. Tr. 1600-01. Instead, Cruickshank explained that he resigned because the CFO position was too much work, required him to live in a hotel, and he was often not paid on time. Tr. 1533, 1595, 1600, 1619-20; Cohen Ex. 149 at 2. Cruickshank's explanation is more believable and is found as fact.

After Cruickshank resigned in August 2010, Jehu Hand (Hand) became CFO on September 27, 2010. Tr. 910-11; Div. Ex. 300 ¶ 9. Cruickshank sent Hand “copies of [the] internal ledger and any detail that he asked for.” Tr. 1598. During Hand's term as CFO, Hand, Cohen, Corazzi, and Rountree were in charge of preparing SEC filings for Natural Blue. Tr. 910.

When Erik Perry (Perry) later assumed office as CEO of Natural Blue on January 27, 2011, Perry told Anaya he had difficulty obtaining the records needed for Natural Blue to prepare its public filings. Tr. 1037-38; Div. Ex. 300 ¶ 7. Perry approved and signed a Form 8-K filed on February 2, 2011, and a Form 8-K/A filed on February 4, 2011, as Natural Blue's CEO. Div. Ex. 300 ¶ 34; Cohen Exs. 392, 393. Perry also approved and signed an amended Form 10Q, filed on February 8, 2011, for the third

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quarter of 2010, that contained the same disclosure as previous filings regarding the Management Agreement and Advisory Agreement with JEC Corp. Div. Ex. 300 ¶ 35.

3. Relationship with Auditors

Although it was audit firm Cross's expectation that Cruickshank, as CFO, would be its primary contact at Natural Blue, Cruickshank was not because Cross found that "he was not very capable or didn't have the knowledge that [Cross] needed." Tr. 576, 601. Cross CPA Horowitz discussed both administrative and substantive matters with Cohen that Horowitz did not discuss with others, such as financial statement disclosure issues related to JEC Corp. Tr. 576-77, 580-81.

Horowitz developed concerns with Natural Blue because of the difficulties Cross encountered in obtaining information needed to conduct the audit. Tr. 583. In addition, Horowitz was concerned that Natural Blue was "situated right next to Mr. Cohen's office" and that "everyone sort of defers to [Cohen] as the guy in charge of the company" despite the fact that "[h]e is not a named officer or principal of the company." Tr. 583-84. Horowitz never interacted with Pelosi, nor was he aware that he was President of Natural Blue. Tr. 578. Horowitz's first interaction with Anaya came in March 2010, shortly before Cross issued its audit report on April 5, 2010. Tr. 577-78; Cohen Ex. 424.

***19** Natural Blue's account with Cross was in arrears. Tr. 577-78, 617; Cohen Ex. 426. Cross also became concerned about the "integrity of management" when it learned about Cohen's disciplinary history. Tr. 589. When Horowitz asked Cohen about his disciplinary history, Cohen denied that the records applied to him and claimed that his middle initial was not "E." Tr. 590. Moreover, Cohen told Horowitz that even if the records did refer to him, "this person is not barred from being involved with public companies. They are barred from dealing with broker-dealers." Tr. 590-91. Cross felt uncomfortable being associated with Cohen and resigned in April 2010. Tr. 573, 589-90; Cohen Exs. 425, 426. Silberstein was subsequently hired as Natural Blue's auditors at Cohen's recommendation. Tr. 1264-65.

4. Control over Natural Blue's Treasury Functions

Natural Blue's procedure for approving invoices required that Cohen approve invoices before Anaya would sign off on them. Tr. 828-30; Div. Exs. 23, 266; Cohen Ex. 11 (describing the need to "[p]ay invoices approved by [Cohen and Vuksich].").

Although only Cruickshank and Anaya had formal authority to make payments on behalf of Natural Blue, Cohen authorized wire transfers on his own. Tr. 1037, 1591. Additionally, Cohen had formal authority over Natural Blue's brokerage account. Div. Exs. 25, 27, 80.

L. 2011 Atlantic Transaction

Atlantic Dismantling and Site Contractors Corp. (Atlantic Dismantling) was a Massachusetts corporation organized in July 2008. Div. Ex. 300 ¶ 14. Atlantic Dismantling was in the business of demolition and site work, which it did principally as a subcontractor on local construction projects. *Id.* at ¶ 15. Atlantic Acquisitions, LLC (Atlantic), was a Massachusetts Limited Liability Company organized in July 2010 to engage in the business of salvaging and selling scrap metal. *Id.* at ¶¶ 16, 18. In January 2011, Atlantic became the parent company of Atlantic Dismantling. Div. Ex. 300 ¶ 17.

In October or November 2010, Eric Ross (Ross), principal of Watch Harbor Asset Management (Watch Harbor), met with Atlantic principals Salvatore Tecce (Tecce) and Joseph Montalto (Montalto) to discuss a potential business venture between Atlantic and Watch Harbor. Tr. 648-50. Atlantic was looking for financing that would allow it to demolish condemned buildings and sell the scrap materials. Tr. 649-50. Ross was eventually put in contact with Erik Perry (Perry) of Atlantic, who explained to Ross in late 2010 that Natural Blue was interested in acquiring Atlantic. Tr. 650, 657-58, 666-67. Ross advised Perry not to get involved with Natural Blue because of the regulatory and other challenges that it would face as a small public company. Tr. 665, 708. Nevertheless, Montalto and Perry participated in several conference calls with Cohen and Corazzi in November and

December 2010. Tr. 1337-38. Although Montalto understood at this time that Anaya was the CEO of Natural Blue, he viewed Natural Blue as Respondents' "baby," because Respondents had formed the company, and "[Respondents] were the ones trying to bring in the projects to the company to keep it going." Tr. 1338-39.

***20** In January 2011, Cohen, Corazzi, Montalto, Perry, Tecce, and Robert Christoff, a developer, met in Miami, Florida, to discuss the budding agreement between Natural Blue and Atlantic. Tr. 1339-40. Cohen and Corazzi told Perry they wanted him to be the President and CEO of Natural Blue. Tr. 1341. Although Tecce had advised Respondents not to select Perry because Perry was ""irrational" and a "loose cannon," Cohen and Corazzi explained that Perry was a good choice because he could be used as "'a puppet' to be [at] the forefront of the company." Tr. 1341. During the meeting, Perry, Corazzi, and Christoff phoned Ross and outlined the rough terms of a deal between Natural Blue and Atlantic. Tr. 671. Perry and Corazzi explained to Ross that Perry would be the new CEO of Natural Blue, and recruited Ross to serve as an advisor to the Natural Blue Board. Tr. 671-72; Div. Ex. 149. Ross subsequently communicated with Corazzi and provided revisions to a draft agreement between Watch Harbor and Natural Blue. Tr. 678-79; Div. Exs. 149, 150.

Anaya first learned the specific provisions of the Atlantic transaction in early January 2011 when Corazzi presented the contract to him. Tr. 970-71. Anaya felt the Atlantic transaction would "provide an exit strategy for [him] to get out of the company and leave it in much better shape than it probably had ever been, based on the representations in the contract." Tr. 970. Anaya never met the management of Atlantic in person, and spoke to Montalto for the first time about two weeks prior to the signing of the agreement. Tr. 970-71, 1328-29.

On January 5, 2011, Anaya emailed Corazzi his comments on the draft agreement with Atlantic. Cohen Ex. 332. Three days later, Anaya emailed Corazzi, Rountree and Cohen, asking that Atlantic's financial information be sent to Paul Whitford, an acquaintance of Corazzi's who had joined the Natural Blue Board, adding that "I don't need to see [the financial information] and would rely on [Whitford's] judgment." Tr. 906, 938-39; Div. Ex. 147 at 2. Anaya relied on "whatever due diligence had been done by Mr. Corazzi and Mr. Cohen, Sr., and their representations to me and to the Board … [as] the primary due diligence" for the Atlantic transaction. Tr. 977.

On January 13, 2011, Ross emailed Corazzi that he was interested in the offer. Tr. 682; Div. Ex. 149. Corazzi and Cohen were the only individuals from Natural Blue to whom Ross spoke regarding the transaction, and Ross's impression was that "Corazzi was making decisions for the company." Tr. 678-79, 682-83, 686, 702; Div. Ex. 152. During the negotiations, Ross "heard about Toney Anaya very infrequently at best." Tr. 688, 730-31.

On January 16, 2011, Anaya emailed Whitford:

> It would be so great — and, the normal way of doing business — to have full facts in front of us before we make any decisions regarding the future of [Natural Blue]. The reality, however, is that I/we will be at the mercy of whatever Joe [Corazzi] chooses to tell us about th[ese] negotiations with Atlantic, which, I suspect, will only be part of the truth and by no means the full facts.

***21** Div. Ex. 260. On January 20, 2011, Cohen emailed Anaya another draft agreement with Atlantic and instructed him not to forward it to anyone and that he was "still negotiating." Cohen Ex. 351. Anaya responded with comments and questions regarding the agreement. *Id.*

On January 21, 2011, Anaya wrote Cohen, explaining: "I want this deal to go through as I can't take any more of what the last several months have been. If you would keep me advised as you have been negotiating, I would know what is in the agreement and why it is in there." Cohen Ex. 359. Anaya added that he would "go along with" whatever Corazzi negotiated, but requested that:

> [i]n asking me to sign something, please don't get [angry] when I ask questions that don't seem to have a clear answer on the face of the documents you sent. Also, please recognize that it is typical to ask me to sign something immediately, under the gun, or the world is going to cave in. A little more advance notice to me or involvement would certainly be beneficial.

Id. Anaya concluded his email by explaining that "[i]f this deal does not close, I will be stepping down and I will coordinate with you guys how that impacts you and the company. I want to close this deal or close my involvement with the company." *Id.*

Cohen was very upset when Anaya proposed certain changes that would affect the compensation Cohen was to receive for putting together the Atlantic transaction. Tr. 983-84. In the end, however, Cohen and Corazzi did agree to a few changes Anaya proposed. Tr. 985. After receiving a revised draft, on January 21, 2011, Anaya emailed Corazzi letting him know that "[i]t appears that the revised draft for Watch Harbor addresses the concerns I raised last night" and that he could "live with it now." Cohen Ex. 360.

Corazzi led a January 21, 2011, call that Ross set up between Natural Blue and Star Funding, a small private fund, to discuss Star Funding potentially funding the letter of credit for the Atlantic acquisition. Tr. 689-91; Div. Ex. 161. Perry and Cohen participated in that call. Div. Ex. 161. On January 22, 2011, Corazzi emailed Ross a copy of a non-compete and non-disclosure agreement which Ross had directly negotiated with Corazzi. Tr. 691-92; Div. Ex. 165.

On January 23, 2011, the consulting agreement between Watch Harbor and Natural Blue, signed by Anaya, went into effect. Tr. 694; Div. Ex. 166. That same day, Anaya signed the agreement with Atlantic; it was approved by the Natural Blue Board four days later, on January 27, 2011. Tr. 1318; Div. Exs. 168, 184, 300 ¶ 31; Cohen Ex. 365. On January 25, 2011, Natural Blue had issued a press release announcing that it had entered into "two key agreements to advance the growth, business interests, and future expected profitability of the Company." Div. Exs. 175, 300 ¶ 32. The release quoted Anaya as saying in a letter to Natural Blue shareholders that the agreement with Atlantic "provides for Atlantic to assign tens of millions of dollars in Atlantic steel contracts to [Natural Blue] and to pursue future steel contracts on behalf of Natural Blue Steel Atlantic, LLC, a wholly owned subsidiary to be formed by [Natural Blue]." *Id.* On January 28, 2011, Natural Blue announced that "the anticipated closing for the [Natural Blue] and Atlantic Dismantling transaction has occurred." Div. Ex. 185. Pursuant to the agreement with Atlantic, Perry and Montalto were elected to the Natural Blue Board, with Perry elected Chairman of the Board and appointed as CEO, replacing Anaya. Tr. 1332-33, 1340-41; Div. Ex. 300 ¶ 33.

M. Removal of Perry as CEO of Natural Blue

***22** Once Perry became CEO of Natural Blue on January 27, 2011, Anaya frequently emailed him to assist in the transition. Tr. 986-87. On February 26, 2011, Anaya cautioned Perry "not to let the inmates run the asylum." Div. Ex. 204. With that email, Anaya forwarded Perry a prior email he had sent to Cohen, and explained that "[t]his is only one of many, many communications I've had with [Cohen] wherein he reminds me that he founded the company and expects to have the right to keep dictating how the company should be run." *Id.* Anaya told Perry that he felt that "Mr. Cohen, Sr. and Mr. Corazzi had been running the company from day one and had created all the frustrations with me." Tr. 989.

Perry's tenure as CEO of Natural Blue was short-lived. Following a June 3, 2011, telephonic Board meeting in which the Board decided that Perry was not acting in the best interests of the shareholders, Perry was removed as CEO of Natural Blue. Tr. 1342-45; Div. Ex. 219; Div. Ex. 300 ¶ 7. Cohen listened in on the Board phone call but did not speak. Tr. 1343-44. After agreeing to remove Perry, the Board elected Phil Braeuning as CEO and Chairman, and Montalto as President. Tr. 1346; Div. Exs. 219, 300 ¶ 7. Montalto testified that Perry was ""a control freak" who "was pursuing contracts that we knew could never be fulfilled or we knew that they weren't real." Tr. 1358. Moreover, Montalto testified that "one of the main reasons why [the Board] got

rid of Erik Perry was the contract with Eric Ross. If that had gone through, it would have been … Erik Perry, Eric Ross, and Christoff running the company, and everybody else would have been out.” Tr. 1353.

After the Board call ended, Montalto immediately called Braeuning and Cohen. Tr. 1347-48; Div. Ex. 218 at 23-77. During the call, Cohen referred to Natural Blue as “my company” and explained that by removing Perry, “we keep this company and, you know what, [Perry] can't turn around and arbitrarily say that the guys who created [Natural Blue] … we're going to zero you out … like Erik Perry has threatened multiple times.” Div. Ex. 218 at 25, 28.

N. Expert Testimony [10]

Robert M. Daines (Daines) testified as an expert witness for the Division on corporate governance, specifically, the functional duties typically performed by corporate officers and directors. [11] Tr. 1435-89; Div. Ex. 301. He articulated his views in terms of their “economic” function. Tr. 1446, 1451, 1457-63, 1470-83; Div. Ex. 301 at 11-13.

1. Role of the Chairman of the Board of Directors and Board Members

The Board is elected by shareholders to represent their interest and it has two key roles: an advisory role — to provide strategic leadership or advice, and an oversight role — to supervise the company and its managers on behalf of shareholders. Div. Ex. 301 at 7-8.

***23** The Board is “collectively responsible for the overall direction of the company and its senior executives” and “[t]ypically … delegat[es] responsibilities to the firm's senior executives and to committees of the Board.” Div. Ex. 301 at 8. While Board members advise management on corporate strategy, they do not generally develop the strategy in detail or prepare the company's financial statements. *Id.*

The Chairman of the Board is responsible for running the Board and his obligations may include: presiding over board meetings; scheduling meetings, planning agendas and distributing materials in advance of meetings; board governance, including succession planning and director recruitment; helping to set and communicate the firm's priorities and strategic plans; evaluating management performance, management and director compensation; and merger-related activity. *Id.* When the Chairman is also an officer of the company, that person is often the CEO of the company. *Id.*

2. Key Officer Roles

To determine whether an individual served the economic function of an officer of a company, Daines would compare the individual's actions and responsibilities to the descriptions below for various officers, and examine the individual's acts to determine whether the individual had “general executive responsibility for the conduct of the business and affairs of the Corporation.” Div. Ex. 301 at 9, 11.

To Daines, relevant factors evidencing whether certain individuals control the Board, CEO, or other officers' decisions would be whether the individuals direct that certain actions be taken, negotiate major transactions and seek approval only as a “rubber stamp,” dictate the company's strategic direction, or act as a gatekeeper with regard to the books and records of the company and disbursement of funds. Div. Ex. 301 at 12-13.

Daines explained that it is common for companies to use consultants to raise capital and identify merger opportunities. Tr. 1488-89. Although senior executive officers receive advice and assistance from non-officers, Daines “would not expect advisers and consultants to have control over the details of the company's operations and strategic decisions.” Div. Ex. 301 at 11.

a. Chief Executive Officer (CEO)

The CEO's economic function is to direct the business and operations of the firm on shareholders' behalf. Div. Ex. 301 at 9. The CEO is hired by and answers to the Board, which monitors and advises the CEO in managing the firm's operations. *Id.* In determining whether an individual served the economic function of a CEO or other officer, Daines would consider whether the person "controlled or directed the [official] CEO (or other officer)." Div. Ex. 301 at 11. Moreover, Daines explained that "[i]f the CEO did not make an independent determination of the merits of a particular action, but instead acted as directed by the controller(s), the CEO's title would be merely formal and real control would reside with the person or group that controlled the Board." Div. Ex. 301 at 12.

b. Other Officers

***24** The President is "a high-ranking officer of a company, second only to the CEO and Chairman." Div. Ex. 301 at 10. The President's specific role is determined by the Board. *Id.* The COO "is typically responsible for the day to day internal operations of their company and reports to the CEO of the company." *Id.* The CFO "is typically responsible for the books and records and official financial statements of the company, interacts with the audit committee of the Board of Directors and with the company's independent auditor." Div. Ex. 301 at 10, 13. The CFO generally oversees the treasury functions of the corporation and the company's key financial decisions, and may report to the CEO or Board of Directors. Div. Ex. 301 at 10.

O. Missing Witness

Respondents suggest that an adverse inference be drawn from the fact that the Division did not call "many other participants in the corporate process" to testify at the hearing. Cohen Br. at 1.

The undersigned has not drawn any inference adverse to the Division's case, or to Respondents', from the absence of the unidentified "participants in the corporate process." They were not unavailable to Respondents as witnesses. *See United States v. Cole,* 380 F.3d 422, 427 (8th Cir. 2004); *United States v. Torres,* 845 F.2d 1165, 1170 (2d Cir. 1988). Respondents could have subpoenaed them pursuant to 17 C.F.R. § 201.232. If the Division had interviewed these individuals in the investigation that led to this proceeding, their investigative testimony would have been available to Respondents long in advance of the hearing (unlike the situation in federal criminal cases [12] such as *Torres*).

III. CONCLUSIONS OF LAW

The OIP charges that Cohen and Corazzi willfully violated Sections 17(a)(1) and 17(a)(3) of the Securities Act. [13] As discussed below, it is concluded that Respondents willfully violated Securities Act Sections 17(a)(1) and 17(a)(3). According to the Division's theory of the case, Cohen and Corazzi (a) were *de facto* officers of Natural Blue; and (b) as such, effected a scheme to defraud within the meaning of Securities Act Sections 17(a)(1) and 17(a)(3) by concealing their role and, thus, their disciplinary history.

A. *De Facto* Officers

There is a dearth of precedent regarding what factors determine whether an individual is a *de facto* officer for the purpose of the antifraud provisions of the securities laws. The Division and Cohen (and by extension, Corazzi) both cite *SEC v. Prince,* 942 F. Supp. 2d 108 (D.D.C. 2013) as support for their respective positions, in addition to referring to Exchange Act Rules 3b-7 and 16a-1 (defining "officer" and "executive officer"). [14] The court in *Prince* conducted an extensive analysis of the available precedent, including *C.R.A. Realty Corp. v. Crotty,* 878 F.2d 562 (2d Cir. 1989), *SEC v. Solucorp Indus., Ltd.,* 274 F. Supp. 2d 379 (S.D.N.Y. 2003), and *SEC v. Enters. Solutions,* 142 F. Supp. 2d 561 (S.D.N.Y. 2001). [15]

***25** Whether or not an individual is a *de facto* officer depends on his function, not his title. *Prince,* 942 F. Supp. 2d at 133-37. *See also Crotty*, 878 F.2d at 563; *Solucorp*, 274 F. Supp. 2d at 382-87; *Enters. Solutions, Inc.*, 142 F. Supp. 2d at 574. A

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significant figure in the management of a company cannot hide behind a vague title, such as "consultant." *Id.* "The few cases that have found an employee to be a de facto officer because of their ability to make policy involved alleged 'consultants' who were actually in total control of a company." *Prince*, 942 F. Supp. 2d at 134 (citing *Solucorp*, 274 F. Supp. 2d at 383; *Enters. Solutions*, 142 F. Supp. 2d at 568).

The key officer function is policy making, which includes such areas as mergers and acquisitions, compensation, and contracts. *Prince*, 942 F. Supp. 2d at 134-36. In *Prince*, defendant Prince, an accountant, had a criminal and disciplinary history, including an accounting bar, which his company did not want disclosed to shareholders. *Id.* at 113-15. The court concluded that Prince was not a *de facto* officer despite having a great deal of influence over, and the office next to, the company's Chairman and CEO, as well as being one of the most highly paid employees at the company; the Chairman and CEO and the heads of various groups in the company had the ultimate authority to make or implement any policy. *Id.* at 113-136. Also, Prince could not sign contracts and did not have check writing or wire transfer authority. *Id.* at 115, 126. His criminal record and the fact that he was barred from practicing as an accountant before the Commission were well-known within the company. *Id.* at 120. The CEO, after consulting with counsel, had created a position for Prince that would not require disclosure in company filings. *Id.* at 114-15, 122. A series of "carveouts" were put in place to "fence in" Prince's roles and duties to ensure Prince was not assuming the role of an officer. *Id.* at 115. For example, Prince was not allowed to participate in accounting staff meetings or help prepare financial statements, and was denied "write" and ""read" privileges with regard to certain network drives. *Id.* Nonetheless, Prince regularly made presentations to the Board and attended Board meetings, reviewed contracts and public filings, and held responsibility for acquisitions. *Id.* at 115-20. The court noted that the Division never alleged that Prince was "running the company," and ultimately concluded that Prince was not an officer and there was no "scheme to defraud." *Id.* at 134, 137-44.

***26** In *Solucorp*, defendant Kemprowski had a criminal and disciplinary history, which led to his resigning as an officer and director of Solucorp and becoming a "consultant" instead. 274 F. Supp. 2d at 383. Yet he continued to occupy the company's largest office and received substantial compensation. *Id.* at 384. Like Cohen and Corazzi, Kemprowski was a forceful individual who made it well known that he was the founder of Solucorp and "responsible for raising money for the Company." *Id.* at 384. Also, as in this proceeding, trial witnesses described Solucorp as Kemprowski's "baby." *Id.* at 385. The court found that Kemprowski was an officer of Solucorp "in that he performed a policy-making function … akin to that of a president, principal financial officer or any vice president in charge of a business unit, division or function." *Id.* at 420.

As founders of Natural Blue Nevada, Cohen and Corazzi recruited Anaya and Pelosi to be officers of the public company. Various Board members, officers, employees, attorneys, and auditors were recommended by Cohen and Corazzi and, mostly, approved by Anaya or shareholder vote. However, Board minutes reflect the fact that Cohen finalized the acquisition of EcoWave without receiving Board approval. The Board approved the consulting agreements by which Cohen and Corazzi received compensation. While Anaya insisted on exercising his rightful authority, he considered that Cohen and Corazzi were at least attempting to continue running the company. Anaya complained that he did not receive timely information and was forced into approving decisions on short notice. He never knew what he was not being told. Cohen and Corazzi also were the face of the company in recruiting investors.

The record shows that Cohen and Corazzi assumed responsibility for Natural Blue's operations and strategic plans and thereby exercised the policy-making functions of public company officers and directors. Since founding Natural Blue Nevada together, Cohen and Corazzi guided the direction of the company. In his role as a "consultant," Cohen personally negotiated the reverse merger with Datameg that resulted in Natural Blue becoming a public company, selected Natural Blue's key officers, directors, employees, attorneys and auditors, including Anaya and Perry to serve as CEOs, negotiated and executed key transactions, including the EcoWave acquisition, participated in Board meetings, recruited investors, orchestrated Pelosi's ouster as President, reviewed and commented on public filings, arranged for Natural Blue's financial records to be kept in office space shared with his wife's company in Florida, had formal authority over Natural Blue's brokerage account, and frequently and aggressively berated the CEO. Cohen presented the EcoWave acquisition to the Board as a *fait accompli*. Cohen commenced negotiating the reverse merger with Datameg before informing the Board. Cohen approved invoices before Anaya signed off on them, and

Cohen authorized wire transfers on his own. In sum, Cohen took on a role akin to the CEO, in which he performed a policy-making function that even made Natural Blue's own auditors uneasy, ultimately leading to their resignation.

***27** Similarly, Corazzi, as co-founder of Natural Blue Nevada, had a critical role in selecting Anaya and Perry as CEOs, personally negotiating the Atlantic transaction, participating in reverse merger negotiations with Datameg, recruiting investors, handling press releases and managing the Natural Blue website, reviewing and commenting on public filings, selecting an audit firm, attending Board meetings, soliciting the ouster of Pelosi, and similarly displaying aggressive dominion over the CEO and on occasion the CFO. Corazzi's role, while not as prominent as Cohen's, still rose to the level of an officer, akin to that of a COO responsible for the day to day internal operations of the company, or at the very least that of a "vice-president … in charge of a principal business unit, division or function" within the meaning of Exchange Act Rule 3b-7.

Within a month of Natural Blue's going public, Pelosi had another full-time job and was therefore unable to carry out his duties as President of Natural Blue. This presented no problem for Natural Blue, however, given that Respondents were quick to assume the duties of overseeing its day-to-day operations. Unlike in *Prince*, no one at Natural Blue consulted counsel or put carveouts in place to limit Respondents' control and prevent them from serving as *de facto* officers. *See Prince*, 942 F. Supp. 2d at 122. Rather, as in *Solucorp*, Cohen and Corazzi made clear to Natural Blue's officers, directors, and negotiating counterparts that they were the founders of Natural Blue and that the company was their "baby." Investors, however, were kept in the dark as to Respondents' true roles at Natural Blue.

Cohen and Corazzi unquestionably made policy-making decisions. Cohen and Corazzi selected Natural Blue's officers and directors — selections that were merely ratified by the Board or shareholders. Cohen informed the Board after the fact of the EcoWave acquisition, rather than soliciting the Board's approval beforehand, and in so doing usurped the Board's role. The fact that the Board may have subsequently thought it was a wise decision does not detract from the conclusion that Cohen made a policy-making decision. Similarly, Corazzi took the lead in negotiating and functionally approving the Atlantic transaction. Although Anaya's signature was on Natural Blue's contracts, the record demonstrates that Anaya fought Respondents for control of Natural Blue and, despite embarking on his role as CEO with good intentions, he largely ratified decisions Respondents had already made.

Respondents point to the facts that public filings were signed by Anaya, Cruikshank, and other officers, that the Board formally elected officers that were recommended by Respondents, and to instances of Anaya attempting to carry out his duties as CEO, as evidence that Respondents were not in control and that the final say rested with Anaya and other officers. Again, the fact that Natural Blue's officers and directors may have made every effort to execute their duties does not preclude the conclusion that Respondents operated as *de facto* officers of Natural Blue. Moreover, the fact that Respondents may have made sensible recommendations that officers and directors ratified is similarly not inconsistent with the conclusion that Respondents operated as *de facto* officers.

***28** Unlike *Prince*, there is no evidence of record that Cohen and Corazzi's legal and disciplinary issues were widely known in Natural Blue. Anaya was aware of Corazzi's officer and director bar before he became involved with Natural Blue, but he did not learn of Cohen's conviction until Cohen divulged it in April 2010.

B. Antifraud Provisions

Respondents are charged with willful violations of Sections 17(a)(1) and 17(a)(3) of the Securities Act, which make it unlawful "in the offer or sale of" securities, by jurisdictional means, respectively, to: (1) employ any device, scheme, or artifice to defraud; or (2) engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

1. Scienter

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Scienter is required to establish violations of Securities Act Section 17(a)(1). *Aaron v. SEC,* 446 U.S. 680, 695-97 (1980); *SEC v. Steadman,* 967 F.2d 636, 641 & n.3 (D.C. Cir. 1992). It is "a mental state embracing intent to deceive, manipulate, or defraud." *Aaron*, 446 U.S. at 686 n.5; *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n.12 (1976); *SEC v. Steadman,* 967 F.2d at 641. Recklessness can satisfy the scienter requirement. *See SEC v. Steadman,* 967 F.2d at 641-42; *David Disner*, Exchange Act Release No. 38234, 1997 SEC LEXIS 258, at *15 & n.20 (Feb. 4, 1997). Reckless conduct is "conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care … to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."' *Rolf v. Blyth, Eastman Dillon & Co., Inc.,* 570 F.2d 38, 47 (2d Cir. 1978) (quoting *Sanders v. John Nuveen & Co.,* 554 F.2d 790, 793 (7th Cir. 1977)).

Scienter is not required to establish a violation of Securities Act Section 17(a)(3); a showing of negligence is adequate. *See SEC v. Steadman,* 967 F.2d at 643 & n.5; *SEC v. Quan,* No. 11-cv-723, 2013 WL 5566252, at *16 (D. Minn. Oct. 8, 2013); *Fundamental Portfolio Advisors, Inc.*, Securities Act Release No. 8251, 2003 SEC LEXIS 1654, at *29 (July 15, 2003), *recons. denied*, Securities Act Release No. 8574, 2005 SEC LEXIS 1192 (May 23, 2005); *Byron G. Borgardt*, Securities Act Release No. 8274, 2003 SEC LEXIS 2048, at *37-38 (Aug. 25, 2003). Negligence is the failure to exercise reasonable care. *IFG Network Secs., Inc.*, Exchange Act Release No. 54127, 2006 SEC LEXIS 1600, at *37 (July 11, 2006).

2. Willfulness

***29** Respondents are charged with *willful* violations of Securities Act Sections 17(a)(1) and 17(a)(3). A finding of willfulness does not require an intent to violate, but merely an intent to do the act which constitutes a violation. *See Steadman v. SEC,* 603 F.2d at 1135; *Tager v. SEC,* 344 F.2d 5, 8 (2d Cir. 1965).

C. Antifraud Violations

1. Respondents' Actions Occurred in the Offer or Sale of Securities

The Supreme Court has adopted an expansive interpretation of "in the offer or sale of any securities" language contained in Section 17(a) of the Securities Act. 15 U.S.C. §§ 77q(a); *see Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit,* 547 U.S. 71, 85 (2006) ("The requisite showing … is deception in connection with the purchase or sale of any security, not deception of an identifiable purchaser or seller." (internal quotation marks and citation omitted)); *United States v. Naftalin,* 441 U.S. 768, 773 (1979) ("in the offer or sale" is "expansive enough to encompass the entire selling process"). By directly soliciting investors for Natural Blue, Cohen and Corazzi engaged in the offer or sale of securities.

2. Violations

As a public corporation subject to Section 15(d) of the Exchange Act, Natural Blue was required to file annual reports on Form 10-K that disclosed the identity and business experience and legal proceedings of its officers and directors. *See* 17 C.F.R. § 229.401(e), (f); Form 10-K, Item 10. This requirement was a problem for Respondents — Corazzi was precluded from being an officer or director of Natural Blue, and Cohen was reluctant to publicize his criminal background. Respondents surmounted this difficulty by maintaining influential roles in the company under the guise of being consultants. Recruiting Anaya and Pelosi and others enabled them to do so. Anaya and Pelosi were prominent and accomplished individuals who added credibility to the company, while others were previously associated with Cohen or Corazzi and might be expected to follow their direction. Anaya's good-faith attempt to execute his responsibilities as Chairman and CEO did not seriously impede Respondents' running the company.

The record shows that Respondents violated Securities Act Section 17(a)(3) through their course of business — essentially, to run Natural Blue under the guise of being consultants, while concealing negative information about their background. Each acted with at least a reckless degree of scienter in engaging in this course of business; Corazzi was subject to an officer and director bar, and Cohen had actually inquired as to the amount of public disclosure that would be required if he were to become

a director. It is additionally concluded that Respondents' course of business amounted to a scheme to defraud in violation of Securities Act Section 17(a)(1).

***30** A fraudulent course of conduct or scheme has been described as a situation where the person engages in "conduct that ha[s] the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme." *See SEC v. Brown,* 740 F. Supp. 2d 148, 172 (D.D.C. 2010) (quoting *Simpson v. AOL Time Warner Inc.,* 452 F.3d 1040, 1048 (9th Cir. 2006), *vacated on other grounds, Avis Budget Group, Inc. v. Cal. Teachers' Ret. Sys.,* 552 U.S. 1162 (2008)). Contrary to Respondents' argument, a fraudulent scheme does not require a "sweeping conspiracy." Cohen Br. at 37.

Respondents argue that the Division's claim is, in essence, material misrepresentation or omission, and thus implicates *Janus Capital Grp., Inc. v. First Derivative Traders,* 131 S. Ct. 2296 (2011). Cohen Br. at 37. To the contrary, the Division has not alleged that Cohen or Corazzi made misstatements or omissions, nor are violations of Exchange Act Section 10(b) or Rule 10b-5 alleged, and thus *Janus* is not implicated. *See* Div. Reply Br. at 16; *John P. Flannery*, Securities Act Release No. 9689, 2014 SEC LEXIS 4981, at *57-58 (Dec. 15, 2014) (holding that the *Janus* "maker" requirement does not apply to Section 17(a) of the Securities Act).

To the extent Respondents argue the involvement of Natural Blue's lawyers in the preparation of the SEC filings is a defense, it fails. In considering whether to credit an advice of counsel claim, the Commission considers four elements: "that the person made complete disclosure to counsel, sought advice on the legality of the intended conduct, received advice that the intended conduct was legal, and relied in good faith on counsel's advice." *Howard Brett Berger*, Exchange Act Release No. 58950, 2008 SEC LEXIS 3141, at *38 (Nov. 14, 2008) (footnote citing precedent omitted), *pet. denied*, 347 F. App'x 692 (2d Cir. 2009), *cert. denied*, 559 U.S. 1102 (2010). Counsel must also be independent. *C.E. Carlson, Inc. v. SEC,* 859 F.2d 1429, 1436 (10th Cir. 1988); *Arthur Lipper Corp.*, 547 F.2d at 181-82. There is no evidence in the record that any Natural Blue attorney was asked for legal advice about Respondents' plans to adopt "consultant" titles as a way to avoid disclosure of their disciplinary histories and their roles as *de facto* officers. Moreover, even if Natural Blue's attorneys had been fully informed of Respondents' roles, Respondents' scienter renders any potential advice of counsel defense void. *See Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R. Co*., 680 F.2d 933, 943 (3d Cir. 1982) (rejecting reliance on counsel defense where defendants "know the materiality of the concealed information and intend the consequences of concealment"); *United States v. King,* 560 F.2d 122, 132 (2d Cir. 1977) ("[S]ignificant representations were made as to specific facts … [and] we cannot understand how a businessman who knows that such factual representations are untrue can screen himself by trying to rely on advice of counsel."); *Dolphin & Bradbury, Inc. v. SEC,* 512 F.3d 634, 641-44 (D.C. Cir. 2008) (noting, in part, that where petitioner "could not have had a genuine belief in" his statements' "completeness and accuracy," he could not rely on a reliance on counsel argument to negate scienter); *SEC v. Goldfield Deep Mines Co. of Nevada,* 758 F.2d 459, 467 (9th Cir. 1985) (reliance-on-professional defense not available where defendants "knew" that statements made in public filings "were false or misleading").

IV. SANCTIONS

***31** The Division requests a cease-and-desist order, disgorgement, civil penalties, and officer and director bars. As discussed below, Cohen and Corazzi will be ordered to cease and desist from violations of Sections 17(a)(1) and 17(a)(3) of the Securities Act and to pay a second-tier penalty of $75,000 each; and officer and director bars will be ordered. [16]

A. Sanction Considerations

In determining sanctions, the Commission considers such factors as:

> 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 defendant's

> recognition of the wrongful nature of his conduct, and the likelihood that the [respondent's] occupation will present opportunities for future violations.

Steadman, 603 F.2d 1126, 1140 (5th Cir. 1979) (quoting *SEC v. Blatt,* 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)). The Commission also considers the age of the violation and the degree of harm to investors and the marketplace resulting from the violation. *Marshall E. Melton*, Exchange Act Release No. 48228, 2003 SEC LEXIS 1767, at *4-5 (July 25, 2003). Additionally, the Commission considers the extent to which the sanction will have a deterrent effect. *Schield Mgmt. Co*., Exchange Act Release No. 53201, 2006 SEC LEXIS 195, at *35-36 & n.46 (Jan. 31, 2006). As the Commission has often emphasized, the public interest determination extends to the public-at-large, the welfare of investors as a class, and standards of conduct in the securities business generally. *See Christopher A. Lowry*, Investment Company Act of 1940 Release No. 2052, 2002 SEC LEXIS 2346, at *20 (Aug. 30, 2002), *aff'd*, 340 F.3d 501 (8th Cir. 2003); *Arthur Lipper Corp*., 1975 SEC LEXIS 527, at *52. The amount of a sanction depends on the facts of each case and the value of the sanction in preventing a recurrence. *See Leo Glassman,* Exchange Act Release No. 11929, 1975 SEC LEXIS 111, at *7 (Dec. 16, 1975).

B. Cease and Desist

Securities Act Section 8A(a) authorizes the Commission to issue a cease-and-desist order against a person who "is violating, has violated, or is about to violate" any provision of the Securities Act. 15 U.S.C. § 77h-1(a). Whether there is a reasonable likelihood of such violations in the future must be considered. *KPMG Peat Marwick LLP*, Exchange Act Release No. 43862, 2001 SEC LEXIS 98, at *101 (Jan. 19, 2001). Such a showing is "significantly less than that required for an injunction." *Id.* at *114. In determining whether a cease-and-desist order is appropriate, the Commission considers the *Steadman* factors quoted above, as well as the recency of the violation, the degree of harm to investors or the marketplace, and the combination of sanctions against the respondent. *See WHX Corp. v. SEC,* 362 F.3d 854, 859-61 (D.C. Cir. 2004); *KPMG*, 2001 SEC LEXIS 98, at *116.

***32** Respondents' conduct was egregious and recurrent, and the violations recent. Respondents conceived of their scheme and acted as undisclosed *de facto* officers of Natural Blue for approximately two years. Each one's conduct involved at least a reckless degree of scienter. Given Respondents' past criminal and disciplinary histories in the financial industry and their failure to reform since then, their occupations will present opportunities for future violations. Moreover, Respondents have not provided any assurances against future violations, further bolstering this concern.

Although the evidence of record does not quantify precisely the degree of harm to investors and the marketplace in dollars, harm to the marketplace is evident from the dishonest nature of Respondents' misconduct. In light of these considerations, a cease-and-desist order is appropriate.

C. Disgorgement

Securities Act Section 8A(e) authorizes disgorgement of ill-gotten gains, including reasonable interest, in cease-and-desist proceedings. 15 U.S.C. § 77h-1(e). Disgorgement of ill-gotten gains is "an equitable remedy designed to deprive a wrongdoer of his unjust enrichment and to deter others from violating the securities laws." *Montford & Co., Inc. v. SEC,* No. 14-1126, 2015 WL 4153861, at * 7 (D.C. Cir. July 10, 2015) (quoting *SEC v. First City Fin. Corp*., 890 F.2d 1215, 1230 (D.C. Cir. 1989)).

"When calculating disgorgement, 'separating legal from illegal profits exactly may at times be a near-impossible task."' *Id.* (quoting *First City Fin. Corp*., 890 F.2d at 1231). "Thus, 'disgorgement need only be a reasonable approximation of profits causally connected to the violation."' *Id.*; *see SEC v. First Pac. Bancorp,* 142 F.3d 1186, 1192 n.6 (9th Cir. 1998) (holding disgorgement amount only needs to be a reasonable approximation of ill-gotten gains); *accord First City Fin. Corp.*, 890 F.2d at 1231-32; *Laurie Jones Canady*, Exchange Act Release No. 41250, 1999 SEC LEXIS 669, at *38 (Apr. 5, 1999) (quoting *SEC v. First Jersey Secs., Inc.,* 101 F.3d 1450, 1475 (2d Cir. 1996)), *pet. denied*, 230 F.3d 362 (D.C. Cir. 2000).

Cohen and Corazzi provided real services to Natural Blue, for example, recruiting investors and negotiating the Atlantic transaction. The fact that Respondents' roles went far beyond the scope of their consulting agreements and resulted in Securities Act violations does not mean, however, that all of the money they received from Natural Blue was unjust enrichment or ill-gotten gains. Respondents undoubtedly provided at least some legitimate services that were within the scope of their consultant agreements, for which remuneration was warranted.

***33** To order disgorgement, a reasonable approximation of the profits connected to Respondents' roles as *de facto* officers of Natural Blue must be determined. However, the figures the Division presented as Respondents' total ""compensation" are unreliable, because they consist of *all* money that Respondents received from Natural Blue, including reimbursements of expenses for their consulting work. Therefore, the figures are not only dubious because they include non-remuneration credits such as reimbursement, but also because the Division did not even attempt to distinguish between what amount might reasonably correspond to remuneration for legitimate consulting services provided, and what amount, if any, might reasonably correspond to improper remuneration for Respondents' roles as *de facto* officers. Thus, the Division failed to meet its initial burden of presenting a "reasonable approximation" of the profits connected to the violations. As a result, no disgorgement will be ordered.

D. Civil Money Penalty

Securities Act Section 8A(g) authorizes the Commission to impose civil money penalties against a person who is or has violated, or was the cause of the violation of, any provision of the Securities Act, where such penalties are in the public interest. 15 U.S.C. § 77h-1(g).

Penalties in addition to the other sanctions ordered are in the public interest. A second-tier penalty is appropriate because Respondents' violative acts involved fraud and a reckless disregard of a regulatory requirement. 15 U.S.C. § 77h-1(g)(2)(B). Under that provision, for each violative act or omission after February 14, 2005, and before March 4, 2009, the maximum second-tier penalty for each violation for a natural person is $65,000. 17 C.F.R. § 201.1003, Subpt. E, Table III. For each violative act or omission after March 3, 2009, and before March 6, 2013, the maximum second-tier penalty for each violation for a natural person is $75,000. 17 C.F.R. § 201.1004, Subpt. E, Table IV. The provisions, like most civil penalty statutes, leave the precise unit of violation undefined. *See* Colin S. Diver, *The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies*, 79 Colum. L. Rev. 1435, 1440-41 (1979).

The events at issue began in 2008 and continued into 2011. They will be considered as one course of action for each Respondent, and a second-tier civil penalty of $75,000 will be ordered against each. Combined with the other sanctions ordered, this penalty is in the public interest.

E. Officer and Director Bar

Securities Act Section 8A(f) authorizes a bar against a respondent who has violated Securities Act Section 17(a)(1) from acting as an officer or director of any issuer with a class of securities registered pursuant to Exchange Act Section 12 or that is required to file reports pursuant to Exchange Act Section 15(d), "if the conduct of that person demonstrates unfitness to serve as an officer or director of any such issuer." 15 U.S.C. § 77h-1(f). In line with the reasoning in *Joseph P. Doxey*, Initial Decision Release No. 598, 2014 SEC LEXIS 1668, at *76-78 (A.L.J. May 15, 2014), the so-called Patel [17] factors will be applied in addition to the *Steadman* factors in evaluating the appropriateness of this sanction.

***34** As discussed above, both Respondents violated Securities Act Section 17(a)(1) while acting with scienter and awareness of the deceptive and manipulative nature of their conduct. The violations continued for approximately two years. Each Respondent's history of misconduct and recidivism in the securities industry makes him a danger to investors. Without an officer and director bar, each would be free to assume officer and director roles in the future. Thus, it is appropriate and in the public interest to impose a permanent officer and director bar against each Respondent, and each will be barred from acting as an

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officer or director of any issuer with a class of securities registered pursuant to Exchange Act Section 12 or that is required to file reports pursuant to Exchange Act Section 15(d).

V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), it is certified that the record includes the items set forth in the record index issued by the Secretary of the Commission on July 29, 2015, as corrected on August 14, 2015. [18]

VI. ORDER

IT IS ORDERED that, pursuant to Section 8A of the Securities Act, JAMES E. COHEN and JOSEPH A. CORAZZI CEASE AND DESIST from committing or causing any violations or future violations of Sections 17(a)(1) and 17(a)(3) of the Securities Act.

IT IS FURTHER ORDERED that, pursuant to Section 8A(g) of the Securities Act, JAMES E. COHEN and JOSEPH A. CORAZZI shall each PAY A CIVIL MONEY PENALTY OF $75,000.

IT IS FURTHER ORDERED that, pursuant to Section 8A(f) of the Securities Act, JAMES E. COHEN and JOSEPH A. CORAZZI are each BARRED from acting as an officer or director of any issuer that has a class of securities registered with the Commission pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act.

Payment of disgorgement, prejudgment interest, and civil penalties shall be made no later than twenty-one days following the day this Initial Decision becomes final, unless the Commission directs otherwise. Payment shall be made in one of the following ways: (1) transmitted electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) direct payments from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or (3) by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order, payable to the Securities and Exchange Commission.

Any payment by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order shall include a cover letter identifying the Respondent and Administrative Proceeding No. 3-15974, and shall be delivered to: Enterprises Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Bld., Oklahoma City, Oklahoma 73169. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

***35** This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then a party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Carol Fox Foelak
Administrative Law Judge

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1 The proceeding has ended as to Natural Blue Resources, Inc. *Natural Blue Res., Inc.*, Initial Decision Release No. 710, 2014 SEC LEXIS 4485 (A.L.J. Nov. 26, 2014), *finality order*, Securities Act of 1933 Release No. 9696 (Jan. 15, 2015).

2 Corazzi appeared at the hearing but did not call any witnesses, offer any exhibits, or otherwise present his own direct case.

3 Citations to the transcript will be noted as "Tr. __." Citations to exhibits offered by the Division of Enforcement and by Cohen will be noted as ""Div. Ex. __" and "Cohen. Ex. __," respectively. The Division's and Cohen's posthearing briefs are noted as "Div. Br. at __" and "Cohen Br. at __," respectively.

4 *See Natural Blue Res., Inc.*, Admin. Proc. Rulings Release No. 2214, 2015 SEC LEXIS 143 (A.L.J. Jan. 13, 2015), *interlocutory review denied*, Securities Act Release No. 9722, 2015 SEC LEXIS 441 (Feb. 5, 2015).

5 A reverse merger is "a merger between an active, privately held company and a publicly traded entity with limited operations. The merger is effectively a way for the private company to merge with and become a public company without going through an [Initial Public Offering]." Div. Ex. 301 at 16.

6 Official notice of this public official record of the Commission is taken pursuant to 17 C.F.R. § 323. The suspension is also reflected in Financial Industry Regulatory Authority, Inc. (FINRA), records. *See* James E. Cohen BrokerCheck Report, *available at* http://brokercheck.finra.org (last visited July 24, 2015). Official notice is taken of this record as well. *See Joseph S. Amundsen*, Exchange Act Release No. 69406, 2013 SEC LEXIS 1148, at *2 n.1 (Apr. 18, 2013), *pet. denied*, 575 F. App'x 1 (D.C. Cir. 2014).

10 To the extent that the expert's evidence does not lead to findings of fact, it will be summarized here and referred to as appropriate in the Conclusions of Law section of this Initial Decision.

11 Daines is the Pritzker Professor of Law and Business at Stanford Law School, Professor of Finance at the Stanford Graduate School of Business, and the Co-Director of the Rock Center for Corporate Governance at Stanford University. Div. Ex. 301 at 2.

12 *See* 18 U.S.C. § 3500, commonly known at the Jencks Act.

13 The Division abandoned claims that Respondents violated Section 10(b) of the Exchange Act and Rules 10b-5(a) and 10b-5(c) thereunder. *See* Div. Reply Br. at 16 ("there are no Exchange Act claims pending against [Respondents]."). Accordingly, this Initial Decision does not address those provisions.

14 Exchange Act Rule 16a-1 defines "officer" as "president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president … in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions." Rule 3b-7 defines ""executive officer" of a registrant as its "president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration, or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant."

15 The Division also cites *U.S. Diagnostic Inc.*, Securities Act Release No. 7928, 2000 WL 1920604 (Dec. 20, 2000), which is a settlement. The Commission has stressed many times that settlements are not precedent. *See Richard J. Puccio*, Exchange Act Release No. 37849, 1996 SEC LEXIS 2987, at *10-11 (Oct. 22, 1996) (citing *David A. Gingras*, Exchange Act Release No. 31206, 1992 SEC LEXIS 2537, at *20 (Sept. 21, 1992), and cases cited therein); *Robert F. Lynch*, Exchange Act Release No. 11737, 1975 SEC LEXIS 599, at *12 (Oct. 15, 1975) (citing *Samuel H. Sloan*, Exchange Act Release No. 11376, 1975 SEC LEXIS 1742, at *12 n.24 (Apr. 28, 1975); *Haight & Co. Inc.*, Exchange Act Release No. 9082, 1971 SEC LEXIS 436, at *68-69 (Feb. 19, 1971); *Sec. Planners Assocs., Inc.*, Exchange Act Release No. 9421, 1971 SEC LEXIS 1035, at *13-14 (Dec. 17, 1971)); *see also Michigan Dep't of Natural Res. v. FERC,* 96 F.3d 1482,

1490 (D.C. Cir. 1996) and cases cited therein (settlements are not precedent). Like all Commission settlement orders, the *U.S. Diagnostic Inc.* settlement order contains a disclaimer to this effect: "The Commission's findings herein are made pursuant to [Respondents'] Offer of Settlement and are not binding upon any other person or entity in these or any other proceedings." 2000 WL 1920604, at *1 n.1.

16 A permanent officer and director bar is already in effect for Corazzi. *See* Div. Ex. 300 ¶ 47. However, this does not preclude imposition of an officer and director bar in this proceeding. *See Hunter Adams*, Exchange Act Release No. 51117, 2005 SEC LEXIS 225, at *4 n.6 (Feb. 1, 2005).

17 The Patel factors are: (1) the egregiousness of the underlying securities law violation; (2) recidivism; (3) the defendant's role or position in the fraud; (4) the degree of scienter; (5) the defendant's economic stake in the violation; and (6) the likelihood of recurrence. *SEC v. Bankosky,* 716 F.3d 45, 48 (2d Cir. 2013); *SEC v. Patel,* 61 F.3d 137, 141 (2d Cir. 1995).

18 *See Natural Blue Res., Inc.*, Admin. Proc. Rulings Release No. 3042, 2015 SEC LEXIS 3350 (A.L.J. Aug. 14, 2015).

Release No. 863 (S.E.C. Release No.), 112 S.E.C. Docket 1378, Release No. ID - 863, 2015 WL 4929878

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Release No. 296 (S.E.C. Release No.), 86 S.E.C. Docket 604, Release No. ID - 296, 2005 WL 2237628

S.E.C. Release No.
Initial Decision

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF RAYMOND JAMES FINANCIAL SERVICES, INC., J. STEPHEN PUTNAM AND DAVID LEE ULLOM

Administrative Proceeding File No. 3-11692
September 15, 2005

***1** BEFORE: Brenda P. Murray, Chief Administrative Law Judge

APPEARANCES:
Luke T. Cadigan, Ian D. Roffman, Bradford E. Ali, and Dawn A. Edick for the Division of Enforcement, Securities and Exchange Commission
Burton W. Wiand, Maya M. Wolfe, Lara Thyagarajan, Seth Rosner, Darren Farfante, and Peter King for Raymond James Financial Services, Inc.
Jerry A. Isenberg, Thomas J. McGonigle, Lindi L. Beaudreault, and J. Burton Hong for J. Stephen Putnam
The Securities and Exchange Commission (Commission) initiated this proceeding on September 30, 2004, pursuant to Section 8A of the Securities Act of 1933 (Securities Act), Sections 15(b) and 21C of the Securities Exchange Act of 1934 (Exchange Act), and Section 203(f) of the Investment Advisers Act of 1940 (Advisers Act). David Lee Ullom (Mr. Ullom) submitted an Offer of Settlement to the Commission in this proceeding on January 27, 2005, which the Commission accepted on January 28, 2005.[1] 84 SEC Docket 2866 (Jan. 28, 2005).

The thirteen days of hearing in January and February 2005 are reflected in 3,636 pages of transcript. The Division of Enforcement (Division) presented fifteen witnesses in its direct case and one expert witness in rebuttal.[2] Raymond James Financial Services, Inc. (Raymond James), presented eleven witnesses, including four experts. J. Stephen Putnam (Mr. Putnam) testified and presented one expert witness. The record contains approximately 510 exhibits. The final brief was submitted on April 28, 2005.

ISSUES

1. Whether Raymond James and Mr. Putnam failed reasonably to supervise Dennis Herula (Mr. Herula), a person subject to their supervision, with a view to preventing or detecting Mr. Herula's violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

2. Whether, as a result of Mr. Herula's fraudulent conduct, Raymond James violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5.

3. Whether Raymond James willfully violated Section 17(a) of the Exchange Act and Rule 17a-4 thereunder.

FINDINGS OF FACT

The findings and conclusions herein are based on the entire record. I applied preponderance of the evidence as the standard of proof. See Steadman v. SEC, 450 U.S. 91, 102 (1981).[3]

Brite Business Corporation

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Brite Business Corporation (Brite Business) was a non-public company set up to defraud investors. (Tr. 883, 1664-65.) Michael Clarke (Mr. Clarke) originated Brite Business in the United Kingdom. (R.J. Ex. 2642.) Mr. Clarke "began soliciting investors through Brite Business S.A., a British Virgin Islands company, which was established in December 1997." (Id.) Mr. Clarke's acquaintance Johan C. Hertzog (Mr. Hertzog) brought in Martin D. Fife (Mr. Fife), who agreed to manage client funds. (Id.) Mr. Fife allegedly had influential friends and accoutrements of wealth, including a residence on Central Park West in New York City. In April 1999, Mr. Fife arranged for Charles Sullivan (Mr. Sullivan) to incorporate Brite Business. (Id.) In 2000, Mr. Fife, Mr. Hertzog, Robert M. Wachtel (Mr. Wachtel), and Mr. Clarke, represented that they were on Brite Business's board. (Putnam Ex. 2210.) Mr. Fife and Mr. Sullivan represented that they were Brite Business's president and vice president, respectively. [4] From April 1999 until it was dissolved around March 2001, Brite Business was a Delaware corporation with an office address in New York City. (Div. Ex. 480 at 3, R.J. Ex. 2210.) Beginning in October 1999, Brite Business maintained investor funds in brokerage accounts at Raymond James's Cranston, Rhode Island, branch office (Cranston branch office). (Tr. 883, 1145.)

***2** From 1999 through 2002, Brite Business engaged in a fraudulent offering scheme, run by Mr. Fife and others, in which it represented that investments of a minimum of one million dollars could earn double digit interest per month. [5] (Tr. 481-83.) Brite Business represented that when it accumulated $100 million it would "leverage" the funds to purchase T-bills, or some other government issue, and without leaving the Brite Business account those deposits would earn astronomical returns. (Tr. 480-81, 515, 559, 594.) It was not clear what Brite Business intended to do with the investment proceeds or how it would be able to pay such astronomical returns. (Tr. 230, 237.) Some understood that Brite Business intended to use the funds as a credit enhancer allowing it to borrow more funds, while others believed that international entities would pay astronomical sums to be allowed to show Brite Business's funds to "enhance their balance sheet." (Tr. 230.) At least one investor believed that Brite Business would deposit his funds at "Bank Raymond James," and would use pooled funds to buy T-bills, which would enable Brite Business to borrow from other sources and earn more than the T-bill rate on the pooled $100 million. (Tr. 234, 237.) All investors believed the investment involved no risk of capital. (Tr. 230, 483-84.)

Raymond James

Raymond James Financial, Inc. (the holding company), a diversified financial services holding company headquartered in St. Petersburg, Florida, and listed on the New York Stock Exchange, combined two of its wholly owned subsidiaries to create Raymond James. [6] In January 1999, a holding company subsidiary, Robert Thomas Securities (Robert Thomas), merged with Investment Management & Research (IMR), another subsidiary, and IMR changed its name to Raymond James. (Tr. 1297-98, 1610-11.) Raymond James is registered with the Commission as a broker-dealer and as an investment adviser pursuant to Section 15(b) of the Exchange Act and Section 203(a) of the Advisers Act, respectively.

Raymond James "is an independent contractor firm that introduces its business into Raymond James & Associates, Inc.," and its primary regulator is the National Association of Securities Dealers (NASD). [7] (Tr. 1601, 2153; R.J. Ex. 2665 at 10.) Raymond James & Associates, Inc., (R.J. & Associates), a member of the New York Stock Exchange, performs the research, execution, clearing, bookkeeping, and is responsible for servicing all customer accounts at Raymond James. (Tr. 1602, 1617-18, 2153, 2752, 2822; R.J. Ex. 2658.) R.J. & Associates has clearing relationships with forty-four other broker-dealers, in addition to Raymond James. (Tr. 2822.) These two broker-dealers conduct the majority of the business of the holding company. (Tr. 3423.)

Raymond James referred to its registered representatives as financial advisers. (Tr. 2048.) During the relevant period, August 1999 through December 2000, Raymond James had from 1,100 to 4,000 registered representatives, who were allowed to engage in business activities other than buying and selling securities. (Tr. 2034, 2325, 3530.) About fifty percent of Raymond James's registered representatives engaged in some type of business activity outside the firm, such as selling insurance or financial planning. (Tr. 1900.) Between ten to twenty percent of Raymond James's registered representatives worked outside their assigned offices regularly, and about five percent never went to the office. (Tr. 2337-38.)

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***3** The NASD applies the same rules to all registered representatives whether they are independent contractors or employees. (Tr. 2488-89.) This proceeding involves the Cranston branch office, part of the securities division of Raymond James. [8] (Tr. 1007, 1612; Div. Ex. 313 at 7.) Most of Raymond James's approximately 550 branch offices located throughout the United States were staffed by two or three registered representatives. (Tr. 1615-16, 1619.) Under NASD rules, Raymond James designated the Cranston branch office as an Office of Supervisory Jurisdiction (OSJ), which required that it have a registered principal. (Tr. 2325-27.)

Mr. Putnam

Mr. Putnam, sixty-two years old, graduated from Bowdoin College in 1965, and served with the Army in Vietnam. (Tr. 1603-04; Putnam Ex. 1075.) Mr. Putnam was with his family's securities firm, F.L. Putnam, from 1968 until 1981, and in 1979 was chairman of the board of directors of the NASD. (Id.) Mr. Putnam's Form U-4 shows five items in the late 1970s or early 1980s: two offers of settlement and three acceptance, waiver & consents. (Tr. 1604; Div. Ex. 286.) These matters involved allegations of failure to supervise, failure to maintain net capital, "integration with respect to a tax incentive investment," and excessive mark-ups. The result in almost each instance was a censure and a fine of $1,000 or $1,500, which F.L. Putnam paid. (Div. Ex. 286; Tr. 1605-09.) Mr. Putnam did not pay anything personally. (Tr. 1604.)

In July 1983, Mr. Putnam became president and chief executive officer (CEO) of Robert Thomas. (Tr. 1610, 1872.) He became an executive vice president and board member of the holding company in about 1987. When Raymond James was created in January 1999, Mr. Putnam became president, chief operating officer, and a director. (Tr. 1601, 1611.) Mr. Putnam reported to the CEO. (Tr. 2046.) Mr. Putnam's responsibilities included direct oversight of the securities division, which included the Cranston branch office. (Tr. 1612, 1614-15.) Mr. Putnam supervised the activities of the branch offices in conjunction with Raymond James's Compliance Department (Compliance Department). (Tr. 1614, 2052.) In carrying out his responsibilities, Mr. Putnam relied on the Compliance Department and the individual branch managers. (Id.) Raymond James's internal investigation did not find that Mr. Putnam was deficient in his supervision of Mr. Herula. (Tr. 1864.)

In April 2003, Mr. Putnam left Raymond James and is now executive vice president, special projects, at the holding company. (Tr. 1599-601.) Mr. Putnam has no supervisory responsibilities in his new position. (Tr. 3431.) The holding company made this move, in large part, because it believed the Commission wanted Mr. Putnam removed. (Tr. 3442.) Several witnesses who worked with Mr. Putnam testified of their high regard for his professional accomplishments, intelligence, honesty, drive, and loyalty to Raymond James. (Tr. 1864-65, 2917, 3430-31, 3445.)

David Ullom

***4** Mr. Ullom, a graduate of Pennsylvania State University, began working in the securities industry in 1970. (Tr. 1002.) From 1974 until 1991, Mr. Ullom was an owner and the CEO of Barclay Investments, a broker-dealer with three offices and twenty registered representatives. (Tr. 1285.) Mr. Ullom first met Mr. Putnam in the 1970s when Mr. Ullom and some associates from Barclay Investments became a division of F.L. Putnam. (Tr. 1634.) Mr. Ullom considered Mr. Putnam a friend and contacted Mr. Putnam in 1991 when he was looking for a position. (Tr. 1013-14.)

Mr. Ullom had no significant regulatory violations when he signed a Registered Representative Agreement with Robert Thomas on June 7, 1992. [9] (Tr. 1287; R.J. Ex. 2016.) In 1994, when he became the principal of the Robert Thomas office in Rhode Island, Mr. Ullom held the following licenses: general securities, financial principal, general principal, options principal, municipal principal, and investment adviser. (Tr. 1002, 1293-94.) The Independent Sales Associate Agreement he signed with Robert Thomas in 1994 provided that Mr. Ullom was an independent contractor with Robert Thomas. (Tr. 1293; R.J. 2016 at 7.)

The terms of the Independent Sales Associate Agreement required Mr. Ullom to maintain an office, to bear the expenses, to be responsible for assuring that registered representatives in the office adhered to all applicable regulations, cooperated with audits, and to indemnify Raymond James against any liability arising from his conduct, or that of a registered representative in the office.

(R.J. Ex. 2016 at 8; Tr. 1295-97.) Mr. Ullom managed Raymond James's Cranston branch office as an independent contractor, Foxhill Management (Foxhill), with a checking account in the name of "Foxhill d/b/a Raymond James Financial Services." (Tr. 1006-07.) The Foxhill account was the operating account for the Cranston branch office, and the account statements for 1999 and 2000 were in the Foxhill file at the Cranston branch office. [10] (Tr. 1280.) Foxhill, a Rhode Island C corporation, provided office space, utilities, staff support, employee benefits, and "interfaced with Raymond James for purposes of receiving commission dollars back that had been generated." (Tr. 1004-06.) Signs in the Cranston branch office identified only Raymond James. (Tr. 1007, 1324.) All mailings, account documents, and client payments were to Raymond James. (Tr. 1008.) Mr. Ullom could hire registered representatives subject to Raymond James's approval. (Tr. 1295; R.J. Ex. 2016 at 8.)

In 1995, Mr. Ullom settled an allegation that a registered investment adviser he co-owned had mischaracterized revenue. David Lee Ullom, 59 SEC Docket 1375 (June 13, 1995). The Commission Order found that Mr. Ullom: (1) made false statements to a Rhode Island Department of Business Regulation examiner; (2) directed the investment adviser's bookkeeper to alter financial documents; (3) distributed a brochure with misleading information; (4) violated Section 207 of the Investment Advisers Act by making untrue statements of material fact in a report filed with the Commission; and (5) knew, or acted with reckless disregard for whether his actions were part of an overall activity that was improper and provided substantial assistance to the adviser's violations. (R.J. Ex. 2022.) When it accepted the settlement, the Commission knew Mr. Ullom was managing a broker-dealer branch office. (Tr. 1288-90; R.J. Ex. 2022 at FW 020432.) The Commission censured Mr. Ullom; ordered him to cease and desist; fined him $10,000; ordered him to retake and pass the general securities principal examination before any future association with an investment adviser in a supervisory capacity; and attached conditions to Mr. Ullom's ownership of more than twenty percent of an investment adviser. (Id.) The Commission's Order did not restrict Mr. Ullom's activities with a broker-dealer or investment adviser. (Tr. 1290, 2468-69.)

***5** The Independent Sales Associate Agreement defined "Other Associates" as qualified registered representatives who enter independent contractor relationships with Raymond James. (R.J. Ex. 2016 at 6.) In the independent contractor relationship, each registered representative in the Cranston branch office had a direct contractual relationship with Raymond James, and a relationship with Foxhill. (Tr. 1004, 1309.) Raymond James took between ten and twenty-five percent of the commissions earned by registered representatives in the Cranston branch office. (Tr. 1311.) Raymond James forwarded the remainder monthly to the Foxhill account to be disbursed roughly twenty-five percent to Foxhill and fifty percent to the registered representatives. [11] (Tr. 1027-28; R.J. Ex. 109.) Raymond James terminated Mr. Ullom in November 2001 for failure to supervise. (Tr. 1273.)

I find Mr. Ullom totally lacking in credibility. He frequently changed his testimony after he was confronted with contradictory prior testimony or exhibits. Mr. Ullom lied and withheld information from Mr. Putnam, and he assisted Mr. Herula's fraudulent activities. (Tr. 1499-50, 1531-33.)

Dennis Herula

Mr. Herula is a fifty-eight-year-old high school graduate who attended college and served in the military. (Tr. 1737-38; Div. Ex. 82.) Mr. Herula claims to have been associated with "Kemper, Merrill Lynch, Shearson Lehman Brothers, Oppenheimer, W.C. Roney & Company, E.F. Hutton" in his twenty or more years in the securities industry. (Tr. 1738.) Mr. Ullom forwarded Mr. Herula's application to become associated with Robert Thomas to the Compliance Department in August 1999. (Tr. 2303-04.) Robert Thomas checked Mr. Herula's criminal record, his financial background, and with his prior employers before hiring him. (Tr. 2109-10, 2432.) In the materials the Compliance Department reviewed, Mr. Herula had no serious reported complaints in ten years of industry experience. (Tr. 2369; R.J. Exs. 2004, 2005.) Mr. Ullom knew Mary Lee Capalbo (Ms. Capalbo) was married to Mr. Herula. (Tr. 1044.) Mr. Putnam terminated Mr. Herula on December 26, 2000, effective the first business day of January 2001. (Tr. 1271, 1517.)

The Registered Representative Agreement (Agreement) between Raymond James and Mr. Herula provided that: (1) Mr. Herula was being retained by Mr. Ullom as an independent contractor pursuant to an Independent Sales Associate Agreement between Raymond James and Mr. Ullom; (2) the Agreement did not create an agency, employment, or joint venture relationship; and

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(3) Mr. Herula had "the right to solicit and engage in the purchase and sale for [Raymond James] approved securities with the general public, and engage in other business activities except to the extent such activities are subject to the rules, regulations and interpretations of Regulatory Authorities." (Div. Ex. 111; Tr. 1036-37.) As branch manager, Mr. Ullom was Mr. Herula's first-level supervisor in 1999 and 2000. (Tr. 989-90, 1345, 2048.)

***6** In August and September 1999, Mr. Herula worked in the Cranston branch office during normal business hours. (Tr. 1319.) For the remainder of 1999, Mr. Herula came to the office late in the day or at night because he said he was caring for his ill wife. (Tr. 1279, 1319-20.) Mr. Ullom claims that he allowed Mr. Herula to work from his home and other locations in accord with Raymond James's policies. (Tr. 990-92.) Beginning in January 2000, Mr. Ullom claims that Mr. Herula came to the office about once a month because he said he was traveling and raising funds for Brite Business, an outside business activity that Raymond James allowed. (Tr. 1091-93, 1179, 1206-07, 1543.) Mr. Herula came into the Cranston branch office about once a month in the first half of 2000, and a total of four times between May and December 2000. (Tr. 1091-92, 1206, 1280.) According to Mr. Ullom, this was unusual for a registered representative, but because the accounts Mr. Herula handled were very conservative accounts, they did not require frequent client contact. (Tr. 1092.)

This administrative proceeding follows a related civil proceeding in the United States District Court for the District of Rhode Island. SEC v. Dennis S. Herula, et al., C.A. No. 02-154 ML (D.R.I.). On October 17, 2002, the district court entered a Final Judgment and enjoined Mr. Herula from further violations of the antifraud provisions of the federal securities laws and ordered him to pay disgorgement and prejudgment interest totaling $18,941,665.63. (Putnam Ex. 1116, R.J. Ex. 2642 at 54009.) On January 27, 2003, the district court entered a Final Judgment and enjoined Ms. Capalbo, from further violations of the antifraud provisions of the federal securities laws and ordered her to pay disgorgement and prejudgment interest totaling $19,292,102.14. The court also ordered Mr. Herula and Ms. Capalbo to each pay civil monetary penalties of $250,000. (R.J. Ex. 2642 at 54009.)

On October 18, 2004, Mr. Herula pleaded guilty to criminal charges of wire fraud that included misrepresentations to investors, money laundering, and bankruptcy fraud brought by the U.S. Attorney in Rhode Island. [12] (Tr. 1713; Div. Exs. 82, 83 at 7, 85) Mr. Herula was sentenced to 188 months and ordered to make restitution of more than $13 million. (Tr. 1719.)

Raymond James and Brite Business

Mr. Ullom, on behalf of Mr. Herula, requested that Mr. Putnam meet with Brite Business, about a business opportunity for Raymond James from people with substantial assets. [13] Mr. Putnam had complete trust in Mr. Ullom and hired him in mid-1992. (Tr. 1014, 1965; Div. Ex. 106.) At the time, Mr. Herula had been associated with Raymond James for about two months and had fifteen to twenty client accounts, the largest with assets of about $2 million. (Tr. 1047-48, 1051, 1349-50.)

Mr. Putnam was on the holding company's Capital Markets Committee, and was told that Brite Business would deposit $5 million in a Raymond James account. (Tr. 1638-39.) On October 19 and 20, 1999, Mr. Herula sent Mr. Putnam the resumes of Ian Doidge (Mr. Doidge), Principal & Practice Leader, Global Asset Services Group, Arthur Andersen Business Consulting (Arthur Andersen), Toronto, and Mr. Fife. (R.J. Exs. 2423, 2424.) Mr. Putnam called Arthur Andersen and confirmed that Mr. Doidge was at the phone number he provided. (Tr. 1665, 2073.) Mr. Putnam believed that Brite Business was a legitimate business enterprise based on Mr. Doidge's position with Arthur Andersen, Mr. Fife's credentials, and Brite Business's $5 million deposit. (Tr. 1665-66, 1679.)

***7** During the week of October 20, 1999, Mr. Putnam, assembled an ad hoc committee composed of John C. Maynard (Mr. Maynard) [14] , a vice president with Raymond James Trust Company (R.J. Trust); Thomas R. Tremaine (Mr. Tremaine), vice president and treasurer at R.J. & Associates; Jeff Julien (Mr. Julien), chief financial officer at the holding company; John Kritsas (Mr. Kritsas) [15] and John Walsh (Mr. Walsh) from R.J. & Associates. This committee met with Mr. Herula and Mr. Doidge, representing Brite Business, at Raymond James's headquarters. (Tr. 1640-42, 2115, 2805-06.) Mr. Ullom was not invited but attended the meeting. (Tr. 1052.)

The meeting lasted less than an hour. (Tr. 1657.) Mr. Putnam understood that Brite Business was involved in construction in foreign jurisdictions. (Tr. 1647.) Brite Business proposed that Raymond James participate in its activities by: (1) loaning money for purchase of Treasuries; (2) holding a trust; (3) doing the transactions such as the purchase of Treasury bonds or securities; and (4) having R.J. Trust hold the assets in escrow as well as the trust receipt. (Tr. 1660-61.) Brite Business described a series of transactions in the range of $50 to $100 million each where United States Treasuries (Treasuries) would enter the United States from England and be leveraged so that the asset side of Brite Business's balance sheet would be increased. (Tr. 1649, 1666.) Brite Business proposed placing the Treasuries and other funds under a trust arrangement, which would protect the funds and allow the transaction to be unwound. (Tr. 1649, 1546.) These activities would supposedly allow Brite Business some tax advantages. (Tr. 1691, 1748.) Supposedly, the interest cost of the borrowing would be a tax benefit as it would offset income earned abroad. (Tr. 1650, 1656.) Mr. Doidge said that the offsetting increase in liabilities did not matter for this particular strategy. However, he claimed that he could not disclose the tax implications in detail because of confidentiality issues. (Tr. 1662-64, 1742.) The meeting participants were told the strategy was proprietary to Arthur Andersen and that Raymond James did not have to be concerned about what happened inside the “black box.” (Tr. 2663-64.) In his investigative testimony, Mr. Putnam acknowledged that there were several renditions of the “balance sheet enhancement,” but that it was a tax strategy and involved “depositing money into some sort of an escrow, buying some treasuries, doing either a repo or a reverse repo with a bank.” (Tr. 1652-53.) Mr. Putnam testified that one issue was whether Raymond James would be willing to make a loan. (Tr. 1655-56, 1760.) In an e-mail sent on January 17, 2000, Mr. Putnam described the transaction as follows:

> It involved moving treasuries from England to the U.S. and creating a loan from one group to another through [Raymond James] and then doing a repo on the instruments with the proceeds going into a trusteed bank account and the transactions being able to be unwound every ninety days. It was suggested that [Raymond James] would be the custodian of the bonds, do the transactions, trustee the account, and have an [Investment Management Program for Advisory Clients] arrangement with respect to the account. We were told this had something to do with a balance sheet for a deal or deals. Arthur Andersen's representative assured us that the money was not fraudulent and that the money came from good sources. The principal Martin Fife sits on the boards of several Dreyfus Funds and his wife has been the Deputy Mayor of NY and he appears to be quite connected.

***8** (R.J. Ex. 2467.)

This transaction would have been very unusual for R.J. Trust, which provided only personal fiduciary trust services to Raymond James's clients. (Tr. 2684-85.) Mr. Maynard attended the meeting in place of his boss, David Ness (Mr. Ness), the head of R.J. Trust, and described Brite Business's proposal as a complicated tax shelter that involved debt-financed purchase of Treasuries. (Tr. 2703.)

The ad hoc committee met only once soon after the October 1999 meeting to discuss the proposal. (Tr. 2138.) Everyone was skeptical about the proposal and questioned Brite Business's motives. (Tr. 1668-70, 1848.) The consensus was that Raymond James should not get involved in something they did not fully understand. (Tr. 1355, 1662, 2861.) Mr. Putnam indicated that the transaction did not sound like something Raymond James would involve itself with. (Tr. 1054, 1061.) In an e-mail on October 29, 1999, Mr. Walsh wrote to Mr. Putnam and others, “My gut feeling on this deal is bad. Let's continue to proceed very cautiously.” (Tr. 1690; Div. Ex. 240.)

Mr. Putnam testified that some people jumped to conclusions about what occurred in October but that the ad hoc committee: (1) did not take a formal vote and reject the transaction; (2) reached a consensus to do more discovery but would not commit to the transaction; and (3) had healthy skepticism, but was willing to look at subsequent proposals from Brite Business. The size of the transaction was beyond Raymond James's normal transaction size. Brite Business also wanted to start the transaction

before the end of 1999. (Tr. 1668-69.) Mr. Putnam testified that the proposal considered in October became moot within days because of its size, complexity, and Brite Business's desire to complete it by year end. (Tr. 1770, 1800, 1810-11; Div. Ex. 253.) Following the October meeting, Mr. Maynard and Mr. Tremaine looked at whether there were some parts of the transaction that Raymond James could be comfortable with. (Tr. 1675, 1683- 84.) For example, on October 25, 1999, Mr. Maynard reported that Brite Business thought "[Mr. Putnam's] suggestion will work" and R.J. Trust might be able to hold the cash for Brite Business. (Div. Ex. 238.)

On October 25, 1999, Brite Business opened a cash account at Raymond James with a $5 million deposit. Mr. Herula was the account representative, and Mr. Ullom approved the new account form. (R.J. Ex. 2342.) The Corporate Resolution accompanying the New Account Form was signed by Brite Business Assistant Secretary, Farouk Alam Khan; President, Mr. Fife; Chairman & CEO, Mr. Hertzog; and trader, Mr. Doidge. (R.J. Ex. 2342.) Mr. Putnam believed that Raymond James knew its client, Brite Business, "quite well." (Tr. 1956.) On October 26, 1999, Brite Business entered an Investment Management Program for Advisory Clients (IMPAC), which provided that Raymond James would be paid $250,000 for investment advisory services. (R.J. Ex. 2106.)

***9** On November 9, 1999, Mr. Ullom called Mr. Ness and yelled at him complaining that Raymond James would lose the Brite Business transactions to First Union Bank "because the folks in the home office were concerned about minor details." (Tr. 2709.) Mr. Ullom claimed that Mr. Maynard had behaved in an unprofessional manner at the October meeting with Brite Business and had lost Raymond James the business. (Tr. 2669-70, 2708.) Mr. Ullom also told Mr. Ness that Brite Business was a big client and that R.J. Trust had one more chance to get the job done. (Tr. 2708-09.)

Mr. Ness informed Mr. Maynard of Mr. Ullom's criticisms, which Mr. Maynard denied. (Tr. 2670.) Mr. Maynard was so taken aback by Mr. Ullom's actions that he learned through business contacts that Brite Business had contacted First Union Bank with the same deal and First Union Bank had "sent them packing." (Tr. 2669-71; Div. Ex. 244.) Contrary to the representations of Mr. Ullom and Mr. Herula, the deal made no sense to First Union Bank and it had "distinctly not" done the deal. (Id.) Mr. Maynard relayed this information to Mr. Ness, Mr. Putnam, Mr. Julien, Mr. Kritsas, and Mr. Tremaine. (Div. Ex. 244.)

On November 10, 1999, upon learning this information, Mr. Ness e-mailed Mr. Putnam and stated that he found the fact that First Union Bank had not done the deal "particularly disturbing since it potentially casts some question in the direction of [Brite Business's] principals." (Div. Ex. 245.) Mr. Tremaine was convinced that Raymond James should not

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Mr. Ness was "profoundly skeptical" and informed Mr. Putnam that Mr. Tremaine and Mr. Walsh opposed involvement in the transaction. (Div. Ex. 245.) Mr. Putnam did not believe that Mr. Ness, Mr. Tremaine, and Mr. Walsh thought that Raymond James should not do business with Brite Business, but, rather, that Raymond James should not do the transaction Brite Business proposed in October 1999. (Tr. 1763.)

On November 9, 1999, in an e-mail to Mr. Putnam, Mr. Julien, Mr. Kritsas, and Mr. Tremaine, Mr. Ness: (1) asked whether Mr. Ullom was a significant producer with experience in sophisticated transactions; (2) criticized the quality of the escrow agreement that Mr. Ullom had sent him for Brite Business; (3) stated that Brite Business's current proposal did not pass "the smell test either," i.e., as an aggressive tax shelter; and (4) stated it was too difficult "to understand the economic justification of the deal." (Tr. 2714-15, 2718, 2730; Div. Ex. 244.) Mr. Ness questioned the economic justification for the deal, the "C Team player" involved, and worried about being the only one with clean hands in a dirty deal and aggressive tax shelter. (Tr. 2716-18.) In a November 10, 1999, response, Mr. Putnam did not adopt Mr. Ness's concerns. (Tr. 1753; Div. Ex. 245.) Rather, Mr. Putnam stated that he understood that "the first deal was done with First Union"; that Mr. Ullom had "run a brokerage firm and been responsible for underwriting multi-million dollar deals"; and he questioned whether the reference to "C Team players" was to the English broker, an alleged participant, whom Raymond James was unable to identify. (Tr. 1693; Div. Exs. 240, 245.)

***11** The fact that First Union Bank could not make sense of the Brite Business transaction did not concern Mr. Putnam because Raymond James "was not going to make the loan." (Tr. 1755.) Mr. Putnam and Michael J. DiGirolamo (Mr. DiGirolamo), who was head of compliance at IMR, believed that the ad hoc committee that met with Brite Business in October 1999 turned the transaction down. (Tr. 1870; Div. Ex. 253.) Mr. Putnam's position was that Raymond James should look at each transaction Brite Business presented, and do extensive due diligence on Brite Business if Raymond James decided to go forward with a transaction.

On November 10, 1999, Mr. Ness responded to a draft agreement from Mr. Ullom concerning a Brite Business transaction. In the transaction, Raymond James would act as an escrow agent where Brite Business borrowed funds from a bank. (Div. Ex. 246.) Mr. Ness viewed Brite Business's November proposal as only using R.J. Trust as an escrow agent, where Brite Business's October proposal would have had Raymond James lend funds, serve as an escrow agent, and do securities transactions. (Tr. 2716-18.)

On December 9, 1999, when Brite Business had about $12.3 million in its Raymond James brokerage account, Raymond James filled a Brite Business order to purchase $115 million of Treasuries on margin. (Tr. 1068-69, 1071, 2069, 2839, 2862.) In effect, Raymond James lent Brite Business approximately $103 million, with the United States Treasuries as security. (Tr. 2840-41.) Considering the liquidity of Treasuries, the risk to Raymond James was minimal. (Tr. 2841.) This purchase was a "highly unusual transaction" for Raymond James because of its size, and was likely the largest margin purchase of Treasuries that Raymond James had ever executed. [16] (Tr. 1386, 1840.)

The transaction was unusual because of its size, but principally because it resulted in a loss to Brite Business, in that the coupon on the Treasuries was less than the lending rate, which created a negative spread. (Tr. 1841-43, 2125, 2813-14.) Mr. Putnam was satisfied that persons representing Brite Business were sophisticated investors who understood the transaction and wanted it to happen. (Tr. 2125.) Kevin A. Carreno (Mr. Carreno), one of three Raymond James principals who could approve such a large trade, approved the transaction and subsequently informed Mr. Putnam of the transaction. (Tr. 2444-45.) Operating persons in Raymond James's government bond department handling the purchase were upset that the order arrived late on a Friday afternoon, without any advance notice, which gave them little time to arrange adequate financing to close the transaction. [17] (Tr. 2184-85, 2811.) On December 13, 1999, Mr. Tremaine informed Mr. Putnam that "[a]t this point I do not want to do another trade of this size in this account. Once we fully contemplate the impact [on operations and the firm's cash and capital position] we can then discuss." (Tr. 1785; Div. Ex. 249.)

***12** Mr. Putnam was not concerned by the transaction, which he considered to be in the normal course of business. (Tr. 1773-74, 2123; Div. Ex. 250.) Mr. Putnam was not concerned that the transaction was part of the balance sheet enhancement program because he understood the purchase was in connection with a repurchase agreement that Brite Business had with the Bank of New York, and that the securities were being delivered to that institution. [18] (Tr. 1744, 1776, 1784; R.J. Ex. 2445.) Mr. Herula gave Mr. Putnam this information after the purchase of the Treasuries. (Tr. 1420; R.J. Ex. 2044.) On December 16, 1999, Mr. Herula mentioned that Mr. Fife would be depositing an additional $22 million in the Brite Business account, and that Mr. Fife had provided a reference to Bill Britt, who had a portfolio of $100 million. (R.J. Ex. 2044.) Mr. Putnam urged Mr. Fife to sell the Treasuries when the reverse repurchase transaction did not occur by January 1, 2000, because he was concerned that regulators might fault Raymond James for the margin interest Brite Business was paying. Mr. Fife, however, assured Raymond James that he wanted the arrangement to continue. (Tr. 1780-81, 1890, 2817.) Mr. Putnam, Mr. Augenbraun, Mr. Carreno, and Mr. Tremaine did not understand the purchase of Treasuries as indicating participation by Raymond James in the transactions that Brite Business proposed in October 1999. (Tr. 1776, 2203-05, 2456, 2849-50.)

Around December 13, 1999, Mr. Putnam told Mr. Carreno that Brite Business was involved in balance sheet enhancement and that Brite Business might bring some managed accounts to Raymond James. [19] (Tr. 1786.) On December 16, 1999, Mr. Putnam indicated to Mr. Tremaine, Dennis Zank (Mr. Zank) and Mr. Van Sayler, from R.J. & Associates, that Mr. Fife appeared to be using a tax strategy using Treasuries, and that if Mr. Fife's relationship with Raymond James was going to be more than a treasury trade, perhaps "Tom [James] or Tremaine and me" should meet with Mr. Fife. (Tr. 1791; Div. Ex. 250.)

On December 20, 1999, the Compliance and Standards Committee of the holding company (C&S Committee), chaired by Thomas James (Mr. James), the chairman and CEO of the holding company, discussed what standards should apply for processing large-size trades on margin. (Tr. 1793, 1874; Div. Ex. 251.) Mr. Putnam, who was also on the C&S Committee, was in London and missed the meeting.

On December 20, 1999, Mr. DiGirolamo informed Mr. Putnam, Mr. Greene, and Mr. Zank that the C&S Committee: (1) noted apparent failures on the bond desk and in the margin department in approving Brite Business's $115 million margin purchase of Treasuries; (2) questioned why the trade was done since the client was paying more in margin interest than it was receiving in interest; (3) questioned why the trade was placed after a committee declined an earlier strategy; and (4) questioned whether the trade should stay on Raymond James's books and wondered if "there was some sort of scam going on." (Tr. 1841-42; Div. Ex. 251.) Mr. DiGirolamo commented that without knowing all the details "this smells a little fishy." (Id.) Mr. Putnam believes the

C&S Committee would have been satisfied if he had been present to explain that Mr. Fife was a sophisticated and knowledgeable client who was being advised by Arthur Andersen. (Tr. 1805.) However, several people who had looked at Brite Business's proposals were on the C&S Committee. (Tr. 1801.) Mr. Putnam had expressed concerns about Brite Business's motives for the Treasury transaction to Mr. DiGirolamo, Mr. Van Sayler, Mr. Zank, and Mr. James. (Tr. 1803-05.) On December 21, 1999, the C&S Committee approved a policy that any retail order for fixed income securities in excess of $1 million must be referred by the trading desk to the Compliance Department for approval prior to execution. (Div. Ex. 438.) The policy was further modified by raising the amount to $5 million, substituting customer relations for the Compliance Department, and specifying the transaction referred to margin purchases. (Tr. 2193.)

***13** Mr. James informed Mr. Putnam on January 8, 2000, that he was strongly biased "to not do any trade or participate in any strategy that we do not understand. Thus, unless the Arthur Andersen and Holland [&] Knight people can convince the original committee to do the transaction, I want no other parts of it executed here." (Div. Ex. 253.) Mr. James understood that those who looked at the transaction in October concluded that Raymond James should not do the transaction, but "then the first phase occurred anyway." (Div. Ex. 253.) Mr. Putnam replied that: (1) he too was leery of doing any transaction that involves large number and appears illogical; (2) the original transaction Brite Business proposed in October was moot; (3) following his trip to New York the ad hoc committee would convene to consider Brite Business's proposals; and (4) the throw-off in personal business from Brite Business could be significant for the branch and the firm. (Id.) Mr. James replied that a participant on the ad hoc committee informed him that it had rejected the transaction, and Mr. James did not want another step taken without a super majority vote of the ad hoc committee, and that at least one person was "more than nervous." (Div. Ex. 253.)

On January 7, 2000, Mr. Herula sent Mr. Putnam an e-mail describing an additional transaction that Brite Business would like to do with Raymond James that included a trust account. (R.J. Ex. 2451.) On January 12, 2000, Mr. Putnam and Barry Augenbraun (Mr. Augenbraun), senior vice president and corporate secretary of the holding company, an attorney and C&S Committee member, met with Mr. Fife and others at Mr. Fife's home, a large penthouse on Central Park West in New York City. (Tr. 1075, 1657, 1974, 2173; Div. Ex. 257.) The purpose of the meeting was to learn more about Brite Business, the new Brite Business proposal, and to meet Mr. Fife and other Brite Business principals. (Tr. 1798, 2194; Div. Exs. 254, 503.) Mr. Augenbraun also wanted to determine why Brite Business had purchased Treasuries on margin in December 1999. (Tr. 2204, 2259.) At the January 2000 meeting, representatives of Brite Business presented an elaborate business plan from a package with Arthur Andersen's name on the cover. (Tr. 2200-01.) Brite Business's plan was to create new corporations, similar to Brite Business, to finance construction projects where Treasuries would be used to enhance the corporate balance sheets. (Tr. 2206-08.) There was no discussion of high-yield trading programs or high rates of return. (Tr. 2261.) Farouk Khan represented that he was involved in a bank in the Middle East. Mr. Doidge and Nick Gatto, an attorney with Holland & Knight, represented that balance sheet enhancement had been used in other places, that Sunoco used it in a bidding process, and that it was done all the time.[20] (Tr. 1673, 1819, 1821, 2074-75, 2208; Putnam Ex. 1047.)

***14** On January 17, 2000, Mr. Putnam sent ten people at Raymond James a: (1) description of the New York meeting, which included a description of a complex transaction that involved an encumbered pool of cash that would convince certain people that Brite Business was large enough to bid on certain jobs; and (2) recommendation from himself and Mr. Augenbraun that Raymond James "not become any further involved in these transactions." (Tr. 1674; Div. Ex. 261.) Mr. Putnam believes that the transactions Raymond James rejected had nothing to do with Brite Business's purchase of Treasuries. (Tr. 1921.) Mr. James and Mr. Maynard informed Mr. Putnam that they agreed with the decision. (Tr. 1890-91; Div. Exs. 259, 260, 261.) Mr. Putnam informed Mr. Fife that Raymond James would not be interested in the transaction Brite Business proposed in January, and suggested that Mr. Fife contact Bear Stearns, because it did a lot of aggressive work in the fixed-income area.[21] (Tr. 2086.) Neither Mr. Augenbraun nor Mr. Putnam saw any need to terminate Brite Business's brokerage account at Raymond James based on the meeting in New York. (Tr. 2260.)

Mr. Putnam believed that Raymond James should continue to "see if there was something [Raymond James] could do that we would feel comfortable doing with" Brite Business. (Tr. 1764, 1807, 1892-93, 1906.) A relationship with Brite Business offered the potential of large fees for Raymond James and the possibility of additional advisory business from wealthy friends

and associates of Mr. Fife. (Tr. 1666-67; Div. Ex. 253.) Mr. Putnam might have rejected Brite Business out of hand, except that the people associated with Brite Business appeared to have substantial wealth, which could translate into new business for Raymond James. (Tr. 1852.)

On January 18 and 19, 2000, Mr. Herula communicated with Mr. Putnam, advancing support for the balance sheet enhancement program and projected that Raymond James would receive a large new account as a referral. (Div. Ex. 466.) Mr. Putnam was not able to obtain confirmation on the legitimacy of balance sheet transactions from two references supplied by Mr. Herula and Brite Business. (Tr. 2083-84; Div. Ex. 467.) On January 19, 2000, Mr. Herula informed Mr. Putnam that a new unnamed account was considering depositing $100 million to purchase an "RJ Bank CD," or another product that "we may wish to structure for him." "The purpose would be to assist Brite [Business] by margining or borrowing against the product." (R.J. Ex. 468.) Mr. Herula asked for Mr. Putnam's help in salvaging the relationship. (Div. Ex. 468.) Mr. Putnam responded on January 19, 2000, that "[i]f this is the only thing they would do I can't see a problem but you mentioned some other transactions including a loan to Brite Business." (Div. Ex. 469.) Mr. Putnam talked with the referral from this transaction, professional investors "who would be purchasing bonds in large amounts, keeping a very large balance with" Raymond James. (Id.) On January 28, 2000, Mr. Fife requested Mr. Putnam's assistance in establishing a line of credit at Raymond James or another institution for fixed income trading by a new special purpose corporation. (Div. Ex. 264.) Mr. Putnam rejected the request on February 1, 2000, because the note issued by a new special purpose corporation backed by assets in escrow and an insurance bond would not be considered a marginable security. (Tr. 2091; Div. Ex. 265.)

***15** Mr. Ullom informed Mr. Putnam on February 29, 2000, that Mr. Fife was raising money and Brite Business would possibly sell the Treasuries it had purchased on margin.[22] (R.J. Ex. 2062.) Mr. Putnam approved the sale of the Treasuries on February 29, 2000, but he and Mr. Zank questioned whether it made sense to do so a week before the maturity date of March 9, 2000. (Tr. 1907, 2140; Div. Ex. 267.) Mr. Zank commented, "I'm not sure why one would sell with maturity so close. However, I haven't understood this trade from the get go, so a sale at this time wouldn't surprise me." (Div. Ex. 471.)

On March 5, 2000, Mr. Herula sent Mr. Putnam an e-mail informing him that: (1) Brite Business planned to deposit substantial funds into its Raymond James account and that it may need to escrow with a third party; (2) Brite Business may need to purchase T-bills; and (3) he was developing additional business from a money manager that may bring in a $100 million deposit. (Div. Ex. 268.) On March 7, 2000, at Mr. Putnam's request, Mr. Ness agreed to look at whether R.J. Trust would serve as an escrow for a portion of Brite Business funds. (Tr. 2724; Div. Ex. 269.)

On March 13, 2000, Mr. Fife directed Mr. Herula to buy $100 million in Treasuries in the "Brite Business margin account" for the purpose of offsetting a substantial tax benefit elsewhere. (Div. Ex. 140.) Mr. Putnam did not consider this proposed Treasury purchase as related to Brite Business's "balance sheet enhancement program." (Tr. 1923-24.) Mr. Putnam considered the March proposal as standing alone. Mr. Putnam would not allow Brite Business to purchase additional Treasuries on margin so he rejected the transaction. (Tr. 1122, 1450, 1924.) Mr. Putnam did not want another situation like December when Raymond James's books showed Brite Business paying margin interest on a Treasury purchase, a situation that lacked economic sense. (Tr. 1914.) On March 15, 2000, Mr. Van Sayler informed Mr. Putnam that he believed that Mr. Herula "misrepresented the facts on this situation to the desk." Mr. Putnam asked for details and Mr. Van Sayler did not provide them. (Tr. 1929-31; Div. Ex. 271.) At the same time, Mr. Putnam approved Brite Business's purchase of $10 million of Treasuries for cash. (Tr. 1129, 1927.)

Investors in Brite Business

1. Rheaume Holdings Ltd. (Rheaume Holdings), an investment vehicle of Mr. and Mrs. Fitzhenry, Canadian citizens and residents of Barbados, deposited $12.5 million in account No. 380 036-82 at Raymond James in the name of Brite Business on March 27, 2000. (Tr. 27-28; Div. Exs. 51, 52.) Mr. Fitzhenry relied on the due diligence investigation and recommendation of Robert Curl (Mr. Curl), his financial adviser since 1983. Mr. Fife represented to Mr. Fitzhenry's representative, Mr. Curl, that he had engaged in this type of private placement, and that his responsibilities with Brite Business were to provide the safety

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of deposits. It was represented that "the moneys are safeguarded so there is no risk of loss and verification is needed daily to participate in a transaction used to finance humanitarian or World Bank, Third World projects." (Div. Ex. 54.)

***16** Mr. Herula wrote a letter to Mr. Fitzhenry on Raymond James letterhead as Raymond James Investment Manager, dated March 10, 2000, in which he acknowledged that:

Raymond James has received irrevocable instructions from Brite Business Corp. regarding the deposit from Rheaume Holdings Ltd., if and when received, in the amount of $12,500,000 USD for the purpose of completing a purchase of US Treasury Bills, Note or Bond.

Raymond James will follow these instructions with the full faith and backing of the company to assure that funds deposited by Rheaume Holdings Ltd. will not be withdrawn from the account without written instructions from Rheaume Holdings Ltd.

Raymond James will return the funds in full, without delays or encumbrances, upon the maturity of the T-Bill, Note or Bond transaction. Accumulated interest on the funds deposited based upon the T-Bill, Note or Bond interest rate from the date of purchase will be included if the T-bill, Note or Bond are held to maturity.

The maturity of the T-Bill, Note or Bond will be 90 days unless specific instructions are received from Rheaume Holdings Ltd. within 10 days of maturity to rollover the treasury instrument.

(Div. Ex. 45.)

In a letter dated March 15, 2000, Mr. Sullivan gave Mr. Herula irrevocable instructions on behalf of Brite Business for the Rheaume Holdings Ltd. $12.5 million deposit when received into the Brite Business account.

Upon my instructions, purchase T-bills, Notes, or Bonds, with a maturity of 90 days from the execution of the order for the purpose of providing leverage for the Brite account at Raymond James.

At no time place these funds in harms way via an investment vehicle not authorized in writing by Robert Fitzhenry.

Upon written notice from Robert Fitzhenry, you are authorized irrevocably to liquidate his Treasury Bill, Note or Bond and return the balance to him upon the standard settlement date of the liquidation.

Accept no requests for these funds to be transferred out of the account except from Robert Fitzhenry.

(Div. Ex. 46.)

Mr. Fitzhenry believed that he was investing in "T-bills" and that, at the least, he would realize the "T-bill" rate and anything additional would be extra. (Tr. 285.) He did not believe that Brite Business would be able to pay the promised ten percent a week interest rate. Mr. Fitzhenry became concerned when he did not receive a payment in twelve business days. He requested the return of funds from Mr. Herula and Mr. Fife after ninety days. (Tr. 289.) Rheaume Holdings never received a single interest payment and Brite Business did not return the $12.5 million investment. Mr. Fitzhenry only received about $3,500 from Mr. Fife. (Tr. 245-46.) Mr. Fitzhenry did not contact Raymond James until 2002, when Rheaume Holdings brought a civil suit against Raymond James, Mr. Herula, Mr. Ullom, and others. That litigation was settled in June 2004. (Tr. 120.)

2. Rashed Mohamed Mahran Al Bloushi (Mr. Al Bloushi), a forty-six-year-old business man, is a citizen of Abu Dhabi, United Arab Emirates (UAE). Mohamed B. Hamad (Hamad), a former Sudanese diplomat with a Masters in Economics, is Mr. Al Bloushi's trusted friend and adviser who conducted business in English on behalf of Mr. Al Bloushi. (Tr. 315-16, 328, 388-89, 437, 490.)

***17** Mr. Al Bloushi started in the Brite Business trading program in May 1999. (Tr. 672.) In June 1999, Mr. Al Bloushi made the largest investment of his life when he signed several documents and transferred $10 million to a Brite Business account at SG Cowan Securities Corp. (SG Cowan). (Tr. 311-13, 319, 344-45; Div. Ex. 1.) Mr. Al Bloushi understood that he would control the account and no one could do anything with the funds without his consent. (Tr. 315; Div. Ex. 1.)

In August 1999, in response to Mr. Fife's request, Mr. Al Bloushi authorized the transfer of $7.5 million of his $10 million from SG Cowan to the Canadian Imperial Bank of Commerce (CIBC), for credit to CIBC Wood Gundy Securities, Inc., for credit to Brite Business on August 14, 1999, and $2.4 million of the $10 million was used to buy a new leverage note from Societe Generale. (Div. Exs. 3, 4, 5.) On October 19, 1999, Brite Business transferred $5 million of Mr. Al Bloushi's $7.5 million from the Brite Business account at CIBC to the Brite Business account at Raymond James. (Tr. 892-93, 958; Div. Ex. 99.) Mr. Clarke, Mr. Hertzog, Mr. Herula, and Mr. Sullivan reaffirmed there was no risk of principal. (Tr. 488, 582.) Mr. Hertzog and Mr. Clarke assured Mr. Bloushi that his funds would be "blocked" in the Brite Business account at CIBC, but CIBC gave no such assurance. (Tr. 587.)

Mr. Hamad first requested promised profits from Brite Business beginning in August 1999. (Tr. 406.) Beginning in the fall of 1999 or early 2000, Mr. Al Bloushi believed that Raymond James was in charge of investing the funds he transferred to Brite Business. (Tr. 330, 605, 607.) In September 1999, Mr. Clarke informed Mr. Hamad, on a confidential basis, that Raymond James was the major financial institution involved in the transaction. (Tr. 591-93, 598-99.) To confirm his oral representations, Mr. Clarke gave Mr. Hamad a copy of a letter on Raymond James letterhead on or about December 9, 1999, signed by Mr. Herula, Raymond James Financial Consultant, to Brite Business confirming the purchase of $115 million of Treasuries in the Brite Business account at Raymond James. (Tr. 426-28, 588-89; Div. Ex. 11.). Mr. Herula first wrote directly to Mr. Al Bloushi on January 21, 2000, using Raymond James letterhead. (Div. Ex. 12.) Mr. Hamad checked and found the information on Raymond James's website to be identical to the letterhead. (Tr. 428.) Mr. Al Bloushi and Mr. Hamad believed that participation by Raymond James, a company that described itself on the Internet as managing $15 billion, indicated that the transaction was legitimate. (Tr. 617.) In a letter on Raymond James letterhead dated March 22, 2000, Mr. Herula told Mr. Al Bloushi that "the treasury account for Brite Business Corp. is in place and has been blocked under my control and supervision at Raymond James Financial Services. You can rest assured that the treasury package will stay in the account." (R.J. Ex. 39.) Mr. Al Bloushi and Mr. Hamad considered this statement a guarantee by Raymond James that Mr. Al Bloushi's $7.5 million was safe. (Tr. 654-55.)

***18** When he never received any of the promised profits, Mr. Al Bloushi demanded the return of his $7.5 million in a letter to Brite Business, Mr. Clarke, and Mr. Hertzog dated November 21, 1999. (R.J. Ex. 40.) Mr. Al Bloushi contacted Raymond James on March 27, 2001. (Tr. 631.) As late as March 2002, Mr. Sullivan represented to Mr. Al Bloushi that Raymond James was working on the transaction and the promised profits were coming. (Tr. 632.) Mr. Al Bloushi has not received his $7.5 million, or any profits or interest on his investment. (Tr. 333-34, 378, 466.) Mr. Al Bloushi has received approximately $1.3 million of the $2.4 million sent to Societe Generale in August 1999. (Tr. 379, 683-84.)

3. Malcolm Joseph Monlezun (Mr. Monlezun), a fifty-two-year-old certified registered nurse anesthetist, signed a new account form for a money market account with Raymond James on October 24, 2000. (Tr. 705, 707, 1257; Div. Ex. 60.) Mr. Ullom approved and signed the new account form. Mr. Herula was the financial adviser on the account. (Tr. 1258; Div. Ex. 60.) When he approved the new account form, Mr. Ullom knew that Mr. Monlezun was participating in transactions with Brite Business. (Tr. 1499-50.) Based on Mr. Herula's representations and instructions, Mr. Monlezun transferred $1 million, on October 26, 2000, for deposit in a money market account at Raymond James. (Tr. 711, 724; Div. Exs. 65, 66, 77, 105.)

Mr. Monlezun opened the account at Raymond James on the advice of Mr. Herula, and a company called ECCE. [23] (Tr. 707, 853.) According to ECCE, trading in medium-term notes would take place outside the United States based on the fact that $100 million was on deposit at a specific location in the United States. Investors would earn returns of between ten and thirty percent a month. (Tr. 771; R.J. Ex. 2124.) Mr. Herula told Mr. Monlezun that he was gathering $100 million, in $1 million minimums, from investors for deposit with Raymond James. Mr. Herula represented to Mr. Monlezun that his funds would stay at Raymond James under Mr. Monlezun's control. Raymond James would issue a document to ECCE that would allow ECCE to facilitate

a transaction, in which Mr. Herula was an expert. (Tr. 707.) Mr. Herula represented that Mr. Monlezun's funds would not be at risk, and returns would be ten to thirty percent a month once the transactions began. (Tr. 712, 730.)

Mr. Monlezun received monthly account statements from Raymond James for the period of October 25 through December 29, 2000. (Tr. 727; Div. Ex. 81.) He also received a statement on Raymond James letterhead dated October 30, 2000, for account No. 44902174 showing receipt of $1 million and the transfer of $1 million to Raymond James's Heritage Cash Trust, a money market account.

When the ECCE transaction did not materialize, Mr. Herula informed Mr. Monlezun that he and Mr. Fife, a well known investor with connections to the Dreyfus Funds, were gathering investors capable of pooling $100 million for similar high-yield transactions. (Tr. 731-32.) According to Mr. Herula, it was possible to make handsome profits based on documentation that deposits of $100 million were in place at Raymond James. (Tr. 741-42.) Mr. Herula represented that the transaction involved no risk, that Monlezun's funds would stay with Raymond James, and that monthly returns could be from ten to thirty percent but monthly returns of ten to twelve percent were more realistic. (Tr. 732-33, 737.) A short time later, Mr. Herula informed Mr. Monlezun that the deal was going forward and that his $1 million had to be transferred to an escrow account set up by Ms. Capalbo, who Mr. Herula represented was an attorney working for Raymond James. (Tr. 733-34, 738.) On November 24, 2000, Mr. Monlezun, based on Mr. Herula's representations, authorized Raymond James to transfer $1 million from his account to the Mary Lee Capalbo, Esq., Special Client Account No. 49114444 at Raymond James. [24] (Tr. 826, 853; Div. Exs. 73, 76, 105.)

***19** Mr. Herula did not tell Mr. Monlezun that Ms. Capalbo was his wife. (Tr. 734-35.) Mr. Herula and Ms. Capalbo assured Mr. Monlezun that transfers from the account would occur only with his written permission, however, $500,000 of the $1 million was immediately transferred out of the Mary Lee Capalbo, Esq., Special Client Account to the Abbot Capitol account. [25] (Tr. 743, 1513; Div. Ex. 75, R.J. Ex. 2390 at 14815.)

Mr. Monlezun received $20,117 from Mary Lee Capalbo Herula, Citizens Bank, on January 8, 2001, and $105,817.30 from Dennis Herula\Mary Lee Herula, at WMB FA bank, on February 6, 2001, which Mr. Herula represented were trading profits. (Tr. 750; Div. Exs. 78, 496.) In February, March, and October 2001, Mr. Monlezun attempted to organize investors willing to invest millions in high-yield investments organized by Mr. Herula. (Tr. 813-19; Div. Exs. 2142, 2145, 2146, 2158.) Mr. Monlezun demanded a return of his $1 million from Mr. Herula in February 2002. (R.J. Ex. 2179.) In that correspondence, Mr. Monlezun acknowledged that Mr. Herula had represented that his funds were in Ms. Capalbo's escrow account at Charles Schwab. (R.J. Ex. 2179.) Mr. Monlezun has not received any additional payments and he has not been able to obtain the return of his $1 million from Mr. Herula. (Tr. 753.) On August 1, 2002, Mr. Monlezun filed with Raymond James a claim for $3 million, plus other damages and attorney fees. (R.J. Ex. 2196.) Also, Mr. Monlezun initiated a civil suit against Raymond James but was ordered to pursue arbitration, which he has not done. (Tr. 2266.) Raymond James has not received a response to its settlement offer. (Tr. 2266.)

Supervision and Compliance at Raymond James

Pursuant to Rule 3030 of the NASD, Raymond James required persons conducting business outside the firm to file a form with the branch manager and the Compliance Department stating the nature of their outside activities. (Tr. 1898-99.) Mr. Putnam and Mr. Ullom knew in August 1999 that Mr. Herula was attempting to raise funds from commercial banks for Brite Business, and that this activity required that a form be filed. (Tr. 1900.) Raymond James has no form or memoranda on file showing that it was aware that Mr. Herula was conducting this outside business activity. (Tr. 1898-02, 2042, 2169-70.) Mr. Ullom did not file a Request for a Non Branch Location for Mr. Herula, which Raymond James required when a registered representative was conducting business from his home. (Tr. 1332-33, 1444, 1723.) Mr. Ullom did not know of any special procedures or compliance policies that Raymond James had in place for supervising registered representatives who worked outside the office. (Tr. 992.) Raymond James had a long-standing policy that all outgoing written communications from registered representatives, including e- mails and facsimiles, had to be approved in advance by the branch manager. (Tr. 2371-72; R.J. Ex. 2640 at 12015, 111961.) Raymond James always prohibited the use of Raymond James stationery for business outside of Raymond James. (Tr. 2940.)

Mr. Ullom never inspected or reviewed Mr. Herula's work locations outside the Cranston branch office. (Tr. 991.) Mr. Putnam did not know that Mr. Herula spent considerable or significant time away from the Cranston branch office. (Tr. 1966.)

***20** Excluding provisions of the money laundering statutes, Raymond James's procedures for disbursing funds from an account had the sole objective of assuring that the client authorized the transfer of funds.[26] (Tr. 2524-25, 2567, 2776.) The branch manager and registered representative are responsible for knowing the client and what type of business the client is conducting. (Tr. 2775.) Raymond James believes it has no right to question why a client is making a disbursement or whether the funds in the account belonged to the client. (Tr. 1951.)

Raymond James considered the transfer of funds to an unrelated or third-party account to be an out-of-the- norm transfer. (R.J. Ex. 2534 at 11514.) In these situations, Raymond James's Operations Manual required:

1. Client signature on a LOA;

2. Branch Manager signature;

3. Verbal verification with client for disbursements over $50,000; and

4. Verbal verification with escrow or title company for property closings. LOA should be sent to Customer Accounts to be stamped, reviewed, and imaged into the client's file; If approved, a letter of acknowledgement will be sent to the client confirming that the disbursement was made on their behalf.

(R.J. Ex. 2534 at 11514.)

On transfers to a third-party account inside Raymond James, the Customer Accounts department at R.J. & Associates checked: (1) that the LOA matched the account registration; and (2) whether the account was restricted. On third-party transfers outside Raymond James, Customer Accounts would also check the designated account at the receiving bank.[27] Customer Accounts then sent the LOA back to Raymond James, where the Operations Department also verified the signatures on the LOA and personally contacted the client to verify.[28] The Operations Department then returned the LOA to the Customer Accounts Department at R.J. & Associates, which would accomplish the transfer. (Tr. 2155-58, 2427, 2581, 2754-57, 2765.) All third-party transfers were noted in exception reports provided to the Compliance Department. (Tr. 2531.) Transfers to an employee related account would be a third-party transfer, and were subjected to the same level of review. (Tr. 2531.) The Compliance Department received reports on funds transferred into employee or employee related accounts. (Tr. 2770.)

Trudy Bixby (Ms. Bixby), R. J. & Associates's Vice President, Customer Accounts Department, sees no problems with the way Raymond James handled the Brite Business account. Ms. Bixby believes that Customer Accountants questioned "compliance at some point, and they spoke with the branch and were comfortable with the type of business the client [was] conducting." (Tr. 2775-76.) Ms. Bixby testified:

> A lot of business accounts do have money that flow through from one business to another or from a business to an escrow account or from a business out to make investments. So [the Brite Business transfers] doesn't look like an unusual pattern in terms of what we were dealing with then.

***21** (Tr. 2779.)

Between January 1999 and March or April 2000, what had been Robert Thomas's and was now Raymond James's securities division and what had been IMR's and was now Raymond James's investment management division, operated two separate compliance departments. Mr. Carreno was director of compliance at Raymond James's securities division and financial institutions division from January 1, 1999, until March 2000. [29] (Tr. 1628-29, 2058, 2295, 2296.) Mr. Carreno reported to Mr. Putnam. (Tr. 2047; R.J. Ex. 2003.) To monitor both the securities division and the financial institutions division, the Compliance Department was staffed with only sixteen employees. [30] (Tr. 2324-25.) Mr. Carreno testified that Robert Thomas had about 1,100 registered representatives located in 300 offices of supervisory jurisdiction. (Tr. 2325.)

Mr. Carreno considered the 1995 settlement Mr. Ullom entered with the Commission in 1995, and decided following discussions with Mr. Ullom and his counsel, that Robert Thomas should not subject Mr. Ullom to additional supervisory procedures. (Tr. 2437-38.) In making his decision, Mr. Carreno considered that Mr. Ullom's actions did not result in losses to clients, the bookkeeping entry involved was $1,800, and the Commission did not restrict Mr. Ullom's activities as a registered representative. (Tr. 2437-38, 2468-69.)

From January 2000 through the end of February 2000, Mr. Carreno spent about seventy percent of his time on compliance matters and he worked directly with Mr. Putnam, James Zahradnick (Mr. Zahradnick), and Mr. DiGirolamo. [31] (Tr. 2300-01.) Mr. Carreno did not know anything about Brite Business until January 2000, when Mr. Putnam mentioned briefly that he was going to meet with representatives of Brite Business in New York City.

When the Robert Thomas and IMR compliance departments merged in about April 2000, Mr. DiGirolamo became chief of compliance for all Raymond James divisions. [32] (Tr. 2473, 2935; Div. Ex. 309.) It appears that when Mr. DiGirolamo took charge, he applied the supervisory policies of IMR to the entire firm. Mr. DiGirolamo installed a new structure for the securities division in which a regional compliance officer reported to an associate director, who then reported to him. (Tr. 2474.) Mr. DiGirolamo reported to Tony Greene (Mr. Greene), Raymond James's CEO and chairman. (Tr. 2046.) Mr. DiGirolamo had no involvement with Mr. Herula or Brite Business in 1999 and 2000. (Tr. 2483.)

Raymond James used its branch managers as its first line of defense against illegal activities by registered representatives. (Tr. 2870; R.J. Ex. 2665 at 20.) Raymond James required that branch managers pass either the branch managers exam or the general securities principal exam. (Tr. 1010-11.)

Raymond James's Compliance Department had three major areas: (1) internal audits; (2) account monitoring, which included exceptions reports; and (3) dealing with customer complaints. (Tr. 2353.) The Compliance Department's role was to: (1) educate financial advisers and staff on rules, regulations, and policies; (2) conduct branch office audits; and (3) review exception reports and report results to supervisors. (Tr. 2868-69.) Raymond James conducted oversight of its branch offices by daily reviews of all business and an annual surprise audit conducted by its Branch Audit Department. (Tr. 1008-09; Div. Ex. 297.) Additional audits were performed if Raymond James had special concerns or special circumstances existed. (Tr. 2339.) The branch audit was the means of determining whether the supervisory practices were, in fact, being carried out. (Tr. 3156.) A compliance audit is not conducted by auditors and auditing standards are inapplicable. A compliance audit is really an inspection or an examination that should be conducted by a person with a questioning mind. (Tr. 3113-14) Broker-dealers depend on effective compliance audits to ensure their branch managers are supervising appropriately. (Tr. 3130.) The internal auditors are part of the Compliance Department. (Tr. 1963.)

***22** According to Mr. Carreno, Raymond James's Internal Supervisory Procedures (Supervisory Procedures) was a summary of the supervisory procedures at Raymond James. (Div. Ex. 321.) Raymond James had more detailed written procedures and there were also NASD rules. [33] (Tr. 2315.) The Supervisory Procedures provided that a branch manager was to review and approve any business communication written by a registered representative to a member of the public, and a copy was to be retained in the branch files for review by the Internal Audit Department. (Tr. 1089, 2315; Div. Ex. 321 at 1017, 1049.) Letters that were to be sent to three or more people were to be forwarded to the Compliance Department for review and approval.

(Tr. 2327.) Registered representatives were to send all business related e-mails from the Cranston branch office to Mr. Ullom for his review. (Tr. 1101.) Registered representatives were prohibited from acting as an agent for a client, or an individual, without permission in writing from Raymond James. Registered representatives were also prohibited from raising, or agreeing to raise, money for any company, or individual, other than as an independent contractor for Raymond James, without written permission. (Tr. 2321-23; Div. Ex. 321 at 1050.) The Supervisory Procedures also required branch offices to submit a monthly Compliance Report to the Compliance Department. (Div. Ex. 321 at 1095.) The Supervisory Procedures contained a single sheet of Procedures for Raymond James Financial Services, Inc., Outside Activity, and a Request to Engage in Outside Activity (Form 1790) to be submitted to the Compliance Department. [34] (Tr. 2519; Div. Ex. 321 at 1134-36.) In some cases, the Compliance Department reviewed the Form 1790. (Tr. 2329.) Mr. Herula's activities in raising funds for Brite Business was the type of business activity that required a Form 1790, however; he never filed one. (Tr. 2330, 2520-21.) Every registered representative, including Mr. Herula, certified annually that he or she knew and understood Raymond James's compliance policies. (Tr. 2394, 2434; R.J. Ex. 2533B, R.J. Ex. 2009.)

During the relevant period, the NASD and Raymond James required that any location where a registered representative worked as a primary or regular work location, other than the branch office, should be registered as a satellite office. (Tr. 3168.) In 1999-2000, the four room Cranston branch office had five or six registered representatives and only three desks. This space allocation was possible because Mr. Herula and three other registered representatives did not work at the branch office. [35] (Tr. 1031-32, 1280, 1389) The evidence is that only Mr. Ullom and Jason Ullom, his son, worked from the Cranston branch office in 1999-2000. (Tr. 1409.) Raymond James depended: (1) on the voluntary submission of requests for a non-branch location to inform them that a registered representative was working regularly from home; and (2) on the branch manager to make sure that correspondence and documentation for business activity conducted outside the office came through the office to which the registered representative was assigned. (Tr. 2106, 2338.) The Compliance Department was never notified that Mr. Herula worked almost entirely from locations other than the Cranston branch office. (Tr. 2440.) In his investigative testimony, Mr. DiGirolamo testified that branch managers were not required to report that a registered representative worked regularly from home, and acknowledged that Raymond James did not know the number of registered representatives working from home. (Tr. 2499-50.) At the hearing, however, Mr. DiGirolamo changed his testimony based on his review of the auditor's questionnaire. He testified that branch managers were asked during the 2000 audit if any registered representatives were working regularly outside the branch office. (Tr. 2498.) Mr. DiGirolamo's present position is that if the registered representative was regularly working at a location other than a branch office in 1999 and 2000, Raymond James required disclosure so that it could register the location as a satellite office with the NASD. (Tr. 2459, 2600.) Donald Runkle (Mr. Runkle), who became Raymond James's chief compliance officer in May 2004, acknowledged that prior to 2003, Raymond James did not maintain a list of who it believed worked at unregistered locations. (Tr. 2865, 2938.)

***23** In accordance with Raymond James's policy, Mr. Ullom allowed Mr. Herula to work from locations other than the Cranston branch office. (Tr. 990-92.) Raymond James allowed this and, in keeping with NASD requirements, insisted that locations outside the branch office could not be advertised, that all correspondence be sent from the branch office, and all files be maintained at the branch office. (Tr. 2332, 2409-10.) Mr. Carreno testified during the investigation that Raymond James did not require a registered representative to obtain approval to work from home. (Tr. 2335.) At the hearing, however, Mr. Carreno testified that Raymond James asked branch managers to fill out a form when a registered representative was going to operate regularly from home. Mr. Ullom never inspected or reviewed Mr. Herula's work locations outside the Cranston branch office. He was also unaware of any special procedures or compliance policies that Raymond James had in place for supervising registered representatives who worked outside the office. (Tr. 991-92.)

The files in the Cranston branch office did not contain copies of correspondence from Mr. Herula to B.B. Britt who operated Beehive International LLC, on Raymond James letterhead, sent from the Cranston branch office. (Tr. 1435, 1437-39.) The Cranston branch office files did not contain a facsimile Mr. Herula sent from the Cranston branch office to B.B. Britt on Raymond James letterhead, dated December 6, 1999, making unauthorized representations and guarantees concerning the $10 million deposit from Bill Britt. (Tr. 1409-10; R.J. Ex. 2035.) Jason Ullom notarized Mr. Herula's signature on the e-mail. (R.J. Ex. 2035.) The Cranston branch office files did not have a copy of a facsimile Mr. Herula sent from the office on Raymond James letterhead

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dated December 7, 1999, which included instructions from Mr. Fife to Mr. Herula concerning Mr. Britt's $10 million deposit. (Tr. 1407; R.J. Ex. 2036.) Mr. Herula was to deposit the funds into the Brite Business account to purchase “T-Bills, Notes or Bonds on margin, with a maturity of 90 days from the execution of the order, for the purpose of transacting a reverse repo using Sovereign Advisers, a Raymond James Advisory Services Group advisor.” (R.J. Ex. 2036.) The Cranston branch office files did not contain: facsimiles sent to Mr. Herula by Mr. Britt on February 4, 2000; a letter from Mr. Britt to Mr. Clarke making demands on Raymond James related to the Brite Business transaction; or a letter from Mr. Herula on Raymond James letterhead to Mr. Britt dated February 16, 2000, stating the Raymond James had his funds in a T-bill. (R.J. Ex. 2054-2056, 2059-60, 2062, 2064.) Mr. Herula testified that he worked out of his home offices from mid-December 1999, until he left Raymond James, and that his files contained copies of all his unauthorized correspondence. (Tr. 1723-24.)

Mr. Ullom submitted monthly compliance reports to Raymond James's Compliance Department in 2000, indicating that the Cranston branch office had no compliance problems. (Tr. 1262; Div. Ex. 441-48, 450, 452-54, R.J. Ex. 2553.) From May 1999 through January 2001, Mr. Ullom represented that he had reviewed and initialed all outgoing correspondence, including e-mails pertaining to the solicitation or execution of securities transactions. (Tr. 1524; Div. Ex. 443, 447, R.J. Ex. 2553.) Mr. Carreno reviewed these compliance reports until the compliance departments merged, and Raymond James went to a regional structure for compliance oversight. (Tr. 2053-54.) The Compliance Department did not contact Mr. Ullom with inquiries on any compliance report in 2000. (Tr. 1262-64.)

***24** Mr. Ullom and the registered representatives in the Cranston branch office signed a form annually representing that they observed the company's ethics policies, and its financial adviser business procedures. (Tr. 1303; R.J. Ex. 2018.) Mr. Ullom did not have Mr. Herula submit a Request to Engage in Outside Activity for his work raising funds for Brite Business. Mr. Ullom testified that this was because Raymond James knew of Mr. Herula's attempts to arrange loans for Brite Business. (Tr. 1302.)

Raymond James's had Operations Manuals for compliance available in hard copy and online during the relevant period. (Tr. 2486-87; R.J. Exs. 2531, 2532, 2539, 2540, 2542.) The Compliance Department established parameters for situations that required review from a compliance perspective and the clearing firm produced computer generated exception reports showing these situations (exception reports). (Tr. 2425-26.) During the relevant period, R.J. & Associates periodically provided Raymond James's Compliance Department with over fifty different exception reports. (Tr. 2359, 2420-21.) On a monthly basis, the Compliance Department sent Mr. Ullom and other branch managers, MARS reports, which were a summary of exception reports applicable to the specific branch. The branch manager was required to review the MARS reports and perform any investigation that was required. (Tr. 2418, 2770; R.J. Ex. 2559 at audit letter dated Aug. 6, 1997.)

Sending the MARS reports to the branch offices, “didn't relieve the [C]ompliance [D]epartment from doing what it needed to do with the exception report” from a compliance perspective (Tr. 2424.) The MARS reports for March, April, May, August, September, and October 2000, noted that the Brite Business and Mary Lee Capalbo, Esq., Special Client, a related account, issued third-party checks for millions of dollars, and/or transferred millions of dollars between accounts at Raymond James. (Div. Exs. 458, 459, 460, 462, 463, 464.) The Compliance Department's concern was that the transactions occurred pursuant to LOAs, and that the client orally confirmed the authorization where the transfer was over a certain amount. (Tr. 2427.) Review by the Compliance Department consisted of ensuring that procedures were followed, that a LOA was authorized, and that operations and customer accounts had signed off on the transaction. (Tr. 2586.) The evidence is that the Compliance Department did nothing more with this information. (Tr. 2424.) Mr. DiGirolamo testified that, after the compliance departments merged in May 2000, compliance procedures that applied to transfers in the investment management division applied to the securities division as well. (Tr. 2588-89.)

Raymond James had the following standards in effect for infractions during the relevant period:

First offense: Letter of caution;

Second offense: Letter of caution and/or a fine; and

Third offense: Fine and potential termination.

***25** (Tr. 2565.)

Following the events that are the subject of this proceeding, Raymond James has taken steps to enhance its compliance efforts. (Tr. 2879.) In the last two years, the firm has changed structurally with new and increased numbers of people occupying key management positions at the firm. (Tr. 3429.) Chet Helck (Mr. Helck), the president and chief operating officer of Raymond James, maintains that supervision and compliance are among the firm's highest priorities and that the tone from the top is to always put the client's interest first. (Tr. 3427-28.) The events that are the subject of the proceeding have been a huge embarrassment for the firm and have strengthened its resolve that they never happen again. (Tr. 3439.) Mr. Helck testified that at the request of the holding company's audit committee, an outside consultant was considering the effectiveness of Raymond James's compliance and supervisory procedures. (Tr. 3439.) On August 19, 2003, following NASD guidance, Mr. DiGirolamo advised all branch managers and registered representatives that:

> Effective immediately, the firm will require audits of each location (home, vacation home, etc.) where any Financial Advisor **regularly** conducts business at least two or more days per week **or** 25 days in any quarter **or** 10 days in any month **or** for six consecutive weeks. (emphasis in original)

(Tr. 3169; Div. Ex. 507.) Raymond James has also increased the number of "compliance professionals," to forty-eight, created a rapid response team, and instituted reviews in new areas. (Tr. 2878-82.) Raymond James has also implemented procedures which, among other things, require additional "assessment of who [its] customers are." [36] (R.J. Ex. 2665 at 21.)

Raymond James's Notice of Mr. Herula's Unauthorized Correspondence and Other Information

Throughout the relevant period Mr. Herula signed and transmitted correspondence on Raymond James letterhead to investors in Brite Business. [37] (Tr. 1104-14; Div. Exs. 12-21, 23, 24.) Mr. Herula signed most of this correspondence on Raymond James letterhead as Financial Consultant or Investment Manager. (Id.) On November 28, 1999, Mr. Herula sent Brite Business, by facsimile, from the Cranston branch office, a form letter with three paragraphs of unauthorized representations and guarantees. This material appears in much of his later correspondence on behalf of Brite Business. (Tr. 1411; R.J. Ex. 2030.) Mr. Ullom denies he knew of this form letter, and agrees that no one at Raymond James was aware of it until a similar unauthorized letter appeared in March 2000. (Tr. 1411.)

1. Provident letter

On January 20, 2000, Mr. Herula informed Mr. Putnam that he had written a letter on December 8, 1999, on Raymond James letterhead to Provident Investment Counsel, Inc., (Provident), an independent investment adviser in the Raymond James Investment Advisor Group. (Div. Ex. 262.) In the Provident letter, Mr. Herula as a representative of Brite Business seeks to enlist Provident in a reverse repurchase agreement between Brite Business and the Bank of New York. (Id.) Mr. Putnam considered the letter questionable, but he does not consider it to be unauthorized correspondence by Mr. Herula. (Tr. 1994.) Mr. Putnam thought it possible that Mr. Herula wrote this letter acting for Raymond James and not for Brite Business. (Tr. 1959-60.) Mr. Putnam assumed Mr. Ullom had approved the Provident letter. (Tr. 2146.) Mr. Putnam warned Mr. Ullom that letters had to accurately portray the relationship between Raymond James and Brite Business. (Tr. 1896-97.) Mr. Putnam did not inform the Compliance Department of the Provident letter. (Tr. 1904.)

2. Lanciano letter

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***26** Hugh M. McGovern, Senior Vice President, Salomon Smith Barney, Inc., provided Joseph Tuorto (Mr. Tuorto), chief compliance officer at R.J. & Associates, a letter written by Mr. Herula on March 1, 2000, on Raymond James letterhead, to Lanciano Limited (Lanciano letter) at an address in Cyprus. (Tr. 1933; Div. Ex. 272.). Mr. Putnam received the letter on or about March 20, 2000.[38] (Tr. 1596; Div. Ex. 272.) In the letter Mr. Herula stated:

Please let me introduce Raymond James Financial, Inc. Raymond James was established in 1962 and is a publicly traded company since 1983. Raymond James Financial is listed on the New York Stock Exchange and manages in excess of $14 billion USD for individuals, pension plans and municipalities with more than 3200 financial advisers in over 1000 offices located throughout the United States.

Brite Business is a valued client of Raymond James, maintaining an account with an aggregate nine-figure balance. This letter is to confirm my review and understanding of the financial plans of Brite Business Corp. Upon extensive review and confirmation of the irrevocable instructions from Brite Business Corp. I am confident that the profits from their Treasury transactions will be used to honor their commitments and contract with you. Further, I know and have worked with our client, Brite Business, and can confirm that they are of the highest rank of moral character and business acumen.

Please be advised of the following acknowledgements:

Raymond James has received irrevocable instructions from Brite Business Corp. regarding the deposit from Lanciano Limited, when received, in the amount of $25,000 USD (Twenty Five Million) for the purpose of completing a purchase of U.S. Treasury Bills, Notes or Bonds for leverage for Brite Business Corp.

Raymond James will follow these instructions with the full faith and backing of the company to guarantee the funds deposited by Lanciano Limited will not be withdrawn from the account without the express written instructions of Lanciano Limited….

I trust you will find this letter acts as a full faith undertaking and guarantee to Lanciano Limited that their funds will not be at risk at any time during or after the anticipated transaction, and as such the funds plus interest will be returned intact, as long as the T-Bills, Notes or Bonds are held to maturity.

(Div. Ex. 272.)

Mr. Putnam's initial concern on reading the Lanciano letter was whether the Brite Business account had funds deposited as a result of the letter. (Tr. 1949-50.) Another concern was that the letter gave the impression that Raymond James owed a duty to Lanciano Limited when its duty ran solely to Brite Business. Mr. Putnam was "plenty agitated," and called the Compliance Department immediately and asked that the Brite Business account be frozen. (Tr. 1943-44, 2092.) The representations in the Lanciano letter, especially the false representations and guarantees, are contrary to Raymond James's policies. (Tr. 1941-42.) Moreover, all the representations were inappropriate, because they were "representations and guarantees that Raymond James could not make" with respect to the Brite Business account. (Tr. 1941.) Mr. Putnam believed that the letter showed that Mr. Herula was conducting an outside business activity using Raymond James stationery. (Tr. 1960.)

***27** Mr. Putnam called Mr. Herula on March 24, 2000, to review the contents of the letter. (Tr. 1945-46, 2093.) Mr. Putnam also called Mr. Ullom, who claimed to have not seen the letter. (Tr.1964, 2094-95.) Mr. Putnam accepted Mr. Herula's representation that Brite Business did not receive funds as a result of the Lanciano letter, and he trusted and relied on Mr. Ullom to make sure this was true. (Tr. 1453, 1946-47.) Mr. Putnam presumed that Raymond James would have been notified if Lanciano Limited had deposited money as a result of the letter. (Tr. 1946.)

Mr. Putnam directed that a copy of the Lanciano letter be sent to Mr. DiGirolamo. (Div. Ex. 272; Tr. 1962.). Mr. Putnam did not inquire or ascertain whether Mr. Herula's statement that Brite Business maintained an account at Raymond James with an aggregate nine-figure balance was true. (Tr. 1935-36; Div. Ex. 403.) It was not. Mr. Putnam did not initiate a review of activity

in the Brite Business account, nor did he direct anyone else to do so. (Tr. 1947.) He did not ask Mr. Herula for a copy of the irrevocable instructions referred to in the Lanciano letter. (Tr. 1960.) Mr. Putnam and Mr. Ullom each talked separately with Mr. Herula, who said he did not understand “the ins and outs of all of these things.” (Tr. 1961.) Mr. Putnam accepted Mr. Herula's representations that this was the only letter of this type he had sent, and was not something Brite Business was doing on an on-going basis. (Tr. 1947, 1960-61.) Mr. Putnam did not fire Mr. Herula because Mr. Herula was contrite and Mr. Putnam believed Mr. Herula was naïve. (Tr. 1961, 2095.) Mr. Herula did not produce anything in response to Mr. Putnam's request for any additional correspondence of this type. (Tr. 1453.)

Mr. Herula was not put on formal heightened supervision status by Mr. Putnam or the Compliance Department. (Tr. 1272, 1961-62.) Mr. Putnam thought heightened supervision would have been unusual based on a single piece of unauthorized correspondence and where Mr. Herula, in Mr. Putnam's view, was naïve. (Tr. 1965.) Mr. Putnam directed Mr. Ullom to monitor Mr. Herula's activities closely and to review Mr. Herula's correspondence. (Tr. 1452, 1961.) Mr. Putnam believed that Mr. Ullom knew he had “to get on top of [Mr. Herula's] correspondence,” and that Mr. Ullom had placed Mr. Herula on enhanced monitoring. (Tr. 2020, 2096.) Mr. Putnam did not follow up to assure that Mr. Ullom was supervising Mr. Herula appropriately. (Tr. 1964.) Mr. Putnam testified that he may have directed Mr. Ullom to tell Mr. Fife to make sure that Brite Business was not misrepresenting its relationship with Raymond James. (Tr. 1968-69.) Mr. Putnam did not contact Mr. Fife directly and he cannot recall whether he checked to see whether Mr. Ullom followed his instructions. (Tr. 1969.)

Mr. Putnam characterized the restriction that he placed on the account as a “little second check.” (Tr. 1949-50.) The restriction required that Mr. Putnam review and approve any funds leaving the account. (Tr. 1130, 1453, 1944.) The account file contained a statement “NO WITHDRAWAL OF FUNDS OR SECURITIES OR ACATING WITHOUT CONTACTING STEVE PUTNAM.”[39] (R.J. Ex. 2344.) The restriction also applied to transfers to other unaffiliated accounts at Raymond James. (Tr. 1456-57, 1569, 1944-45.) Considering that Raymond James had more than 500,000 accounts, the restriction on the account by the president of Raymond James was unusual. (Tr. 2788.) Mr. Putnam did not monitor the account, but relied on the Operations Department to call him when there was an issue. (Tr. 1949.) When the Operations Department contacted Mr. Putnam pursuant to the restriction, Mr. Putnam would simply ensure that Mr. Fife, or another person from Brite Business, had authorized the transfer. (Tr. 1949.) Mr. Putnam and Raymond James followed the directions of Mr. Fife or Brite Business as to disbursements from the account without any questions.[40] (Tr. 1958.)

***28** The Compliance Department was never informed about the Lanciano letter. Mr. DiGirolamo testified that he did not see the Lanciano letter and had no involvement with Mr. Herula or Brite Business through the end of 2000. (Tr. 2483.) Mr. Putnam did not instruct the internal auditors to take action because he was not responsible for compliance. (Tr. 2022-23.) Mr. Putnam never sent internal auditors to the Cranston branch office to review Mr. Herula's correspondence. (Tr. 1963, 2000.) Raymond James's auditors are instructed to look for correspondence like the Lanciano letter; unauthorized correspondence can be the basis for further investigation. (Tr. 1942-43.) No one from Raymond James's headquarters came to the Cranston branch office to interview Mr. Herula or review his correspondence file following Mr. Putnam's receipt of the Lanciano letter. (Tr. 1137.)

R.J. & Associates's Client Services Department informed Mr. Putnam of the transfers to and from the restricted Brite Business account. (Tr. 1144, 1153, 1160, 1166, 1169; Div. Exs. 187, 190, 195.) Raymond James followed its procedures and established that the person controlling the account authorized each transfer. Mr. Putnam did not stop transfers from the Brite Business restricted account or question Mr. Ullom about them; no one at Raymond James called for more information on transfers of more than a million dollars from a restricted account to non-restricted accounts at Raymond James, and then to accounts outside Raymond James. (Tr. 1139-41, 1158, 1160-61, 1163-67, 1169-71, 1202.)

3. The Fingessa letter

On March 9, 2000, Mr. Herula sent a letter to Fingessa, S.A., Lugano, Switzerland, (Fingessa letter) on Raymond James letterhead, stating that:

(1) Raymond James had received irrevocable instructions from Brite Business concerning Fingessa's deposit of $12.5 for the purpose of completing a purchase of U.S. Treasury Bills, Notes, or Bond;

(2) Raymond James will follow these instructions with the full faith and credit of the company to assure that funds deposited by Fingessa will not be withdrawn from the account without written instructions from Fingessa;

(3) Raymond James will return the funds in full, without delays or encumbrances, upon the maturity of the instruments; and

(4) The maturity of the T-Bill, Note or Bond will be 90 days unless specific instructions are received from Fingessa within 10 days of maturity to roll over the treasury instrument.

(Div. Ex. 44.)

4. Additional Unauthorized Correspondence and Disturbing Information

On April 10, 2000, Mr. Herula sent a letter sent from the Cranston branch office on Raymond James letterhead, which acknowledged wiring Vince Farrugia, Jr., J.C. Bradford & Co., $4.5 million from an attorney escrow account at Raymond James on behalf of his unnamed client. (Tr. 1467-68; R.J. Ex. 2338.) If no transaction took place between his client and Capital Dynamics Corporation, Mr. Herula instructed that the funds were to be returned to First Union National Bank, Mary Lee Capalbo, Esq., Special Client Account. (Id.) This correspondence was not in the files of the Cranston branch office. (Tr. 1463-64.) Mr. Herula's April 10 letter followed a letter on April 6, 2000, to Jude Onukwugha in which Mr. Herula requested the coordinates to transfer funds to J.C. Bradford, pursuant to a conversation with Dorian Brisbois (Mr. Brisbois). (Tr. 1469-70.) Mr. Ullom denied knowing of the subject matter of Mr. Herula's April 6 and 10, 2000, letters; however, Mr. Ullom wrote five letters between June 28 and December 28, 2000, attempting to collect on a personal loan to Mr. Brisbois from Mr. Herula. (Tr. 1466-71; R.J. Ex. 2075.) In those letters, Mr. Ullom refers to his review with Mr. Herula “of any deals with Martin that might have life in them” and noting that the “Bradford/Jude” deal is dead for all practical purposes. (R.J. Ex. 2075.) Mr. Ullom did not provide Mr. Putnam with any information on these matters. (Tr. 1471.)

***29** On April 12, 2000, Mr. Herula and Dana Sherman (Mr. Sherman), administrative assistant at the Cranston branch office, sent by facsimile to Brite Business a signed letter, on Raymond James letterhead, confirming, “with full banking responsibility and liability,” that specific United States Treasury bonds were held in a custodial account in Brite Business's name, and that the cash value was $110,860,000.[41] (R.J. Ex. 2071.) On June 1, 2000, Mr. Herula and Mr. Sherman, sent by facsimile to Brite Business a signed letter on Raymond James letterhead confirming that certain treasury bills that matured on June 8, 2000, would be replaced, and that the market value on June 8, 2000, would be approximately $112 million. (R.J. Ex. 2073.) The information in both letters was false. Brite Business did not have treasury bills with a cash value of $110 million on deposit with Raymond James. (Tr. 1463-64.) This correspondence was not in the files of the Cranston branch office. (Tr. 1468.)

On July 7, 2000, the Cranston branch office received a letter by facsimile from Lewis P. Blackburn (Mr. Blackburn) requesting that Mr. Herula provide him with an accounting of his position with Brite Business. Mr. Blackburn noted the long wait and happiness at seeing “it come to fruition.” (R.J. Ex. 2077.) Mr. Ullom did not inform anyone at Raymond James. (Tr. 1473.)

5. Brite Business's Solicitation to Michael McCue

Mr. Ness informed Mr. Putnam on May 3, 2000, that a Raymond James employee in Cleveland, Tennessee, reported that Brite Business representatives had offered a local attorney, Michael McCue, participation in a transaction where banks would borrow from a $100 million fund at Raymond James Trust at a discount, and the attorney, acting as a middleman, would place the debt with an investor at par and pocket the spread. (Tr. 1173-74, 2724; Div. Ex. 275.) Mr. Ness told Mr. Putnam:

> What bothers me here is someone may be out there using [Raymond James Trust Company's] name without our knowledge and involving us in a transaction or using our name to give legitimacy to a potentially questionable situation. As I recall, the folks at First Union had a similar reaction when we spoke to them.

(Div. Ex. 275.)

Mr. Putnam responded to Mr. Ness that "absent a retail account we have no current dealings with [Brite Business]." (Id.) On inquiry by Mr. Putnam, Mr. Ullom reported that the persons named were not representatives of Brite Business. (Tr. 1972-73.) Mr. Putnam did not send Mr. Ness's communication to the Compliance Department. (Tr. 1972.) Mr. Putnam suggested to Mr. Ullom that Brite Business should be more circumspect in its statements. (Id.)

6. Mr. Cohn and Four Star Financial Services, LLC

On or about July 10 and 12, 2000, Mark Cohn, representing Four Star Financial Services, LLC (Four Star), informed Mr. Ullom that Four Star was "the real party in interest" to $12 million in the Brite Business account and demanded that Raymond James not allow transfers out of the account until Four Star's claim was satisfied. (Tr. 1207-09; Div. Exs. 149-152.) Mr. Cohn provided Mr. Ullom with materials that described deposits from Larry Taggart and Lewis P. Blackburn in January and February 2000 made in connection with Brite Business's purchase of Treasuries. (R.J. Ex. 2082.) The materials included a letter dated March 10, 2000, that stated Raymond James would provide safekeeping for the transaction and provided instructions and coordinates for depositing $5.5 million in a Brite Business account at Raymond James. (Tr. 1213; Div. Ex. 151 at 98.) Also included were letters, on Raymond James letterhead, to Mr. Blackburn dated March 8, 9, and 22, 2000, and May 16, 2000, one of which repeated some of the unauthorized representations contained in the Lanciano letter. (Tr. 1226, 1536-37; Div. Ex. 149.) Based on his review of the materials, it was clear to Mr. Ullom that Mr. Herula had written the letters. (Tr. 1475; Div. Ex. 506.)

***30** Mr. Ullom called Mr. Putnam and claims he forwarded Mr. Cohn's letter and maybe some of the materials he received from Mr. Cohn to Mr. Putnam. (Tr. 1474-75, 1538, 1546-47, 1579; investigative testimony July 16, 2002 at 191-93.) Given Mr. Ullom's lack of credibility, I accept Mr. Putnam's position that: (1) he never asked to see the letter and materials because initially he was in Alaska where there was with limited facsimile capability and when he returned on July 19, Mr. Ullom told him the issue was resolved; and (2) Mr. Ullom told him that the Four Star correspondence was unlike the Lanciano letter, as it did not commit Raymond James to anything; and (3) he did not ask to see the Four Star correspondence when he returned because Mr. Ullom told him the matter had been resolved. (Tr. 1596, 1993-2002.)

On July 13, 2000, Mr. Putnam informed Mr. Augenbraun and Mr. James that Mr. Cohn had a letter written by Mr. Herula and that: (1) he was nervous that Raymond James's name was mentioned; (2) he had instructed Mr. Ullom to inform Mr. Fife that Raymond James was closing the Brite Business account; and (3) "since this is the second time that this has taken place," he wanted "[Mr. Herula] out of here after [Mr. Ullom] gets every piece of paper that he ever wrote on this subject back as well as a debrief."[42] (Tr. 1216; Div. Ex. 506.) Mr. Augenbraun's sole focus was dealing with the demand for funds in a Raymond James account. He did not request to see the correspondence, which was the basis for Mr. Putnam's statement that, "this is the second time that [unauthorized correspondence on Raymond James letterhead] has taken place." (Tr. 2225-27, 2230; Div. Ex. 506.) Neither Mr. Putnam nor Mr. Augenbraun informed the Compliance Department of the Four Star correspondence. (Tr. 2001, 2229.)

Mr. Augenbraun advised Mr. Putnam to wait for Mr. Fife and Mr. Cohn to resolve their dispute before disbursing any funds from the account. (Tr. 1477-78; Div. Ex. 506.) Mr. Putnam followed that advice. At that time, Mr. Augenbraun did not opine on whether Mr. Herula should be terminated. (Tr. 2226.)

Mr. Putnam did not request that Mr. Fife move the Brite Business account, and all related accounts out of Raymond James. (Tr. 1222, 1245-46, 1250; Div. Exs. 277, 435, 506) Mr. Putnam did not fire Mr. Herula because he believed: (1) the issue was resolved rapidly; (2) the unauthorized letter on Raymond James letterhead was not of the same nature as the Lanciano letter; and (3) Mr. Herula did not understand that this type of letter had to be approved. (Tr. 2018, 2105.) Mr. Putnam believed he and Mr. Ullom had educated Mr. Herula after the Lanciano letter but that, perhaps, he was not clear enough about correspondence so he gave him Mr. Herula another chance. (Tr. 2018.) Mr. Putnam did not prohibit Mr. Herula from sending out correspondence, examine the Brite Business account, or restrict Mr. Herula's activities with Brite Business. (Tr. 2019.) Mr. Putnam had Mr. Ullom tell Mr. Herula that he would be fired if there were any more unauthorized correspondence. (Tr. 2017, 2105.) On July 19, 2000, with Mr. Putnam and Mr. Augenbraun's knowledge, Mr. Ullom approved an LOA that transferred $1.5 million and $5.5 million from the Brite Business account to Mr. Blackburn that would “retire Cohen's interest with Blackburn.” (R.J. Ex. 2651, July 19, 2000, e-mail at 2:26 p.m.) Mr. Ullom was the only person at Raymond James, other than Mr. Herula, who had any contact with Mr. Cohn. (Tr. 1485.) Mr. Putnam approved the transfer believing it was part of resolving the Four Star situation. (Tr. 2023-24; Div. Ex. 203.) On July 19, 2000, Mr. Ullom represented to Mr. Augenbraun that the Four Star matter was resolved. (Tr. 2264; R.J. Ex. 2085.)

***31** Mr. Ullom did not tell Mr. Putnam or Mr. Augenbraun, that Mr. Cohn complained again, in August 2000, that significant funds in the Brite Business account belonged to Four Star. (Tr. 2264; Div. Exs. 155, 156, 157.) Mr. Cohn included a March 8, 2000, letter on Raymond James letterhead that made the same commitments to Mr. Blackburn as were contained in the Lanciano letter. (R.J. Ex. 2087.) Mr. Ullom did not inform Raymond James that he had received an August 10 letter from Mr. Cohn, but he sent the letter to Mr. Fife and discussed it with Mr. Fife and Mr. Cohn. (Tr. 1487.) On November 16, 2000, Mr. Ullom approved an LOA transferring $850,000 from the Mary Lee Capalbo, Esq., Special Account to Mr. Cohn. (Div. Ex. 93; R.J. Ex. 2089.) Mr. Ullom did not inform Raymond James that he entered a new independent contractor agreement with Mr. Herula on November 9, 2000, increasing the pay outs to Mr. Herula and adding a new category, “Financing Deals and Fees of $250,000 or more,” which referenced Brite Business and others. (Tr. 1506; R.J. Ex. 2007.)

On January 10, 2001, Mr. Cohn made a third demand that Raymond James hold funds of Brite Business and affiliates until Four Star's claims were satisfied. In this letter, Mr. Cohn noted that Mr. Herula had represented that Raymond James was making partial payments. (R.J. Ex. 2097.) With the letter, Mr. Cohn sent a November 1, 2000, communication from Mr. Herula stating that he was transmitting $1.5 million from the Brite Business account to Abbot Capital, a Four Star subsidiary. (R.J. Exs. 2092, 2097.)

No one told Mr. DiGirolamo that Four Star had made a claim on funds in a Raymond James account, and he was not involved in discussion on whether Mr. Herula should have been terminated. (Tr. 2484.)

7. Seaview Development & Holdings Ltd. (Seaview) 2000 Letter

On October 17, 2000, Mr. Herula provided Mr. Fife with a letter, on Raymond James letterhead, stating that Seaview had been a substantial nine-figure asset management account with Raymond James. (R.J. Ex. 2090.) The representation was false. Seaview never had an account with assets in nine figures, nor was it engaged in trading or other asset management activities. (Tr. 1508.) Mr. Herula did not submit a copy of the letter to the correspondence file of the Cranston branch office. (Tr. 1508-09.) On October 18, 2000, Ms. Capalbo, as agent for Mr. Fife and Brite Business, transferred $25,000 from the Mary Lee Capalbo, Esq., Special Client account to the Seaview account. (Tr. 1509; R.J. Ex. 2091.) Mr. Ullom approved the transfer and received ninety percent of the $25,000, which was used to pay Seaview's IMPAC fee. (Tr. 1509.)

Brite Business Accounts at Raymond James

Mr. Fife and others used the following five brokerage accounts at Raymond James to conduct fraudulent activities:
Brite Business Corp. Account, No. 58003682 (Brite Business account);

Brite Business Special, Account, No. 58005252;

***32** Mary Lee Capalbo, Esq., Special Client Account, No. 4911444;

Seaview Development & Holding Ltd., Account, No. 53902669; and

Seaview Development & Holding Ltd., Special Account, No. 57038258.

Mr. Herula was the account executive on each of these accounts.[43] (Tr. 1140-41, 1569-70, 2965-69; Div. Ex. 403.) All the transfers from these Raymond James accounts had properly executed LOAs. (Tr. 965-66.) Trudy Bixby, vice president of the Customer Accounts Department (Customer Accounts) at R.J. & Associates during the relevant period, testified that Customer Accounts followed the procedures in place at the time for all disbursements from the Brite Business account and related accounts. (Tr. 2751, 2790-91.) The multi-million dollar size of the deposits and transfers did not give Mr. Putnam pause, because Brite Business was a large entity doing financing. (Tr. 2100.)

According to the Division, during the relevant period, these five accounts disbursed over $47 million as follows: Mr. Herula and Ms. Capalbo received over $8.5 million; Mr. Fife received almost $7.5 million; Mr. Sullivan received $350,000; over $29 million went back to investors; and Raymond James received almost $1.8 million in margin interest and about $51,156 in charges and fees.[44] (Tr. 946-52; Div. Exs. 99, 484.) The funds that were disbursed to Mr. Herula and Ms. Capalbo went to personal bank accounts and were used for personal and business expenses. (Tr. 951.)

According to Raymond James, the five accounts received total inflows of $69,056,826 and had total outflows, not including income/expenses and fees, of $69,012,288. (Tr. 2946; R.J. Ex. 2422 at 2.) Almost $51 million of the total outflows went to non-Raymond James accounts, $17 million went to Raymond James accounts and approximately $54,000 in cash disbursements went to non-Raymond James entities. (R.J. Ex. 2422.)

1. Brite Business Corp. Account, No. 58003682 (Brite Business account)

According to the Division, the Brite Business account received $46 million in investor funds from the following sources: (Tr. 900; R.J. Ex. 2422.)

Mr. Al Bloushi	$5 million on October 19, 1999;
Beehive/Britt	$10 million on December 7, 1999;
Four Star	$7 million on March 9 & 10, 2000;
Trigon	$10 million on March 23, 2000;
Rheaume/Mr. Fitzhenry	$12.5 million on March 28, 2000; and
Other	$1.5 million on October 10, 2000.

***33** (Div. Ex. 99.)

Funds were transferred from the Brite Business account to the following accounts within Raymond James: (1) the Mary Lee Capalbo, Esq., Special Client account; (2) the Seaview Development & Holdings Ltd. account; (3) the Seaview Development & Holdings Ltd. Special account; and (4) the Brite Business Corp. Special account 5800-5252.[45] Mr. Monlezun's $1 million investment went first into the Malcolm & Ursula Monlezun account 4490-2174, and then into the Mary Lee Capalbo, Esq.,

Special Client account.[46] (Id.) Mr. Fife authorized disbursements from the Brite Business account and the Seaview accounts and from the Mary Lee Capalbo, Esq., Special Client. (Tr. 936.)

The Brite Business account disbursed $25,000 on November 19, 1999, and $225,000 on November 29, 1999. (R.J. Ex. 2342 at FW 012844.) Raymond James received $25,000, and sent ninety percent to Foxhill. (Tr. 1413.) Mr. Ullom testified that the IMPAC fee was $25,000, yet he co-signed a letter with Mr. Herula to Brite Business on November 29, 1999, acknowledging receipt of a $250,000 IMPAC fee.[47] (Tr. 1369; R.J. Ex. 2031.) Mr. Ullom did not disclose to Raymond James that Brite Business paid Foxhill $250,000. (Tr. 1414.) Mr. Ullom approved Mr. Fife's LOA for transfer of $225,000 to the Mary Lee Capalbo Attorney at Law account at Fleet Bank for legal and advisory services. (Tr.1373; R.J. Ex. 2033.) On the same day, the same Mary Lee Capalbo Attorney at Law account at Fleet Bank sent Foxhill $90,000, which Mr. Ullom testified was forty percent due under the terms of Mr. Herula's employment contract. (Tr. 1373-74; Div. Ex. 123, R.J. Ex. 2033.) Mr. Ullom does not recall "putting the two together": (1) his approval of a $225,000 disbursement from the Brite Business account on November 29, 1999; and (2) a $90,000 check dated November 29, 1999, to Foxhill, a company he co-owned.[48] (Tr. 1375.)

2. Mary Lee Capalbo, Esq., Special Account, No. 4911444

On March 28, 2000, shortly after Mr. Putnam placed restrictions on the Brite Business account, Ms. Capalbo opened the Mary Lee Capalbo, Esq., Special Client account, 49114444, at Raymond James. (Div. Ex. 142.) An account number that began with No. 4911 indicated that the principal party opening the account had a relationship with an employee of Raymond James (employee related account). (Tr. 1151.)

The Mary Lee Capalbo, Esq., Special Client account received and disbursed a total of $21,441,665. (Div. Ex. 486A.) Raymond James received proper LOAs for all transfers from the Mary Lee Capalbo, Esq., Special Client account. (Tr. 965.)

3. Seaview Development & Holding Ltd., Account No. 53902669

The Seaview Development & Holdings Ltd. account received and disbursed $36,699. Some $35,000 was received from the Mary Lee Capalbo, Esq. Special Client account at Raymond James, and $35,990 was disbursed to a Seaview account controlled by Mr. Fife at Bank of America. (Tr. 922-23; Div. Ex. 103, 487.)

4. Seaview Development & Holding Ltd., Special Account, No. 57038258

***34** The Seaview Development & Holdings Ltd Special account received and disbursed almost $1.2 million. (Div. Ex. 488A.) The account received deposits of $675,000 from the Mary Lee Capalbo, Esq. Special Client account and $513,305 from the Brite Business Special account at Raymond James. (Div. Exs. 104, 488.) Mr. Fife approved transfer of $1.2 million to a Seaview account at Chase Manhattan bank and $150,000 to International Fisheries.

2000 Audit of the Cranston Branch Office

During the relevant period, Raymond James conducted a surprise compliance audit at its branch offices annually and at its satellite offices every other year. Raymond James's records did not show that the Cranston branch office had any satellite offices. (Tr. 3090.) Neither Raymond James's internal auditors nor any compliance representative visited the Cranston branch office between the audit conducted on November 15, 1999 (1999 audit) and the audit on September 19, 2000 (2000 audit). (Tr. 1278.)

Thomas Wegner (Mr. Wegner) conducted the 2000 audit of the Cranston branch office. Mr. Wegner was a registered representative with Raymond James and worked for Independent Auditing & Consulting (IAC). (Tr. 3054.) IAC is an independent contractor hired by Raymond James to conduct audits. (Tr. 3055.) In 2000, IAC charged Raymond James a flat fee of $475 per branch office audit. IAC could request additional compensation if an audit went longer than one day or if the

audit involved unforeseen circumstances. (Tr. 3093.) IAC took a $50 override and paid Mr. Wegner $425.[49] Typically a branch office audit takes five or six hours. (Tr. 3067.) Mr. Wegner completed the Cranston branch office audit in one day. Mr. Wegner submitted his report to the Compliance Department, which issued a final report to Mr. Ullom. A copy of the final report was also sent to Mr. Putnam. (Tr. 3091-92; R.J. Ex. 2563 at 3762-63.)

Through IAC, Mr. Wegner received a pre-audit packet from Raymond James in preparation for the audit. Mr. Wegner's audit had three components: (1) the compliance interview with the branch manger or the person in charge the day of the audit; (2) review of information made public; and (3) suitability of transactions. Another emphasis was to examine the flow of funds. (Tr. 3024-25.) Mr. Wegner also reviewed the MARS reports to assess whether the branch manager was reviewing them. (Tr. 3171.)

Mr. Ullom was absent, so Jason Ullom, deputy branch manager, met with Mr. Wegner. (Tr. 1565-66, 3028; Div. Ex. 302.) Mr. Wegner used a checklist of questions in conducting the audit. (Tr. 3020; R.J. Ex. 2563 at 3764.) The Audit Summary consisted of eight pages of questions with boxes for answers under columns headed “S” for satisfactory, “U” for unsatisfactory, and “N” for not applicable. (Tr. 3030.) Jason Ullom answered the Audit Summary. The Audit Summary used in the 2000 audit did not contain the questions about rogue brokers that had been part of the 1999 audit summary. (Tr. 3134-35; R.J. Exs. 2560, 2563.)

***35** Auditors do not interview individual registered representatives as part of an audit. (Tr. 2926.) The audit includes a four-page Financial Advisor Annual Compliance Interview that has forty-six questions. (R.J. Ex. 2563.) Mr. Wegner left Financial Advisor Annual Compliance Interview questionnaires for David Ullom, James Crowley, Dennis Herula, and Jeffrey Toth, because they were not in the office on the day of the audit. (Tr. 3033-35; R.J. Ex. 2563 at 3772.) The forms were to be filled out and returned to the Compliance Department. Mr. Toth, Mr. Crowley and Mr. Ullom returned their forms, but Mr. Herula did not. (Tr. 3035.) It is not Mr. Wegner's responsibility to check on the accuracy of the representations made by the branch manager or deputy branch manager. (Tr. 3074.)

Mr. Wegner did not know where Mr. Herula, Mr. Crowley, or Mr. Toth regularly worked. (Tr. 3090-91.) Jason Ullom told Mr. Wegner that all the registered representatives worked from the branch office, which was false. (Tr. 990-91, 2016-17, 2464, 3030-31; R.J. Ex. 2563 at 3770.) Mr. Wegner knew that Mr. Ullom, Mr. Crowley, and Mr. Herula had outside activity forms on file with Raymond James. Mr. Herula's form was for fund raising consultation for a charitable foundation, Angels of the Sea. (R.J. Ex. 2563 at 3653.) Neither Jason Ullom nor anyone else at Raymond James informed Mr. Wegner that Mr. Herula was conducting outside business activity for Brite Business. (Tr. 3051-52, 3076, 3080; R.J. Ex. 2563 at 3753.)

The Cranston branch office's correspondence files, one by client and one by branch, contained a couple of pieces of correspondence for each month. (Tr. 2505, 3041.) The files did not have copies of any of the unauthorized correspondence sent by Mr. Herula in 2000. (Tr. 3043, 3092-93.) Raymond James relied on the representations by registered representatives and branch managers, and customer feedback, to assure that the branch office files contained all business correspondence from registered representatives who worked outside the branch office. (Tr. 2346-48.) Based on what he saw in the correspondence files, Mr. Wegner determined that the Cranston branch office was keeping correspondence for a three-year period. This included hard copies of e-mails. (Tr. 3044, 3055-56.)

An NASD Regulatory and Compliance Alert, promulgated in June 1997, recommended the review of all operational bank accounts maintained in branch offices as a “best practice.” (Tr. 3152-53; Div. Ex. 337.) In keeping with Raymond James's procedures in place at the time, Mr. Wegner did not review the Cranston branch office operating account so he was unaware of the 2000 bank statements for the Foxhill account. (Tr. 1042, 1047, 1280-81, 1570-71, 2345, 3037.) Because of this omission, Raymond James did not know that Mr. Herula gave Mr. Ullom: a check from Ms. Capalbo's account at Fleet Bank, payable to Foxhill, for $90,000 on November 29, 1999; a check payable to Foxhill for $50,000 from the Mary Lee Capalbo Special Client Account on August 18, 2000; and that Mr. Herula wired $50,000 to the Foxhill account on October 12, 2000. (Tr. 1038-39; Div. Exs. 123, 160, 232 at FXHL 40.) Mr. Ullom deposited the checks in the Foxhill account that was used to operate the Cranston branch office. (Tr. 1040; Div. Exs. 229 at FXHL 115, 232 at FXHL 34.) Mr. Ullom received some, or all of the money, when Foxhill declared a bonus. (Tr. 1301.)

***36** In the 2000 audit, Mr. Wegner, following Raymond James procedures, did not examine the computers used by registered representatives or look at e-mail accounts. [50] (Tr. 3081.) Raymond James's surprise audit of the Cranston branch office on September 19, 2000, did not raise any concerns about Mr. Herula's activities.

Expert Testimony

1. Thomas P. Forde (Mr. Forde)

Raymond James presented Mr. Forde as an expert on the propriety of Raymond James's systems of supervision. [51] (Tr. 3186.) In Mr. Forde's opinion, Raymond James and Robert Thomas (Mr. Forde used Raymond James collectively): (1) satisfied the requirements of NASD's Rule 3010, which required, among other things, that Raymond James have written supervisory procedures in place that address how it reasonably supervised the activities of registered representatives; (2) reasonably implemented those supervisory procedures; and (3) had an appropriate system of supervision, which it implemented with respect to enhanced or special supervision. (R.J. Ex. 2665 at 11-14.) Mr. Forde testified that Raymond James had policies in place for heightened supervision and it acted appropriately in terms of heightened supervision for Mr. Herula and Mr. Ullom. (R.J. 2665 at 14-16.) He believes that “Mr. Herula's activities did not rise to the level that [Raymond James] felt it was necessary to place him on enhanced supervision because at the time the full seriousness of the situation was not known.” (R.J. Ex. 2665 at 16.) Mr. Forde acknowledges that Raymond James learned of Mr. Ullom's conduct due to the Commission's investigation and based on this information, it put Mr. Ullom on heightened supervision and ultimately fired him. (R.J. Ex. 2665 at 15.)

Mr. Forde believes that an account holder has an unfettered right to funds in the account and a broker-dealer cannot reject an account holder's request to transfer assets. (Tr. 3173; R.J. Ex. 2665 at 17-18.) Mr. Forde has never heard of any broker-dealer with procedures that protect the clients of account holders at the broker-dealer, and he believes it would be inappropriate for Raymond James to question the purpose of fund transfers. (R.J. Ex. 2665 at 19.) Mr. Forde finds that, from 1999 through the present, Raymond James had reasonable procedures in place for the disbursement of funds to third-party and related accounts, and it reasonably implemented those procedures. [52] (R.J. Ex. 2665 at 16, 21.) An LOA existed for, and Mr. Ullom approved, every transfer of funds that Mr. Forde reviewed. (R.J. Ex. 2655 at 17, 19.) Mr. Forde knows of few firms that contact the account holder twice to confirm a transfer to a third-party account. (R.J. Ex. 2665 at 17.)

Mr. Forde believes that Raymond James appropriately supervised Mr. Herula. He believes that Mr. Herula was absent from the Cranston branch office and wrote unauthorized correspondence, but Mr. Forde does not agree that Mr. Herula worked at an off-site location because he was not conducting Raymond James business. (Tr. 3117; R.J. Ex. 2665 at 24.) Mr. Forde finds Raymond James's procedures, past and present, for determining whether a registered representative is working off-site to be reasonable. (R.J. Ex. 2665 at 24, 27.)

***37** Mr. Forde considers it reasonable that the 2000 audit did not examine the operating account of the Cranston Branch office. In his view, there was no regulatory requirement that the operating account be reviewed, and Robert Thomas's audit procedures did not require such review. However, when the compliance departments merged, Raymond James adopted the procedure that had been in place at IMR. (R.J. Ex. 2665 at 29.)

Mr. Forde believes that during the relevant period, Raymond James had supervision policies and procedures in place that exceeded the industry standard in many areas, and he knew of no firm that had more stringent disbursement procedures. (Tr. 3160-62.)

2. Harold F. Corrigan (Mr. Corrigan)

Raymond James presented Mr. Corrigan as an expert on the propriety of the conduct of Raymond James's management in discharging their supervisory responsibilities. [53] (Tr. 3186.) Mr. Corrigan saw nothing in the materials he reviewed that would have informed Raymond James of Mr. Herula's conduct. (R.J. Ex. 2666 at 25.) Mr. Corrigan believes that a system of supervision cannot function when a branch manager deliberately acts to circumvent the firm's procedures. (R.J. Ex. 2666 at 23-24.) Mr. Corrigan believes Raymond James's management, above the branch manager level, acted appropriately and reasonably with respect to Raymond James's treatment of: Brite Business's original proposal; Brite Business's purchase of Treasuries on margin; and handling of the Lanciano letter.

Mr. Corrigan finds it reasonable for Raymond James to have left to Mr. Ullom the tasks of investigating the Lanciano letter and assuring that similar unauthorized correspondence did not occur. (R.J. Ex. 2666 at 17.) Mr. Corrigan finds that Raymond James acted reasonably in May 2000 to reports that representatives of Brite Business were touting a transaction to investors that involved a $100 million fund in a Raymond James Trust. His reason is that Raymond James could not supervise the statements of persons outside the company. (R.J. Ex. 2666 at 19.) Mr. Corrigan does not fault Raymond James's conduct in response to the Four Star letter.

Mr. Corrigan testified that Raymond James had a very strong system of approving disbursements because it required approval beyond the branch manager. (R.J. Ex. 2666 at 25.) Mr. Corrigan considers that no misappropriation of funds occurred because all transfers were authorized by the account owner.

3. Lorena J. Kern (Ms. Kern)

Mr. Putnam presented expert testimony from Ms. Kern. [54] (Putnam Ex. 1118.) Ms. Kern testified: (1) that it was reasonable for Mr. Putnam to rely on Mr. Ullom; and (2) that Raymond James had a reasonable system of supervision to supplement the branch manager's front-line supervision. That supplemental supervisory system consisted of written supervisory procedures, an effective and functioning compliance department, and a method of effective and substantive review for exception reports. (Tr. 3454-55; Putnam Ex. 1118.) Ms. Kern considered it critical that senior management knew of Mr. Herula's outside activity concerning Brite Business. Mr. Kern testified that Mr. Putnam responded reasonably to the red flag raised by the unauthorized correspondence discovered in March 2000, and that there were no other red flags to alert Mr. Putnam to Mr. Herula's illegal activities. (Tr. 3461, 3484; Putnam Ex. 1118.) Ms. Kern knows of no way Mr. Putnam could have checked that Mr. Ullom was in fact reviewing Mr. Herula's business correspondence. (Tr. 3481-82.) Ms. Kern's position is that no reasonable system of supervision would have revealed this fraud where the registered representative and branch manager acted in concert. (Putnam Ex. 1118.)

Record Retention for Broker-Dealers

***38** During the relevant period, Raymond James's written procedures on advertising and communications provided that copies of correspondence with Branch Manager approval should be maintained in the branch's correspondence file, as well as the client file, for a minimum of three years. (Tr. 2392-93, 2448; R.J. Ex. 2640 at 011961.)

Eugene Fredriksen (Mr. Fredriksen) was the assistant vice president of information security at R.J. & Associates from May 1999 through 2000. [55] (Tr. 3208.) R.J. & Associates operates the centralized Information Technology Department (IT) for all units of the holding company. (Tr. 3200.) Mr. Fredriksen testified that it was Raymond James policy for each registered representative to receive a Raymond James e-mail account. (Tr. 3268, 3316-17.) [56] Registered representatives could use their Raymond James e-mail address to access their e-mail accounts from home computers. [57] (Tr. 3326.) Raymond James's policy was that all business should be conducted using a Raymond James account. However, there was no technology to prevent a registered representative from using a personal e-mail account to conduct business, or to copy and send Raymond James e-mails via a personal account. (Tr. 3363-64.) In 1999 and 2000, there was no technology available to prevent someone from using a personal e-mail account to conduct Raymond James business on a computer in a Raymond James branch office. (Tr. 3268-69.)

Mr. Fredriksen believes that the Commission's 1997 Release on Rule 17a-4 was: a codification of information given in a 1993 no-action letter; expanded the scope of the term "business records"; and marked the first written Commission directive that e-mails were business records that broker-dealers were required to retain. (Tr. 3219-22; R.J. Ex. 2618 at 10.) According to Mr. Fredriksen, in 1999 persons in the industry were concerned about: (1) the scope of the requirement in terms of "[w]hich e-mail in which context;" and (2) while the ability to store the material existed, the "front-end" technology of monitoring, scanning, cataloging, indexing, and archiving a thousand e-mails a minute did not exist or was still in its infancy. [58] (Tr. 3232, 3236-37, 3239, 3244-45.) Raymond James generates approximately 150 million e-mails annually. (Tr. 3228-29.)

From 1997 until May 1999, Raymond James's controls over the retention of e-mails consisted of: (1) backup tapes on its e-mail servers; and (2) a policy that required the branch manager to review, and to save at the branch office, all business-related e-mails generated in the branch. (Tr. 3283-84.) These two measures continue in 2005; however, the home office in St. Petersburg, Florida, did not, and does not, print out e-mails. (Tr. 3285, 3288.)

E-mails sent from computers in the Cranston branch office are handled by one of about twenty e-mail servers at R.J. & Associates's data center in Florida. (Tr. 3261, 3264.) Similarly, all incoming e-mails to a Raymond James's e-mail account are received and held by one of these servers, until they are opened by the addressee. (Tr. 3621.) These servers were used for all of the holding company's business units. (Tr. 3366.) The backup tape system Raymond James used in 1999 and 2000 did not capture e-mails that were received after 6:00 a.m. and opened before 6 p.m. [59] (Tr. 3323-24.) E-mails sent by registered representatives using personal accounts or e-mails sent to registered representatives' personal accounts from non-Raymond James accounts are not backed up. (Tr. 3329.) In October 1998, Raymond James suspended its policy of overwriting or recycling e-mail server back-up tapes every ninety days and began saving back-up tapes for three years in a secure location. (Tr. 3259, 3262.) Since October 1998, Raymond James has had three years of e-mails back-up tapes preserved and organized. [60] (Tr. 3281.) Mr. Fredriksen considers that in 1998 this was the most robust e-mail retention system available. (Tr. 3362.) Raymond James's back-up tapes were not WORM compliant, because Raymond James believes the technology did not exist in 1998. (Tr. 3276.) Mr. Fredriksen did not see corruption of back-up tapes as a problem; however, Raymond James informed the Division in 2003 that:

> ***39** Inherent in the restoration process is the probability that some of the database on any given day will be corrupted. We are told that 90 percent of the time the database is corrupted. This requires the IT Department to run a utilities program to fix the corruption.

(Tr. 3375-76; Div. Ex. 308.)

Raymond James knew during 1999 and 2000 that the Commission required retention of business-related correspondence for three years, either in hard copy or electronically, and that the Commission never formally relaxed or modified the 1997 Release. (Tr. 3236, 3350.) The problem, in Mr. Fredriksen's view, was either archiving all e-mails, which was thought to be prohibitively expensive, or seeking guidance on the meaning of the term "business as such." (Tr. 3347.) Mr. Fredriksen thought the Commission was committed to working with the industry to deal with the issues and that the Commission indicated flexibility in the timetable for implementing the 1997 Release because of industry concerns. (Tr. 3242, 3248.) Mr. Fredriksen believes that the Commission caused the industry to believe that it would not enforce Rule 17a-4, as interpreted in the 1997 Release, while dialogue with the industry was ongoing. For example, in May 2001, high-level brokerage industry representatives met with the Commission's staff to discuss the compliance burdens imposed by Rule 17a-4. (Tr. 3250, 3349; R.J. Ex. 2661.)

However, in November 2002, five securities firms paid fines totaling $8.3 million to settle allegations of deficient e-mail retention. (Tr. 3251-52; R.J. Ex. 2662.) At the time, the Director of the Commission's Division of Market Regulation acknowledged some expectation of prosecutorial discretion while the Commission engaged in talks with industry representatives

but, according to the Director, the five firms in the settlement were egregious situations, in that some of them had no e-mail retention policies whatsoever. (R.J. Ex. 2662.)

Mr. Fredriksen notes that Raymond James has spent over $2.5 million from 1999 to the present on tapes to comply with the 1997 Release. [61] (Tr. 3273-75.)

In 1999, Raymond James instructed Mr. Fredriksen to take steps to address the 1997 Release and he did so. (Tr. 3256-57.) In May 2000, at Mr. Fredriksen's recommendation, Raymond James contracted with Syntegra, formerly Control Data, at a cost of more than $1.4 million to centrally manage e-mail traffic; assure that what was being saved was virus free; and archive e-mails and route them to a disk in a WORM format that satisfied the 1997 Release. (Tr. 3288-300; R.J. Ex. 2582.) In Mr. Fredriksen's opinion, there was no better technology to retrieve e-mails that fit Raymond James's needs in 2000 than Syntegra. (Tr. 3378.) By the end of 2000, Raymond James had a fully automated e-mail archival system in place. (Tr. 3259.) Implementation of the Syntegra systems in December 2000, gave Raymond James three "redundant" or partially duplicative systems of e-mail retention. (Tr. 3301-03.) These consisted of: (1) back-up tapes; (2) the firm policy that required that business e-mails be printed out in hard copy and filed; and (3) Syntegra. (Tr. 3302-04.) Mr. Fredriksen believes Raymond James was the first broker-dealer to archive e-mails firm-wide in a WORM technology. (Tr. 3301.) According to Mr. Fredriksen, there was no technology available in 1999-2000 that would have prevented an individual from deleting an e-mail from the system by "double deleting." (Tr. 3362.)

***40** In 2004, Raymond James contracted with Centra at a cost of $1.5 million for a second-generation e-mail retrieval system in response to business needs and new technology. The progression from back-up tapes to Syntegra to Centera has cut the time for retrieving e-mails from days to minutes. (Tr. 3377.)

Raymond James estimates it has spent approximately $6 million solely to accomplish e-mail retention. Raymond James has spent considerably more to comply with the 1997 Release than firms who chose not to comply and entered settlements or firms that waited until 2003 to comply. (Tr. 3309-30.)

Salvatore Pallante (Mr. Pallante) [62]

Mr. Pallante, who retired in 2004 as the New York Stock Exchange's (NYSE) Executive Vice President, Member Firm Regulation, testified for Raymond James. (R.J. Ex. 2667 at 4.) Even before the 1997 Release, the NYSE took the position that any record that pertains to a broker-dealer's business, including e-mails, had to be retained. (Tr. 3386.) Mr. Pallante believes the 1997 Release was the first time the Commission stated in writing that e-mails relating to business must be retained. (Tr. 3384-85; R.J. Ex. 2618 at 14.) The NYSE and the Commission received a lot of "push-back" from the industry for taking this position. (Tr. 3386.) In Mr. Pallante's view, the issue has been how the regulators were going to enforce Exchange Act Rule 17a-4. (Tr. 3386-95.)

In the fall of 2000, NYSE examiners observed that a large broker-dealer was not retaining electronic communications, and the e-mails that were being retained were not in a WORM format. This was a violation of Exchange Act Rule 17a-4 and the Commission's 1997 Release. Following its standard operating procedures, the NYSE contacted the firm and was told that Commission examiners had brought similar findings to the firm's attention and that the firm had responded to the Commission. (R.J. Ex. 2667 at 15-16.) Mr. Pallante then called the Associate Director of the Commission's Division of Compliance, Inspections, and Examinations (OCIE), who told him that OCIE was not recommending enforcement action based on such findings. He was also told that the Commission's policy group in the Division of Market Regulation was looking into e-mail issues and discussing them with the industry. (Tr. 3399; R.J. Ex. 2667 at 17.) Mr. Pallante was aware that the industry was seeking relief from the requirements of Rule 17a-4 from the Commission and that the Commission's staff appeared sympathetic. (Tr. 3391-92.)

Between the fall of 2000 and the end of 2001, the NYSE's Division of Member Firm Regulation referred about twelve instances of e-mail retention deficiencies to the NYSE's enforcement division. [63] (Tr. 3390.) Mr. Pallante was somewhat taken aback

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when the Director of the Commission's Division of Market Regulation called him in the spring of 2001 and requested that the Division of Member Firm Regulation withhold making any enforcement referrals on e-mail findings and record retention; and withdraw any referrals that it had made to the NYSE's enforcement division because she wanted to be acting in good faith with the industry while discussions were ongoing. (Tr. 3393, 3401-04; R.J. Ex. 2667 at 21-23.) Mr. Pallante believes that the industry was annoyed by the NYSE's aggressive attempts at enforcement and complained to the Commission. (Tr. 3390, 3401; R.J. Ex. 2667 at 21.)

***41** Mr. Pallante confirmed that the Director of OCIE agreed with the information he had received from the Director of Market Regulation because Mr. Pallante was concerned that OCIE examiners might be critical if the NYSE stopped referring findings of violations to the NYSE's enforcement unit. (Tr. 3402-04; R.J. Ex. 2667 at 23-24.) To memoralize the understanding, Mr. Pallante wrote a letter to the Director of Market Regulation, with a copy to the Director of OCIE, stating that consistent with the request he would not refer future e-mail retention violations to enforcement and he would withdraw the referrals he had already made. (Tr. 3405; R.J. Ex. 2667 at 24-25.) In public statements following these events, Mr. Pallante would state that the NYSE was finding violations but was not taking enforcement action pending the outcome of discussions the Commission was having with the industry. (Tr. 3406-08.) Later, Mr. Pallante received a draft proposal to relax the rules on retaining records pertaining to business records, such as e-mails. The draft was never implemented. (R.J. Ex. 2667 at 26.)

In Mr. Pallante's view, the Commission's posture changed and it began taking an aggressive approach with respect to e-mails and missing records after e-mails provided the “smoking gun” in New York Attorney General Eliot Spitzer's legal action, joined in by other regulators, against five Wall Street firms in late 2002. (Tr. 3409-10; R.J. Ex. 2667 at 27-28.) Mr. Pallante considers it unreasonable for the Division to bring an enforcement action alleging e-mail retention in 1999 and 2000 in view of the directions Commission staff gave the NYSE and the industry. (Tr. 3411-13; R.J. Ex. 2667 at 29.)

Charles Weeden (Mr. Weeden)

Mr. Weeden, an expert called by the Division, testified that the fact that a communication was in e-mail format did not change the existing retention obligation. The obligation that broker-dealers maintain copies of e-mails in a hard-copy document, on microfiche or microfilm, predated, and was not changed by, the 1997 Release. [64] (Tr. 3553-54.) The 1997 Release, with twelve required elements, was the first Commission release that addressed e-mails. (Tr. 3553, 3559-60.) According to Mr. Weeden, in 1999 and 2000, most compliance officers did not distinguish e-mails from hard copy communications; however, some in the industry argued that e-mails were not covered by Rule 17a-4 because they were akin to phone calls. (Tr. 3555.)

Mr. Weeden determined that in the late 1990s, the marketplace provided products from well-established vendors that allowed broker-dealers to fully comply with the 1997 Release with respect to e-mail retention. (Tr. 3516.) Mr. Weeden's testified that in August 1997 there were at least three credible software products available to electronically archive e-mails in WORM technology. (Tr. 3588.) Those products were: Assentor from SRA; Enterprise Vault originated by Digital Equipment and, later acquired by Compaq and then KVS; and XVMail or XVault now known as EMailXtender. (Tr. 3525, 3532, 3599, 3602-03, 3636.) SRA and Compaq were supported by established public companies, while EMailXtender was a recent start- up. Mr. Weeden thinks it was unreasonable to expect one product to accomplish three functions; however, he acknowledges that Assentor would not solve virus problems and management, as well as archiving. (Tr. 3613-14, 3616.) However, Assentor was a viable e-mail retention product available in 1999 that could have been used to comply with Rule 17a-4. (Tr. 3635.) According to Mr. Weeden, most of the industry people he spoke with did not consider the three vendors Raymond James considered in 1999. (Tr. 3616.) Mr. Weeden does not consider back-up tapes an archiving method because archiving involves saving to a non-rewriteable media. (Tr. 3619.)

***42** Mr. Weeden does not know which Microsoft Exchange version that Raymond James used in 1999-2000, but a journaling capability was an option on the Microsoft Exchange platform and it would have allowed Raymond James to archive e-mails without buying an expensive new software product. [65] (Tr. 3535, 3623.) Journaling would not accomplish full text indexing that

Rule 17a-4 required, however, and Raymond James would have had to purchase additional software to satisfy that requirement. (Tr. 3541.)

Mr. Weeden believes that Raymond James could have preserved e-mails that were opened during the business day on the server by exercising another configuration option available on the Microsoft Exchange software. (Tr. 3543-44.)

In December 2002, Mr. Weeden was of the view that a majority of broker-dealers had something in place to address e-mail archiving but he estimated that less than half were compliant with Commission regulations. (Tr. 3548; R.J. Ex. 2671.) On February 24, 2005, Mr. Weeden opined that Raymond James was partially, but not fully, compliant with Rule 17a-4 from 1999 through 2000. (Tr. 3544.) Mr. Weeden is complimentary of the Commission's efforts and considers that Rule 17a-4 has established a model for compliance within numerous regulated industries. (Tr. 3632.)

CONCLUSIONS OF LAW

I deny Raymond James's contention that an administrative law judge does not have authority to order sanctions because the Commission's appointment procedures violate the Appointments Clause of the U. S. Constitution, art. II, clause 2. (R.J. Post-Hearing Br. 2 n.1; R.J. Prehearing Br. § III.G.)

The Constitutional arguments are perhaps more properly addressed to the Commission who assigned the case to an administrative law judge. However, pursuant to Section 4A of the Exchange Act, the Commission can delegate authority to an administrative law judge to make an initial decision, which includes sanctioning, in any proceeding in which the administrative law judge presides in which a hearing is required to be conducted in conformity with the Administrative Procedure Act, 5 U.S.C. § 557, unless all the parties waive the initial decision and the Commission does not order that one be prepared, and in any other proceeding in which the Commission directs the judge to make an initial decision. 17 C.F.R. § 200.30-9. The OIP ordered that a hearing be held before an administrative law judge who shall also issue an initial decision. The Commission is not bound by the initial decision. Under the Commission's Rules of Practice, the Commission may affirm, reverse, modify, or set aside or remand an initial decision and may make any findings or conclusions that, in its judgment, are proper on the basis of the record. 17 C.F.R. § 201.411.

1. Supervision of Mr. Herula

Arguments of the Parties

***43** The Division maintains that Raymond James failed to adequately supervise Mr. Herula because its agent, Mr. Ullom, failed to do so. The Division argues that it is insufficient for a broker-dealer to establish a system of supervisory procedures that relies solely on supervision by branch managers, and that Raymond James was required to provide checks to ensure that the first-line supervisor was functioning adequately. The Division contends that broker-dealers conducting business through off-site offices cannot adequately discharge their supervisory obligations when there is no inspection of off-site locations. The Division charges that Raymond James had essentially no policies or procedures in place for supervising registered representatives working outside the branch office. (Div. Post-Hearing Br. 91.) It claims that Raymond James failed to keep track of who was working off-site, or how they were being monitored. The Division claims that Raymond James had no systems in place to ensure that Mr. Ullom was examining Mr. Herula's off-site office, monitoring Mr. Herula's correspondence, or providing additional scrutiny once red flags were discovered as to Mr. Herula's unauthorized activities. (Div. Post-Hearing Br. 87.)

The Division further alleges that Raymond James acted unreasonably by failing to take adequate steps to investigate or terminate Mr. Herula's illegal activities until approximately $16.4 million in investor funds were misappropriated or otherwise dissipated. The Division faults Raymond James for: (1) not reviewing the operating account as part of the Cranston branch office audit; (2) not having written procedures for placing registered representatives on heightened supervision, and for not placing Mr. Herula

on heightened supervision; and (3) not investigating transfers from the Brite Business account to the employee-related Mary Lee Capalbo Esq., Special Client account. (Div. Post-Hearing Br. 93-95.)

The Division views the three procedures that Raymond James claims to have used to ensure compliance — the internal audit, the monthly compliance reports, and exception reports — as largely ineffective. It notes that: (1) the internal audit and the monthly compliance reports place undue reliance on self-reporting; (2) the internal auditor lacked information or resources necessary to perform a meaningful audit; and (3) no one in the compliance department reviewed the exceptions reports for accuracy and there is no evidence that the majority of suspicious trades that appeared on the exceptions reports were reviewed. (Div. Post-Hearing Br. 87.)

Next, the Division argues that Mr. Putnam, Mr. Ullom, and other Raymond James executives failed to respond reasonably to the following events that raised red flags suggesting that Mr. Herula was engaged in inappropriate activities. (Div. Post-Hearing Br. 29, 88-90.)

1. Expressions of concern by Mr. James, Mr. Augenbraun, Mr. DiGirolamo, Mr. Ness, Mr. Maynard, Mr. Walsh, and unnamed members of the C&S Committee about Raymond James's involvement with Brite Business. (Div. Post-Hearing Br. 5-8.)

***44** 2. The negative reaction of the ad hoc committee following the meeting in October 1999, as to participation by Raymond James in a proposal by Brite Business. (Div. Post-Hearing Br. 8-12.)

3. The fact that Mr. Herula continued to urge Raymond James to stay involved and consider proposals from Brite Business after the ad hoc group came to a consensus that it would not do the transaction Brite Business proposed. (Div. Post-Hearing Br. 12-13.)

4. The suspicions of persons at Raymond James and affiliates in November 1999 on learning that Mr. Herula and Mr. Ullom had falsely represented that First Union Bank had agreed to the Brite Business transaction. (Div. Post-Hearing Br. 13-17.)

5. The purchase on margin of approximately $115 million of U.S. Treasuries by Brite Business in December 1999 that made no economic sense. (Div. Post-Hearing Br. 17-22.)

6. Expressions of concern by members of the C&S Committee, in particular Mr. James and Mr. DiGirolamo, when the committee considered the Brite Business purchase of U.S. Treasuries on margin in December 1999. (Div. Post-Hearing Br. 22-25.)

7. The skepticism of Mr. Putnam and Mr. Augenbraun following the meeting with Brite Business in January 2000, and their recommendation that Raymond James not become involved further in the transaction that Brite Business was proposing. (Div. Post-Hearing Br. 25-26.)

8. In January 2000, Mr. Ullom became aware that Mr. Herula had sent an e-mail from his Raymond James account soliciting an investor to deposit $100 million at Raymond James. Mr. Herula signed the e-mail as a Raymond James representative and stated that Brite Business agreed to ensure a ten percent return on the investment.

9. In January 2000, Mr. Putnam learned of the Provident letter that Mr. Herula wrote in December 1999 on Raymond James letterhead stationery seeking Provident's involvement in a reverse-repurchase agreement for Brite Business. Mr. Putnam considered the use of letterhead questionable. (Div. Post-Hearing Br. 26- 27.)

10. On or about February 29, 2000, a week prior to their maturity, Mr. Herula sold the $115 million in Treasury bills for Brite Business. The timing of the transaction made no sense to Mr. Putnam or Mr. Zank of R.J. & Associates. (Div. Post-Hearing Br. 27-29.)

11. Beginning in December 1999, until he was fired in December 2000, Mr. Herula worked out of an apartment in Cranston that had a computer, a fax machine, a copier, a scanner, telephones, and copies of correspondence. No one at Raymond James

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ever inspected this office. Beginning in October 2000, Mr. Herula began working at an office he set up in his home in Tiburon, California. (Div. Post-Hearing Br. 30- 32.)

12. From January 2000 through March 2000, Mr. Herula signed an e-mail as a Raymond James registered representative using his Raymond James account, soliciting an investor to deposit $100 million at Raymond James in connection with Brite Business. Mr. Herula forwarded the e-mail to Mr. Ullom. In the same period, Mr. Herula engaged in correspondence with Mr. Al Bloushi in which he made false representations. (Div. Post-Hearing Br. 32-36.)

***45** 13. In March 2000, Mr. Putnam, Mr. Ullom, and others at Raymond James and its affiliates, learned that Mr. Herula was sending or had sent the Lanciano letter, a misleading piece of correspondence on Raymond James stationery, to a potential investor soliciting funds for deposit at Raymond James. In this same period, Mr. Herula authored similar correspondence to Mr. Fitzhenry. (Div. Post-Hearing Br. 37-41.)

14. The unexplained activity in the Brite Business and Mary Lee Capalbo accounts, which included multi-million dollar deposits promptly followed by transfers to related and third-party accounts, coupled with the suspicious nature of Brite Business's balance sheet enhancement program, and its purchase of Treasuries, constitute indicia of money laundering that should have triggered further investigation. (Div. Post-Hearing Br. 30-32.)

15. In May 2002, Mr. Putnam and others at Raymond James and its affiliates learned through Mr. Ness at R.J. Trust that individuals in Cleveland, Tennessee, supposedly associated with Brite Business were, misrepresenting Raymond James's role in Brite Business's activities. (Div. Post-Hearing Br. 48-49.)

16. In July and August 2000, Raymond James received notice from Four Star demanding return of approximately $12 million it claimed to have deposited in the Brite Business account. Mr. Putnam and Mr. Ullom also learned that contrary to his representations, Mr. Herula had sent additional unauthorized correspondence on Raymond James letterhead, the Blackburn letter, making similar representations to the Lanciano letter, as a means of soliciting funds for Brite Business. (Div. Post-Hearing Br. 49-54.)

17. Mr. Putnam considered terminating Mr. Herula and closing the Brite Business account no later than July 13, 2000, but he did not do so until December 2000. (Div. Post-Hearing Br. 90.)

Finally, the Division argues that Mr. Putnam had actual knowledge of multiple red flags that alerted him to Mr. Herula's suspicious activities, yet he failed to respond to them. (Div. Post-Hearing Br. 96.) The Division argues that Mr. Putnam cannot excuse his failure to supervise Mr. Herula by claiming that he relied on Mr. Ullom because: (1) Mr. Putnam did not develop a system to ensure that Mr. Ullom was monitoring Mr. Herula; (2) Mr. Putnam should have known that Mr. Ullom's supervision of Mr. Herula was deficient; and (3) as the president of a corporate broker-dealer Mr. Putnam was ultimately responsible for all the firm's requirements. (Div. Post-Hearing Br. 98.)

Raymond James represents that throughout the relevant period it had procedures and systems in place that were reasonably designed to prevent and detect securities law violations. Raymond James insists that these supervisory procedures were in accord with NASD Conduct Rule 3010-Supervision. Raymond James argues that the failure to detect wrongful conduct does not by itself establish a failure to supervise. Raymond James maintains that it reasonably discharged its supervisory duties and obligations and had no reasonable cause to believe that the procedures and systems were not being followed. Raymond James argues, further, that a broker-dealer's branch manager is its first line of defense and that its reliance on Mr. Ullom was reasonable. (R.J. Post-Hearing Br. 34-35.) According to one Raymond James expert, the branch manager is responsible for making sure that everything is done properly and that nothing unauthorized is released. (R.J. Ex. 2666 at 22.) Raymond James notes that when it hired Mr. Ullom to manage the Cranston branch office, he had no prior record of supervisory problems. Mr. Ullom was

an experienced manager, and Mr. Putnam had known him for many years. Raymond James cites expert testimony to support its position that broker-dealers customarily rely on branch managers to enforce their supervisory rules and regulations.

***46** Raymond James insists that it had no cause to believe that its supervisory procedures were being violated. It cites various written materials such as operations manuals, newsletters, an Intranet digest that addressed compliance, a dedicated compliance staff, and training for its twenty-eight compliance professionals. (R.J. Post-Hearing Br. 35-39.) Raymond James stresses its efforts at oversight including over seventy types of exception reports, branch office compliance reports, and branch audits.

Raymond James denies the existence of any red flags that would have put it on notice of Brite Business's prime bank scheme. Raymond James rejects the Division's inference that Raymond James let Brite Business pursue the balance sheet enhancement program it proposed in October 1999 when it allowed Brite Business to purchase United States Treasuries in December 1999. Raymond James argues that the Division has mischaracterized both the reactions of the ad hoc committee and the C&S Committee's questions about Brite Business. According to Raymond James, if Mr. Putnam had been present at the C&S Committee meeting, he would have been able to answer the questions.

Raymond James insists that, during the relevant period and at present, its procedures for: (1) supervising off-site locations; (2) reviewing branch office operating accounts; (3) disbursing or transferring funds from accounts; and (4) placing registered representatives on heightened supervision, met or exceeded industry standards. (R.J. Post-Hearing Br. 44-56.) Raymond James reiterates, as it did throughout the hearing, that a broker-dealer's duty of supervision is imposed to protect the investing public and is owed only to its customers, not to third parties. In support, it refers to NASD Rule 3010.

Raymond James maintains that it was deceived about the nature of Mr. Herula's outside business activities, that these activities did not involve Raymond James's business, and did not trigger any supervisory responsibility for the firm. (R.J. Post-Hearing Br. 60.) It notes that the NASD has addressed the issue of “non-member business conducted by an associated person” in Rules 3030 and 3040. An associated person may be involved in non-member business in two categories: outside business activities and private securities transactions. According to Raymond James, by definition then, a registered representative's outside business activity is not the business of the member firm. (R.J. Post-Hearing Br. 61.)

Mr. Putnam maintains that the Division's so-called red flags did not suggest the fraud that occurred. Mr. Ullom, the key in a reasonable system of supervision, was actively involved in the fraud and withheld critical information from Mr. Putnam and Raymond James.

Mr. Putnam argues that several issues must be considered when assessing the reasonableness of his supervision of Mr. Herula. Mr. Putnam denies that he was responsible for the adoption and implementation or design of Raymond James's supervisory procedures in his position as president and chief operating officer. The CEO of Raymond James did not delegate responsibility for the adoption and implementation of the firm's compliance procedures or responsibility for the firm's supervisory system to him. Second, Mr. Putnam delegated to Mr. Ullom the job of gathering all Mr. Herula's correspondence, placing Mr. Herula under close scrutiny, and reporting any problems. Mr. Putnam had a reasonable expectation that Mr. Ullom would do as he was directed.

***47** Mr. Putnam argues that Brite Business's balance sheet enhancement program and strategy described in October 1999 did not give him reasonable cause to understand that Mr. Herula was associated with a suspicious business entity. Mr. Putnam maintains that no one at Raymond James expressed a view that Brite Business was acting illegally or fraudulently, or that Raymond James should not consider doing any kind of business with Brite Business. (Putnam Post-Hearing Br. 49.)

Mr. Putnam contends that, given the circumstances, his actions fell within the zone of reasonableness at all times. Mr. Putnam denies the existence of any red flags other than the Lanciano letter. He argues that he did not ignore Mr. Herula's unauthorized communications; rather, he maintains that he took significant steps to prevent any recurrence.

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Conclusions

Section 15(b) of the Exchange Act provides that the Commission may sanction any person associated with a broker or dealer or the broker-dealer itself, if it finds that such person or broker-dealer "failed reasonably to supervise, with a view to preventing violations of [the securities laws], another person who commits such a violation, if such other person is subject to their supervision." Exchange Act Section 15(b) further provides that no person shall be deemed to have failed reasonably to supervise if: (1) procedures, and a system for applying those procedures, have been established, which would reasonably be expected to prevent and detect any such violation; and (2) the person has reasonably discharged the duties and obligations incumbent upon him by reason of [his firm's] procedures and system and had no reasonable basis for believing that those procedures were not being followed. Arthur James Huff, 50 S.E.C. 524, 526- 28 (1991). Ultimately, the test is whether the supervision was reasonable under the circumstances. Kevin Upton, 52 S.E.C. 145, 153 (1995); Albert Vincent O'Neal, 51 S.E.C. 1128, 1135 (1994). Section 203(f) of the Advisers Act, incorporating Section 203(e)(6) by reference, contains similar language.

The fact that Raymond James's CEO did not formally delegate to Mr. Putnam responsibility for the design, adoption and implementation of Raymond James's supervisory procedures does not change the fact that Mr. Putnam was responsible for supervising Mr. Herula. Mr. Putnam controlled Mr. Herula's activities. From August 1999 until at least February 2000, Mr. Carreno reported to Mr. Putnam. Raymond James's Compliance Manual showed Mr. Putnam had responsibility for hiring financial advisers within branch offices, and for sales management branch management oversight. (Div. Ex. 325 at 5978, 5980.) Mr. Putnam had the power to fire Mr. Herula, which he did, finally, in December 2000. (Tr. 1623, 1993.) I find that Mr. Putnam was Mr. Herula's supervisor throughout the relevant period. Huff, 50 S.E.C. at 532, (the most probative factor as to whether a person is responsible for actions of another is the power to control another's conduct); John H. Gutfreund, 51 S.E.C. 93, 111 n.21, 113, (1992) (president of a broker-dealer is responsible for compliance and supervisor is person with authority or ability to affect employee's conduct) (settled order).

***48** During the relevant period, Raymond James did not have procedures in place which would reasonably be expected to prevent and detect antifraud violations by its registered representatives or a system for applying those procedures. Furthermore, neither Raymond James nor Mr. Putnam reasonably discharged the duties and obligations incumbent upon them by reason of the procedures and systems that existed.

At the time Robert Thomas and IMR merged in January 1999, each company had separate and different compliance programs. After the firms merged, Raymond James operated two separate compliance programs for several months. During these months, the separate programs were headed by two different compliance directors. The two compliance departments merged in March or April 1999, under the leadership of Mr. DiGirolamo. A new compliance manual for the merged company was not produced until May 2000. (Tr. 2361-62.) It appears that in March 2000, Raymond James did not have specific heightened supervision policies but it did have procedures to deal with extraordinary situations, which Mr. Carreno called enhanced supervision. (Tr. 2339, 2362.) Mr. Putnam indicated that under Raymond James's procedures at the time of the Lanciano letter, the branch, not the individual, was placed on heightened supervision. (Tr. 2020). A meeting was held every quarter to review either the individual or branch where someone was in heightened supervision status. (Tr. 1962, 2021-22.) The process is not structured to disclose outside business activities. (Tr. 2021.) The evidence is that Raymond James's first written heightened supervision polices for registered representatives occurred in October 2001. (Tr. 2936- 38; Div. Ex. 508, R.J. Ex. 2536E.)

Mr. Forde, an expert witness for Raymond James, testified that after January 1999, Robert Thomas and IMR retained their individual compliance procedures until "the firms' compliance departments reviewed and tried to get the compliance functions and supervisory procedures together, which probably didn't happen until sometime — I think it was '01." (Tr. 3133.) As a result, for at least four or five months during the relevant period, Raymond James did not have in place clear, reasonably effective supervisory policies and procedures, or a system for implementing those policies and procedures, for supervising its registered representatives. My conclusion is derived from the totality of the evidence, but in particular: (1) Mr. DiGirolamo's testimony that he implemented a policy of auditing branch operating accounts; however, Mr. Wegner testified that he did not audit the operating account at the Cranston branch office in October 2000 because the policy did not become effective until the 2001

Cranston branch audit;[66] (2) general confusion among the witnesses as to whether Raymond James had policies to deal with rogue brokers and procedures for placing registered representatives in heightened supervision status, and, if any policies and procedures existed, what they were; and (3) similar general confusion on what was required of people who worked regularly away from their assigned office. (Tr. 2461-62, 2516.)

***49** The evidence does not support Raymond James's and Mr. Putnam's position that they reasonably relied on Mr. Ullom to carry out their supervisory responsibilities. The Commission has repeatedly warned that procedures that rely solely on supervision by branch managers are insufficient. Rita H. Malm, 52 S.E.C. 64, 70 (1994); Donald T. Sheldon, 51 S.E.C. 59, 79 (1992), aff'd, 45 F.3d 1515 (11th Cir. 1995); Prudential-Bache Sec., Inc., 48 S.E.C. 372, 400 (1986).

Raymond James retained Mr. Ullom as a supervisor knowing that he settled a proceeding with the Commission in which Mr. Ullom was found to have: (1) given false information to a state securities examiner; (2) directed an employee of an investment adviser he co-owned to alter documents that Mr. Ullom submitted to state authorities; and (3) filed a Form ADV with the Commission that contained false information. (R.J. Ex. 2022.) The settlement found that Mr. Ullom violated the Advisers Act; willfully aided and abetted violations by the investment adviser; and caused the investment adviser's violations. It was patently unreasonable for Raymond James to rely on Mr. Ullom in a position, which the experts agree was Raymond James's "first line of defense," and someone Raymond James relied on to make sure everything was done properly, when in 1995 Mr. Ullom deliberately submitted false information to securities regulatory agencies. See Consol. Inv. Servs., Inc., 52 S.E.C. 582, 587-88 (1996) (hiring registered representative subject to NASD complaint required heightened supervision); O'Neal, 51 S.E.C. at 1129-33 ("disquieting history" of registered representative relevant in failure to supervise case).

In addition to adopting effective procedures for supervision, broker-dealers must also "provide effective staffing, sufficient resources, and a system of follow up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers, and other personnel is being diligently exercised." Mahon, Nugent & Co., 47 S.E.C. 862, 867 (1983) (settled order). The system must provide sufficient checks "to insure that the first line of compliance, the branch manager, [is] functioning adequately." Shearson Lehman Brothers, Inc., 36 SEC Docket 1075, 1083 (Sept. 24, 1986) (settled order). "The need for central control increases, not decreases, as the branch offices become more numerous, dispersed, and distant." Shearson, Hamill & Co., 42 S.E.C. 811, 843 (1965).

***50** Raymond James's Compliance Department relied on the branch manager's monthly compliance reports, the annual internal audit, and exception reports as tools to accomplish supervision. Each of these instruments is a valid means of supervision, but Raymond James failed to use them in a reasonable or effective manner. Mr. Ullom submitted compliance reports monthly to the Compliance Department. There is no evidence that Raymond James independently verified the contents of the reports. This case provides ample evidence that a monthly compliance report submitted by the branch manager representing that he has discharged his responsibilities, which is not subject to any verification, is a self-serving document without any value. It was unreasonable for Raymond James to accept that the information in Mr. Ullom's monthly compliance report was true without any type of verification.

Under the circumstances, Raymond James's internal compliance audit of the Cranston branch office in 2000 was not an effective procedure to prevent and detect violations. Raymond James's characterization of the process as "an audit" is a misnomer. Raymond James did not reasonably prepare Mr. Wegner for the audit. According to Mr. Wegner, who I find to be a knowledgeable and credible witness, much of the audit was "just a review of procedures and systems in place at the branch." (Tr. 3025.) Mr. Wegner testified that he would have liked to have known any concerns regarding the branch office he was auditing and would have given emphasis to those areas during the audit. Raymond James did not inform Mr. Wegner that Mr. Herula had a business relationship with Brite Business, that Mr. Herula had sent out unauthorized correspondence, or that Mr. Herula worked outside the Cranston branch office throughout 2000. (Tr. 3065- 66, 3079.) Mr. Wegner testified that he would have liked to have known that Mr. Herula was working for Brite Business. (Tr. 3080.) In addition, Mr. Wegner was not aware that: (1) a third party had made a claim for the funds in an account where Mr. Herula was the registered representative (the Four Star letter); (2) the president of Raymond James had put a restriction on the Brite Business account where Mr. Herula was

the registered representative; or (3) Mr. Herula was almost fired in July 2000 for sending unauthorized correspondence. (Tr. 3066-67.) Mr. Wegner believes that anything that resembles a complaint should be in the branch office compliant file, however; the Four Star correspondence was not in the file. (Tr. 3080.)

Because Mr. Wegner did not know that Mr. Herula did not come to the office throughout 2000, he accepted Jason Ullom's false answer that no registered representatives worked outside the Cranston branch office. Mr. DiGirolamo did not think notice of problems with unauthorized correspondence was necessary if the branch manager believed the problem had been resolved. [67] (Tr. 3078, 3080.) Mr. Wegner was unaware, and could not report, that Mr. Herula never returned the Financial Advisor Annual Compliance Interview questionnaire he left for him because, under Raymond James's procedures, Mr. Wegner's responsibility for the audit ended when he submitted his report to the Compliance Department. (Tr. 3033- 35, 3068.)

***51** Raymond James did not follow NASD Notice to Members 98-38 (Notice 98-38), issued May 1998, which states that a member's supervisory responsibility includes maintaining a record of the location of all unregistered offices. Notice 98-38 cites NASD Rule 3010(c) as requiring that members conduct inspections of unregistered locations in accordance with a regular schedule. (Div. Ex. 336.) Raymond James's expert testified that he saw nothing to indicate that Raymond James had an inspection schedule. (Tr. 3127.) The evidence is that Raymond James did not have accurate information about the actual work locations of the approximately five or six registered representatives assigned to the Cranston branch office. Jason Ullom told Mr. Wegner that there were no registered representatives working outside the office. (Tr. 3030) Mr. Ullom, however, testified that three of the six registered representatives, excluding Mr. Herula, did not regularly work at the Cranston branch office. (Tr. 1031-32.) Even accepting that NASD's notices to members are advisory, given Raymond James's large number of widely dispersed registered representatives, I find that it should have maintained a record of those who operated regularly from unregistered locations and inspected those locations on a regular schedule.

At a minimum, the following matters should have alerted Raymond James to possible illegal conduct and required more investigation than Raymond James provided: (1) the Provident letter in January 2000; (2) the Lanciano letter in March 2000; [68] (3) oral reports from sources outside Raymond James in May 2000, that Brite Business representatives were using Raymond James's name in solicitations; and (4) the Four Star correspondence received in July/August 2000. The Commission has stated that "it is especially imperative in organizations that those in authority exercise particular vigilance when indications of irregularity reach their attention." Shearson Lehman Hutton, Inc., 49 S.E.C. 1119, 1124 (1989) (citing Wedbush Sec., 48 S.E.C. 963, 967 (1988)). The evidence, however, does not support the Division's position that some of the other situations were red flags. The unanimous evidence is that no one at Raymond James, except Mr. Ullom who is not credible, saw a connection between the transactions Brite Business proposed and Brite Business's purchase of Treasuries, or suspected that Brite Business was an illegal enterprise.

Based on his demeanor and responses to cross examination, I find that Mr. Putnam gave credible, candid testimony. The record, however, contains no reasonable explanation why Mr. Putnam excused Mr. Herula's violations of Raymond James's rules against unauthorized correspondence as naïve errors when Mr. Herula had more than twenty years of experience in the securities industry. In addition, Mr. Putnam knew that Mr. Herula was raising funds for Brite Business. Given this knowledge, it was unreasonable for Mr. Putnam to accept Mr. Herula's representation that he would not write any additional letters like the Provident and Lanciano letters; to rely completely on Mr. Ullom to ensure that Mr. Herula was in compliance; and to accept, without verification, Mr. Ullom's representations that the oral reports in May 2000 did not involve Brite Business representatives and that the Four Star correspondence was unlike the Lanciano letter. See Shearson Lehman Bros., Inc., 36 SEC Docket 1075, 1085 (Sept. 24, 1986) (the Commission has often expressed its views that a system of supervisory procedures which rely solely on the branch manager is insufficient); Charles Schwab & Co., Inc., Admin. Proc. 3-6222 (Dec. 28, 1983), final, 29 SEC Docket 1070 (Jan. 26, 1984) (It is unacceptable to take an employee's words or explanations when questionable events are looked into).

***52** Mr. Putnam and Mr. DiGirolamo held widely different views on the role of the Compliance Department. These differences prevented implementation of Raymond James's supervisory procedures. Mr. Putnam appears to believe that the Compliance Department operated independently without input from him. (Tr. 2022-23.) In contrast, Mr. DiGirolamo, viewed the Compliance

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Department's role as a support function for senior management, and that senior management had to approve any disciplinary action. (Tr. 2543-44, 3441; Div. Ex. 325 at 5981.) Mr. Putnam intended to send Mr. DiGirolamo a copy of the Lanciano letter; however, Mr. DiGirolamo never received it. (Div. Ex. 272; Tr. 1962.) Mr. Putnam never told the Compliance Department to place Mr. Herula on heightened supervision because if the Compliance Department "had wanted to put him on heightened supervision, [Mr. DiGirolamo] could do so, you know, if he felt it was appropriate." (Tr. 1962.)
Well, what normally happens is if compliance finds something that they are concerned enough with, they will want to put someone on heightened supervision. If someone gets a major complaint, you know, the compliance people will put people on heightened supervision. If they want to discuss that with us as sales supervisors, they'll come and discuss it with us.

(Tr. 1962.) Mr. Putnam does not explain how the Compliance Department would have been alerted to the facts showing that Mr. Herula required heightened supervision if he, as Mr. Herula's supervisor, did not inform the Compliance Department of Mr. Herula's conduct.

Mr. Putnam did not inform Mr. DiGirolamo, or anyone in the Compliance Department, about Mr. Herula's unauthorized letters that were in the Four Star correspondence. Mr. Putnam did not suggest closer scrutiny of Mr. Herula's activities because "the internal auditors don't report to me. That is a compliance function, so I would not be telling the internal auditors anything." (Tr. 2022-23.) As a result, Raymond James's Compliance Department was unaware of any questions or concerns regarding Mr. Ullom's supervision of Mr. Herula during the relevant period. (Tr. 2536.) From January through August 2000, Mr. Putnam and Mr. Ullom knew that Mr. Herula sent unauthorized e-mails and at least three pieces of unauthorized correspondence, and Mr. Putnam knew of one suspect oral representation by Brite Business. The Compliance Department detected none of these happenings through its compliance efforts and Mr. Herula's supervisors did not provide it with this information.

The restrictions Mr. Putnam placed on the Brite Business account following the Lanciano letter were meaningless. Mr. Putnam expert viewed them as "simply an informational check." (Tr. 3479.) The record shows nothing that would cause Mr. Putnam to be so confident that he would not seek confirmation that Mr. Herula was being closely supervised. On these facts, Mr. Putnam did not act reasonably. He should have asked the Compliance Department to investigate whether Mr. Herula was acting legitimately and whether Mr. Ullom was closely supervising Mr. Herula.

***53** It is impossible to reconcile the evidence in this record and the expert opinions of Mr. Corrigan, Mr. Forde, and Ms. Kerns, that Raymond James's system of supervision met or exceeded industry standards and/or Raymond James exercised reasonable supervision. [69] The overwhelming evidence requires a different conclusion. Mr. Herula sent out many pieces of unauthorized correspondence on Raymond James letterhead in 1999 and 2000 that went undetected. The head of the Compliance Department was unaware of Mr. Herula or Brite Business. Raymond James knew Mr. Herula was working for Brite Business, yet it took no effective action despite five unauthorized pieces of correspondence and one oral report that Brite Business was using Raymond James's name in solicitation efforts for Brite Business. [70] Mr. Herula never received a letter of caution or a fine for sending unauthorized correspondence even though those sanctions were called for by Raymond James's standards for the treatment of infractions. (Tr. 2565, 2636- 37.) Mr. Herula worked at the Cranston branch office infrequently in the first half of 2000 and not at all in the second half of the year, yet the Cranston branch audit conducted in October 2000 indicated he did not work outside the office. The deficiencies in Raymond James's supervisory procedures also include: (1) Mr. DiGirolamo's failure to receive a copy of the Lanciano letter, a significant matter to which there was no follow up; and (2) the Compliance Department's lack of knowledge that Mr. Herula never filed a request to do outside work for Brite Business and never returned the Financial Advisor Annual Compliance Interview questionnaire that the auditor left for him in 2000.

The record contradicts Mr. Helck's claim that Raymond James has higher standards than many broker- dealer firms and terminates registered representatives for a variety of reasons, including unprofessional behavior and low production. (Tr. 3433-35.) Mr. Herula worked for Raymond James for over a year with few clients, he was unprofessional and, according to Raymond James, the firm did not profit financially from his endeavors. (R.J. Ex. 2422.)

For all the reasons stated, I find in these circumstances that Raymond James and Mr. Putnam failed to reasonably supervise Mr. Herula, a person subject to their supervision, with a view to preventing or detecting Mr. Herula's violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5.

2. Alleged Antifraud Violations

Arguments of the Parties

The Division argues that Raymond James is liable for Mr. Herula's fraudulent actions because Mr. Herula was "acting within the apparent authority of his position as a [Raymond James] representative." (Div. Post-Hearing Br. 78; Div. Reply Br. 1-24.)

Raymond James responds that it did not violate Section 17(a) of the Securities Act or Section 10(b) of the Exchange Act and Rule 10b-5. (R.J. Post-Hearing Br. 1-29; R.J. Proposed Findings 162-71.) Raymond James argues that the antifraud charge is: (1) inconsistent with Commission policy; (2) unwarranted because Raymond James did not commit securities fraud in that it did not engage in the offer or sale of Brite Business securities and did not make representations to defraud investors; (3) barred by Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (Central Bank); (4) barred because federal courts refrain from creating liability that is not specified in the securities statute; and (5) barred because no corporate officers of Raymond James were actors or participants in the fraud. In addition, Raymond James argues that general agency theories do not provide for liability by Raymond James for Mr. Herula's criminal conduct. It contends that the Division failed to prove the requirements of the legal doctrines of respondeat superior and apparent authority.

Conclusions

***54** I reject Raymond James's position that Central Bank eliminated respondeat superior liability and that, in this administrative proceeding, the only liability theory available to the Division is aiding and abetting. I find these arguments to be without merit. Central Bank eliminated the ability of private litigants to bring civil claims for aiding and abetting under the securities laws and, therefore, its holding is limited to private civil actions. See 511 U.S. at 191. For these reasons, it is wholly inapplicable to whether, on these facts, Raymond James violated the antifraud provisions of the securities statutes in a Commission administrative proceeding.

I conclude that the law of agency and the doctrine of respondeat superior are available to find Raymond James liable for Mr. Herula's illegal actions. [71] I conclude that Central Bank did not invalidate the existing law on agency, the doctrine of respondeat superior, or the legal theory of apparent authority. Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 101 (2d Cir. 2001); Dinco v. Dylex Ltd., 111 F.3d 964, 968 (1st Cir. 1997); AT&T Co. v. Winback Conserve Program, Inc., 42 F.3d 1421, 1430-31 (3rd Cir. 1994).

I reject Raymond James's argument that it would be inconsistent with Commission policy to hold it liable for Mr. Herula's actions. Raymond James fails to cite to any authority that directly supports its position that the Commission has "reserved the use of direct fraud charges against a broker-dealer to those instances in which principals are senior managers of the firm involved in the fraud and the entity is essentially acting as a fraudulent enterprise." (R.J. Post-Hearing Br. 9.) In fact, as the Division correctly points out, corporations, including broker-dealers, have frequently been held liable for the actions of lower-level employees. (Div. Reply Br. 6-7.) (citing AT&T Co., 42 F.3d at 1438 (independent contractor sales representatives); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1567, 1578-79 (9th Cir. 1990) (registered representative); Hunt v. Miller, 908 F.2d 1210, 1216 n.15 (4th Cir. 1990) (broker); King v. Horizon Corp., 701 F.2d 1313, 1314, 1318-19 (10th Cir. 1983) (sales representative); Henricksen v. Henricksen, 640 F.2d 880, 881, 887-88 (7th Cir. 1981) (registered stockbroker); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1118-19 (5th Cir. 1980) (registered representative); Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705, 715-17 (2d Cir. 1980) (broker-trainee); Holloway v. Howerdd, 536 F.2d 690, 694, 696 (6th Cir. 1976) (registered agent); Lewis v. Walston & Co., Inc., 487 F.2d 617, 625 (5th Cir. 1973) (registered representative); Armstrong, Jones & Co. v. SEC, 421 F.2d 359, 362 (6th Cir. 1970) (salesmen); SEC v. Currency Trading Int'l, No. CV 02-05143PA, 2004 WL 2753128, at *11

(C.D. Cal. Feb. 2, 2004) (brokers); Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp 203, 207, 215 (D. Mass. 1978) (broker/registered representative); Merrill Lynch, Pierce, Fenner & Smith, Inc., 13 SEC Docket 646, 651 n.13 (Nov. 9, 1977) (account executives) (settled order)).

***55** Finally, Raymond James argues that it cannot be held liable because Mr. Herula's actions were criminal. As authority for this proposition Raymond James cites Restatement (Second) Agency § 231. However, Section 231 states that "an act may be within the scope of employment although consciously criminal or tortious." (R.J. Post-Hearing Br. 23.) Section 231 also states, an employer will not be "responsible for acts which are clearly inappropriate to or unforeseeable in the accomplishment of the authorized result." Restatement (Second) Agency § 231(a) (1958). Thus, if Mr. Herula's acts, although criminal, were in the scope of his employment or foreseeable in the accomplishment of an authorized result, Raymond James should be held liable. (Id.)

I take official notice of the Memorandum and Order by U.S. District Court Judge Mary M. Lisi holding Mr. Herula liable for violating Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5. 17 C.F.R. § 201.323; SEC v. Herula, C.A. No. 02-154 ML (D.R.I. Oct. 17, 2002). [72] Mr. Herula committed these antifraud violations while he was associated with Raymond James as a registered representative. (R.J. Answer; Div. Ex. 82; Putnam Ex. 1116; R.J. Post-Hearing Br. 2.).

It is a well-established principle that a corporation may be held liable for the acts of its agents. See American Soc'y of Mech. Eng'rs, Inc. v. Hydrolevel Corp., 456 U.S. 556, 565-66 (1982). Specifically, a principal is liable for the tortious acts of its agent, even though not authorized, if the agent was acting within the scope of his employment or with apparent authority. Id.; see also Hollinger, 914 F.2d at 1576 & 1577 n.28; Armstrong, Jones & Co., 421 F.2d at 362; Merrill Lynch, Pierce, Fenner & Smith, Inc., 13 SEC Docket 646, 651 n.13 (Nov. 9, 1977); Restatement (Second) of Agency §§ 219, 229, 257, 261, 265 (1958). The Commission has long held the position "that a broker-dealer may be sanctioned for the willful violations of its agents through [common law principles of agency]." Armstrong, Jones & Co., 421 F.3d at 362 (collecting cases); see also Merrill Lynch, 13 SEC Docket at 651 n.13 (citing several Commission enforcement proceedings wherein common law principles of agency were applied); SEC v. Cooper, 402 F.Supp. 516, 525 n.31 (S.D.N.Y. 1975) ("[r]egistrant as a firm can only act through its employees and agents").

***56** For an agent's conduct to be within the scope of employment, it must be the same general nature as that authorized, or unauthorized but similar or incidental to authorized conduct. Restatement (Second) Agency § 229 (1958). An agent's conduct is "incidental" to his authorized duties if it is "foreseeable," meaning it was "a direct outgrowth of the employee's instructions or job assignment." Haddon v. United States, 68 F.3d 1420, 1424 (D.C. Cir. 1995) (quoting Boykin v. District of Columbia, 484 A.2d 560, 562 (D.C. 1984)). Even when an agent acts outside the scope of their employment, a principal may still be held responsible for the agent's actions if a third party relied on the agent's apparent authority. Restatement (Second) § 219(2)(d) (1958).

Liability arises under apparent authority when a principal allows or causes a third person to believe that the agent acted with the principal's authorization. See American Soc'y of Mech. Eng'rs, 456 U.S. at 566; First Interregional Equity Corp. v. Haughton, 805 F. Supp. 196, 201-02 (S.D.N.Y. 1992); Moro-Romero v. Prudential Securities, Inc., 1991 WL 494175, *3 (S.D. Fla. 1991) (unpublished); Restatement (Second) Agency § 261 (1958). The appearance of authorization may be created through silence by the principal, and the principal's authorization or knowledge of the agent's misrepresentations is irrelevant. Moro-Romero, 1991 WL 494175, at *3. The fact that the agent acted entirely for his or her own benefit does not absolve the principal of liability, so long as the third party justifiably relied on the agent's apparent authority. Id. However, the third party has a duty of inquiry if a reasonable person would inquire given the same factual setting. Id.

The initial factual consideration is determining whether Mr. Herula's actions were within the scope of his employment, or whether Raymond James positioned Mr. Herula to portray himself as acting on behalf of Raymond James when he violated the antifraud provisions of the securities statutes.

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Purchasing securities and opening accounts for customers at Raymond James was within the scope of Mr. Herula's employment with Raymond James as a registered representative. Raymond James also allowed Mr. Herula to conduct other business activities. The Registered Representative Agreement that established Raymond James's business relationship with Mr. Herula gave him "the right to solicit and engage in the purchase and sale for [Raymond James] approved securities with the general public, and engage in other business activities, except to the extent such activities are subject to the rules, regulations and interpretations of the Regulatory Authorities." (Div. Ex. 111 at 2; Tr. 1036.) Raymond James failed to follow its procedures for approving Mr. Herula's other business activity, which was raising funds for Brite Business. However, Raymond James tacitly approved of Mr. Herula engaging in this "other business activity" because Mr. Putnam and Mr. Ullom, Mr. Herula's supervisors, and Mr. Carenno became aware in approximately October 1999, that Mr. Herula was raising funds for Brite Business and never directed him to cease.

***57** It is rare for a broker-dealer firm, where the registered representatives are employees, to allow registered representatives to engage in any outside business activities. [73] (Tr. 1898.) On its face, Raymond James's allowing Mr. Herula to raise funds for Brite Business created a potential conflict with Raymond James's activities as a broker-dealer. For example, it was not clear to Mr. Putnam whether Mr. Herula wrote the Provident letter acting on behalf of Raymond James or Brite Business. (Tr. 1902.) Mr. Putnam characterized the Provident letter as covering a gray area. (Id.) Soliciting people to open accounts at Raymond James was within the scope of Mr. Herula's employment. Mr. Herula continually held out to Raymond James the possibility that people with substantial assets associated with Brite Business were going to do business with Raymond James.

Mr. Putnam and Mr. Ullom testified that they thought Mr. Herula was raising funds for Brite Business from commercial institutions. The evidence is that Mr. Putnam's and Mr. Ullom's beliefs were wrong and unfounded. There was no written authorization, and thus there is no record of any limitation. Mr. Herula's oral representations and the correspondence in the record indicate that Mr. Herula attempted to raise funds for Brite Business from any source, be it a financial institution or an individual. (Tr. 89-93, 707, 710, 742- 43; Div. Exs. 44, 45, 272.) Raymond James did not authorize Mr. Herula to represent that he was acting on behalf of Raymond James when raising funds for Brite Business; however, he did so. Raymond James enabled Mr. Herula to make representations to investors that appeared to be representations by Raymond James.

Raymond James gave Mr. Herula substantial credibility by entering an employment agreement with him in August 1999. Mr. Herula was able to use his status and title as a representative of a major broker-dealer to hold himself out to the public as a person with a position with Raymond James. The evidence is that in 2000 Raymond James depicted itself in advertisements and on the Internet as a diversified financial services holding company managing over $15 billion in assets. (Tr. 232, 453; Div. Ex. 22.) Mr. Herula was allowed to use various means for conducting business that portrayed him as a representative of Raymond James, such as an e-mail address and a desk in a space identified to the public as the offices of Raymond James. Raymond James also supplied Mr. Herula with letterhead stationery that described Raymond James as member of the NASD and the Securities Investor Protection Corporation and listed the address, and telephone and facsimile numbers for the Cranston branch office.

Raymond James's name appeared on the window of the Cranston branch office, which was located in a small commercial mall. (Tr. 90.) Mr. Curl met with Mr. Herula in the Cranston branch office and Mr. Herula sat at a desk that had a sign with his name. (Tr. 91.) Mr. Herula assured Mr. Curl that Mr. Fitzhenry's funds would be safe in a Raymond James account and that they would be invested in United States Treasuries. (Tr. 89-93.) Mr. Curl passed these representations on to Mr. Fitzhenry. (Tr. 230-35.) Mr. Curl received two copies of a letter dated March 10, 2000, on Raymond James letterhead, signed by Mr. Herula as Investment Manager, addressed to Mr. Fitzhenry that made the unauthorized representations and guarantees on behalf of Raymond James as to Mr. Fitzhenry's $12.5 million deposit in the Brite Business account at Raymond James. Mr. Curl received one copy from Mr. Herula at the meeting at the Cranston branch office. He received a second copy by facsimile. (Div. Exs. 45, 498; Tr. 94-95.) Mr. Fitzhenry viewed Mr. Herula's March 10, 2000, letter as being, in fact, from Raymond James. (Tr. 233.)

***58** Mr. Fitzhenry thought his investment was safe because his funds were being deposited with Raymond James to be used to purchase United States Treasuries and Raymond James would return his funds at his request. [74] (Tr. 238-39.) Mr. Fitzhenry thought, at a minimum, he would receive the interest rate on "T-bills" and anything above that would be extra. (Tr. 285.) Mr.

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Fitzhenry would not have invested $12.5 million without assurances that his funds would be safe at Raymond James and would be returned at his request. (Tr. 233.) This letter, along with another letter from Brite Business, persuaded Mr. Fitzhenry that his funds would be one hundred percent safe. (Tr. 235.) The evidence is that Mr. Fitzhenry and Rheaume Holdings invested $12.5 million in Brite Business on March 27, 2000, based on the false representations Mr. Herula made as a Raymond James Investment Manager. Mr. Fitzhenry had a reasonable basis for his belief that Mr. Herula acted with authorization from Raymond James.

Mr. Herula confirmed information Mr. Monlezun received from people in Texas that he could participate in a pool of funds which would result in a high-yield transaction. (Tr. 711.) Mr. Herula was allegedly an expert, having done similar transactions many times for Raymond James. (Tr. 707.) Mr. Herula contacted Mr. Monlezun and promised fantastic returns and a safe investment. (Tr. 711-12, 729.) Mr. Monlezun transferred $1 million to the Mary Lee Capalbo, Esq., Special Client Account at Raymond James to invest in Brite Business based on false representations and guarantees made by Mr. Herula as a Raymond James Investment Manager. Among other things, Mr. Herula falsely represented that Mr. Monlezun's funds would be safe and that transfers from the account would occur only with Mr. Monlezun's written permission. The fact that Mr. Monlezun believed that high-yield transactions existed, that he had been trying to participate in one for several years, and that he tried to gather other investors to participate, does not change the fact that Mr. Herula, acting with apparent authority from Raymond James, committed fraud in connection with Mr. Monlezun's investment of $1 million in Brite Business. [75]

The evidence is that Mr. Fitzhenry and Mr. Monlezun reasonably believed that Mr. Herula was authorized to act for Raymond James and relied on his fraudulent representations and guarantees apparently made on behalf of Raymond James in making their decisions to invest in Brite Business. Mr. Herula's association with Raymond James gave him the ability: to establish brokerage accounts related to Brite Business; to use Raymond James letterhead stationery to make unauthorized representations and guarantees; to use Raymond James's name, reputation, business address, and communication networks to make his representations appear legitimate and on behalf of Raymond James; and at the same time Raymond James allowed Mr. Herula to raise money for Brite Business. For all the reasons stated, I find Raymond James liable for Mr. Herula's violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5.

3. E-Mail Retention

Arguments of the Parties

***59** The Division claims that Raymond James violated Section 17(a)(1) of the Exchange Act and Rule 17a-4 because prior to January 2001, Raymond James's systems did not systematically preserve all its branch offices' electronic mail. The Division contends the system omitted: (1) branch office personnel to whom Raymond James did not assign an e-mail account/mailbox; and (2) branch office personnel with mailboxes who opened the message the same day the message was received or who deleted items from their delete file (double delete) the same day the item was sent or received. In the alternative, the Division faults Raymond James for failing to have adequate policies and procedures for making and filing hard copies of business related e-mails. (Div. Post-Hearing Br. 101.)

Raymond James advances five major arguments why the Division has not shown that it willfully committed the alleged books-and-records violations during the relevant period. According to Raymond James, it used the best available methods to comply with the 1997 Release by adopting a paper printout policy, retaining daily e-mail server back-up tapes, and implementing a first-generation computerized e-mail retention and storage system. (R.J. Post-Hearing Br. 64.) Raymond James contends it reasonably relied on Commission staff assurance that the Division would not enforce the 1997 Release in view of discussions, which the participants thought would result in guidance or relief. The technology needed to achieve compliance with the 1997 Release was not available. The 1997 Release is invalid because: (1) the Commission did not comply with the Administrative Procedures Act, the Paperwork Reduction Act, and the Regulatory Flexibility Act; and (2) it conflicts with the Electronic Signatures in Global National Commerce Act. (R.J. Post-Hearing Br. 69-72.)

Conclusion

Section 17(a)(1) of the Exchange Act provides that each member of a national securities exchange, broker, or dealer "shall make and keep for prescribed periods such records, furnish copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title." Exchange Act Rule 17a-4(b)(4), which requires broker-dealers to "preserve for a period of not less than three years, the first two years in an easily accessible place … [o]riginals of all communications received and copies of all communications sent … by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such," has been in place for many years. 17 C.F.R. § 240.17a-4(b)(4).

On February 5, 1997, the Commission issued the 1997 Release titled a Final Rule, Reporting Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934. 63 SEC Docket 2298 (Feb. 5, 1997) (1997 Release). The 1997 Release made clear that Rule 17a-4 includes electronic communications and that:

> ***60** the content of the electronic communication is determinative, and therefore broker-dealers must retain only those e-mail and Internet communications (including inter-office communications) which relate to the broker-dealer's "business as such."

Id.

The persuasive evidence is that Raymond James assigned mailboxes to all registered representatives and had a policy that all business should be conducted using a Raymond James account. (Tr. 1271, 3268, 3316- 17, 3363-64.) The Division's information from Raymond James that "[p]rior to January 1, 2001, only some branch office personnel were assigned RJFS mailboxes" was erroneous. (Tr. 3320; Div. Ex. 313 at 27.)

The evidence is that Raymond James supervisory manuals required that branch offices retain three years' worth of correspondence. (Tr. 2448-50; R.J. Ex. 2533 at 8663.)

It is undisputed that in the relevant time period Commission's staff was (1) informing the industry that Rule 17a-4(b)(4) would be modified, and (2) requesting that the NYSE not enforce the rule. The undisputed testimony of Mr. Pallante, which corroborates Mr. Fredriksen's testimony, is that in 1999 and 2000, senior staff members of the Commission represented to the broker-dealer industry generally and openly that the Commission would likely modify and make less stringent the requirements of the 1997 Release. In these circumstances, it would be patently unfair and unacceptable in view of the senior staff's actions and representations to find that Raymond James did not take steps to comply with Rule 17a-4(b)(4). My ruling does not violate the well settled principle that individual Commission staff members cannot speak for the Commission.

I observed Mr. Fredriksen and find that he gave credible testimony. Nothing in the record contradicts Mr. Fredriksen's representation that Raymond James instructed him as assistant vice president of information security in May 1999 to take steps to have Raymond James comply with the 1997 Release. Furthermore, the evidence is that Raymond James implemented what Mr. Fredriksen recommended as the most appropriate actions to accomplish that objective. (Tr. 3256-57, 3378.) The Division's expert, Mr. Weeden, also gave thoughtful, credible testimony. Mr. Weeden would have made different decisions than Mr. Fredriksen, in terms of software purchases and other actions to comply with the 1997 Release, but he acknowledged that Raymond James had been partially compliant. (Tr. 3544.) The testimony of Mr. Fredriksen and Mr. Weeden is that Raymond James made a good faith effort to comply. It could probably have done more, but there is no evidence of bad faith or lack of effort.

For these reasons, I find that Raymond James did not willfully violate Section 17(a) of the Exchange Act and Rule 17a-4 during the relevant period.

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SANCTIONS

The Division requests (1) a disgorgement order, plus prejudgment interest, against Raymond James; (2) imposition of civil penalties against Raymond James and Mr. Putnam; (3) a cease-and-desist order against Raymond James; (4) an order barring Mr. Putnam from associating in a supervisory capacity, or otherwise, with any broker or dealer or investment adviser; and (5) an order requiring Raymond James to retain an independent compliance consultant and prohibiting Raymond James from opening any new branch offices or hiring any new registered representatives until it takes remedial measures. (Div. Post-Hearing Br. 103- 19, Div. Reply Br. 59-71.)

Disgorgement and Prejudgment Interest

***61** Section 8A(e) of the Securities Act and Section 21C of the Exchange Act provide for disgorgement, including reasonable interest, in any cease-and-desist proceeding. Section 203(j) of the Advisers Act contains similar language. Disgorgement is an equitable remedy whose purpose is "to deprive a wrongdoer of his unjust enrichment and to deter others from violating the securities laws." SEC v. First City Fin. Corp., 890 F.2d 1215, 1230 (D.C. Cir. 1989). It is settled that the disgorgement figure need only be a reasonable approximation of profits causally connected to the violations and not an exact number. First City, 890 F.2d at 1231. Once the Division shows that its disgorgement figure reasonably approximates the amount of unjust enrichment, the burden shifts to the respondent to clearly demonstrate that the Division's disgorgement figure is not a reasonable approximation. SEC v. Lorin, 76 F.3d 458, 462 (2d Cir. 1996). Any risk of uncertainty as to the disgorgement amount falls on the wrongdoer whose misconduct created the uncertainty. First City, 890 F.2d at 1232.

The Division requests that Raymond James, as Mr. Herula's principal, be held jointly and severally liable for Mr. Herula's antifraud violations and should also be liable for failing to supervise Mr. Herula, thereby failing to prevent those violations. According to the Division, Raymond James should be ordered to disgorge $13,873,858.34, the amount of funds the Division alleges was under Raymond James's control that was not returned to investors. (Div. Post-Hearing Br. 105.) If an insufficient basis exists for disgorgement of this amount, the Division requests disgorgement of $8,530,842.65, the amount Mr. Herula and Ms. Capalbo misappropriated for their personal benefit while the funds were under Raymond James's control. (Div. Reply Br. 61.)

The Division also requests that Raymond James be ordered to disgorge $1,840,976.98 in margin interest, fees, and commissions that Raymond James and its affiliates received from Brite Business investors. (Div. Post-Hearing Br. 107.) Included in this amount is $1,789,820.58 of margin interest earned by R.J. & Associates. (R.J. Ex. 2422.) Finally, the Division cites Rule 600(a) of the Commission's Rules of Practice, 17 C.F.R. § 201.600, that requires payment of prejudgment interest on disgorged sums. (Div. Post- Hearing Br. 107-08.)

Raymond James argues that disgorgement is not available because it received no illegal profits and no unjust enrichment. Raymond James contends that the Division's disgorgement amount is inappropriate because R.J. & Associates, a separate entity, extended the margin loan to Brite Business and earned most of the margin interest. Raymond James claims that it received no financial benefit from the transaction. (R.J. Post-Hearing Br. 77.) Raymond James also contends that the net margin interest received by R.J. & Associates was $471,823. (R.J. Ex. 2422.) Raymond James arrives at this figure by claiming that R.J. & Associates would have earned $1.2 million on these funds by investing in overnight securities. It also argues that the net total was further reduced because R.J. & Associates borrowed funds from an unrelated bank at a cost of $45,173 and Raymond James paid out an additional $35,603 to the Cranston branch office. [76] (R.J. Ex. 2422.)

***62** From November 2, 1999, through December 15, 2000, the Brite Business and related accounts generated total gross commissions of $54,875.00. (Tr. 2833-34; R.J. Ex. 2660.) Of this amount, $49,008.75 went to the Cranston branch office for distribution to Foxhill, Mr. Ullom and Mr. Herula, Raymond James retained $5,866.25, and R.J. & Associates retained $313.50. (Id.) Raymond James argues that none of these funds came from an illegal transaction. Raymond James concludes that after

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considering the $2.5 million settlement reached with Rheaume Holdings/Mr. Fitzhenry, it lost almost $2.5 million as a result of the activity in Brite Business and related accounts. (R.J. Ex. 2422.)

The undisputed evidence is that Raymond James retained $5,866.25 in commissions and fees from the Brite Business accounts and that it earned this amount as a result of the fraud in which Mr. Herula participated. (Tr. 2834.) I find that $5,866.25 can be considered as ill-gotten gains or unjust enrichment and Raymond James should disgorge this amount, plus prejudgment interest beginning January 1, 2001, the first day of the month after it terminated Mr. Herula.

I reject the Division's position that as to Raymond James either the $13,873,858.34 or the $8,530,842.65, funds in the Brite Business accounts at the broker-dealer, come within the accepted definitions of ill-gotten gains or unjust enrichment. To gain or be enriched by something, you have to receive a benefit or use it in some way. Raymond James did neither with respect to these funds. Rather, it acted as custodian and followed the directions of Mr. Fife or Ms. Capalbo and transferred the funds to others. Raymond James did not use these funds or receive any benefit from them.

I also find that Raymond James should not be ordered to disgorge the $1,789,821 paid to R.J. & Associates as a result of Brite Business's purchase of Treasuries on margin. The margin loan was made by R.J. & Associates, not Raymond James. (Tr. 2821-22.) R.J. & Associates, a separate business entity, is not a named respondent. There is no evidence that Raymond James made a profit from the transaction. (Tr. 2958; R.J. Ex. 2422.) Moreover, the record does not show that the purchase of Treasuries on margin by Brite Business involved fraud by Mr. Herula. Despite the various creative theories advanced by the Division, there is no legal basis for ordering Raymond James to disgorge margin interest received by R.J. & Associates and not Raymond James.

Civil Penalties

Section 21B of the Exchange Act provides that in any proceeding instituted under Section 15(b) of the Exchange Act, the Commission may impose a civil penalty against a person if it finds that the person has willfully violated a provision of the Securities Act or the Exchange Act, or the rules thereunder, or has failed reasonably to supervise within the meaning of Section 15(b) of the Exchange Act.[77] The Commission must also find that such a penalty is in the public interest. Section 203(i) of the Advisers Act contains similar language.

***63** Section 21B of the Exchange Act and Section 203(i) of the Advisers Act identify the following factors for determining whether a penalty would be in the public interest: (1) whether the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the resulting harm to others; (3) unjust enrichment, taking into account any restitution made; (4) prior violations; (5) need for deterrence; and (6) such other matters as justice may require.

The maximum amount per act or omission is set out in Section 21B(b) of the Exchange Act and Section 203(i)(2) During the relevant period, the maximum penalty for each act or omission at the first tier was $5,500 by a natural person and $55,000 by any other person; $55,000 for each act or omission by a natural person and $275,000 by any other person at the second tier; and $110,000 for each act or omission by a natural person and $550,000 by any other person at the third tier.[78] 17 C.F.R. § 201.1001. A second- tier penalty is permissible if the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. A third-tier penalty is permissible for an act or omission that not only must have involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, but also must have "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 or omission."

The Division recommends imposition on Raymond James of a civil penalty at the third- tier level for each of "at least [twenty-seven] misleading letters" and [one] e-mail that Mr. Herula sent on Raymond James letterhead, or, alternatively, for each of "at least [sixteen] categories of red flags" that Raymond James ignored and "for each of the [six] general bases" the Division cited as Raymond James's failure to supervise. (Div. Post-Hearing Br. 110.)

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The Division recommends imposition on Mr. Putnam of a reasonable civil penalty at the third-tier level. The Division suggests a penalty for each of "at least [fifteen] categories of red flags" that Mr. Putnam allegedly ignored. At a minimum, the Division would impose a civil penalty for each of the three unauthorized pieces of correspondence that Mr. Putnam knew about. (Div. Post-Hearing Br. 111.)

Raymond James argues that the Division has not shown that it committed a willful violation, a requisite for the assessment of a civil penalty. It maintains that it is not in the public interest to impose a civil penalty at any level, but certainly not at the third-tier level where: (1) Raymond James was not involved in any fraud, deceit, or manipulation and did not deliberately or recklessly disregard any regulatory requirement; (2) no individual was harmed by its actions; and (3) it was not enriched. Raymond James argues that the Commission should not impose a penalty on Raymond James because the district court and the Commission have assessed penalties against Mr. Herula and Mr. Ullom, the individuals who participated in and perpetuated the fraud.

***64** Mr. Putnam argues that no civil penalty is justified in that his actions were reasonable at the time. Mr. Putnam contends that even if he failed to supervise Mr. Herula, his conduct did not meet the criteria for a penalty at the second or third tier. Mr. Putnam argues that failure to supervise involves a course of conduct, not a discrete violation, and that distinction makes the Division's proposed method of calculating a penalty inapplicable.

This Initial Decision finds Raymond James liable for willful violations of the Securities Act and Exchange Act and rules thereunder, and that Raymond James and Mr. Putnam failed reasonably to supervise, within the meaning of Section 15(b)(4)(E) with a view to preventing violations of the antifraud provisions by a person who was subject to their supervision. Addressing the six factors used to analyze whether a civil penalty is in the public interest, I conclude the following: Mr. Herula's violations, for which Raymond James is liable, involved fraud, deceit, or deliberate or reckless disregard of regulatory requirements. The significant financial losses suffered by investors were a result of Mr. Herula's actions for which Raymond James is liable. It is probable that Raymond James's and Mr. Putnam's failures to supervise Mr. Herula contributed to investor losses. Raymond James evidenced a low regard for supervision and compliance during the relevant period because it had from 1,100 to 4,000 registered representatives operating in small offices throughout the country without uniform policies and a restructured compliance program that was inadequately staffed for a new merged entity. Raymond James's and Mr. Putnam's failure to supervise Mr. Herula was such that he was able to participate in a large-scale fraud using his position at Raymond James for over a year. This fact, which occurred despite some red flags, indicates that Raymond James had serious problems with supervision during the relevant period. This finding is confirmed by the fact that Mr. Putnam only learned that Mr. Ullom knew about Mr. Herula's correspondence and received funds from Mr. Herula as a result of the Commission investigation. [79] (Tr. 1595.) An important purpose of sanctions is to serve as a deterrent against further violations by the individuals involved and for others in the securities industry. See Meyer Blinder, 53 S.E.C. 250, 253 (1997); Kenneth Sonken, 48 S.E.C. 832, 836 (1987). For all the reasons cited, in these circumstances, I find a strong penalty is warranted.

Civil penalties should be assessed at the third-tier level because the violations involved fraud, deceit, or deliberate or reckless disregard of the regulatory requirements and resulted in substantial losses to investors. I will not apply the maximum amounts allowed at the third-tier level because, except for the events at issue, the record does not show that Raymond James and Mr. Putnam have a poor record of compliance. In making this judgment, I have considered the twelve arbitration awards over the past three years cited by the Division and the fact that Raymond James requires that its customers agree to binding arbitration. The number of arbitration awards seems low given that Raymond James had over 500,000 accounts during this period. (Tr. 2788.) I have also considered that Mr. Putnam's prior violations occurred more than twenty-five years ago.

***65** I find that Raymond James should pay a civil penalty of $300,000 for each of twenty-three unauthorized pieces of correspondence that Mr. Herula sent on Raymond James letterhead in connection with his fraudulent activities that are in evidence, and which were part of Raymond James's failure to reasonably supervise Mr. Herula with a view to preventing Mr. Herula's antifraud violations. [80] I find that Mr. Putnam should pay a civil penalty of $50,000 for each of four occurrences where he failed to reasonably supervise Mr. Herula with a view to preventing Mr. Herula's antifraud violations. The four occurrences

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are the Provident letter, the Lanciano letter, the Four Star correspondence, and the oral information from Mr. Ness that persons were using Raymond James's name when raising funds for Brite Business.

Proposed amendments to the Commission's Rules of Practice state that one purpose is to make clear that an administrative law judge has authority under Rule 1100, 17 C.F.R. § 201.1100, to create a Fair Fund under Section 308 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7246(a). See Commission Release No. 34-51595 (April 21, 2005). I will use Rule 1100 to create a Fair Fund to benefit Mr. Fitzhenry and Mr. Monlezun, the investors harmed by the violations.

Cease-and-Desist Order

The Division argues that Raymond James should be ordered to cease and desist from committing any future violations of Sections 17(a) of the Securities Act and Sections 10(b) and Rule 10b-5.[81] The Division contends that Mr. Herula's antifraud violations, which are attributable to Raymond James, were egregious, recurrent and demonstrated a high degree of scienter. The Division contends that in the last three years Raymond James has been found liable in twelve arbitrations indicating that there is a risk of future violations by Raymond James's agents. (Div. Post- Hearing Br. 113.) The Division argues that Raymond James has failed to acknowledge its wrongdoings and has not offered any persuasive assurances against future violations. (Div. Post-Hearing Br. 114.)

Raymond James contends that a cease-and-desist order is unjustified because there is no risk of any future violation. (R.J. Post Hearing Br. 90.) None of the managers involved in these matters continue to hold supervisory positions. Since December 2000, Raymond James has made large-scale changes to its management structure and added compliance personnel. Raymond James's CEO is committed to making compliance and supervision one of Raymond James's highest operational priorities. (R.J. Post Hearing Br. 91-92.)

Sections 8A of the Securities Act and 21C of the Exchange Act provide that the Commission may issue a cease-and-desist order when it finds that a person is violating, has violated, or is about to violate any provision of the statutes or rules thereunder. The Commission's standard for ordering someone to cease and desist is as follows:

> ***66** Along with the risk of future violations, we will continue to consider our traditional factors in determining whether a cease-and-desist order is an appropriate sanction based on the entire record. Many of these factors are akin to those used by courts in determining whether injunctions are appropriate, including the seriousness of the violation, the isolated or recurrent nature of the violation, the respondent's state of mind, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the respondent's opportunity to commit future violations. In addition, we consider whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceedings.

KPMG Peat Marwick, LLP, 74 SEC Docket 384, 436 (Jan. 19, 2001).

I conclude that this record will not support imposition of a cease-and-desist order. The evidence is that traditional factors like egregious conduct, recurrent violations over an extended period, serious harm to investors, and opportunity for future violations are all present. However, there are other significant factors that show that the risk of future violations is slight. See WHX Corp. v. SEC, 362 F.3d 854 (D.C. Cir. 2004). Raymond James has fired Mr. Herula and Mr. Ullom. In deference to what it believed are the Commission's wishes, Raymond James took action so that Mr. Putnam is no longer at Raymond James nor a supervisor. (Tr. 3441-42.) I found the several witnesses associated with Raymond James and affiliated companies to be knowledgeable and

committed to complying with the applicable statutes and regulations. I conclude, therefore, that the violations shown in this record do not reflect the corporate culture at Raymond James. I accept the sworn testimony of Mr. Helck that Raymond James is embarrassed that these events occurred and that it will give more scrutiny to the day-to-day activities of persons associated with the firm. (Tr. 3439, 3443.) Most important, I give significant weight to Mr. Helck's testimony that Raymond James is in the process of carrying out the request of the audit committee of the holding company that it retain an outside consultant to evaluate its compliance and supervision systems and report its conclusions to the audit committee. (Tr. 3438-39.)

For all these reasons, I conclude that a cease-and-desist order is not necessary for the future protection of public investors and the capital markets.

Bar from Association on Mr. Putnam

The Division recommends that the Commission bar Mr. Putnam from associating with a broker-dealer or investment adviser in a supervisory capacity, or otherwise. The Division alleges that Mr. Putnam's failure to reasonably supervise Mr. Herula was egregious, continued over an extended period, and that Mr. Putnam's failure to act appropriately “was responsible, in part, for the success, magnitude and duration of Herula's fraudulent scheme.” (Div. Post-Hearing Br. 116.) The Division notes that Mr. Putnam remains convinced that neither he nor Raymond James failed to supervise Mr. Herula.

***67** Mr. Putnam argues that a bar is unjustified based on his conduct. Moreover, Mr. Putnam does not supervise sales personnel any longer and he has no plans to do so in the future. (Putnam Post-Hearing Br. 67-70.)

Sections 15(b)(6) of the Exchange Act and 203(f) of the Advisers Act provide that the Commission may censure, place limitations on the activities or functions, or suspend for a period of up to twelve months or bar a person who was associated with a broker-dealer or investment adviser at the time she committed wrongdoing. The factors for assessing whether a sanction is appropriate pursuant to Section 15(b)(6) of the Exchange Act and Section 203(f) of the Advisers Act are very similar to those detailed in the discussion of a cease-and-desist order. Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981). Mr. Putnam's conduct was serious. He was president of Raymond James and was Mr. Herula's supervisor. Mr. Putnam acknowledges being aware of unauthorized correspondence by Mr. Herula in March 2000, and he did not terminate Mr. Herula until nine months later. The evidence is that Mr. Putnam, a man of great accomplishment and integrity, failed reasonably to supervise Mr. Herula, a fact he fails to recognize. In these circumstances, I find it necessary to suspend Mr. Putnam from associating with a broker or dealer or investment adviser in a supervisory capacity for ninety days.

Requiring an Independent Assessment

The Division contends that Raymond James is unable to establish, implement, and then objectively assess whether its compliance policies and procedures are appropriate. The Division argues, therefore, that it is necessary that an independent consultant be mandated to ensure that appropriate changes are made. The Division would prohibit Raymond James from hiring new registered representatives and opening new branch offices until it follows the recommendations of the independent consultant. (Div. Post-Hearing Br. 118-19.)

Raymond James characterizes this proposal as draconian and unwarranted. It maintains that Raymond James, on its own initiative, is in the process of retaining an outside consultant to evaluate its systems and report on their effectiveness. (R.J. Post-Hearing Br. 98.)

Intervention of the type the Division proposes is an extreme measure warranted when it appears that the broker-dealer will not, or cannot, take remedial action on its own initiative. The evidence does not show that to be true in this situation. I accept the representation of Mr. Helck that Raymond James has taken positive steps to remedy the regulatory deficiencies shown to have existed during the relevant period, and that it is in the process of carrying out the request of the holding company's audit committee for an outside consultant's evaluation of its compliance and supervision systems. Furthermore, almost all the persons

associated with Raymond James and affiliated companies who testified were credible and displayed a positive attitude about conscientiously observing the regulatory requirements of a broker-dealer firm. For the reasons stated, I deny the request that Raymond James be required to hire an outside consultant and be prohibited from opening offices and from hiring additional registered representatives.

RECORD CERTIFICATION

***68** Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I hereby certify that the record includes the items set forth in the revised record index issued by the Secretary of the Commission on July 28, 2005.

ORDER

Based on the findings and conclusions set forth above:

I ORDER, pursuant to Section 8A(e) of the Securities Act of 1933, Section 21C(e) of the Securities Exchange Act of 1934, and Section 203(j) of the of the Investment Advisers Act of 1940, that Raymond James Financial Services, Inc., shall disgorge $5,866.25, plus prejudgment interest at the rate established under Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), compounded quarterly, pursuant to 17 C.F.R. § 201.600. Prejudgment interest is due from January 1, 2001, through the last day of the month preceding the month in which payment is made.

I FURTHER ORDER, pursuant to Section 21B of the Securities Exchange Act of 1934 and Section 203(i) of the Investment Advisers Act of 1940, that Raymond James Financial Services, Inc., shall pay a civil penalty of $6,900,000.

I FURTHER ORDER, pursuant to Section 21B of the Securities Exchange Act of 1934 and Section 203(i) of the Investment Advisers Act of 1940, that J. Stephen Putnam shall pay a civil penalty of $200,000.

I FURTHER ORDER, pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Section 203(f) of the Investment Advisers Act of 1940, that J. Stephen Putnam is suspended from association with any broker, dealer, or investment adviser in any supervisory capacity for a period of ninety days.

I FURTHER ORDER, that a Fair Fund pursuant to Rule 1100 of the Commission's Rules of Practice shall be established.

I FURTHER ORDER, that the allegation that Raymond James violated Section 17(a)(1) of the Securities Exchange Act of 1934 and Exchange Rule 17a-4 is dismissed.

I FURTHER ORDER, that the Division's request that Raymond James be ordered to cease and desist from violations of Sections 17(a) of the Securities Act of 1933 and Sections 10(b) and 17(a) of the Securities Exchange Act of 1934 and Exchange Act Rules 10b-5 and 17a-4 is denied.

Payment of disgorgement, prejudgment interest, and civil penalties shall be made on the first day following the day this initial decision becomes final. Payment shall be made by certified check, United States Postal money order, bank cashier's check, or bank money order, payable to the U.S. Securities and Exchange Commission. The disgorgement, prejudgment interest, and civil money penalties shall be distributed pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002 (Fair Fund distribution). The payment, and a cover letter identifying the Respondent and the proceeding designation, shall be delivered to the Comptroller, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0- 3, Alexandria, Virginia 22312. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

***69** This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party. ___________________________________

Brenda P. Murray
Chief Administrative Law Judge

Footnotes

1 Mr. Ullom was barred: (1) from association in a supervisory capacity with any broker, dealer, or investment adviser; and (2) from association in any capacity with any broker, dealer, or investment adviser, with the right to reapply for association in a non-supervisory capacity after one year. Mr. Ullom was also ordered to pay a civil penalty of $100,000. Div. Ex. 480; 84 SEC Docket 2866 (Jan. 28, 2005). As a result of the conduct underlying this proceeding, on December 6, 2004, the district court entered a Final Judgment as to Relief Defendant David L. Ullom in SEC v. Dennis S. Herula, No. CA 02-154 ML (D.R.I. Dec. 12, 2004), which ordered Mr. Ullom liable for disgorgement of $190,000, but waived payment of all but $10,000. (Div. Ex. 182.)

2 Citations to the transcript of the hearing will be noted as “(Tr. __.).” Citations to the Division's exhibits will be noted as “(Div. Ex. __.).” Citations to Raymond James's and Mr. Putnam's exhibits will be noted as “(R.J. Ex. __.),” and “(Putnam Ex. __.),” respectively. Citations to the Division's Proposed Findings of Fact and Conclusions of Law and its Post-Hearing Brief will be noted as “(Div. Proposed Findings __.)” and “(Div. Post-Hearing Br. __.),” respectively. Citations to Raymond James's and Mr. Putnam's Proposed Findings of Fact and Conclusions of Law and Post-Hearing Briefs will be noted as “(R.J. Proposed Findings __.)” and “(R.J. Post-Hearing Br. __.),” and “(Putnam's Proposed Findings __.)” and “(Putnam Post-Hearing Br. __.),” respectively. Citations to the Division's Reply Brief will be noted as “(Div. Reply Br. __.).”

3 I have considered and rejected all arguments and proposed findings and conclusions that are inconsistent with this Initial Decision. I deny Raymond James's contention that clear and convincing evidence is required to show that a respondent has violated Section 10(b) of the Exchange Act and Rule 10b-5. (R.J. Post-Hearing Br. 6 n.7.) The cases that Raymond James cites, Collins v. SEC, 562 F.2d 820, 824 (D.C. Cir. 1977) and Whitney v. SEC, 604 F.2d 676, 681 (D.C. Cir. 1979), were overruled by Steadman, supra.

4 According to Brite Business, Mr. Fife, a Lehigh University graduate, was a trustee of each of the Dreyfus Funds and one of the most respected investment bankers in South Africa. Mr. Clarke gained extraordinary marketing expertise in the telecommunications industry as an area manager for British Telecom. Mr. Wachtel, Brite Business's representative for North, South, and Central America, “converted, leveraged, compounded and traded assets for some of the most well-known and influential industrialists, financial magnates such as the world-renowned gold trader, Mr. Jack Lazar.” Mr. Sullivan served for eight years as Chairman of the National Football League. (R.J. Ex. 2210.)

5 All amounts are in United States dollars.

6 In February 2005, the holding company had about twenty subsidiaries or affiliates. (Tr. 1830.) These included Raymond James, Raymond James & Associates, Raymond James Trust Company, Raymond James Insurance, and Raymond James Bank. (Tr. 1618, 1830-31, 3423-24.)

7 The expert testimony is that many brokerage firms operate with independent contractors, persons who have other businesses or sell products other than securities. The major self-regulatory organizations do not encourage independent contractors. (Tr. 2036; R.J. Ex. 2665 at 9.) In the "wire house" model, used by older national firms such as Merrill Lynch, Salomon Smith Barney, and Dean Witter, all registered representatives are employees and they are strongly discouraged from engaging in outside activities. The term comes the fact that years ago broker-dealers with branch offices communicated by Western Union's wire system, (Tr. 1619, 2040.)

8 Raymond James's other divisions are the financial institutions division, the investment management division, and the business development division. (Tr. 2297.)

9 Prior to joining Raymond James, Mr. Ullom had a net capital violation and was involved in a dispute over the sale of a limited partnership. (Tr. 1287.)

10 Mr. Ullom failed to produce the Foxhill check register for 2000 in response to a Commission subpoena. (Tr. 1522.)

11 As branch manager, Mr. Ullom was entitled to a percentage of the commissions earned by the branch. He assigned that amount to Foxhill. (Tr. 1310.) Foxhill paid out to the registered representatives forty-five percent of gross commissions on stocks/bonds, fifty percent on mutual funds and unit investment trusts, and fifty-five percent on insurance, variable and fixed annuities, and fifty-five percent on financial planning and advisory services. (Tr. 1310; Div. Ex. 109.)

12 The Rhode Island criminal proceeding was transferred to Colorado.

13 In 1999, the average account at the Cranston branch office had assets of $1 or $2 million; a few accounts exceeded that amount, and no accounts had assets in excess of $4 million. (Tr. 1009, 1050.) This was the first meeting Mr. Ullom had ever arranged. (Tr.1349.) Mr. Fife was allegedly referred to Mr. Herula by a Canadian investment adviser.

14 Mr. Maynard, a graduate of Miami University in Oxford, Ohio, and the University of Wisconsin Law School, has over thirty years experience in the area of trusts. He served in Vietnam with the Marine Corps. (Tr. 2639-40.)

15 Mr. Julien was controller for the holding company and Mr. Kritsas was a vice president at R.J. & Associates. (Tr. 1681-82.)

16 Mr. Ullom claims not to have seen a facsimile Mr. Herula sent from the Cranston branch office to Brite Business dated December 9, 1999, on Raymond James's letterhead confirming the purchase, but omitting that the purchase was made on margin. He also claimed not to have seen facsimiles of Treasuries confirmations to Mr. Hertzog or "BB Brit, Beehive Int'l." (Tr. 1385, 1390; R.J. Exs. 2040-43.)

17 Mr. Ullom testified that Mr. Herula gave Raymond James advanced notice of the purchase but this appears to be erroneous. (Tr. 1068-72.)

18 Mr. Putnam understood that as part of the repurchase agreement, the Bank of New York would buy the Brite Business Treasuries held at Raymond James. Brite Business would receive any amounts over the amounts owed in margin interest, and Brite Business would agree to repurchase the Treasuries from the Bank of New York at a later date at a fixed price. (Tr. 2128-29.)

19 Mr. Putnam was referring to the situation where an outside investment adviser provides the advice and Raymond James provides the record keeping. This is one of Raymond James's principal businesses, and is different from IMPAC where the financial adviser advises the client. (Tr. 1790.)

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20 Mr. Putnam came away thinking that balance sheet enhancement was used in the bidding process, but he remained uncomfortable, especially with the litigation that could result if something went wrong. (Tr. 1821-22.) Mr. Doidge provided copies of his resume on Arthur Andersen letterhead. (Tr. 2259; R.J. Ex. 2423.)

21 Mr. Augenbraun believed that Mr. Putnam was going to inform Mr. Fife to wind down the Brite Business account so that Raymond James was not extending credit on the purchase of Treasuries. (Tr. 2211-12.)

22 Mr. Ullom did not tell Mr. Putnam that, on the same day, he had approved a letter of authorization (LOA) transmitting $10 million from the Brite Business account to Beehive International, LLC (Beehive), and a LOA transmitting $100,000 to Bill Britt representing "interest and is final payment to close out Britt/Beehive investment." (Div. Ex. 136, R.J. Exs. 2059, 2060.) Raymond James's Customer Accounts notified Mr. Putnam of the $10 million transfer to Beehive because it was a third-party distribution and it was unable to verbally confirm with Mr. Fife. (Div. Ex. 470.)

23 Benjamin L. Moss, III (Mr. Moss), a resident of Halton City, Texas, and graduate of Louisiana State University, is one of three ECCE owners. (Tr. 2972-74.) According to his sworn testimony, Mr. Morse believes that ECCE is legitimate. (Tr. 2974-75, 2997.)

24 The Manager Account Review System (MARS) report mistakenly omitted this $1 million dollar transfer. (Tr. 2533-34; Div. Ex. 81 at 2461.) However, the underlying records show that Raymond James followed its internal procedures and called Mr. Monlezun to confirm that he wanted the transfer made. (Tr. 1512; R.J. Exs. 2132, 2390, 2391, 2593-95.)

25 In March 4, 2002, Mr. Monlezun gave a more detailed and slightly different version of these events in a sworn statement. (Tr. 847; R.J. Ex. 2191.) The major difference is that in the written statement, Mr. Monlezun recalled that Herula transferred his $1 million to the Capalbo account at Charles Schwab in early 2001, and Mr. Monlezun agreed to participate in European trading programs initiated by Herula in February and March 2001. (Id.) Mr. Monlezun testified at the hearing that he did not authorize the transfer of his $1 million from the Mary Lee Capalbo, Esq., Special Client Account at Raymond James. (Tr. 755, 804-05.)

26 These events occurred before enactment of the United States Patriot Act and before major changes were made to the anti-money laundering statutes. (Tr. 2778-79.)

27 According to one of Raymond James's experts, Mr. Forde, Customer Accounts contacted the customer on transfers to third-party or related accounts to confirm that the account holder authorized the transfer. (R.J. Ex. 2665 at 17.) Both Customer Accounts and Operations confirmed with account holders transfers of more than $50,000. (Tr. 3162; R.J. Ex. 2665 at 17.)

28 The Operations Department maintained a list of every third-party LOA that it approved. (Tr. 2768-69; R.J. Ex. 2408.)

29 Mr. Carreno, a graduate of the U.S. Air Force Academy and the University of Denver Law School, became chief compliance officer at Robert Thomas in 1994. Mr. Carreno assumed a position with Raymond James in England in March 2000. (Tr. 2350-52, 2295.)

30 Persons in Operations and New Accounts at R.J. & Associates had compliance responsibilities and reported serious items to the Compliance Department. (Tr. 2325.)

31 Division Exhibit 321 contains the internal supervisory policies in effect at Raymond James's securities division and financial institutions division between April 1999 and March or April 2000. (Tr. 2311; Div. Ex. 309.) Mr. Zaharadnick replaced Mr. Carreno until the compliance departments of Robert Thomas and IMR merged. (Tr. 2058, 2061, 2352-53.)

32 Mr. DiGirolamo has been with Raymond James since graduating from the University of Florida in 1984. He has spent almost his entire career in compliance. (Tr. 2490-01.)

33 The Compliance Department continued to use "Robert Thomas Securities, Inc. Supervisory Procedures," which it had used before the merger. (Tr. 2361-62; Div. Ex. 321, R.J. Ex. 2529.) That document has a seven-page section on Rogue Brokers, which was a response to the Commission's concern about the supervision of registered representatives with a history of poor compliance. (Tr. 2363; Div. Ex. 2559 at 4102.) Before April 2000, the rogue broker provisions of Robert Thomas applied to the securities division and financial institutions division. (Tr. 3133, 3167.)

34 Mr. Carreno estimates that thirty percent of Raymond James's registered representatives are employed outside for compensation and therefore, should, submit an Outside Activity form. (Tr. 2331.)

35 One person worked out of an office of Robert Thomas in Westerly, Rhode Island, and two people, who were primarily active in insurance type products and financial planning, worked from home offices. (Tr. 1031-32.)

36 This change was required by NASD's Notice to Members 0221, prompted by the United States Patriot Act.

37 Mr. Ullom denied seeing the e-mails Mr. Herula sent and received at the Cranston branch office concerning Brite Business on January 12 and 13, and February 23, 2000. (Div. Exs. 132, 133, 135.)

38 The facsimile cover sheet indicates Mr. DiGirolamo was sent a copy, but he denies that he saw it. (Tr. 2483-84; Div. Ex. 272.)

39 In this situation, ACATING meant that no positions in the account were to be transferred to another broker-dealer or bank without contacting Mr. Putnam. (Tr. 1455.)

40 Mr. Putnam knew Ms. Capalbo was married to Mr. Herula when he authorized the transfers from the Brite Business account. (Tr. 1952.)

41 The facsimile was sent from Mr. Herula's home number.

42 It would have been significant for Raymond James to close a "good account like Brite Business." (Tr. 2006.) Mr. Putnam sent a copy to Mr. James because Mr. Cohn's correspondence incorrectly indicated that Mr. Cohn sent Mr. James a copy of his letter. (Div. Ex. 506.) Mr. Ullom did not send Mr. Putnam a second letter from Mr. Cohn dated July 12, 2000, or his response to the letter. (Tr. 1213-24; Div. Ex. 153.)

43 The Malcolm & Ursula Monlezun Account, No. 44902174 was also involved, in that it transferred funds into the Mary Lee Capalbo, Esq., Special Client Account.

44 The Division's witness was unaware that Mr. Monlezun received $4,207 in 1999, apparently interest while his funds were in a money market fund. (Tr. 976; Div. Ex. 81.) 37

45 Mr. Ullom approved Mr. Fife's application to open the Seaview account on August 17, 2000. (Div. Ex. 157.) Mr. Ullom did not inform Mr. Putnam that he had approved opening another account for Mr. Fife. (Tr. 1497.) The Division maintains that Mr. Fife also carried out a fraudulent trading program through Seaview. (R.J. Ex. 2642.)

46 Mr. Fife opened the Seaview Development & Holdings, Ltd. account in the Cranston branch office on August 17, 2000. (Div. Ex. 159.)

47 A letter on Foxhill letterhead bearing Mr. Ullom's signature was sent by facsimile from the Cranston branch office on March 6, 2000. Mr. Ullom believes the letter is a forgery. (Tr. 1445.) The letter stated that Mr. Herula, a financial consultant in good standing with Foxhill, had been paid the first installment under an IMPC financial agreement with Brite Business. (R.J. Ex. 2064.) Mr. Ullom testified that two letters stating that Mr. Herula earned a quarterly IMPAC fee of $250,000 sent by facsimile from the Cranston office were also forgeries but he admits signing a letter on March

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10, 2000, approving the transfer of $10,000 from Mr. Herula's account to purchase a house. (Tr. 1447, 1450; R.J. Exs. 2065, 2066, 2067.)

48 Mr. Ullom signed a branch office compliance report on November 30, 1999, in which he verified that "no personnel in [the Cranston] branch office have accepted client checks made payable to a Financial Advisor or FA's support company." (R.J. Ex. 2553 at FW 025196.) Mr. Ullom made the same representation following receipt by Foxhill of two $50,000 checks: in August 2000, and the other in October or November 2000. Mr. Ullom acknowledges that it was inappropriate for a registered representative to receive funds from a client where the broker-dealer had no knowledge and the registered representative had not filed an outside activity report. (Tr. 1404-05.)

49 Mr. Wegner, age thirty-nine, holds a degree in finance from Mercer University and a Masters in Business Administration from the University of Denver. (Tr. 3014.) Mr. Wegner conducted about 250 audits for Raymond James prior to the 2000 audit of the Cranston branch office. (Tr. 3043.) Mr. Wegner, a resident of Atlanta, Georgia, pays his expenses, including travel. (Tr. 3063.) Conducting audits for Raymond James is Mr. Wegner's primary source of income. (Tr. 3062.)

50 As the result of new policies: (1) beginning in 2001, auditors began reviewing the branch operating account; (2) beginning in 2002 or 2003, auditors began looking at the contents of computers of registered representatives; and (3) beginning in 2003, Raymond James began examining unregistered locations where registered representatives conducted business activities. (Tr. 2516, 2939-40, 3037, 3061, 3154.)

51 Mr. Forde, a 1965 graduate of St. John's University, was a supervisor with the NASD from 1968 until 1991. He was Compliance Director at First Union Brokerage Services, Inc., from 1991 to 1994. From 1994 to 2000, Mr. Forde was Director, Regulatory Compliance Consulting Group at PricewaterhouseCoopers LLP. (R.J. Ex. 2665.)

52 Mr. Forde characterizes Raymond James's procedures as more stringent than those employed generally in the industry. (R.J. Ex. 2665 at 18, 21.)

53 Mr. Corrigan graduated from Adelphi University, served in the U.S. Marine Corps, and worked at Merrill Lynch for thirty-five years, retiring as First Vice President and Managing Director. Mr. Corrigan now owns and operates Candlewood Consultants Corp. (R.J. Ex. 2666.)

54 Ms. Kern has a Bachelor of Arts from Randolph-Macon Women's College, a Master of Arts from the University of North Carolina, and a Juris Doctor from Fordham Law School. From 1983 to 1988, Ms. Kern was with Dean Witter Discover Co., and from 1989 until 2003, she was Director of Compliance at Morgan Stanley Dean Witter. Ms. Kern is currently a partner with Ferguson Pollack Kern Consulting. (Tr. 3449; Putnam Ex. 1119.)

55 Mr. Fredriksen became the holding company's chief security officer and Vice President, Technology Risk Management in February 2005. He graduated from Southwestern University in Tucson, Arizona, and has twenty years experience with the Eaton Corporation and the American Family Insurance. (Tr. 3195, 3200-01, 3205-06.) The 2004 Computer Security Institute's annual conference named Mr. Fredriksen one of the top five information executives. (Tr. 3196.)

56 According to Mr. Ullom, each registered representative in the Cranston branch office had an assigned Raymond James e-mail address and was assigned a computer owned by Foxhill. Mr. Ullom also testified that the registered representatives and others in the Cranston branch office had private e-mail addresses, but they were not approved for use in the office. (Tr. 1271.)

57 Mr. Fredriksen's testimony contradicts the following information that the Division received from Raymond James concerning e-mail retention.

Prior to January 1, 2001, only some branch office personnel were assigned RJFS mailboxes. Others maintained mailboxes with other e-mail service providers and any e-mail sent to or received from such persons would not be captured on the backup tape. E-mails sent by branch office personnel who had been assigned a RJFS mailbox would be saved on

the backup tape; however, e-mails they received that had been opened and downloaded from the server to their desktop were automatically deleted from the server and, therefore, not saved on the daily backup tape (any e-mails sent to or received from the home office, however, would still be maintained on the server and captured). (footnote omitted.)

(Tr. 3320; Div. Ex. 313 at 27.)

58 The “back-end” technology of storing e-mails had been around for only a couple of years. (Tr. 3236.) The 1997 Release required that the storage be done in a write once, read many times format (WORM), which had been available for some time. (Tr. 3237-38.)

59 The servers are backed up daily between 6:00 p.m. and 6:00 a.m. Technology existed that would have saved the e-mails that came into the server and were opened during business hours, but either Raymond James's software did not have the functionality or, if it did, Raymond James did not utilize it. (Tr. 3325.)

60 The tapes are kept in an off-site location in Florida, under a twenty-four-hour monitoring system, access is limited, and they are numbered and bar coded. Raymond James has a master documentation system and can recall a tape in twenty-four hours. (Tr. 3270-71.)

61 According to counsel, settlements with firms who did not comply have been in the $500,000 to $800,000 range.

62 Mr. Pallante, a graduate of Brooklyn College, worked for New York Stock Exchange (NYSE) from 1973 until he retired in 2004. From 1990 until 2004, Mr. Pallante was Executive Vice President, Member Firm Regulation. (R.J. Ex. 2667 at 4.) With 360 people, Member Firm Regulation is the largest of the NYSE's three regulatory divisions. The NYSE works very closely with the Commission and the NASD and considers that it takes an aggressive approach to regulation. (R.J. Ex. 2667 at 8.)

63 Mr. Pallante knew that the Commission's staff was speaking with the industry, and that the NASD was not addressing the issue. (R.J. Ex. 2667 at 18-19.) He does not recall that any firms were retaining documents in an electronic format. (R.J. Ex. 2667 at 19-20.)

64 Mr. Weeden is an expert on the issue of the e-mail retention requirements of Exchange Rule 17a-4 and the technology available in 1999 and 2000. (Tr. 3523-24.) Mr. Weeden is the president of 17a-4, LLC, an e-mail consulting company. (Tr. 3514.) Mr. Weeden graduated from the University of California at Berkeley, California, in 1974 and attended Fordham Law School. He began his career with Weeden & Company, an equity and fixed-income trading company. (Tr. 3505-06.) In 1978, Mr. Weeded helped form a start-up company, QV Trading Systems, that marketed the electronic trading system. In 1991, he began a second start up, Document Technologies, a company that developed software to support filing reports electronically with the Commission. Document Technologies developed a software product, EdgarEase, that Mr. Weeden estimates was used by half the filings submitted to Electronic Data Gathering and Retrieval (EDGAR). (Tr. 3506-13.)

65 Journaling sends a copy of every e-mail that goes to a server to a separate mail box. (Tr. 3535.) It is superior to backing up the servers because it copies all e-mails that are opened during business hours, and does not permit someone to double delete. (Tr. 3535.) The journaling mailbox gets large so the contents are usually stored on tape or to a WORM device. (Tr. 3538-40.)

66 I reject Mr. Forde's expert opinion that it was reasonable for Raymond James not to have included a review of the operating account for the Cranston branch office as part of its branch audit procedures in 2000. It is common sense that a broker-dealer needs to review the objective evidence contained in the operating account for the branch office when assessing whether an independent contractor who conducted branch operations has observed correct supervisory procedures.

67 According to Mr. DiGirolamo, senior management would not involve compliance where it had resolved an issue. (Tr. 2541.) Mr. DiGirolamo and Mr. Runkle testified that where managers believe they have solved problems of registered

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representatives sending out unauthorized correspondence, the managers do not necessarily have to mention the problems to the Compliance Department so that auditors would be aware of the situation. (Tr. 2505-06, 2512, 2928.) Mr. Runkle, a graduate of the University of South Florida, was associate director of Raymond James's Compliance Department from December 1999 until he became the chief compliance officer in May 2004. (Tr. 2865-66.)

68 Raymond James's expert Mr. Forde admits that the Lanciano letter raised a red flag about Mr. Herula's conduct and was the second occasion in which Mr. Herula made highly inappropriate representations on behalf of Raymond James. (Tr. 3141.) 60

69 Mr. Corrigan claims that Raymond James's systems and procedures were working because Raymond James's senior management was involved in the Lanciano letter. (R.J. Ex. 2666 at 17.) However, Mr. Putnam and Mr. Augenbraun were only involved in the Lanciano letter because an outside person sent a copy to the head of compliance at R.J. & Associates who then forwarded the letter to Mr. Putnam. (Div. Ex. 272.)

70 The five letters are: the Provident letter, the Lanciano letter, the Fingessa letter, the Fitzhenry letter, and the Four Star correspondence.

71 Raymond James did not challenge the Division's assertions that Mr. Herula's independent contractor status is not relevant to whether he was acting within the apparent scope of his authority, and that the Commission does not recognize the concept of independent contractor for purposes of the Exchange Act, William V. Giordano, 61 SEC Docket 453, 458 (Jan. 19, 1996) (settled order). (Div. Reply Br. 16 n.19.) The NASD applies the same supervisory standards to all registered representatives, employees or independent contractors.

72 Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder proscribe fraudulent conduct in connection with the offer, purchase, and sale of securities. These provisions prohibit essentially the same type of conduct. See United States v. Naftalin, 441 U.S. 768, 773 n.4 (1979). To establish violations of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, the Division must establish: (1) misrepresentations or omissions of material facts or other fraudulent devices; (2) made in connection with the offer, sale, or purchase of securities; and (3) that the respondent acted with scienter. Scienter is not required for violations of Sections 17(a)(2) or 17(a)(3) of the Securities Act; rather, negligence is sufficient to establish liability. Aaron v. SEC, 446 U.S. 680, 697 (1980); SEC v. Solucorp Indus., 274 F. Supp. 2d 379, 419 (S.D.N.Y. 2003); SEC v. Scott, 565 F. Supp. 1513, 1525-26 (S.D.N.Y. 1983).

Scienter is defined as "a mental state embracing intent to deceive, manipulate or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). The scienter requirement may be satisfied by a showing of recklessness. Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990); David Disner, 52 S.E.C. 1217, 1222 & n.20 (1997) (citation omitted). Recklessness is defined as "an extreme departure from the standards of ordinary care … presenting a danger of misleading buyers or sellers that is either known to the [respondent] or is so obvious that the [respondent] must have been aware of it." Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044-45 (7th Cir. 1977) (citation omitted), cert. denied, 434 U.S. 875 (1977).

73 Ms. Kern, an expert, testified that at Morgan Stanley Dean Witter, employees were only allowed to work outside on matters that were completely unrelated to the work of the firm. (Tr. 3458.) Morgan Stanley Dean Witter viewed anything that had a financial connection as posing a potential conflict down the road and as a distraction from the business. (Tr. 3458, 3500-01.)

74 I found Mr. Fitzhenry's testimony to be candid and highly credible. I reject Respondents' assertions that Mr. Fitzhenry's testimony should not be given full credit because Mr. Curl relayed some of the information, and that when he made his investment, Mr. Fitzhenry doubted Brite Business would pay the projected ten percent weekly return. (Tr. 283.)

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75 Raymond James cannot be held liable for Mr. Herula's actions with respect to Mr. Al Bloushi because Mr. Al Bloushi did not rely on representations by Mr. Herula in making his investment in Brite Business.

76 R.J. & Associates had to borrow funds for four days until it could release funds from its reserve account. R.J. & Associates paid Raymond James $35,603 as a result of the borrowing because it had an agreement with Raymond James to pay it 375 basis points on any borrowings in balances carried in its client accounts. Raymond James in turn paid the $35,603 to the Cranston branch office where presumably it was divided among Foxhill, Mr. Ullom and Mr. Herula. (Tr. 2825-28; R.J. Ex. 2659.)

77 Willfully under Section 15(b) of the Exchange Act means no more than intentionally committing the act that constitutes the violation. Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965); C. James Padgett, 64 SEC Docket 319, 331 n.34 (Mar. 20, 1997).

78 As required by the Debt Collection Improvement Act of 1996, the Commission increased the maximum penalty amounts for violations occurring after December 9, 1996, and, again for violations occurring after February 2, 2001. 17 C.F.R. §§ 201.1001, .1002. 73

79 Raymond James put Mr. Ullom under heightened supervision in August 2002 as the result of a customer complaint. (Tr. 2033.) 74

80 Div. Exs. 12, 14, 16, 18-20, 24, 44, 45, 52, 53, 55, 56, 57, 149 (four letters included), 272, 282, 362, 498, and R.J. Ex. 2035. One exhibit cited by the Division is not in evidence and the other four exhibits are not examples of unauthorized correspondence. (Div. Post-Hearing Br. 110.)

81 I have found that Raymond James did not violate Section 17(a) of the Exchange Act and Rule 17a-4 and, therefore, will not consider the Division's request for a cease-and-desist order as to these provisions. 75

Release No. 296 (S.E.C. Release No.), 86 S.E.C. Docket 604, Release No. ID - 296, 2005 WL 2237628

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Release No. 1392 (S.E.C. Release No.), Release No. ID - 1392, 2019 WL 7284955

S.E.C. Release No.
Initial Decision

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF RETIREMENT SURETY LLC, CRESCENDO FINANCIAL LLC, THOMAS ROSE, DAVID LEEMAN, AND DAVID FEATHERSTONE

Administrative Proceeding File No. 3-18061
December 20, 2019

***1** APPEARANCES:
Jennifer K. Vakiener, Steven Rawlings, and Jack Kaufman for the Division of Enforcement, Securities and Exchange Commission
Jeffrey J. Ansley and Troy (T.J.) Hales, Bell Nunnally & Martin LLP, for Respondents Thomas Rose, David Leeman, and David Featherstone

BEFORE: James E. Grimes, Administrative Law Judge

Initial Decision

Summary

In this administrative proceeding, the Securities and Exchange Commission alleged that Respondents David Featherstone, David Leeman, and Thomas Rose sold securities in violation of the registration requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934. The parties agreed to a partial settlement which included findings of fact and a finding of liability on a no-admit, no-deny basis. I partially granted the Division of Enforcement's motion for summary disposition and found that Featherstone, Leeman, and Rose should pay disgorgement and prejudgment interest. This initial decision resolves the remaining issues. I conclude that Featherstone, Leeman, and Rose did not act with scienter, first-tier civil penalties are in public interest, and the disgorgement to be paid by Featherstone and Leeman but not Rose should be reduced due to a demonstrated inability to pay.

Procedural Background

The Commission initiated this proceeding in July 2017, when it issued an order instituting proceedings alleging that Featherstone, Leeman, and Rose (Respondents), together with Retirement Surety LLC and Crescendo Financial LLC, violated Securities Act Section 5(a) and (c) by selling unregistered securities and Exchange Act Section 15(a)(1) by acting as brokers without registering with the Commission. In November 2017, the Commission entered an order accepting Respondents' settlement offer. [1] The settlement order made findings of fact and determined that they committed the charged violations.

The settlement order also resolved claims against Retirement Surety and Crescendo based on their agreement to each be legally dissolved. [2] As to Featherstone, Leeman, and Rose, the settlement order provided for additional proceedings to resolve whether they should be ordered to pay disgorgement, prejudgment interest, and civil penalties. [3] In these additional proceedings, Respondents cannot contest that they violated Section 5 and Section 15 or the settlement order's factual findings, which must be accepted as true. [4]

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Following issuance of the settlement order, the Division moved for summary disposition. A previously assigned administrative law judge granted that motion in April 2018 and issued an initial decision. [5] In August 2018, following the Supreme Court's decision in *Lucia v. SEC,* the Commission remanded all pending administrative proceedings on appeal from this office, including this one; ordered that each proceeding must be reassigned to an administrative law judge who did not previously participate in the matter, unless the parties expressly agreed otherwise; and directed the newly assigned judges to give each respondent the opportunity for a new hearing. [6]

***2** After initial reassignment, this proceeding was reassigned to me in March 2019. [7] The Division filed a new motion for summary disposition. Respondents opposed the motion and asserted inability to pay as an affirmative defense. I granted the Division's motion in part. [8] I determined, based on the violations found in the settlement order, that Featherstone, Leeman, and Rose should disgorge the commissions they received for selling the unregistered securities and that prejudgment interest was appropriate. [9] I concluded, however, that factual disputes prevented me from deciding whether Featherstone, Leeman, and Rose acted with scienter. [10] Because scienter is a factor to be weighed in determining civil penalties and whether disgorgement or penalties should be reduced due to an inability to pay, I was unable to resolve those questions. [11]

I asked the parties to jointly propose a procedure and schedule for resolving the remaining issues, and the parties proposed that I decide the proceeding based on the existing written record, supplemented by additional briefing and evidence, without an in-person hearing. Based on the parties' agreement and the Commission's order on the continuation of proceedings, I adopted this proposal. [12]

In conducting this proceeding, I gave no weight to the opinions, orders, or rulings of the administrative law judge who presided over this proceeding before the Commission's remand. [13]

Findings of Fact

The findings and conclusions in this initial decision are based on the record and on facts officially noticed. [14] After my summary disposition order, Featherstone, Leeman, and Rose each submitted a new declaration regarding his financial condition in support of the inability-to-pay defense. Otherwise, the factual record is the same as the summary disposition record. For this reason, the factual findings below are largely similar to those made in the order on summary disposition. [15] On summary disposition, however, I reviewed the evidence in light most favorable to Respondents. In this decision, I resolve any factual disputes by a preponderance of the evidence as the standard of proof. [16] In a separate section, I make new findings about Respondents' ability to pay.

Background

Respondents are in their 60s or 70s and at relevant times described themselves as licensed insurance agents. [17] None of them hold securities licenses and none of them has ever been registered as a broker-dealer or associated with a registered broker-dealer. [18]

The unregistered securities at issue in this proceeding were created by William R. Schantz. [19] Schantz was sanctioned and suspended in 2002 by the National Association of Securities Dealers for brokering the sale of unregistered nine-month promissory notes guaranteed by insurance companies without disclosing the sales to the NASD-member firm with which he was associated. [20] In 2006, he entered into a consent order with the New Jersey Bureau of Securities for the same conduct. [21] Schantz agreed to disgorge $7,000 in commissions to New Jersey. [22] Respondents were aware of the consent order. [23] In 2009, Schantz formed Verto Capital Management LLC. [24]

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***3** In late 2013, Verto began issuing 7% promissory notes that are central to the findings and charges in the settlement order.[25] From then until November 2015, Verto issued about $12.5 million of these notes.[26]

In May 2017, the Commission filed a civil complaint against Schantz and Verto in the United States District Court for the District of New Jersey.[27] Following settlement, the court entered judgment against Schantz and Verto, permanently enjoining them from violating Securities Act Sections 5 and 17(a) and, after amendment, ordering them to pay about $4.8 million in disgorgement, interest, and civil penalties.[28] About $1.5 million remains due to 36 investors, 32 of whom were Respondents' clients.[29]

Respondents managed Retirement Surety from 2013 through 2015.[30] It described itself on its website as an organization "comprised of a group of "state licensed partners,' all from 'career[s] outside of the financial services industry' who provide investment advice for retirement planning."[31] Retirement Surety has never been associated with a registered broker-dealer or registered as a broker-dealer.[32]

Rose and Leeman also managed Crescendo, which was formed in June 2013 to broker the sale of Verto notes.[33] Crescendo's website described its members as "licensed partners" using language almost identical to that found on Retirement Surety's website.[34] It also has never been associated with a registered broker-dealer or registered as a broker-dealer.[35]

Sales of Verto Notes

Turning to the events in this case, Schantz first contacted Leeman sometime in 2012.[36] Rose and Featherstone first met Schantz in late 2012.[37] Schantz proposed to offer "a nine month note product … that caught [Respondents'] eyes, because [they] thought it was not a security."[38] And Respondents knew that if the Verto notes were securities, they "should not be selling" the notes because Respondents held no securities licenses.[39]

Respondents began selling Verto notes in November 2013.[40] In order to satisfy themselves that Verto notes were not securities, they took certain steps, including conferring with Schantz and his attorney, John Pauciulo with the firm Eckert Seamans Cherin & Mellott, LLC, who told Respondents that the nine-month note "wasn't a security because of [certain] exemptions."[41] Before Respondents began selling Verto notes, Schantz told them that Pauciulo opined that the notes were not securities.[42] Rose testified that he, Leeman, and Schantz also had "a couple of phone call conversations" with Pauciulo, and "some" of those calls were before they started selling Verto notes.[43] Respondents and Schantz participated in phone conference calls with Pauciulo, during which Pauciulo told Respondents that the Verto notes were not securities.[44]

***4** As part of their "due diligence outside of the law firm" that Schantz retained—meaning Pauciulo and Eckert Seamans—Respondents performed internet research about what constitutes a security and exemptions from registration, including the nine-month note exemption.[45] Their research led Respondents to conclude that a nine-month note "may or may not be a security" depending on "different criteria."[46] When asked what criteria Respondents found, Rose stated: "One, the fact that it is nine months; two, it said even if it was longer than nine months, as long as the note is backed by assets of a company, then it is not a security."[47] Based on their research, Respondents "felt that [a Verto note] wasn't a security."[48]

Leeman emailed Schantz on November 15, 2013, to say that another individual, Dave Valencia, told Leeman that he (Valencia) would "not participate" because Valencia's attorney believed the Verto notes were securities.[49] Leeman added, however, that his internet research revealed nothing "that would call a 9 month note a security unless the laws are different in California."[50] Schantz responded that "[w]e use very good and expensive counsel to vet these issues and there is no problem at all with a 9

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month note. You may be correct that there is something in California …. I would be happy to have [Valencia's] counsel speak to ours ….”[51]

On November 19, 2013, Schantz emailed Leeman and attorney Thomas D. Sherman, of Locke Lord LLP, in order to introduce the two to each other.[52] Context shows that Sherman was the attorney who told Valencia that the Verto notes were securities. Schantz said he would be “happy to discuss our 9 month note program” and added that Pauciulo, who “has an extensive securities background and is an ex investigator for the SEC,” was “[o]ur counsel for the note program.”[53]

Sherman responded the next morning raising issues relating to whether the Verto notes could qualify for certain registration exemptions.[54] He also noted that California does not have a commercial-paper exemption and asked why the notes would not be securities under California law.[55] Leeman responded that he hoped “it's all OK because I wrote up $75,000 today!”[56] This statement by Leeman is the earliest evidence of when an investor purchased a Verto note brokered by Respondents. Based on a preponderance of the evidence, November 20, 2013, was the first day Respondents sold Verto notes.

***5** The next day, November 21, 2013, Leeman forwarded Sherman's email to Rose.[57] Among other things, Leeman said that if Schantz and Pauciulo convinced Sherman that “it's OK” for them to sell the notes, “we've scored a big win for future people who may question it.”[58] He added that he “hope[d] it all works out because I wrote about $85,000 yesterday.”[59] There is no evidence that Respondents had additional contact or discussions with Sherman.

At some point before November 21, 2013, Respondents also spoke to a securities attorney in Dallas named David Shelmire.[60] Leeman testified that Respondents spoke to Shelmire before November 21, 2013, about whether Verto notes were securities.[61] And when asked whether Respondents “consult[ed] any other attorney about” whether Verto notes were securities, Rose responded that Respondents spoke to Shelmire.[62]

The Division asserts that Respondents did not speak to Shelmire about whether the Verto notes were securities but instead consulted him on other issues.[63] Respondents did not disclose attorney-client communications with Shelmire. For this reason, I will not give any weight to Respondents' consultations with Shelmire in determining Respondents' mental state when selling the Verto notes.

In any event, as noted, Respondents began selling Verto notes in November 2013.[64] Over the next two years, Respondents sold 162 notes to 82 investors.[65] Respondents received a 7% commission for each note they sold, with 5% going to the individual seller and 2% to Crescendo.[66]

Respondents solicited investors, including their insurance clients; gave investors offering materials; advised investors; and monitored and managed investor repayments.[67] Rose and Leeman advertised the notes on two radio networks and directed listeners to Retirement Surety's website.[68] According to the site, a Verto note was “A Nine Month, Short-Term Investment with significantly higher returns than CDs or other safe money investments,” and was “200% collateralized” by life settlement policies.[69] Crescendo's website described an investment in the Verto notes as low risk and said the investment was “not a speculative investment influenced by market performance or the economy but rather an investment backed by 200% collateral with a known value.”[70]

Respondents also provided investors with a brochure.[71] In the brochure, Respondents stated that investments were “fully collateralized and secured by a collateral assignment and pledge agreement of the life settlements acquired and owned by Verto.”[72] They added that “life settlement assets will have a minimum ratio of 2:1 or 200% (loan to face value) in life settlements

acquired and traded."[73] Respondents also stated that the investment was "not … speculative" and "[a]ll the risk of a life settlement maturing at an accurately determined life expectancy is born by the institutions that purchase them from Verto."[74]

***6** In late June 2014, Leeman emailed Schantz to ask about "the difference between" the notes that led to Schantz's consent order "and what we have?"[75] Leeman added that "it looks like" the notes Schantz previously sold ""were also 9 month notes."[76]

In early August 2014, Pauciulo responded to Leeman's forwarded email that the law in the area "is complex and can be confusing."[77] He said, however, "We have drafted the documents with the intent to meet the requirements of the 9 month note exemption."[78] Although Pauciulo thought the Commission or a court would agree they are exempt, he wrote that it "would not be feasible" to "provid[e] a formal legal opinion" on the subject.[79] He also offered that they could rely on the exemption in Securities Act "Section 4(2)" and ""possibly, Regulation D."[80] Finally, he suggested that rather than accepting commissions, Respondents "could serve as a purchaser representative and be retained and paid by the purchaser."[81]

Verto was sometimes unable to pay investors under the terms of their notes.[82] When that happened, Respondents negotiated and arranged "forbearance agreements" between Verto and the investors.[83] Respondents received an additional 4% commission for each forbearance agreement.[84]

Respondents received $565,419 in commissions for brokering Verto notes, $89,279 for obtaining signed forbearance agreements, and an additional $29,552 for obtaining second forbearance agreements.[85] In total, this broke down to $297,360 for Rose, $243,435 for Leeman, and $120,760 for Featherstone.[86]

For purposes of this proceeding, it is established that the Verto notes were securities and that no registration exemption applied to them.[87] No registration statement was ever filed for the offer and sale of the Verto notes.[88] Respondents knew that at least five of their investors were unaccredited.[89] Respondents did not provide investors with the financial information required by Securities Act Rule 502(b)(2), and no one ever filed a Form D with the Commission stating that Verto had complied with the exemptions in Securities Act Rule 506.[90]

Financial Condition of Respondents

The facts concerning Respondents' financial condition come from the Respondents' statements of financial condition and supporting documentation, which were prepared in May 2017, and supplemented by Respondents' August 2019 declarations.[91]

Featherstone

***7** Featherstone is 72 years old.[92] He is self-employed as a piano tuner and rebuilder, which can be a physically demanding job and becomes more difficult as he ages.[93] A significant portion of his income comes from Social Security benefits.[94] Featherstone provides for two adult dependents who require around-the-clock care.[95] Caring for his dependents reduces the time he has to work, although he relies on a friend to help when he needs to work or run errands.[96] Featherstone expects to incur "significant expenses" related to the care of his dependents.[97]

In 2017, Featherstone's monthly household income varied from month to month and was approximately $11,000.[98] His monthly household expenses were about $8,600.[99] Because of the need to devote additional time to the care of his dependents,

Featherstone's household income decreased to approximately $4,000 per month as of August 2019. [100] He did not provide an update to his monthly expenses. Featherstone reported assets of about $1,500,000, including a home valued at $300,000, and liabilities of about $140,000, by far the largest of which was his home mortgage, on his 2017 statement of financial condition. [101]

Leeman

Leeman is 70 years old. [102] He is self-employed selling life insurance and a self-published book. [103] The vast majority of his household income comes from his wife, but she is 71 years old and wishes to retire. [104] Leeman has a significant medical condition that requires expensive treatment and hinders his ability to work. [105] Since 2017, Leeman's monthly household income has been approximately $6,300 and his monthly expenses were about $8,000. [106] In 2017, his total assets were over $430,000, including a home, and liabilities were about $200,000. [107]

Rose

Rose is 63 years old. [108] He is a self-employed insurance salesperson. [109] His combined household income is about $6,000 per month, the majority of which is Social Security benefits. [110] Rose's monthly expenses are about $9,200. [111] Rose's household income was significantly higher before 2017 due to changes in his wife's employment. [112] Including two homes with a combined value of about $650,000, Rose and his wife have over $1,000,000 in total assets and about $320,000 in total liabilities. [113]

Conclusions of Law

Civil Penalties

***8** I denied the Division's motion for summary disposition with respect to civil money penalties due to material questions of fact regarding whether respondents acted recklessly. Reviewing the record again, I do not find sufficient evidence to conclude that they were reckless. Applying the statutory factors and considering the other sanctions imposed, I find that first-tier civil money penalties are in the public interest.

Legal Standards

In this proceeding, the Commission may impose civil monetary penalties if a respondent has willfully violated a provision of the Securities Act or Exchange Act and the penalty is in the public interest. [114] The settlement order conclusively resolves against Respondents the question of whether they violated the Securities Act or Exchange Act and whether they acted willfully. [115] That leaves the public interest and the penalty tier.

In determining whether civil penalties are in the public interest, the Commission considers (1) whether the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm to others; (3) any unjust enrichment; (4) the respondent's history of securities-law violations or criminal offenses; (5) the need for deterrence; and (6) such other matters as justice requires. [116] The maximum civil penalty that may be imposed is based on the culpability of the respondent and is divided into three tiers. A first-tier penalty for the period at issue in this proceeding is limited to $7,500 and may be imposed for any violation. [117] A second-tier penalty, which has a maximum of $80,000, may be imposed if the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. [118] And a third-tier penalty, with a maximum of $160,000, may be imposed if the requirements for second-tier penalties are met and the violation resulted in either “substantial losses or created a significant risk of substantial losses to other persons” or “substantial pecuniary gain to the person who committed the act or omission.” [119]

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There is no allegation that Respondents' conduct involved fraud, deceit, or manipulation. The parties dispute whether Respondents acted in reckless disregard of a regulatory requirement. Recklessness is not a "heightened form of ordinary negligence" but requires "an 'extreme departure from the standards of ordinary care … which presents a danger of misleading buyers … that is … so obvious that the actor must have been aware of it.'" [120] For example, the "'egregious refusal to see the obvious, or to investigate the doubtful' … is strong evidence of recklessness." [121]

Parties' Arguments

***9** The Division argues that third-tier civil penalties should be imposed because Respondents recklessly disregarded the registration requirements of the Securities Act and Exchange Act. [122] In support of this, the Division contends that Respondents harbored concerns that the Verto notes could be securities and were on notice after hearing from Valencia that he would not participate due to his attorney's opinion that the Verto notes were securities. [123] The Division also argues that Respondents could not have reasonably relied on the information they received from Schantz and Pauciulo— who, as Verto's attorney, was not a disinterested party. [124] According to the Division, Respondents began selling the notes before hearing from Pauciulo, and Pauciulo stated that he could not provide a formal legal opinion. [125] The Division further contends that Respondents' sale of the notes created a substantial risk of loss to investors. [126]

Respondents assert that they acted in good faith. Because they were inexperienced in securities matters, they relied on others, including Schantz and Pauciulo, who repeatedly told them that the Verto notes were not securities. [127]

Recklessness

The evidence does not show that Respondents recklessly disregarded the registration requirements of the securities laws. Respondents knew they could not sell securities. [128] And they were interested in the Verto notes because they believed the notes were not securities under the nine-month exemption. [129] Although Respondents did some research on their own, because they did not have a securities background, they primarily relied on others' advice. [130] In this proceeding, Respondents did not assert a formal advice of counsel defense, but "reliance on the advice of counsel need not be a formal defense; it is simply evidence of good faith," and therefore "a relevant consideration in evaluating … scienter." [131]

Given Schantz's position and disciplinary background, if Respondents had relied solely on his word that the Verto notes were not securities, their reliance would have been misplaced and they consequently might have been reckless to sell the notes. But the same is not true about Respondents' reliance on Pauciulo. Respondents knew that he was "from a very large and reputable law firm in Philadelphia," [132] and that he had extensive securities experience. [133] Rose and Leeman communicated with Pauciulo and received his assurance that the Verto notes were exempt before starting sales. [134] When Leeman raised questions about the exemption in 2014, Pauciulo again advised that the notes were created to meet the exemption's requirements. [135] It is true that Pauciulo conditioned his analysis with the statement that "a formal legal opinion" regarding the Verto notes was not ""feasible." [136] Although this might have been a red flag to experienced securities practitioners, Respondents were not experienced. And while the Division remarks on Pauciulo's statement that he could not "provid[e] a formal legal opinion," it has neither explained the significance Respondents as laymen should have attached to this qualifier nor denied that Pauciulo was, in fact, an experienced securities attorney.

***10** Respondents were unwise and perhaps overly credulous, but relying on Pauciulo's advice was not an egregious refusal to investigate the doubtful. [137] Although there were some red flags, the evidence does not show that it was so obvious the

notes were securities that Respondents *must* have known it. Respondents, therefore, did not act with scienter when they failed to register as brokers and sold unregistered securities. The first public interest factor weighs in Respondents' favor.

Other Factors

Regarding harm to others, the Verto notes did not perform as advertised, causing some investors to lose money. The fair fund established in *SEC v. Schantz* is evidence of the significant overall harm caused by the Verto notes, and as of April 2019 Schantz still owed $1.5 million to investors under the terms of his judgment. [138] Respondents' conduct contributed to this harm, although their role in selling the notes based on Schantz's assertions was not as significant as Schantz's role in creating the notes and making unlikely assertions about them. Twenty-three investor customers of Leeman and Rose, who invested about $1.65 million or roughly 20% of the investments brokered by Leeman and Rose, submitted declarations stating that they were ""happy with the services provided." [139] Of those 23 investors, 11 had received a full return of principal and interest. [140]

Respondents received large commissions—7% on the original sales and 4% on the forbearance agreements. These commissions constituted unjust enrichment. On the other hand, Respondents do not have any history of violations of the securities laws or prior disciplinary history. And given Respondents' age, current employment, suspensions from industry association, and cease-and-desist order, the need for specific deterrence is minimal and the need for general deterrence is adequately covered by the other sanctions imposed.

As to "such other matters as justice requires," Respondents' liability hinges on whether the Verto notes were securities. Although Respondents now concede— and the settlement order confirms—that the notes were securities, Respondents were not reckless in determining that the notes were not securities. [141] I cannot ignore, however, the fact that Respondents "held themselves out as financial advisors providing specialized knowledge on investments," when they lacked any specialized knowledge. [142] And although they were aware of Schantz's background, Respondents accepted his unlikely assertions about Verto notes at face value without further investigation and without supporting documentation. [143] They therefore told prospective investors that Verto notes were non-speculative, low risk and "200% collateralized" based only on what Schantz told them. [144] So, while Respondents did not act with scienter in violating Section 5 and Section 15, their actions leave much to be desired.

Conclusion

***11** Because Respondents did not act with scienter, only first-tier civil penalties may be imposed. Respondents' misconduct led to serious harm to investors and Respondents received hundreds of thousands in unjust enrichment. Weighing Respondents' conduct and the other statutory factors, and Respondents' ability to pay, which is addressed below, a civil penalty within the first-tier range is appropriate and in the public interest. I will order each Respondent to pay a $3,750 civil penalty.

Ability to Pay

In determining whether disgorgement, interest, or monetary penalties are in the public interest, the Commission or its administrative law judges may consider evidence concerning ability to pay. [145] Considering this evidence is an exercise of discretion, and even if the Commission considers ability to pay, it "is only one factor … and is not dispositive." [146] Respondents bear the burden of proving their inability to pay. [147]

The Commission has not provided extensive guidance concerning inability to pay, but it has imposed penalties despite a demonstrated inability to pay when the misconduct at issue is "sufficiently egregious." [148] I will apply a twopart inquiry in determining whether to reduce monetary sanctions due to an inability to pay. [149] First, I will consider whether any Respondent has demonstrated an inability to pay in whole or in part. Second, if a Respondent has demonstrated an inability to pay, I will consider whether I should credit that in view of the seriousness or egregiousness of the violation in relation to the Commission's

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mission of "'protecting investors[,] … safeguarding the integrity of the markets,"' and "making securities law violations unprofitable."[150]

Featherstone

Although Featherstone reported significant assets on his statement of financial condition, review of that document shows that his net assets are not as significant as they appear.[151] Since he submitted that statement, his income has decreased substantially and he has an additional adult dependent. Featherstone's income is now insufficient to cover his monthly expenses, and his long-term earning potential is low.

I previously determined that Featherstone should disgorge $120,760.[152] While I did not calculate prejudgment interest, it is likely to be significant— more than $13,000.[153] Comparing this amount to Featherstone's current financial condition, he has established an inability to pay the entire amount. Turning to the second part of the inquiry, while the violations are serious,[154] Featherstone's conduct was not egregious. As discussed, he did not act with scienter. It is appropriate to credit his inability to pay.

***12** Because Featherstone's monthly cash flow is negative and not likely to increase in the future, and because of the economic challenges he faces resulting from the fact he must provide long-term, continuous care for two dependents, it is appropriate to discount his disgorgement amount. But because of the importance of Section 5 and Section 15, and because of the manner in which Respondents held themselves out as financial advisors and accepted and repeated Schantz's claims, I cannot waive the entire disgorgement amount. I will discount it by half, for a final disgorgement figure of $60,380, plus prejudgment interest.[155]

Leeman

Leeman reported a net worth of about $240,000, most of which is equity in his home.[156] His monthly household expenses exceed his monthly household income, and this income is likely to decrease in the future considering his significant medical condition and his and his wife's age. I previously determined that Leeman should disgorge $243,435, and prejudgment interest is likely to exceed $26,000.[157] I find that Leeman has established an inability to pay. Leeman did not act with scienter, and his conduct was not otherwise egregious. I will credit his inability to pay.

Leeman's financial condition is precarious and unlikely to improve in the future. Nevertheless, Leeman is not impecunious, and the seriousness of the violations and his behavior requires that some monetary sanction be imposed. Balancing these factors with Leeman's health, income, and expenses, I reduce the disgorgement amount to $24,343.50, or 10% of the determined total, plus prejudgment interest.

Rose

Rose is the youngest of the Respondents and in the best financial condition. Although he reported that his expenses currently exceed his household income, he has the highest prospects for increasing income in the future. Rose owns two homes with a combined value of about $650,000, he and his wife have over $1,000,000 in total assets and about $320,000 in total liabilities.[158] I previously determined that Rose should disgorge $297,360 and prejudgment interest is likely to exceed $31,000.[159] Comparing this amount to Rose's financial condition, I find that he has not demonstrated an inability to pay.

Although Rose reported negative monthly cash flow, his net worth is significant, and it appears likely that his household income will increase (or his expenses will decrease) in the future. He and his wife have not yet reached retirement age. For these reasons, I find that Rose can pay the amount of the disgorgement ordered, plus prejudgment interest.[160]

Order

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Under Rules of Practice 322 and 630(c), I ORDER that pages 1505 to 1514 of Respondents' appendix and accompanying exhibits be maintained under seal.

***13** Under Section 8A(e) of the Securities Act of 1933 and Sections 21B(e) and 21C(e) of the Securities Exchange Act of 1934, David Featherstone must DISGORGE $60,380; David Leeman must DISGORGE $24,343.50; and Thomas Rose must DISGORGE $297,360. Respondents must pay prejudgment interest on the amount of disgorgement imposed. The prejudgment interest owed will be calculated from January 1, 2017, to the last day of the month preceding the month in which payment of disgorgement is made. Prejudgment interest will be computed at the underpayment rate of interest established under Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), and compounded quarterly.

Under Section 8A(g) of the Securities Act of 1933 and Section 21B(a)(1)- (2) of the Securities Exchange Act of 1934, David Featherstone, David Leeman, and Thomas Rose must each PAY A CIVIL MONEY PENALTY of $3,750.

Under Rule of Practice 1100, I ORDER that any funds recovered by disgorgement or civil penalties be placed in a fair fund for the benefit of investors harmed by the violations.

Payment of civil money penalties, disgorgement, and interest must be made no later than 21 days following the day this initial decision becomes final, unless the Commission directs otherwise. Payment must be made in one of the following ways: (1) transmitted electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) direct payments from a bank account via Pay.gov through the SEC website at http://www.sec.gov/ofm; or (3) by certified check, bank cashier's check, bank money order, or United States postal money order made payable to the Securities and Exchange Commission and hand-delivered or mailed to the following address alongside a cover letter identifying the Respondent and Administrative Proceeding No. 3-18061: Enterprise Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Blvd., Oklahoma City, Oklahoma 73169. A copy of the cover letter and instrument of payment must be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

This initial decision will become effective in accordance with and subject to the provisions of Rule 360. [161] Under that rule, a party may file a petition for review of this initial decision within 21 days after service of the initial decision. Under Rule of Practice 111, a party may also file a motion to correct a manifest error of fact within ten days of the initial decision. [162] If a motion to correct a manifest error of fact is filed by a party, then a party has 21 days to file a petition for review from the date of the order resolving such motion to correct a manifest error of fact.

***14** The initial decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct a manifest error of fact or the Commission determines on its own initiative to review the initial decision as to a party. If any of these events occur, the initial decision will not become final as to that party.

James E. Grimes
Administrative Law Judge

1 *Retirement Surety LLC*, Securities Act Release No. 10436, 2017 WL 5437486 (Nov. 14, 2017) (Settlement Order).

2 Settlement Order § III.E.

3 *Id.* § IV.

4 *Id.*

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5 *Retirement Surety*, Initial Decision Release No. 1250, 2018 WL 1872124 (ALJ Apr. 18, 2018).

6 *Pending Admin. Proc.*, Securities Act Release No. 10536, 2018 WL 4003609, at *1, *6 (Aug. 22, 2018); *see also Lucia v. SEC,* 138 S. Ct. 2044 (2018).

7 *Retirement Surety*, Admin. Proc. Rulings Release No. 6475, 2019 SEC LEXIS 294 (ALJ Mar. 4, 2019).

8 *Retirement Surety*, Admin. Proc. Rulings Release No. 6602, 2019 SEC LEXIS 1385, at *45 (ALJ June 13, 2019).

9 *Id.* at *27-29.

10 *Id.* at *29-41.

11 *Id.* at *41, *44.

12 *Retirement Surety*, Admin. Proc. Rulings Release No. 6634, 2019 SEC LEXIS 1794 (July 19, 2019); *see* Settlement Order § IV ("[T]he hearing officer may, in his discretion, determine the issues raised in the additional proceedings on the basis of the written record, without a hearing."); *Pending Admin. Proc.*, 2018 WL 4003609, at *1 (ordering administrative law judges to consider the parties' "proposals for the conduct of further proceedings" in remanded proceedings). The parties waived any claim on appeal that determining the outcome on the basis of a written record without an in-person hearing was error. *Retirement Surety*, 2019 SEC LEXIS 1794, at *1.

13 *See Pending Admin. Proc.*, 2018 WL 4003609, at *1.

14 *See* 17 C.F.R. § 201.323.

15 *See* 2019 SEC LEXIS 1385, at *6-24 & nn.18-101.

16 *See John Francis D'Acquisto*, Investment Advisers Act of 1940 Release No. 1696, 1998 WL 34300389, at *2 (Jan. 21, 1998).

17 Settlement Order ¶¶ 3-5. The Commission's factual findings in Section III of the Settlement Order are cited by paragraph number.

18 *Id.* ¶¶ 3-5, 29.

19 *Id.* ¶¶ 6, 12.

20 *Id.* ¶ 6.

21 *Id.* I take official notice of Schantz's consent order with the New Jersey Bureau of Securities. *See Clearing Servs. of Am., Inc.*, No. BOS 1796-02 (N.J. Bureau of Sec. Jan. 18, 2006), http://www.njconsumeraffairs.gov/Actions /20060117_ClearingServicesofAmericaIncschantz.pdf; 17 C.F.R. § 201.323.

22 Settlement Order ¶ 6.

23 *Id.* ¶ 27.

24 *Id.* ¶ 9.

25 *Id.* ¶¶ 9, 12.

26 *Id.* ¶12.

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27 *See* Complaint, *SEC v. Schantz,* No. 1:17-cv-03115 (D.N.J. May 4, 2017), ECF No. 1. I take official notice of the district court's docket and its orders and the parties' filings, as reflected in the docket. *See* 17 C.F.R. § 201.323.

28 Settlement Agreement, *Schantz* (May 4, 2017), ECF No. 3; Final Judgment as to Defendants William R. Schantz and Verto Capital Management LLC at 1-4, *Schantz* (May 8, 2017), ECF No. 4; *see* Amended Final Judgment as to Defendants William R. Schantz and Verto Capital Management LLC 1, 4, *Schantz* (Feb. 27, 2018), ECF No. 13.

29 Vakiener Decl. ¶ 14.

30 Settlement Order ¶ 1.

31 *Id.* (alteration in original).

32 *Id.*

33 *Id.* ¶ 2.

34 *Id.* (alterations in original).

35 *Id.*

36 Vakiener Decl., Ex. D at 106; *see* Resp'ts' App. 1509.

37 Resp'ts' App. 1506, 1512; *see* Vakiener Decl., Ex. D. at 107.

38 Vakiener Decl., Ex. D. at 107.

39 Resp'ts' App. 1430; *see* Vakiener Decl., Ex. D at 107.

40 Settlement Order ¶ 27.

41 Vakiener Decl., Ex. D. at 107; *see* Resp'ts' App. 1513. During investigative testimony, Schantz stated, "it's pretty clear. I've read the code" and "it specifically states that notes [that] would mature in nine months or less are not … securities." Resp'ts' App. 1447.

42 Resp'ts' App. 1431. And Leeman testified that he believed Schantz: "most of all, we had the testimony of Mr. Schantz, who we believed would have never engaged in selling" Verto notes "if his attorney had said you better not, it is a security. He wouldn't do that." Vakiener Decl., Ex. E at 106.

43 Vakiener Decl., Ex. D at 137. Leeman testified that they had received Pauciulo's "view" that the Verto notes were not securities before sales started, but he could not recall whether that view was expressed in a phone call or email exchange. Vakiener Decl., Ex. E at 106; *see* Resp'ts' App. 1513.

44 Vakiener Decl., Ex. D at 136-38.

45 Vakiener Decl., Ex. D at 108; *see id.* at 110 ("[J]ust doing Google searches, right, and trying to find SEC documents. We're obviously not securities licensed, so we wanted to make sure we weren't, you know, doing anything wrong."); Vakiener Decl., Ex. E at 109; Vakiener Decl., Ex. F at 7917.

46 Vakiener Decl., Ex. D at 108, 110.

47 *Id.* at 109.

48 *Id.* at 108.

49 Vakiener Decl., Ex. F at 7917.

50 *Id.*

51 *Id.*

52 Vakiener Decl., Ex. G at 271.

53 *Id.*

54 *Id.* at 269-70.

55 *Id.* at 270.

56 *Id.* at 269. He added, "Nice that we have an attorney vetting the company for us on Dave Valencia's nickel!!" *Id.*

57 Vakiener Decl., Ex. H at 31789.

58 *Id.*

59 *Id.*

60 Vakiener Decl., Ex. D at 108-10, Ex. E at 107-08.

61 Vakiener Decl., Ex. E at 107.

62 Vakiener Decl., Ex. D at 108-09.

63 Mot. at 8, 18.

64 Settlement Order ¶¶ 12, 27.

65 *Id.* ¶¶ 12, 20.

66 *Id.* ¶ 21.

67 *Id.* ¶¶ 13-20.

68 *Id.* ¶ 18.

69 *Id.*

70 *Id.* ¶ 19.

71 Vakiener Decl. ¶ 11.

72 Vakiener Decl., Ex. J at 3 (capitalization altered).

73 *Id.* (capitalization altered).

74 *Id.* at 4.

75 Settlement Order ¶ 27.

76 *Id.*

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77 Vakiener Decl., Ex. I at 1.

78 *Id.*

79 *Id.*

80 *Id.* The reference to Section 4(2) is presumably a reference to Securities Act Section 4(a)(2), which provides a registration exemption for issuer transactions not involving any public offering. 15 U.S.C. § 77d(a)(2). Regulation D under the Securities Act establishes exemptions for "limited offerings" and transactions deemed not to be public offerings. 17 C.F.R. §§ 230.504(a), .506(a).

81 Vakiener Decl., Ex. I at 1.

82 Settlement Order ¶ 22.

83 *Id.* ¶¶ 16, 22.

84 *Id.* ¶ 22.

85 *Id.* ¶ 23.

86 *Id.* ¶ 24.

87 *Id.* ¶¶ 26, 28.

88 *Id.* ¶ 28.

89 *Id.* Rule 506 under Securities Act Regulation D deals with unregistered offerings to accredited investors—those who meet certain income or sophistication requirements found in Rule 501(a). 17 C.F.R. §§ 230.501(a), .506.

90 Settlement Order ¶ 28. Rule 502(b)(2) governs the information that must be given to investors when securities are sold under Rule 506. 17 C.F.R. § 230.502(b)(2). Issuers that rely on Rule 504 or 506 use Form D to file notice with the Commission of an offering. 17 C.F.R. § 230.503(a).

91 Pages 1 to 1425 of Respondents' appendix are filed under seal. *Retirement Surety*, Admin. Proc. Rulings Release No. 6526, 2019 SEC LEXIS 665 (ALJ Mar. 28, 2019). For the same reasons, Respondents' supplemental filings, pages 1505 to 1514 of the appendix and accompanying exhibits, will be placed under seal. Because Respondents' ability to pay is one of the core issues in this proceeding, however, I will discuss some high-level details from those materials that do not reveal personally identifiable or otherwise sensitive information. *See* Rules of Practice, 60 Fed. Reg. 32,738, 32,792-93 (June 23, 1995) (comment to adoption of 17 C.F.R. § 201.630(c)).

92 Resp'ts' App. 1505.

93 *Id.* at 1506.

94 *Id.* at 1505.

95 *Id.* at 1505-06.

96 *Id.*

97 *Id.* at 1506.

98 *Id.* at 1015-16.

99 *Id.* at 1016.

100 *Id.* at 1505-06.

101 *Id.* at 1012-13.

102 *Id.* at 6, 1508.

103 *Id.* at 1508.

104 *Id.* at 4-6, 1508.

105 *Id.* at 1508-09.

106 *Id.* at 1508. Leeman's household income was substantially higher in 2016. *Id.* at 5.

107 *Id.* at 1-3.

108 *Id.* at 1511.

109 *Id.*

110 *Id.*

111 *Id.* at 1512.

112 *Id.*

113 *Id.* at 420-22.

114 15 U.S.C. §§ 77h-1(g)(1), 78u-2(a)(1). Under Exchange Act Section 21B(a)(2), the Commission may also impose civil monetary penalties here because this proceeding was instituted as a cease-and-desist proceeding and Respondents violated a provision of the Exchange Act. 15 U.S.C. § 78u-2(a)(2). Section 21B(a)(2) does not explicitly require a finding that a Respondent acted willfully or that the penalty be in the public interest. *Id.*

115 Settlement Order § III.D.

116 15 U.S.C. § 78u-2(c). Although the Securities Act does not contain a statutory list of public-interest factors, the Commission considers the factors listed under the other securities statutes when assessing the public interest under the Securities Act. *See* *Thomas C. Gonnella*, Securities Act Release No. 10119, 2016 WL 4233837, at *14 & n.70 (Aug. 10, 2016), *pet. argued*, No. 16-3433 (2d Cir. Sept. 9, 2019); *see generally* 15 U.S.C. § 77h-1.

117 15 U.S.C. §§ 77h-1(g)(2)(A), 78u-2(b)(1); 17 C.F.R § 201.1001, tbl.I. Higher maximum penalty amounts apply to conduct occurring after November 2, 2015. *See* Adjustments to Civil Monetary Penalty Amounts, 84 Fed. Reg. 5122 (Feb. 20, 2019). Although the last Verto notes were sold in November 2015, Settlement Order ¶ 12, and Respondents earned commissions on forbearance agreements in 2016, *id.* ¶ 24, the vast majority of commissions were earned before November 2, 2015. Because the Division did not make any argument to the contrary, I will use the maximum civil penalty amounts in effect from March 6, 2013, to November 2, 2015.

118 15 U.S.C. §§ 77h-1(g)(2)(B), 78u-2(b)(2); 17 C.F.R § 201.1001, tbl.I.

119 15 U.S.C. §§ 77h-1(g)(2)(C), 78u-2(b)(3); 17 C.F.R § 201.1001, tbl.I.

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120 *SEC v. Steadman,* 967 F.2d 636, 641-42 (D.C. Cir. 1992) (quoting *Sundstrand Corp. v. Sun Chem. Corp.,* 553 F.2d 1033, 1045 (7th Cir. 1977)).

121 *Bernerd E. Young*, Securities Act Release No. 10060, 2016 WL 1168564, at *17 (Mar. 24, 2016) (quoting *Chill v. General Elec. Co.,* 101 F.3d 263, 269 (2d Cir. 1996)), *argued*, No. 16-1149 (D.C. Cir. Dec. 16, 2019).

122 Div. Supp. Reply at 2

123 *Id.* at 2-3; Settlement Order ¶ 27.

124 Div. Supp. Reply at 3.

125 *Id.*

126 *Id.* at 4-5.

127 Supp. Resp. at 7.

128 *See* Vakiener Decl., Ex. D. at 107.

129 *See Id.*

130 One court has observed that because "securities laws are 'complex and often uncertain"' a "'layman [*i.e.*, a non-lawyer] has no real choice but to rely on counsel."' *Howard v. SEC,* 376 F.3d 1136, 1147 n.20 (D.C. Cir. 2004) (quoting Douglas W. Hawes & Thomas J. Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 Va. L. Rev. 1, 36 (1976) (alteration in original)).
Although a securities attorney familiar with the history of the nine-month exemption might think otherwise, the statute's plain language could be read to support a blanket exception for all nine-month notes. 15 U.S.C. §§ 77c(a)(3) (listing as exempted securities any note "which has a maturity at the time of issuance of not exceeding nine months"); 78c(a)(10) ("The term "security' … shall not include … any note … which has a maturity at the time of issuance of not exceeding nine months …."). *But see Reves v. Ernst & Young,* 494 U.S. 56, 63 (1990) ("[T]he phrase 'any note' should not be interpreted to mean literally 'any note,' but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts."); *id.* at 73 (Stevens, J., concurring) (noting that the courts of appeals "have been unanimous in rejecting a literal reading" of the nine-month-note exemption); Interpretation of Section 3(a)(3), 26 Fed. Reg. 9158, 9159 (Sept. 20, 1961) (explaining the reach of the nine-month exemption).

131 *Howard*, 376 F.3d at 1147.

132 Vakiener Decl., Ex. E. at 105.

133 Vakiener Decl., Ex. G at 271.

134 Vakiener Decl., Ex. D at 136-38; Ex. E at 106; Resp'ts' App. 1513.

135 Vakiener Decl., Ex. I at 1.

136 *Id.*

137 Some securities professionals, including experienced registered representatives, have a duty to investigate "'where there are any unusual factors"D' and the failure to do so in the face of an "abundance of red flags" is evidence of extreme recklessness despite the approval of a compliance officer. *See Graham v. SEC,* 222 F.3d 994, 1005-06 (D.C. Cir. 2000) (quoting *Sharon M. Graham*, Exchange Act Release No. 40727, 1998 WL 823072, at *6 n.30 (Nov. 30, 1998)). But Respondents were inexperienced and unregistered—a violation of the securities laws for which they are liable. While they perhaps should have known better, in their position not further investigating the notes was not extremely reckless. *Cf.*

id. at 1006. Indeed, in another case involving the sale of unregistered securities, the Commission held that consulting with others, including an attorney, "whom [the respondent] reasonably regarded as more sophisticated … than … himself" was a strong mitigating factor that weighed in favor of a minor sanction. *Charles C. Carlson*, Exchange Act Release No. 14246, 1977 SEC LEXIS 162, at *20 (Dec. 12, 1977).

138 Vakiener Decl. ¶ 14; Amended Final Judgment as to Defendants William R. Schantz and Verto Capital Management LLC, *Schantz* (Feb. 27, 2018), ECF No. 13. Schantz and the Commission have continued to litigate over the unsatisfied balance of the consent judgment. *See* Order, *Schantz* (July 1, 2019), ECF No. 28 (holding Schantz in contempt); Consent Order, *Schantz* (Sept. 23, 2019), ECF No. 45 (appointing an agent to sell a property).

139 Resp'ts' App. 1451-60, 63-78, 81-82, 1487-1504; *see* Settlement Order ¶ 24.

140 Resp'ts' App. at 1451, 1453, 1455, 1457, 1471, 1473, 1477, 1489, 1493, 1495, 1497.

141 Respondents' situation is similar to that in *Carlson*, where the Commission held that although Carlson sold unregistered securities, his liability was mitigated by the fact that he relied on the advice of others, including an attorney, "whom he reasonably regarded as more sophisticated … than he was." 1977 SEC LEXIS 162, at *20; *see Id.* at *20 n.40 (stating that although "those assurances [were] incorrect[,] … we cannot shut our eyes to the fact that some" authoritative sources "appear[ed] to have agreed with … the assurances on which Carlson relied.").

142 Settlement Order ¶ 25; Vakiener Decl., Ex. E at 112.

143 Vakiener Decl., Ex. D at 76, 89-90.

144 Settlement Order ¶¶ 18-19; Vakiener Decl., Ex. D at 76, 89-90.

145 17 C.F.R. § 201.630(a); *see* 15 U.S.C. §§ 77h-1(g)(3), 78u-2(d). Because the Division has not disputed Respondents' ability-to-pay evidence, I take it at face value.

146 *Thomas C. Bridge*, Securities Act Release No. 9068, 2009 WL 3100582, at *25 (Sept. 29, 2009), *pet. denied sub nom. Robles v. SEC,* 411 F. App'x 337 (D.C. Cir. 2010).

147 *Philip A. Lehman*, Exchange Act Release No. 54660, 2006 WL 3054584, at *4 & nn.29-30 (Oct. 27, 2006).

148 *Bridge*, 2009 WL 3100582, at *25; *Lehman*, 2006 WL 3054584, at *4.

149 *See Retirement Surety*, 2019 SEC LEXIS 1385, at *42-44.

150 *Gordon Brent Pierce*, Securities Act Release No. 9555, 2014 WL 896757, at *19 (Mar. 7, 2014) (quoting *SEC v. Rind,* 991 F.2d 1486, 1491 (9th Cir. 1993)) (describing the Commission's mission in the course of explaining the purpose of disgorgement), *pet. denied*, 786 F.3d 1027 (D.C. Cir. 2015).

151 In his May 2017 statement of financial condition, Featherstone declared that his net worth exceeded $1 million. Resp'ts' App. at 1012-13. His largest asset, however, was identified as the "Cash Surrender Value of Insurance." *Id.* at 1012. But in his explanation of assets, Featherstone stated that his insurance policies were "beneficial to [his] family as stated in the policy," and "[b]oth are term, not permanent life." *Id.* at 1013. Featherstone's next biggest asset is his home, but it is partially encumbered by a mortgage and is the home for two dependents who depend on him to provide constant care. *Id.* at 1012- 13. One of Featherstone's dependents is also the beneficiary of a trust that, in 2017, provided annual income of about $3,000. *Id.* at 1419-20.

152 *Retirement Surety*, 2019 SEC LEXIS 1385, at *27.

153 *See id.* at *27 n.106.

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154 The registration requirements in Securities Act Section 5 “are a keystone of the entire system of securities regulation, and set forth basic requirements for the protection of investors.” *Sirianni v. SEC,* 677 F.2d 1284, 1289 (9th Cir. 1982). Similarly, the registration requirement in Exchange Act Section 15 “is ‘of the utmost importance in effecting the purposes of the Act’ because it enables the SEC ‘to exercise discipline over those who may engage in the securities business and it establishes necessary standards with respect to training, experience, and records.’” *SEC v. Benger,* 697 F. Supp. 2d 932, 944 (N.D. Ill. 2010) (quoting *Celsion Corp. v. Stearns Mgmt. Corp.,* 157 F. Supp. 2d 942, 947 (N.D. Ill. 2001)).

155 Prejudgment interest will be calculated from January 1, 2017, as Respondents' earned Commissions “through 2016.” Settlement Order ¶ 24.

156 Resp'ts' App. at 1-3.

157 *Retirement Surety*, 2019 SEC LEXIS 1385, at *27 & n.106.

158 Resp'ts' App. at 420-22.

159 *Retirement Surety*, 2019 SEC LEXIS 1385, at *27 & n.106.

160 *Cf. Robert L. Burns*, Advisers Act Release No. 3260, 2011 WL 3407859, at *12 (Aug. 5, 2011) (holding that, where a respondent's net worth exceeded the total amount of disgorgement, penalties, and interest, the respondent had not shown an inability to pay).

161 *See* 17 C.F.R. § 201.360.

162 *See* 17 C.F.R. § 201.111.

Release No. 1392 (S.E.C. Release No.), Release No. ID - 1392, 2019 WL 7284955

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Release No. 4116 (S.E.C. Release No.), Release No. IA - 4116, 111 S.E.C. Docket 4357, 2015 WL 3653814

S.E.C. Release No.
Investment Advisers Act of 1940

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF SFX FINANCIAL ADVISORY MANAGEMENT ENTERPRISES, INC. AND EUGENE S. MASON, RESPONDENTS.

Administrative Proceeding File No. 3-16591
June 15, 2015

SUMMARY

The Securities and Exchange Commission (SEC) accepted offers of settlement submitted by SFX Financial Advisory management Enterprises, Inc. and Eugene S. Mason (Respondents). The SEC alleged, inter alia, that Respondents, a registered investment adviser and its Chief Compliance Officer, failed to adopt policies and procedures reasonably designed to prevent the misappropriation of client assets, failed to implement the policies it did have, and failed to conduct an annual compliance review. As a result, Respondents committed or caused violations of Sections 206(2), 206(4), and 207 of the Investment Adviser Act of 1940 (15 USCA 80b-6(2), (4), and 80b-7) and Rule 206(4)-7 (17 CFR 275.206(4)-7) thereunder. Pursuant to Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act, the SEC ordered Respondents to cease and desist from committing or causing violations of the above-mentioned sections, censured Respondents, and ordered Respondents to pay a civil money penalty.

REGULATION
17 C.F.R.275.206

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 203(e), 203(f), AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, MAKING FINDINGS, AND IMPOSING A CEASE- AND-DESIST ORDER

I.

***1** The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e), 203(f) and 203 (k) of the Investment Advisers Act of 1940 ("Advisers Act") against SFX Financial Advisory Management Enterprises, Inc. ("SFX") and Eugene S. Mason ("Mason" and, collectively, "Respondents").

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V as to Mason, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e), 203(f), and 203 (k) of the Investment Advisers Act of 1940, Making Findings, and Imposing a Cease-and-Desist Order ("Order"), as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds [1] that:

Summary

From 2006 through 2011, Brian Ourand ("Ourand"), while SFX's Vice President and President, misappropriated at least $670,000 in assets from three client accounts. During this time, SFX failed to supervise Ourand and also committed compliance failures. In particular, SFX failed to adopt policies and procedures reasonably designed to prevent the misappropriation of client assets, failed to implement the policies it did have, violated the custody rule, and falsely stated in its Form ADV that it reviewed client accounts used for bill-paying services. SFX also failed to conduct its annual compliance review in 2011. Mason, SFX's Chief Compliance Officer ("CCO"), caused SFX's failure to implement its compliance policies, conduct an annual review and is responsible for a material misstatement in a Form ADV filing.

Respondents

1. **SFX Financial Advisory Management Enterprises, Inc.** is a Delaware corporation headquartered in Washington, District of Columbia. SFX became registered with the Commission as an investment adviser on September 21, 1992, but withdrew its registration on September 12, 2012. SFX is currently registered in the District of Columbia. In its most-recent Form ADV filing in March 2014, SFX disclosed that it managed $15 million on a discretionary basis.

***2** 2. **Eugene S. Mason**, age 51, is a resident of Dayton, Maryland. Mason has been SFX's CCO since 2004.

Related Individual

3. **Brian Ourand**, age 53, is a resident of Miami, Florida. Ourand was SFX's Vice President from 2003 to 2007 and President until August 2011, when he was terminated. Ourand is named as a respondent in a separate administrative proceeding relating to his conduct described in this Order.

Background

4. SFX specializes in providing advisory and financial management services to high net-worth individuals, primarily current and former professional athletes. SFX provides clients with a range of services including management of investment portfolios, bill payment, financial planning, and tax consultation and support.

5. Several of SFX's clients had bank and brokerage accounts over which SFX had the power to withdraw and deposit assets. Ourand had discretionary authority to trade in client accounts as well as authority over client bank accounts to pay bills, transfer money, and deposit checks. As a result, SFX had custody over the assets in the client accounts.

6. From 2006 to 2011, Ourand misappropriated at least $670,000 from three clients. During this time, Ourand wrote unauthorized checks from client bank accounts payable to "cash" or himself, and wired unauthorized amounts to himself for his own personal use. He also wired money using client credit cards for unauthorized amounts to others for their personal use.

7. In July 2011, Mason learned that Ourand had misappropriated assets when a client complained that he could not use one of his credit cards. SFX and Mason promptly conducted an internal investigation. Ultimately, SFX terminated Ourand and reported his conduct to the criminal authorities.

8. Individuals at SFX, including Ourand, had full signatory power over client bank accounts relating to SFX's bill-paying services. Therefore, there was a significant risk that those individuals could misappropriate client funds. SFX's compliance policies and procedures were not reasonably designed, and were not effectively implemented, to prevent the misappropriation

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of client funds. As CCO, Mason was responsible under the policies and procedures for implementation of the policies and procedures.

9. In particular, SFX's policies were not reasonably designed to prevent the person authorizing payments that SFX made from client accounts from circumventing secondary review of those payments. Thus, Ourand was able to circumvent secondary review of the payments he authorized from client accounts.

10. In addition, SFX's compliance policy required, among other things, that there be a review of "cash flows in client accounts." SFX and Mason did not effectively implement this provision for the client accounts used for bill-paying services. In addition, SFX did not have a reasonable basis to believe, after due inquiry, that custodians were providing clients with bank statements.

***3** 11. SFX's Form ADV, Part 2 brochure filed on March 31, 2011, disclosed that "Client's cash account used specifically for bill paying is reviewed several times each week by senior management for accuracy and appropriateness." This statement was untrue because a review for "appropriateness" indicates a review by senior management other than the person responsible for the relevant transactions, yet no one other than Ourand reviewed the bill-paying accounts over which he had signing authority and from several of which he misappropriated funds. Mason executed Part 1 of the brochure filed concurrently with Part 2.

12. In the midst of an internal investigation following the discovery of Ourand's misappropriation, SFX did not conduct an annual review of its compliance program in 2011. Mason was responsible for ensuring the annual review was completed and was negligent in failing to conduct the annual review.

Violations

13. As a result of the conduct described above, SFX willfully [2] violated Section 206(2) of the Advisers Act, which prohibits fraudulent conduct by an investment adviser.

14. As a result of the conduct described above, SFX failed reasonably to supervise Ourand, within the meaning of Section 203(e)(6) of the Advisers Act.

15. As a result of the conduct described above, SFX willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, which requires that an investment adviser have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of its clients for which it maintains funds or securities.

16. As a result of the conduct described above, SFX willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require, among other things, that a registered investment adviser adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser and its supervised persons, and review, no less frequently than annually, the adequacy of the policies and procedures.

17. As a result of the conduct described above, Mason caused SFX's violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

18. As a result of the conduct described above, SFX and Mason willfully violated Section 207 of the Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission … or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

Respondents' Remedial Efforts

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In determining to accept the Offers, the Commission considered remedial acts promptly undertaken by Respondents and cooperation afforded the Commission staff.

IV.

***4** In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offers.

Accordingly, pursuant to Sections 203(e), 203(f), and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent SFX cease and desist from committing or causing any violations and any future violations of Sections 206(2), 206(4) and 207 of the Advisers Act and Rules 206(4)-2 and 206(4)-7 thereunder.

B. Respondent Mason cease and desist from committing or causing any violations and any future violations of Sections 206(4) and 207 of the Advisers Act and Rule 206(4)-7 thereunder.

C. Respondents are censured.

D. Respondent SFX shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of $150,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with Exchange Act Section 21F(g)(3). Respondent Mason shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of $25,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Payment must be made in one of the following ways:
(1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondents may make direct payment from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or

(3) Respondents may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:
Enterprise Services Center

Accounts Receivable Branch

HQ Bldg., Room 181, AMZ-341

6500 South MacArthur Boulevard

Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying the relevant party as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to C. Dabney O'iordan, Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., 11th Floor, Los Angeles, California 90036.

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V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondent Mason, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent Mason under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent Mason of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

***5** By the Commission.
Brent J. Fields
Secretary

Footnotes

1 The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

2 A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC,* 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC,* 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC,* 348 F.2d 798, 803 (D.C. Cir. 1965)).

Release No. 4116 (S.E.C. Release No.), Release No. IA - 4116, 111 S.E.C. Docket 4357, 2015 WL 3653814

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Release No. 919 (S.E.C. Release No.), 112 S.E.C. Docket 6264, Release No. ID - 919, 2015 WL 7730856

S.E.C. Release No.
Initial Decision

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF SPRING HILL CAPITAL MARKETS, LLC, SPRING HILL CAPITAL PARTNERS, LLC, SPRING HILL CAPITAL HOLDINGS, LLC, AND KEVIN D. WHITE

Administrative Proceeding File No. 3-16353
November 30, 2015

***1** APPEARANCES:
Nicholas A. Pilgrim and Daniel M. Loss for the Division of Enforcement, Securities and Exchange Commission
Ronald W. Dunbar, Jr., and Andrew E. Goloboy of Dunbar Law P.C. for Respondents Spring Hill Capital Markets, LLC, Spring Hill Capital Partners, LLC, Spring Hill Capital Holdings, LLC, and Kevin D. White

BEFORE: Carol Fox Foelak, Administrative Law Judge

INITIAL DECISION

SUMMARY

This Initial Decision concludes that Spring Hill Capital Partners, LLC, violated the registration provisions by operating as an unregistered broker-dealer from May 2009 through February 2010, that Spring Hill Capital Markets, LLC, violated the recordkeeping, net capital, and reporting provisions during March 2010, and the remaining Respondents were secondarily liable for violations of those provisions. The Initial Decision imposes cease-and-desist orders; orders disgorgement of $3,953,608 plus prejudgment interest; orders civil penalties totaling $82,500; and censures Spring Hill Capital Markets, LLC, and Kevin D. White.

I. INTRODUCTION

A. Procedural Background

The Securities and Exchange Commission instituted this proceeding with an Order Instituting Proceedings (OIP) on January 22, 2015, pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 (Exchange Act) and Section 9(b) of the Investment Company Act of 1940. The undersigned held a four-day hearing in New York City on May 11-14, 2015. The Division of Enforcement (Division) called fourteen witnesses from whom testimony was taken, including one expert. Respondents called three witnesses. Numerous exhibits were admitted into evidence. [1]

The findings and conclusions in this Initial Decision are based on the record and public official records of which official notice has been taken, pursuant to 17 C.F.R. § 201.323. Preponderance of the evidence was applied as the standard of proof. *See Steadman v. SEC,* 450 U.S. 91, 96-104 (1981). Pursuant to the Administrative Procedure Act, 5 U.S.C. § 557(c), the following post-hearing pleadings were considered: (1) the Division's Post-Hearing Brief and Proposed Findings of Fact and Conclusions of Law; (2) Respondents' Post-Hearing Brief and Proposed Findings of Fact and Conclusions of Law (including their September 1, 2015, Notice of Filing of Supplemental Authority regarding their Appointments Clause argument); (3) the Division's Post-Hearing Responsive Brief; and (4) Respondents' Reply Brief. All arguments and proposed findings and conclusions that are inconsistent with this Initial Decision were considered and rejected.

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B. Allegations and Arguments of the Parties

***2** This proceeding concerns two separate fact situations involving Respondents: (1) a history of transactions from May 2009 through February 2010, while Spring Hill Capital Market's application for registration as a broker-dealer was pending, during which the OIP alleges that Spring Hill Capital Partners acted as an unregistered broker-dealer; and (2) a series of transactions in a bond, known as the Gramercy Bond, in March 2010, during which, the OIP alleges, Spring Hill Capital Markets, by then a registered broker-dealer, failed to keep an accurate blotter, to keep required minimum net capital, and to timely inform the Commission of a net capital deficiency. There is little dispute between the Respondents and the Division as to the facts, but rather as to the legal conclusions to be drawn from the facts. The OIP alleges that Respondents violated, or aided and abetted and caused violations of, the registration, recordkeeping, net capital and reporting provisions of the Exchange Act. Respondents have stipulated to one of the violations charged, at OIP ¶ 31, related to the Gramercy Bond transactions: that White and Spring Hill Capital Holdings willfully aided and abetted and caused a violation by broker-dealer Rafferty Capital Markets, LLC, through which Spring Hill Capital Markets introduced trades, of Exchange Act Section 17(a) and Rule 17a-3(a)(1), which require brokerdealers to make and keep current blotters containing an accurate itemized daily record of all purchases and sales of securities. Supp. Stip. 13.

The Division is seeking cease-and-desist orders, disgorgement, civil monetary penalties, and a bar and censure against one or more Respondents. Respondents argue that the administrative proceeding against them is procedurally defective and that the charges are unproven and no sanctions should be imposed.

C. Procedural Issues

Respondents argue that the proceeding is unconstitutional because the Commission appoints Administrative Law Judges in a manner that is inconsistent with the Appointments Clause of the United States Constitution and because it otherwise lacks due process. However, the Commission has rejected the Appointments Clause argument. *Raymond J. Lucia Cos., Inc.*, Exchange Act Release No. 75837, 2015 SEC LEXIS 3628, at *76-90 (Sept. 3, 2015), *appeal pending*, No. 15-1345 (D.C. Cir.); *accord Timbervest, LLC*, Investment Advisers Act of 1940 Release No. 4197, 2015 SEC LEXIS 3854, at *89-104 (Sept. 17, 2015), *appeal pending*, No. 15-1416 (D.C. Cir.); *David F. Bandimere*, Securities Act of 1933 Release No. 9972, 2015 SEC LEXIS 4472, at *74-86 (Oct. 29, 2015). Respondents' argument that the proceeding deprives them of their right to a jury trial also fails. *Atlas Roofing Co. v. OSHRC,* 430 U.S. 442 (1977).

***3** Respondents argue that the Commission prejudged the proceeding as to them by making findings of fact concerning the events at issue in its May 15, 2014, order settling proceedings against Rafferty Capital Markets, *Rafferty Capital Mkts., LLC*, Exchange Act Release No. 72171, 2014 SEC LEXIS 1688 (May 15, 2014), and issuing a press release about the settlement order.

The Commission has considered and rejected this argument on several occasions. *See The Stuart-James Co.*, Exchange Act Release No. 28810, 1991 SEC LEXIS 168, at *2-18 (Jan. 23, 1991), *adhered to by C. James Padgett*, Exchange Act Release No. 38423, 1997 WL 126716, at *15-16 (Mar. 20, 1997), *pet. for review denied*, *Sullivan v. SEC,* 159 F.3d 637 (table), 1998 WL 388511 (D.C. Cir. 1998) (per curiam); *Steadman Sec. Corp.*, Exchange Act Release No. 13695, 1977 SEC LEXIS 1388, at *56 n.82 (June 29, 1977); *Edward Sinclair*, Exchange Act Release No. 9115, 1971 SEC LEXIS 898, at *13-14 (Mar. 24, 1971), *aff'd*, 444 F.2d 399 (2d Cir. 1971); *see also Hortonville Joint Sch. Dist. No. 1 v. Hortonville Educ. Ass'n,* 426 U.S. 482, 493 (1976) ("Mere familiarity with the facts of a case gained by an agency in the performance of its statutory role does not, however, disqualify a decisionmaker.") (citations omitted).

It is well established that the Commission's combining administrative and adjudicative functions is consistent with due process, including when the Commission considers settlement as to one or more respondents, but reviews an initial decision as to another respondent based on similar facts. A policy prohibiting settlements during the pendency of a multi-party proceeding would be contrary to the APA, which requires an agency to give all interested parties the opportunity for the submission and

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consideration of offers of settlement, when time, the nature of the proceeding, and the public interest permit. 5 U.S.C. § 554(c)(1). Further, while agency staff are obligated under the APA to be separated according to investigative, prosecution, and adjudicative functions, 5 U.S.C. § 554(d), the APA exempts Commission members from this separation of functions requirement. 5 U.S.C. § 554.

The precedent that Respondents cite is inapposite. In *Antoniu v. SEC,* the court nullified Commission administrative proceedings where a Commissioner made a public speech indicating prejudgment of the respondent. 877 F.2d 721 (8th Cir. 1989), *cert. denied*, 494 U.S. 1004 (1990). In the speech, the Commissioner singled out the respondent as an "indifferent violator" and announced that the bar imposed on respondent had been "made permanent," although the proceedings against the respondent had yet to become final and the Commission had yet to issue its opinion upholding the Administrative Law Judge's initial decision. *Id.* at 723. The court explained that the Commissioner's "words describing [the respondent's] bar as permanent can only be interpreted as a prejudgment of the issue." *Id.*

***4** In *Antoniu*, the Commissioner's conduct was held to - and did not comport with - the appearance of justice. *Id.* at 724. The circumstances here are entirely different, and the Commission's publication of findings of fact, agreed on in a settlement as to Rafferty, does not conflict with the appearance of justice. The other cases that Respondents cite are similarly misplaced, involving a speech by a Commissioner criticizing a party in a pending proceeding or a Commissioner who had actually worked on the matter before becoming a Commissioner. *See Texaco, Inc. v. Fed. Trade Comm'n,* 336 F.2d 754 (D.C. Cir. 1964), *vacated on other grounds*, 381 U.S. 739 (1965); *Amos Treat & Co. v. SEC,* 306 F.2d 260 (D.C. Cir. 1962); *see also MFS Secs. Corp v. SEC,* 380 F.2d 611 (2d Cir. 2004) (actual conflict of interest cured by recusal of individual Commissioners with conflict); *Gilligan Will & Co. v. SEC,* 267 F.2d 461 (2d Cir. 1959) (press release not a bar to enforcement action).

Respondents contend that the claim that Spring Hill Capital Partners violated Exchange Act Section 15(a) by operating as an unlicensed broker-dealer accrued on April 28, 2009, when it signed a contract with Rafferty Capital Markets, and that the claim is barred by the applicable statute of limitations. However, cease-and-desist orders and disgorgement are not subject to the five year statute of limitations provided in 28 U.S.C. § 2462. *Riordan v. SEC,* 627 F.3d 1230, 1234-35 (D.C. Cir. 2010); *Johnson v. SEC,* 87 F.3d 484, 491 (D.C. Cir. 1996).[2] As to those sanctions that are covered by the statute of limitations, acts outside the statute of limitations may be considered to establish a respondent's motive, intent, or knowledge in committing violations that are within the statute of limitations.[3] *Sharon M. Graham*, Exchange Act Release No. 40727, 1998 SEC LEXIS 2598, at *41 n.47 (Nov. 30, 1998) (citing Fed. R. Evid. 404(b) and *Local Lodge No. 1424 v. NLRB,* 362 U.S. 411 (1960)), *aff'd*, 222 F.3d 994 (D.C. Cir. 2000); *Terry T. Steen*, Exchange Act Release No. 40055, 1998 SEC LEXIS 1033, at *14-15 (June 1, 1998) (citing *H.P. Lambert Co. v. Sec'y of the Treasury,* 354 F.2d 819, 822 (1st Cir. 1965)). Further, such acts may be considered in determining the appropriate sanction if violations are proven. *Steen*, 1998 SEC LEXIS 1033, at *14-17.

II. FINDINGS OF FACT

A. Relevant Individuals and Entities

1. Spring Hill Entities

***5** Spring Hill Capital Holdings, LLC (SHCH), is a holding company that is the sole direct owner of Spring Hill Capital Partners, LLC (SHCP), Spring Hill Capital Markets, LLC (SHCM), and Spring Hill Management Company, LLC (SHMC) (collectively, Spring Hill). Answer at 2. SHCH had full and exclusive authority to manage SHCP and SHCM. Tr. 483-85; Supp. Stip. 2; Div. Ex. 1G at F318.[4] Kevin White founded Spring Hill, is CEO of the entities, and owns 80% of SHCH. Answer at 2-3; Div. Ex. 1C. He formed Spring Hill with former Lehman Brothers colleagues in office space made available *gratis* by the Dechert law firm. Tr. 522-28. These Lehman Brothers alumni included Paul Tedeschi, Philip Bartow, John Fernando, Hui Chen, Patrick Quinn, and Lauren O'Neill. Tr. 528-33.

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SHCP has never been registered with the Commission in any capacity. Stip. 2. SHCP has not had active business activity since SHCM commenced operations on approximately March 4, 2010. Stip. 4.

SHCM is a registered broker-dealer headquartered in New York City. Answer at 3; Stip. 1. Its registration as a broker-dealer became effective on February 26, 2010. *See* Spring Hill Capital Markets, L.L.C., BrokerCheck Report, *available at*http://brokercheck.finra.org (last visited October 14, 2015). [5] It commenced operations on March 4, 2010. Div. Ex. 187 at SHAP255; Stip. 4. SHCM operated as a dealer pursuant to Exchange Act Rule 15c3-1(a)(2)(iii). Div. Ex. 1 at F49 (FINRA Form NMA); Div. Ex. 1B (attached to Form NMA) at F204. SHCM computed its net capital pursuant to Exchange Act Rule 15c3-1(a)(2)(iii). *Id.* Its minimum net capital requirement was $100,000, and White knew this. *Id.*; Div. Ex. 10 at F2247, F2249. SHCM's primary business was trading, on an agency basis on behalf of clients, bonds - predominantly structured finance bonds, such as asset-backed bonds, residential mortgagebacked securities, commercial mortgage-backed securities, collateralized loan obligations (CLOs), and collateralized debt obligations (CDOs). Tr. 219-20.

SHCP transferred approximately $235,025 to SHCM and $2,600,000, through SHMC, to SHCH. Stips. 11-13.

2. Kevin D. White

White started working in the financial industry in 1986, at Kidder Peabody. Tr. 516. Subsequently, he attended business school and ultimately, in 1991, joined Lehman Brothers, where he worked for seventeen years. Tr. 218, 247, 258, 517-18. From 1994 until 2007, he worked in the asset-backed trading group, then headed a fixed-income sales group of about fifty people until March 2008, when he joined the real estate group to help sell Lehman Brothers' $55 billion commercial real estate portfolio; he remained there following the firm's September 15, 2008, bankruptcy until the real estate group was let go a month later by Lehman Brothers' successor, Barclays Capital. Tr. 218-19, 431-32, 518-20. He formed Spring Hill shortly thereafter. Tr. 522-28. White was associated as a registered representative with Rafferty Capital Markets from August 2009 to February 2010. [6] Tr. 264. White had never been the subject of enforcement action prior to this case. Stip. 20.

3. Rafferty Capital Markets, LLC

***6** Rafferty Capital Markets, LLC (Rafferty), is, and was during the events at issue, a Commission-registered broker-dealer headquartered in Garden City, New York. Stips. 5, 6, 15. Rafferty is an introducing broker; during the time at issue its clearing broker was first Jefferies and subsequently Merrill Lynch Broadcort. [7] Tr. 749-50. SHCM's Form NMA represented that it would have a piggyback arrangement with Rafferty and clearing through Broadcort. Div. Ex. 1 at F76. Accordingly, from March 2010 during the time at issue, SHCM conducted trading through Rafferty. White and Michael Rafferty, Rafferty's president, are friends. Tr. 327, 534.

4. Gramercy

Gramercy Capital Corp. (GKK or Gramercy) was a real estate investment trust (REIT). Tr. 730. Roger Cozzi was its CEO during the time at issue. Tr. 730. At issue in this proceeding is a series of transactions in a bond issued by a CDO known as Gramercy Real Estate CDO 2005-1, whose manager was a GKK subsidiary (Gramercy Bond). Supp. Stip. 1.

B. SHCP's Operations

White understood that it would take 270 days to obtain registration as a broker-dealer; for the interim he arranged for traders employed by SHCP to become associated with Rafferty and for a piggyback arrangement with Rafferty such that Rafferty would be the introducing broker for their trades which would be cleared by Rafferty's clearing broker. [8] Tr. 535-45. Resp. Ex. 1. Rafferty drafted the agreement regarding this arrangement; it was evaluated on Spring Hill's side by John Fernando, a SHCP partner. Tr. 545-75; Resp. Exs. 2-20, 47; Stips. 16-18. The agreement was signed on April 28, 2009, [9] and licenses of Spring

Hill employees were moved to Rafferty so that they became registered representatives of Rafferty. [10] Tr. 575-76; Stip. 19. The agreement's introduction provided that Rafferty and SHCP "have determined to enter into this Agreement for their mutual benefit to provide market information, settlement, clearing and execution services for certain securities transactions." Resp. Ex. 47 at RCML-SEC-1642. The agreed Purpose was stated as "to facilitate transactions initiated by [SHCP] with clients in order to accommodate the administration, clearance and settlement of these trades." *Id.* The agreement provided that "Services Provided" included "clearing and trade processing for trades introduced by [SHCP]." Resp. Ex. 47 at RCML-SEC-1647. Rafferty retained 15% of the revenue generated by the Spring Hill trading to compensate it for services such as processing transactions, clearing, FINOP, compliance, and counterparty credit; SHCP received the remaining 85%. *Id.*; Tr. 583-84. White negotiated the 85%-15% revenue sharing with Michael Rafferty. Tr. 417, 1146.

***7** In the discussions leading up to the agreement, Michael Rafferty told White on March 23, 2009, "We can act as B/D of record for your registered reps. We would hold the licenses and assume those potential liabilities.… In effect, you would be operating as a branch of the RaffCap B/D." Resp. Ex. 1. These registered representatives would be trading mortgage-related structured products, which Rafferty did not trade. Tr. 580, 1049-50. Rafferty was to "provide the necessary compliance and review associated with [Spring Hill] trades" and "to register certain Spring Hill employees as registered representatives of its broker-dealer [who] shall be deemed to be independent representatives of the broker-dealer and not employees of [Rafferty]." Resp. Ex. 36 at RCML-SEC-1627; Resp. Ex. 47 at RCML-SEC-1647. The agreement also provided that "Spring Hill's offices will be registered as a Non-OSJ branch of [Rafferty]." [11] *Id.* However, this never occurred. Tr. 581, 1170, 1190-91.

White and his Spring Hill partners, not Rafferty, made marketing decisions, trading decisions, and compensation decisions for SHCP employees who were fixed income traders. Tr. 608-11, 748-49. SHCP did business with large financial institutions such as Barclays Capital, Deutsche Bank, and Swiss Re. Tr. 792-95; Div. Ex. 287.

Between May 2009 and February 2010, SHCP employees who were registered representatives of Rafferty conducted approximately ninety-five matched trades (essentially, agency trades that did not place the broker or dealer's capital at risk, consisting of ninety-five purchases matched with ninety-five sales of the same security that was purchased) - approximately sixty-one in 2009 and thirty-four in January and February 2010. Tr. 972-73; Stip. 10.

SHCP marketing materials [12] described it, *inter alia*, as a broker-dealer or as providing broker-dealer services; some material that was distributed to potential customers disclosed that FINRA broker-dealer registration had been filed and was pending, but most did not. Div. Exs. 20-32, 33A, 34-37, 39-49, 50-51, 52A, 56A, 57B, 58A, 63, 65, 66A, 67B; Resp. Exs. 60, 62, 101-03, 115A. White himself distributed these marketing materials to financial firms with the intent of drumming up business. Tr. 439-41; Div. Exs. 33, 49, 52, 57, 58, 63, 66, 67; Resp. Ex. 115A.

1. SHCP Records

SHCP kept a trade blotter (referred to by White as a "spreadsheet") to track its trading activity; this same record continued as the blotter of SHCM when it opened for business as a broker-dealer and SHCP ceased operations. Tr. 331-36; Div. Exs. 138, 138A; Stip. 8. All invoices to and payments from Rafferty changed from SHCP to SHCM as of the effective date. Div. Ex. 199.

2. SHCP Commission Revenues

***8** From May 2009 until it ceased business activity in March 2010, SHCP received revenues of $3,953,608.61 that were commissions from securities transactions arranged by SHCP employees for clients. Tr. 110; Div. Ex. 138A; Stip. 10. This total includes payments made directly by Rafferty, at SHCP's request, to the SHCP employees who arranged the transactions. Div. Ex. 138A.

3. Equivocation

In prosecuting its application for broker-dealer registration, FINRA Form NMA, SHCM affirmed: "This statement will confirm that the applicant has not previously conducted a securities business, is not currently engaged in the conduct of a securities business, and will refrain from conducting a securities business until it has received approval from FINRA." Div. Ex. 1 at F12-13. Further, it represented that SHCM's affiliate SHCP provided consulting services to clients, including Rafferty, in return for consulting fees, and that SHCP "does not conduct a securities business." Div. Ex. 1A at F85; Div. Ex. 1C; Div. Ex. 1D; Div. Ex. 1F; Div. Ex. 4 at SH-SEC11645; Div. Ex. 8 at SH-SEC11749. White was aware that SHCM represented to FINRA that SHCP offered "consulting services" and "does not conduct a securities business." Tr. 502-03; Div. Ex. 8 at SH-SEC11747, 11749; Div. Ex. 10 at F2248-49. In responding to a Commission query, Respondents again represented SHCP's revenues as for "consulting," not as "commissions." [13] Tr. 693-94; Div. Ex. 178 at SH-SEC14315. In contrast, Spring Hill provided data to its accountant showing that SHCP had ""Commission Income" of $1,985,493.48 during 2009. Tr. 667-71; Div. Ex. 185 at 2. Respondents also arranged for Rafferty to remit funds from SHCP's 85% in round numbers rather than the exact amounts that it had earned during the billing period. [14] Tr. 136-38; Div. Exs. 130, 206C, 206D, 206F-I. The explanation for the representation that SHCP did not conduct a securities business - that registered representatives associated with Rafferty (who happened to be SHCP employees), not SHCP itself, conducted a securities business - is somewhat sophistical. Additionally, "commission" is a more accurate term than "consulting" to describe the transaction-based compensation that SHCP received for its business activities involving the purchase and sale of securities.

C. The Gramercy Transactions

When SHCM commenced business operations as a broker-dealer and SHCP ceased business operations on March 4, 2010, Spring Hill's operations and its relationship with Rafferty continued unchanged. Tr. 1201-02. SHCM continued the piggyback arrangement with Rafferty. Tr. 809; Div. Ex. 1 at F5. The April 28, 2009, "Services and Cost Sharing Agreement" remained in force at least until April 28, 2010. Resp. Ex. 47 at RCML-SEC-1642. There is no evidence in the record that the parties signed a new agreement during the time at issue. Spring Hill and Rafferty continued the same 85%-15% revenue sharing. Tr. 117-28; Div. Ex. 121. Rafferty and SHCM's Commission Sharing Agreement, dated July 19, 2010, "formalizes the revenue sharing terms under which [SHCM and Rafferty] will operate, and have been operating." Div. Ex. 121 at SH-SEC982. Even the trade blotter remained the same, with sequential numbering: trade 191 occurred on February 26, 2010, during SHCP's business operations, and trade 192 on March 4, 2010, during SHCM's. Div. Exs. 138, 138A; Stip. 8. Spring Hill remained liable for any fails. Div. Ex. 121 at SH-SEC983; Div. Ex. 178 at SH-SEC14315-16.

***9** Spring Hill's first revenue, in the beginning of 2009, was from an advisory contract with Gramercy pursuant to which SHCP evaluated Gramercy's existing CDOs. Tr. 530-31. Gramercy paid Spring Hill $100,000 for the first month and $50,000 per month for about the next six months. Tr. 530-31. This engagement ended by the end of 2009. Tr. 533, 732. Thereafter White and Cozzi discussed Spring Hill's finding Gramercy CDO bonds for Gramercy to buy back to redeem or hold on its balance sheet as an investment. Tr. 732-33. Rafferty was not mentioned. Tr. 733. On February 23, 2010, Spring Hill located the Gramercy Bond for sale. Tr. 734-35; Div. Ex. 109; Supp. Stip. 1.

On February 23, 2010, White solicited Cozzi for a potential purchase of the Gramercy Bond. Div. Ex. 109 at 2; Supp. Stip. 1. Cozzi initially expressed interest in purchasing the Gramercy Bond at a price of up to $75. Supp. Stip. 3. However, on February 25, 2010, Cozzi told White that, after speaking with his attorneys, he would not feel comfortable buying the bond until after an earnings call scheduled for March 4, 2010. *Id.* Cozzi explained that his decision was driven by the fact that the market would not have the same information GKK had before its earnings call. *Id.* Cozzi told White, "If the bonds trade away in the interim, so be it." *Id.*

On March 1, 2010, White instructed Paul Tedeschi, a registered representative of Rafferty, [15] who was also an employee of Spring Hill, to buy $15 million face amount of the Gramercy Bond from Citi at a price of $70.25. Supp. Stip. 4. On March 1, 2010, Tedeschi followed White's instruction and arranged an extended settlement schedule with Citi so that delivery of the bond could take place after GKK's scheduled earnings release and GKK would be in a position to make the contemplated purchase. Supp. Stip. 5. For ten days, with White's knowledge, Spring Hill withheld from Rafferty the trade ticket for the purchase of

the Gramercy Bond from Citi. Supp. Stip. 6. The trade ticket sent from Citi to Tedeschi noted the trade as “Citi sells to Spring Hill.” Div. Ex. 80. White knew that Rafferty expected Spring Hill to engage only in agency trading and understood that Rafferty would want to be alerted to the trade on the date the trade was confirmed with Citi. Supp. Stip. 7.

Following the purchase of the Gramercy Bond on March 1, 2010, the GKK earnings call originally scheduled for March 4, 2010, was pushed back to March 15, 2010. Supp. Stip. 8. On March 11, 2010, Rafferty received an inquiry from Citi regarding settlement of the Gramercy Bond purchased on March 1, 2010. Supp. Stip. 9. This was the first Rafferty learned of the transaction. *Id.* Also on March 11, 2010, the Gramercy Bond was sold to Barclays at a price of $70.25, and Spring Hill finally submitted to Rafferty a trade ticket for the March 1, 2010, purchase, along with a ticket for the March 11, 2010, sale. Supp. Stip. 10. The trade ticket sent by Tedeschi for the March 11, 2010, sale noted the trade as “Spring Hill sells to Barcap.” Div. Ex. 143. Due to Spring Hill's failure to turn over the trade ticket to Rafferty, Rafferty's books did not reflect the purchase of the Gramercy Bond from Citi for at least ten days. Supp. Stip. 11. SHCM's trade blotter incorrectly showed that the purchase from Citi and the sale to Barclays both took place on March 12, instead of on the actual dates of the trades, March 1 and March 11, respectively. Div. Exs. 133, 133A, 138, 138A, 173, 173A. [16]

***10** By no later than March 16, 2010, Tedeschi purchased the Gramercy Bond back from Barclays at a price of $70.75. Supp. Stip. 12. The trade ticket sent by Barclays to Tedeschi noted the trade as “Barclays sells to Spring Hill.” Div. Ex. 151. The bond was then sold to Gramercy at least several hours later. Specifically, the purchase occurred no later than 11:36 a.m. on March 16. Div. Ex. 151. The sale occurred no earlier than 6:17 p.m. on March 16. Div. Ex. 104. White negotiated the sale to Gramercy, at $74, and was aware that Tedeschi had already purchased the bond from Barclays. Div. Ex. 104. The trade ticket and confirmation for the sale submitted by SHCM trader Patrick Quinn [17] and by Gramercy showed the trade date for the sale to Gramercy as March 17. Div. Exs. 148, 149. The documents noted the trade as “Spring Hill sells to Gramercy” and Quinn as the trader. *Id.* Quinn confirmed to Rafferty that Gramercy would know March 17 as the trade date. Div. Ex. 150. Spring Hill earned about $414,000 from the Gramercy Bond transaction. Tr. 314.

As found above, SHCM's minimum net capital requirement was $100,000. Prior to the purchase from Barclays and sale to Gramercy, SHCM had net capital of between $200,000 and $395,508, according to its FOCUS reports of February 26 and March 31, 2010. Div. Exs. 216, 313. SHCM owed Barclays approximately $10.6 million plus accrued interest, for the purchase of the bond ($15 million face amount at a price of $70.75). Div. Ex. 151. To calculate SHCM's net capital, this liability is offset by the value of the bonds as an asset, subject to a haircut of 9%. Div. Ex. 320 at 4. Thus, SHCM had negative net capital of over $500,000 for at least several hours on March 16. It is undisputed that Spring Hill did not inform the Commission of any net capital deficiency.

SHCM's trade blotter that was provided to the Commission shows the trade dates of the March 1 Gramercy Bond purchase from Citi and the March 11 sale to Barclays both as March 12. Tr. 341; Div. Exs. 138, 138A, 173, 173A. The blotter showed March 17 as the trade date for the purchase from Barclays (as well as for the sale to Gramercy). Div. Exs. 138A, 173A. SHCM used trade date accounting in its recordkeeping. Tr. 966.

D. Expert Testimony [18]

Yui Chan, managing director in charge of the broker-dealer operations and financial responsibilities department at FINRA, testified for the Division. Tr. 958-1022; Div. Ex. 320. He was accepted as an expert in net capital requirements. Tr. 960. He testified concerning the purchase of the Gramercy Bond from Barclays and sale to Gramercy. Tr. 958-1022; Div. Ex. 320. Chan opined that SHCM was subject to moment-to-moment net capital, and was not relieved of this requirement by its piggyback arrangement with Rafferty. Tr. 966-68; Div. Ex. 320 at 4-5.

III. CONCLUSIONS OF LAW

The OIP charges violations of the broker-dealer registration, books and records, net capital and reporting provisions of the securities laws. Specifically, the OIP charges that SHCP willfully violated Exchange Act Section 15(a), by operating as an unregistered broker-dealer prior to SHCM becoming registered, and that SHCM willfully violated Exchange Act Sections 15(c)(3) and 17(a) and Rules 15c3-1, 17a-3(a)(1), and 17a-11(b)(1), in connection with the March 2010 transactions in the Gramercy Bond, through inaccurate entries in its trade blotter and a net capital deficiency of which it failed to notify the Commission. The OIP charges that SHCH and White willfully aided and abetted and caused all of those alleged violations except for SHCM's alleged violation of Exchange Act Rule 17a-3(a)(1). Additionally, it charges that SHCH and White aided and abetted and caused a violation by Rafferty of Exchange Act Section 17(a) and Rule 17a-3(a)(1) in connection with the first Gramercy Bond transaction; SHCH and White stipulated to their secondary liability to that charge.

***11** As discussed below, it is concluded that: (1) SHCP willfully violated Exchange Act Section 15(a); and White and SHCH willfully aided and abetted and caused SHCP's violation; and (2) SHCM willfully violated Exchange Act Sections 15(c)(3) and 17(a) and Rules 15c3-1, 17a-3(a)(1), and 17a-11(b)(1); and White and SHCH caused SHCM's violations of Exchange Act Sections 15(c)(3) and 17(a) and Rules 15c3-1 and 17a-11(b)(1).

A. Primary and Secondary Liability

1. Willfulness

Respondents are charged with *willful* primary or secondary violations, of Exchange Act Sections 15(a), 15(c)(3), and 17(a) and Rules 15c3-1, 17a-3(a)(1), and 17a-11(b)(1). A finding of willfulness does not require an intent to violate, but merely an intent to do the act which constitutes a violation. *See Steadman v. SEC,* 603 F.2d 1126, 1135 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981); *Tager v. SEC,* 344 F.2d 5, 8 (2d Cir. 1965).

2. Corporate Liability

SHCH, SHCP, and SHCM are accountable for the actions of their responsible officers, including White. *See C.E. Carlson, Inc. v. SEC,* 859 F.2d 1429, 1435 (10th Cir. 1988) (citing *A.J. White & Co. v. SEC,* 556 F.2d 619, 624 (1st Cir. 1977)). A company's scienter is imputed from that of the individuals controlling it. *See SEC v. Blinder, Robinson & Co., Inc.,* 542 F. Supp. 468, 476 n.3 (D. Colo. 1982) (citing *SEC v. Manor Nursing Ctrs., Inc.,* 458 F.2d 1082, 1096-97 nn.16-18 (2d Cir. 1972)). White, as 80% owner of SHCH, the 100% owner of SHCP and SHCM, was an associated person of the broker-dealer[s]. *See* Sections 3(a)(18) and 15(b)(4) of the Exchange Act. As an associated person of a broker-dealer, White's conduct and scienter are also attributed to the broker-dealer. *See* Section 15(b)(4) of the Exchange Act.

3. Aiding and Abetting; Causing

The OIP charges that White and SHCH "aided and abetted" and "caused" violations by SHCP, SHCM, and Rafferty of the registration, net capital and reporting provisions of the securities laws. For "aiding and abetting" liability under the federal securities laws, three elements must be established: (1) a primary or independent securities law violation committed by another party; (2) awareness or knowledge by the aider and abettor that his or her role was part of an overall activity that was improper; and (3) that the aider and abettor knowingly and substantially assisted the conduct that constitutes the violation. *See Graham v. SEC,* 222 F.3d 994, 1000 (D.C. Cir. 2000); *Woods v. Barnett Bank of Ft. Lauderdale,* 765 F.2d 1004, 1009 (11th Cir. 1985); *Investors Research Corp. v. SEC,* 628 F.2d 168, 178 (D.C. Cir. 1980); *IIT v. Cornfeld,* 619 F.2d 909, 922 (2d Cir. 1980); *Woodward v. Metro Bank of Dallas,* 522 F.2d 84, 94-97 (5th Cir. 1975); *SEC v. Coffey,* 493 F.2d 1304, 1316-17 (6th Cir. 1974); *Russo Sec. Inc.*, Exchange Act Release No. 39181, 1997 SEC LEXIS 2075, at *16-17 & n.16 (Oct. 1, 1997); *Donald T. Sheldon*, Exchange Act Release No. 31475, 1992 SEC LEXIS 3052, at *18 (Nov. 18, 1992), *aff'd*, 45 F.3d 1515 (11th Cir. 1995); *William R. Carter*, Exchange Act Release No. 17597, 1981 SEC LEXIS 1940, at *78 (Feb. 28, 1981). A person cannot escape aiding and abetting liability by claiming ignorance of the securities laws. *See Sharon M. Graham*, Exchange Act Release No. 40727, 1998 SEC LEXIS 2598, at *29 n.33 (Nov. 30, 1998), *aff'd*, 222 F.3d 994 (D.C. Cir. 2000). The knowledge or awareness requirement

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can be satisfied by recklessness when the alleged aider and abettor is a fiduciary or active participant. *See Ross v. Bolton*, 904 F.2d 819, 824 (2d Cir. 1990); *Cornfeld*, 619 F.2d at 923, 925; *Rolf v. Blyth,* 570 F.2d 38, 47-48 (2d Cir. 1978); *Woodward*, 522 F.2d at 97. That is, it must be established that a respondent either acted with knowledge or that he "encountered 'red flags,' or 'suspicious events creating reasons for doubt' that should have alerted him to the improper conduct of the primary violator," or there was a danger so obvious that he must have been aware of it. *Howard v. SEC,* 376 F.3d 1136, 1143 (D.C. Cir. 2004).

***12** For "causing" liability, three elements must be established: (1) a primary violation; (2) an act or omission by the respondent that was a cause of the violation; and (3) the respondent knew, or should have known, that his conduct would contribute to the violation. *Robert M. Fuller*, Exchange Act Release No. 48406, 2003 SEC LEXIS 2041, at *13-14 (Aug. 25, 2003), *pet. for review denied*, 95 F. App'x 361 (D.C. Cir. 2004). A respondent who aids and abets a violation also is a cause of the violation under the federal securities laws. *See Graham*, 1998 SEC LEXIS 2598, at *30 n.35. Negligence is sufficient to establish liability for causing a primary violation that does not require scienter. *See KPMG Peat Marwick LLP*, Exchange Act Release No. 43862, 2001 SEC LEXIS 98, at *82 (Jan. 19, 2001), *recons. denied*, Exchange Act Release No. 44050, 2001 SEC LEXIS 422 (Mar. 5, 2001), *pet. for review denied*, 289 F.3d 109 (D.C. Cir. 2002), *reh'g en banc denied*, 2002 U.S. App. Lexis 14543 (D.C. Cir. 2002).

B. SHCP

1. Registration Provision

Section 15(a)(1) of the Exchange Act makes it unlawful for any entity to effect transactions in securities, by jurisdictional means, without registering as a broker or dealer. 15 U.S.C. § 78***o***(a). "Broker" is defined in Section 3(a)(4) of the Exchange Act as "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4). Scienter is not required to establish a violation of this provision. *SEC v. Montana,* 464 F. Supp. 2d 772, 785 (S.D. Ind. 2006).

Activities of a broker are characterized by "a certain regularity of participation in securities transactions at key points in the chain of distribution." *Mass. Fin. Servs., Inc. v. Sec. Investor Prot. Corp.,* 411 F. Supp. 411, 415 (D. Mass. 1976), *aff'd*, 545 F.2d 754 (1st Cir. 1976). Other relevant factors include whether the alleged broker: "1) is an employee of the issuer; 2) received commissions as opposed to salary; 3) is selling, or previously sold, the securities of other issuers; 4) is involved in negotiations between the issuer and the investor; 5) makes valuations as to the merits of the investment or gives advice; and 6) is an active rather than passive finder of investors." *SEC v. Zubkis,* No. 97-cv-8086, 2000 WL 218393, at *9 (S.D.N.Y. Feb. 23, 2000) (quoting *SEC v. Hansen,* No. 83-cv-3692, 1984 WL 2413 at, *10 (S.D.N.Y. Apr. 6, 1984)). However, "transaction-based compensation" is "one of the hallmarks of being a broker-dealer." *SEC v. Kramer,* 778 F. Supp. 2d 1320, 1334 (M.D. Fla. 2011) (quoting *Cornhusker Energy Lexington, LLC v. Prospect Street Ventures,* No. 8:04-cv-586, WL 2620985, at *6 (D. Neb. Sept. 12, 2006)).

2. Registration Violation

***13** White sought to comply with the registration provisions through the arrangement with Rafferty, whereby certain SHCP employees became registered representatives associated with Rafferty and Rafferty acted as introducing firm for transactions negotiated by these SHCP employees. Nonetheless, SHCP was clearly "in the business of effecting transactions in securities for the accounts of others" in violation of Section 15(a)(1) of the Exchange Act. Over the course of ten months, SHCP regularly participated in securities transactions by negotiating and conducting ninety-five matched trades on behalf of its clients. There is no dispute that SHCP received transaction-based compensation for its activities, amounting to 85% of the commissions generated by its trading. White and his Spring Hill partners, not Rafferty, decided what trades were made and determined the compensation of the Rafferty-registered SHCP traders, refuting the argument that the trades were Rafferty's rather than SHCP's. White also sought to generate business for SHCP by distributing marketing materials touting its brokerdealer services. Finally, SHCP and Rafferty's Services and Cost Sharing Agreement made clear that the parties expected SHCP to act as a broker; it specified that the services provided included "clearing and trade processing for trades introduced by Spring Hill."

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The facts that Respondents sought to disguise the commission payments that SHCP received as consulting payments and that they represented to FINRA that SHCP was not conducting a securities business (a representation of which White was aware) indicates that White was aware that the arrangement was not a completely legitimate method of speeding up Spring Hill's entry into the securities business.

3. White

White aided and abetted and caused SHCP's violation of Section 15(a)(1) of the Exchange Act. He was an active participant in marketing SHCP's broker-dealer services, and his knowledge that his role was part of an overall activity that was improper is shown by his awareness that Respondents affirmatively represented to FINRA that SHCP was not conducting a securities business. This is shown as well by the facts that SHCM sought to become registered and that White knew this would be a lengthy process, during which he did business through SHCP. As CEO, 80% owner, and founder of SHCH, the 100% owner of SHCP, White's secondary liability for SHCP's violation is attributed to SHCH, as well.

C. SHCM

The OIP charged SHCM with violating Exchange Act Section 17(a) and Rule 17a-3(a)(1), based on false information on its trade blotter; a net capital deficiency, in violation of Exchange Act Section 15(c)(3) and Rule 15c3-1; and failing to notify the Commission of the net capital deficiency in violation of Exchange Act Section 17(a) and Rule 17a-11(b)(1). The OIP charged White and SHCH with aiding and abetting and causing SHCM's violation of these provisions, except Rule 17a-3(a)(1).

1. Books and Records Provisions

***14** Section 17(a)(1) of the Exchange Act provides that brokers and dealers "shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest." 15 U.S.C. § 78q(a)(1). The requirement that records be kept embodies the requirement that they be accurate. *James F. Novak*, Exchange Act Release No. 19660, 1983 SEC LEXIS 2023, at *12 (Apr. 8, 1983).

The Commission has emphasized the importance of the records required by the record keeping rules as "the basic source documents and transaction records of a broker-dealer." *Statement Regarding the Maintenance of Current Books and Records by Brokers and Dealers*, Exchange Act Release No. 10756, 1974 SEC LEXIS 3290, at *3 (Apr. 26, 1974). The "recordkeeping rules are a keystone of the surveillance of brokers and dealers by [Commission] staff and by the securities industry's self-regulatory bodies." *Edward J. Mawod & Co.*, Exchange Act Release No. 13512, 1977 SEC LEXIS 1811, at *16 n.39 (May 6, 1977) (citation omitted), *aff'd*, 591 F.2d 588 (10th Cir. 1979). Scienter is not required to prove a violation of Section 17(a)(1) of the Exchange Act and the rules thereunder. *SEC v. Drexel Burnham Lambert Inc.,* 837 F. Supp. 587, 610 (S.D.N.Y. 1993), *aff'd sub nom. SEC v. Posner,* 16 F.3d 520 (2d Cir. 1994); *see Stead v. SEC,* 444 F.2d 713, 716-17 (10th Cir. 1971).

2. Blotter - Rule 17a-3(a)(1)

Rule 17a-3 requires brokers and dealers to make and keep current certain books and records, including blotters containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries, all receipts and disbursements of cash, and all other debits and credits (Rule 17a-3(a)(1)). [19] 17 C.F.R. § 240.17a-3(a)(1).

SHCM violated Section 17(a) of the Exchange Act and Rule 17a-3(a)(1) because its trade blotter incorrectly showed the March 1 purchase of the Gramercy Bond from Citi and the March 11 sale to Barclays as taking place on March 12. Additionally, SHCM's trade blotter incorrectly showed March 17 as the date of the purchase from Barclays and sale to Gramercy when the trade date of those transactions was March 16. White was heavily involved in these transactions - he negotiated the sale to Gramercy and was aware that Tedeschi had already purchased the bond from Barclays. Respondents' defense to the trade blotter violation is, essentially, that Rafferty's trade blotter is the only relevant trade blotter in that the traders involved were registered

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representatives of Rafferty and that SHCM piggybacked on Rafferty as introducing broker.[20] This argument is inconsistent with these facts: Tedeschi, the trader for the purchase from Citi and the sale to and purchase from Barclays, was also a registered representative of SHCM (as of February 26, 2010); Quinn, the trader for the sale to Gramercy, was a registered representative of SHCM and not of Rafferty; and the trade tickets reflected "Spring Hill" as the buyer from Citi and the seller to Barclays in the first transaction and the buyer from Barclays and seller to Gramercy in the second transaction. Indeed, if the argument were carried to its logical conclusion, there would be no point in SHCM's having become a registered broker-dealer. The record does not include any evidence, such as a written agreement, that places the responsibility for maintaining a trade blotter for SHCM's trades solely on Rafferty.

3. Net Capital - Exchange Act Section 15(c)(3) and Rule 15c3-1

15** Exchange Act Section 15(c)(3) requires the Commission to establish, and broker-dealers to comply with, minimum financial responsibility requirements. 15 U.S.C. § 78o***(c)(3). Those requirements are found in Exchange Act Rule 15c3-1, the net capital rule. 17 C.F.R. § 240. 15c3-1. As found above, SHCM's minimum net capital was $100,000, and during at least several hours on March 16, 2010, SHCM had negative net capital of at least $500,000. SHCM had not finalized the terms of the sale to Gramercy when it bought the bond from Barclays, even though White had a well-founded expectation that Gramercy would buy it. During those several hours, SHCM had bought the bond and did not yet have a firm order to sell it. The firm's capital was at risk during that time. Accordingly, SHCM violated Exchange Act Section 15(c)(3) and Rule 15c3-1.

4. Exchange Act Rule 17a-11(b)(1)

Exchange Act Rule 17a-11(b)(1) requires a broker-dealer whose net capital declines below the minimum required pursuant to the net capital rule, Rule 15c3-1, to notify the Commission on the same day. 17 C.F.R. § 240.17a-11(b)(1). SHCM did not inform the Commission of any net capital deficiency and thus violated Rule 17a-11(b)(1).

5. White and SHCH

White was involved in the Gramercy Bond transactions without which the net capital and reporting violations would not have occurred. He knew that SHCM had not finalized the terms of the sale to Gramercy when it bought the bond from Barclays, and this should have caused him to question the potential effect on SHCM's required minimum net capital. Nonetheless, there is no evidence in the record that shows that he had actual knowledge of SHCM's net capital on March 16, 2010, or participation in, or knowledge of, the failure to report SHCM's net capital deficiency. Therefore, in light of the Division's burden of proof, it is concluded that White did not aid and abet but did cause SHCM's violations, because he should have known that his conduct would contribute to the violations. As CEO, 80% owner, and founder of SHCH, the 100% owner of SHCM, White's secondary liability for SHCM's violation of the net capital and reporting rules is attributed to SHCH, as well. As noted above, White and SHCH stipulated that they aided and abetted and caused Rafferty's violation of Exchange Act Section 17(a) and Rule 17a-3(a)(1) in regard to the first Gramercy Bond trade.

IV. SANCTIONS

The Division requests cease-and-desist orders; disgorgement, jointly and severally by SHCP, SHCH, and White, of ill-gotten gains arising from violations of Exchange Act Section 15(a) in the amount of $3,953,608 plus prejudgment interest; civil penalties of $225,000, $725,000, $950,000, and $272,500 against SHCM, SHCP, SHCH, and White, respectively; and a censure of SHCM and an industry bar against White.

***16** As discussed below, the following will be ordered: cease-and-desist orders; disgorgement, jointly and severally by SHCP, SHCH, and White, of $3,953,608 plus prejudgment interest; civil penalties, jointly and severally, against SHCP, SHCH, and White of $75,000; civil penalties, jointly and severally, against SHCM, SHCH, and White of $7,500; and a censure of SHCM and White.

A. Sanction Considerations

In determining sanctions, the Commission considers such factors as:

> 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 defendant's recognition of the wrongful nature of his conduct, and the likelihood that the [respondent's] occupation will present opportunities for future violations.

Steadman, 603 F.2d 1126, 1140 (quoting *SEC v. Blatt,* 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)). The Commission also considers the age of the violation and the degree of harm to investors and the marketplace resulting from the violation. *Marshall E. Melton*, Exchange Act Release No. 48228, 2003 SEC LEXIS 1767, at *4-5 (July 25, 2003). Additionally, the Commission considers the extent to which the sanction will have a deterrent effect. *Schield Mgmt. Co*., Exchange Act Release No. 53201, 2006 SEC LEXIS 195, at *35-36 & n.46 (Jan. 31, 2006). As the Commission has often emphasized, the public interest determination extends to the public- atlarge, the welfare of investors as a class, and standards of conduct in the securities business generally. *See Christopher A. Lowry*, Investment Company Act of 1940 Release No. 2052, 2002 SEC LEXIS 2346, at *20 (Aug. 30, 2002), *aff'd*, 340 F.3d 501 (8th Cir. 2003); *Arthur Lipper Corp*., Exchange Act Release No. 11773, 1975 SEC LEXIS 527, at *52 (Oct. 24, 1975). The amount of a sanction depends on the facts of each case and the value of the sanction in preventing a recurrence. *See Leo Glassman*, Exchange Act Release No. 11929, 1975 SEC LEXIS 111, at *7 (Dec. 16, 1975).

B. Cease and Desist

Exchange Act Section 21C authorizes the Commission to issue a cease-and-desist order against a person who “is violating, has violated, or is about to violate” any provision of the Exchange Act or who “is, was, or would be a cause of the violation.” 15 U.S.C. § 78u-3(a). Whether there is a reasonable likelihood of such violations in the future must be considered. *KPMG*, 2001 SEC LEXIS 98, at *101. Such a showing is “significantly less than that required for an injunction.” *Id.* at *114. In determining whether a cease-and-desist order is appropriate, the Commission considers the *Steadman* factors quoted above, as well as the recency of the violation, the degree of harm to investors or the marketplace, and the combination of sanctions against the respondent. *See WHX Corp. v. SEC,* 362 F.3d 854, 859-61 (D.C. Cir. 2004); *KPMG*, 2001 SEC LEXIS 98, at *116.

***17** White and SHCH have acknowledged their secondary liability for Rafferty's violation of Exchange Act Section 17(a) and Rule 17a-3(a)(1) (inaccurate trade blotter related to the first Gramercy Bond transaction). Consistent with a vigorous defense of the charges against them, White, SHCH, SHCP, and SHCM have not otherwise affirmatively recognized the wrongful nature of their conduct or given assurances against future violations.

White, SHCH, and SHCP's conduct in operating SHCP as an unregistered broker-dealer was egregious and recurrent over a period of ten months. The violation was neither recent nor distant in time. While scienter is not an element of this violation, White, SHCH, and SHCP were at least reckless - their awareness that they were operating in a potentially violative manner is shown by their representation to FINRA that SHCP “does not conduct a securities business.” While White's and SHCH's occupations theoretically provide opportunity for future violations, SHCP has ceased business activity, and the motive for White and SHCH to operate an unregistered broker-dealer was removed with the registration of SHCM. Nonetheless, circumstances could change. There was no financial harm to investors and the marketplace, and the transactions that SHCP introduced (which involved major financial firms) were otherwise entirely legitimate. However, harm to the marketplace is evident from the flouting of the requirement that a broker-dealer be licensed. In light of the combination of sanctions against White, SHCH, and SHCP, a cease-and-desist order is appropriate.

The violations related to the Gramercy Bond transactions were serious but not recurrent - the recordkeeping violation occurred twice, and the net capital and reporting violation, once. While scienter is not an element of these violations, White and SHCH acknowledged aiding and abetting Rafferty's trade blotter violation concerning the first Gramercy Bond trade. Again, there was no actual harm to the marketplace, although, potentially, had SHCM failed to firm up a sell order to Gramercy, in the second transaction, it had insufficient capital to pay for the purchases. Again, White's, SHCM's, and SHCH's occupations provide opportunity for future violations.

Accordingly, a cease-and-desist order is appropriate against SHCP, SHCH, and White for the SHCP violations and against SHCM, SHCH, and White for the SHCM violations.

C. Disgorgement

Exchange Act Section 21C(e) authorizes disgorgement of ill-gotten gains, including reasonable interest, in cease-and-desist proceedings. 15 U.S.C. § 78u-3(e). Disgorgement of illgotten gains is "an equitable remedy designed to deprive a wrongdoer of his unjust enrichment and to deter others from violating the securities laws." *Montford & Co., Inc. v. SEC,* 793 F.3d 76, 84 (D.C. Cir. 2015) (quoting *SEC v. First City Fin. Corp*., 890 F.2d 1215, 1230 (D.C. Cir. 1989)).

***18** "When calculating disgorgement, 'separating legal from illegal profits exactly may at times be a near-impossible task."' *Id.* (quoting *First City Fin. Corp*., 890 F.2d at 1231). "Thus, 'disgorgement need only be a reasonable approximation of profits causally connected to the violation."' *Id.*; *see SEC v. First Pac. Bancorp,* 142 F.3d 1186, 1192 n.6 (9th Cir. 1998) (holding disgorgement amount only needs to be a reasonable approximation of ill-gotten gains); *accord First City Fin. Corp*., 890 F.2d at 1231-32; *Laurie Jones Canady*, Exchange Act Release No. 41250, 1999 SEC LEXIS 669, at *38 (Apr. 5, 1999) (quoting *SEC v. First Jersey Secs., Inc.,* 101 F.3d 1450, 1475 (2d Cir. 1996)), *pet. denied*, 230 F.3d 362 (D.C. Cir. 2000).

"[T]he power to order disgorgement extends only to the amount with interest by which the defendant profited from his wrongdoing. Any further sum would constitute a penalty assessment." *SEC v. ETS Payphones, Inc.,* 408 F.3d 727, 735 (11th Cir. 2005) (quotation omitted). However, "how a defendant chooses to spend his ill-gotten gains, whether it be for business expenses, personal use, or otherwise, is immaterial to disgorgement." *SEC v. Aerokinetic Energy Corp.,* 444 F. Appx. 382, 385 (11th Cir. 2011) (quotation omitted). Accordingly, "the overwhelming weight of authority holds that securities law violators may not offset their disgorgement liability with business expenses." *SEC v. Brown,* 658 F.3d 858, 861 (8th Cir. 2011) (quotation omitted).

SHCP received $3,953,608.61 in commissions from its operation as an unregistered broker-dealer; it ordered Rafferty to pay a portion of that amount directly to SHCP employees who were the registered representatives who arranged the transactions. In accord with precedent, neither the commissions paid directly to the SHCP employees, nor any other SHCP business expenses, will be omitted from the disgorgement total. Disgorgement of $3,953,608 will be ordered jointly and severally against SHCH, SHCP, and White in view of the common ownership among the Spring Hill entities, White's ultimate 80% ownership and leadership, and the flow of funds among the entities. *See, e.g., First Jersey Secs., Inc.*, 101 F.3d at 1475; *SEC v. Capital Solutions Monthly Income Fund, LP,* 28 F. Supp. 3d 887, 899 (D. Minn. 2014), *appeal pending*, No. 15-1072 (8th Cir.).

D. Civil Money Penalty

***19** Exchange Act Section 21B authorizes the Commission to impose civil money penalties against a person who violated, or was the cause of the violation of, any provision of the Exchange Act, or rules thereunder, where such penalties are in the public interest. 15 U.S.C. § 78u-2(a). In considering whether a penalty is in the public interest, the Commission may consider six factors: (1) fraud or deliberate or reckless disregard of a regulatory requirement; (2) harm to others; (3) unjust enrichment; (4) previous violations; (5) deterrence; and (6) such other matters as justice may require. *See* Section 21B(c) of the Exchange Act; *New Allied Dev. Corp.*, Exchange Act Release No. 37990, 1996 SEC LEXIS 3262, at *30 n.33 (Nov. 26, 1996); *First Sec. Transfer Sys., Inc.*, Exchange Act Release No. 36183, 1995 SEC LEXIS 2261, at *9 (Sept. 1, 1995); *see also Jay Houston*

Meadows, Exchange Act Release No. 37156, 1996 SEC LEXIS 1194, at *25-27 (May 1, 1996), *aff'd*, 119 F.3d 1219 (5th Cir. 1997); *Consol. Inv. Servs., Inc.*, Exchange Act Release No. 36687, 1996 SEC LEXIS 83, at *22-24 (Jan. 5, 1996).

Fraud, harm to others, and previous violations are absent from the instant case. However, the SHCP violation involved a reckless disregard of a regulatory requirement and resulted in unjust enrichment. Deterrence also requires penalties for both the SHCP and SHCM violations.

Penalties in addition to the other sanctions ordered are in the public interest. Pursuant to Exchange Act Section 21B(b)(1), for each violative act or omission after March 3, 2009, and before March 6, 2013, the maximum first-tier penalty is $7,500 for a natural person and $75,000 for any other person. 17 C.F.R. § 201.1004, Subpt. E, Table IV. A second-tier penalty is appropriate when a respondent's violative acts involved a deliberate or reckless disregard of a regulatory requirement. Exchange Act Section 21B(b)(2). Under that provision, for each violative act or omission during the same time period, the maximum second-tier penalty for each violation for a natural person is $75,000 and for any other person is $375,000. 17 C.F.R. § 201.1004, Subpt. E, Table IV.

The provisions, like most civil penalty statutes, leave the precise unit of violation undefined. *See* Colin S. Diver, *The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies*, 79 Colum. L. Rev. 1435, 1440-41 (1979).

The events at issue will be considered as two courses of action - SHCP's operations as an unregistered broker-dealer and the violations associated with SHCM's Gramercy Bond transactions. A second-tier civil penalty of $75,000 for the SHCP violation is appropriate because it involved a reckless disregard of a regulatory requirement. *See* Exchange Act Section 21B(b)(2). The penalty for the SHCP violation will be imposed jointly and severally on SHCP, SHCH, and White. A first-tier penalty of $7,500 for the SHCM violations is appropriate as aggravating factors are largely absent. It will be imposed jointly and severally on SHCM, SHCH, and White. Combined with the other sanctions ordered, these penalties are in the public interest.

E. Exchange Act Section 15(b)(4), (6) Sanctions

***20** The Division requests an industry bar against White and a censure of SHCM. A censure of SHCM is clearly in the public interest, in combination with the other sanctions ordered. However, a lesser sanction than a bar - a censure - is appropriate for White. No Commission opinion in a litigated administrative proceeding has imposed a bar on a respondent solely for operating as an unregistered broker-dealer.[21] Such a sanction is found where the respondent has also violated, or aided and abetted violation of, the antifraud provisions. *See David F. Bandimere*, Securities Act Release No. 9972, 2015 SEC LEXIS 4472 (Oct. 29, 2015) (violation of antifraud, broker-dealer registration, and securities registration provisions); *Maria T. Giesige*, Exchange Act Release No. 60000, 2009 SEC LEXIS 1756 (May 29, 2009); *Paul Carroll Ferguson*, Exchange Act Release No. 6009, 1959 SEC LEXIS 549 (July 7, 1959) (violation of antifraud, broker-dealer registration, and other provisions; respondent's registration as a brokerdealer revoked); *Gregory & Co., Inc.*, Exchange Act Release No. 5680, 1958 SEC LEXIS 251 (Apr. 18, 1958) (violation of antifraud, broker-dealer registration, and other provisions; respondent's application for registration as a broker-dealer denied); *The Whitehall Corp.*, Exchange Act Release No. 5667, 1958 SEC LEXIS 246 (Apr. 2, 1958) (violation of antifraud, broker-dealer registration, and other provisions; respondent's application for registration as a broker-dealer denied).

It is concluded above that White caused, but did not aid and abet, SHCM's net capital and reporting violations; White admitted that he aided and abetted and caused Rafferty's trade blotter violation. However, even had he aided and abetted all the violations, no Commission opinion in a litigated administrative proceeding has imposed a bar for violation of Exchange Act provisions and Commission rules regarding recordkeeping, net capital, and reporting. Rather, such a sanction is found where the respondent has also violated the antifraud provisions. *See Orlando Joseph Jett*, Securities Act Release No. 8395, 2004 SEC LEXIS 504 (Mar. 5, 2004) (violation of antifraud provisions; secondary liability for broker-dealer's violation of recordkeeping provisions); *Zion Capital Mgmt. LLC*, Securities Act Release No. 8345, 2003 SEC LEXIS 2939 (Dec. 11, 2003) (violation of antifraud and recordkeeping provisions); *David E. Lynch*, Exchange Act Release No. 46439, 2002 SEC LEXIS 3416 (Aug. 30, 2002) (violation of antifraud provisions, secondary liability for broker-dealer's violation of net capital and recordkeeping provisions);

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Abraham and Sons Capital, Inc., Exchange Act Release No. 44624, 2001 SEC LEXIS 2773 (July 31, 2001) (primary or secondary violation of antifraud, recordkeeping, and other provisions; bar with right to reapply in five years); *Marc N. Geman*, Exchange Act Release No. 43963, 2001 SEC LEXIS 282 (Feb. 14, 2001) (secondary liability for violation of the antifraud, recordkeeping, and other provisions; bar with right to reapply in three years).

***21** Even those few cases in which a respondent was suspended or barred in the absence of fraud involved conduct that was much more serious, long-running, and otherwise harmful to the markets than White's conduct. *See Russo Secs., Inc.*, Exchange Act Release No. 44186, 2001 SEC LEXIS 2771 (Apr. 17, 2001) (broker-dealer violated net capital and related recordkeeping and reporting provisions; chief financial officer suspended for one year; firm had included in its net capital calculations stock that it did not even have and that had no ready market; firm had negative net capital for three months); *Ronald S. Bloomfield*, Securities Act Release No. 9553, 2014 SEC LEXIS 698 (Feb. 27, 2014) (registered representatives sold large amounts of unregistered penny stocks from highly questionable customers, and manager failed reasonably to supervise them with a view toward detecting and preventing their registration violations; all aided and abetted and caused broker-dealer's failure to file Suspicious Activity Reports; registered representatives barred; manager barred with a right to reapply in a non-proprietary, non-supervisory capacity after two years).

Accordingly, in combination with the other sanctions ordered, a censure of White and of SHCM is in the public interest.

V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), it is certified that the record includes the items set forth in the revised record index issued by the Secretary of the Commission on November 27, 2015, as corrected herein. [22]

VI. ORDER ON MOTION FOR SUMMARY DISPOSITION

During the hearing the undersigned reserved ruling on Respondents' motion for summary disposition on the net capital charge, made at Tr. 1039-41. Based on the findings and conclusions set forth above:

IT IS ORDERED that Respondents' motion for summary disposition IS DENIED IN PART and GRANTED IN PART.

VII. ORDER

IT IS ORDERED that, pursuant to Section 21C of the Exchange Act, SPRING HILL CAPITAL PARTNERS, LLC, SPRING HILL CAPITAL HOLDINGS, LLC, and KEVIN D. WHITE CEASE AND DESIST from committing or causing any violations or future violations of Section 15(a) of the Exchange Act.

IT IS FURTHER ORDERED that, pursuant to Section 21C of the Exchange Act, SPRING HILL CAPITAL MARKETS, LLC, SPRING HILL CAPITAL HOLDINGS, LLC, and KEVIN D. WHITE CEASE AND DESIST from committing or causing any violations or future violations of Sections 15(c)(3) and 17(a) of the Exchange Act and Rules 15c3-1, 17a-3(a)(1), and 17a-11(b)(1) thereunder.

IT IS FURTHER ORDERED that, pursuant to Section 21C of the Exchange Act, SPRING HILL CAPITAL PARTNERS, LLC, SPRING HILL CAPITAL HOLDINGS, LLC, and KEVIN D. WHITE, JOINTLY AND SEVERALLY, DISGORGE $3,953,608 plus prejudgment interest at the rate established under Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), compounded quarterly, pursuant to 17 C.F.R. § 201.600(b). Pursuant to 17 C.F.R. § 201.600(a), prejudgment interest is due from April 1, 2010, through the last day of the month preceding which payment is made.

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***22** IT IS FURTHER ORDERED that, pursuant to Section 21B of the Exchange Act, SPRING HILL CAPITAL PARTNERS, LLC, SPRING HILL CAPITAL HOLDINGS, LLC, and KEVIN D. WHITE shall, JOINTLY AND SEVERALLY, PAY A CIVIL MONEY PENALTY OF $75,000, and SPRING HILL CAPITAL MARKETS, LLC, SPRING HILL CAPITAL HOLDINGS, LLC, and KEVIN D. WHITE shall, JOINTLY AND SEVERALLY, PAY A CIVIL MONEY PENALTY OF $7,500.

IT IS FURTHER ORDERED that, pursuant to Section 15(b) of the Exchange Act, SPRING HILL CAPITAL MARKETS, LLC IS CENSURED for violating Exchange Act Sections 15(c)(3) and 17(a) and Rules 15c3-1, 17a-3(a)(1), and 17a-11(b)(1) and KEVIN D. WHITE IS CENSURED for aiding and abetting SHCP's violation of Exchange Act Section 15(a) and Rafferty's violation of Exchange Act Section 17(a) and Rule 17a-3(a)(1).

Payment of disgorgement, prejudgment interest, and civil penalties shall be made no later than twenty-one days following the day this Initial Decision becomes final, unless the Commission directs otherwise. Payment shall be made in one of the following ways: (1) transmitted electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) direct payments from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or (3) by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order, payable to the Securities and Exchange Commission.

Any payment by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order shall include a cover letter identifying the Respondent[s] and Administrative Proceeding No. 3-16353, and shall be delivered to: Enterprises Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Bld., Oklahoma City, Oklahoma 73169. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then a party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

***23** Carol Fox Foelak
Administrative Law Judge

1 Citations to the transcript will be noted as "Tr. __." Citations to exhibits offered by the Division and by Respondents will be noted as "Div. Ex. __" and "Resp. Ex. __," respectively, and citations to the parties' May 6, 2015, Stipulations and May 11, 2015, Supplemental Stipulations will be noted as "Stip." and "Supp. Stip.," respectively.

2 The sole precedent to the contrary cited by Respondents is a U.S. District Court decision. *See* *SEC v. Graham,* 21 F. Supp. 3d 1300 (S.D. Fla. 2014), *appeal pending*, No. 14-13562 (11th. Cir.).

3 Recently, the Commission declared its non-acquiescence to the ruling of the U.S. Court of Appeals for the D.C. Circuit in the *Johnson* case that sanctions such as associational bars are subject to the statute of limitations. *Timbervest*, 2015 SEC LEXIS 3854, at *55 & n.71.

4 Reference to Bates numbers will omit leading zeros. Thus, "F000318" is noted as "F318."

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5 Official notice is taken of this and the other Financial Industry Regulatory Authority, Inc. (FINRA), records cited herein. *See Joseph S. Amundsen*, Exchange Act Release No. 69406, 2013 SEC LEXIS 1148, at *2 n.1 (Apr. 18, 2013), *pet. denied*, 575 F. App'x 1 (D.C. Cir. 2014).

6 *See* Kevin Donald White BrokerCheck Report, *available at*http://brokercheck.finra.org (last visited October 14, 2015). As CEO of SHCM, he could not be dually registered at Rafferty and at SHCM, although other registered representatives could be and were. Tr. 262.

7 An "introducing" (also called "correspondent") firm, such as Rafferty, sends its order tickets to its clearing (also called "carrying") firm, which clears and settles the transactions, provides computer support, and sends confirmations and account statements to the customers of the introducing firm. Tr. 967-68, 974.

8 When SHCM became a registered broker-dealer, it also had a piggyback arrangement with Rafferty. Div. Ex. 1 at F5. It continued the same 85%-15% revenue sharing. Div. Ex. 121. Rafferty and SHCM's Commission Sharing Agreement, dated July 19, 2010, "formalizes the revenue sharing terms under which [SHCM and Rafferty] will operate, and have been operating." *Id.* at SH-SEC982.

9 The entire April 28, 2009, "Services and Cost Sharing Agreement" is at Resp. Ex. 47 at RCML-SEC-1642-47.

10 Paul Tedeschi and Philip Bartow were associated as registered representatives of Rafferty from April 2009 to January 2014; John Fernando, from September 2009 to February 2010; and Patrick Quinn, from April 2009 to February 2010. *See* BrokerCheck Reports of Paul Tedeschi, Philip Bartow, John Chinniah Fernando, and Patrick Griffin Quinn, *available at* http://brokercheck.finra.org (last visited October 14, 2015). Typically, Tedeschi, Quinn, and Bartow executed trades for Spring Hill during 2009 and 2010. Tr. 816-17. Their trading commenced after they were registered with Rafferty. Tr. 848-50. There were no trades done by SHCP personnel prior to their becoming associated with Rafferty as registered representatives. Tr. 604-05. Rafferty provided authorized trader letters to their counterparties, stating that Rafferty authorized them to trade with the counterparties. Tr. 850-52; Resp. Ex. 26.

11 A Non-OSJ branch office would not be an office of supervisory jurisdiction and thus would have to fall under the supervision of a Rafferty office of supervisory jurisdiction. Tr. 1170.

12 Respondents dispute the characterization of these as "marketing" materials on the basis that the warning "**For Informational Purposes Only**" appeared on the title page of each, and none pitched a specific product. Resp. Reply at 5-6. This interpretation is rejected. The materials were clearly intended to interest the recipients in SHCP's services.

13 In explaining why Rafferty remitted $1,900,000 to SHCP for ""consulting" performed during January and February 2010, Spring Hill stated:

SHCP provided consultation and advice to Rafferty regarding significant capital markets transactions for clients of Rafferty and Rafferty and SHCP mutually agreed that compensation for the consultation and advice should be in the form of the referenced fixed fees. The facilitation of the transactions occurred through SHCP employees who were registered representatives of Rafferty and who were acting in their capacity as registered representatives of Rafferty.

Div. Ex. 178 at SH-SEC14315.

14 White downplayed his involvement in the decision to leave some funds at Rafferty. Tr. 406. However, Division Exhibit 130 shows his involvement. *See also* Tr. 139.

15 Tedeschi was also associated as a registered representative of SHCM. *See* Paul Tedeschi BrokerCheck Report, *available at* http://brokercheck.finra.org (last visited October 14, 2015) (showing Tedeschi as a registered representative of SHCM on and after February 26, 2010).

16 Versions of the blotter that Spring Hill provided to the Commission in 2011 showed the trade dates for both the purchase from Barclays and the sale to Gramercy as March 12. Div. Exs. 138, 138A, 173, 173A. The blotter that Spring Hill provided to FINRA in October 2012 showed March 11 as the trade date for the sale to Barclays. Div. Exs. 133, 133A.

17 At that time, Quinn was a registered representative of SHCM and not of Rafferty. *See* Patrick Griffin Quinn BrokerCheck Report, *available at* http://brokercheck.finra.org (last visited October 14, 2015) (showing Quinn's association as a registered representative of Rafferty ended in February 2010 and his association as a registered representative of SHCM started in February 2010).

18 To the extent that the expert's evidence does not lead to findings of fact, it will be summarized here and referred to as appropriate in the Conclusions of Law section of this Initial Decision.

19 Specifically, Rule 17a-3(a)(1) requires broker-dealers to make and keep current:
Blotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities, all receipts and deliveries of securities (including certificate numbers), all receipts and disbursements of cash and all other debits and credits. Such records shall show the account for which each such transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price (if any), the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered.

20 Respondents even argue that the Commission is estopped from ascribing a trade blotter violation to SHCM in light of the blotter violation ascribed to Rafferty in the Rafferty settlement, *Rafferty*, 2014 SEC LEXIS 1688, at ¶¶ 14-15. Respondents do not, however, explain why the inaccuracy of Rafferty's books and records (downstream from SHCM's) absolves SHCM from responsibility.

21 To the extent that the Division cites to settlements to support its request for a bar, it goes without saying that a settlement is not precedent, as the Commission has stressed many times. *See* *Richard J. Puccio*, Exchange Act Release No. 37849, 1996 SEC LEXIS 2987, at *10-11 (Oct. 22, 1996) (citing *David A. Gingras*, Exchange Act Release No. 31206, 1992 SEC LEXIS 2537, at *20 (Sept. 21, 1992), and cases cited therein); *Robert F. Lynch*, Exchange Act Release No. 11737, 1975 SEC LEXIS 599, at *12 n.17 (Oct. 15, 1975) (citing *Samuel H. Sloan*, Exchange Act Release No. 1376, 1975 SEC LEXIS 942, at *12 n.24 (Apr. 28, 1975); *Haight & Co., Inc.*, Exchange Act Release No. 9082, 1971 SEC LEXIS 436, at *67-69 (Feb. 19, 1971), *aff'd without opinion*, (D.C. Cir. 1971); *Security Planners Assocs., Inc.*, Exchange Act Release No. 9421, 1971 SEC LEXIS 1035, at *13-14 (Dec. 17, 1971)); *see also* *Mich. Dep't of Natural Res. v. FERC,* 96 F.3d 1482, 1490 (D.C. Cir. 1996), and cases cited therein (settlements are not precedent). Indeed, Commission settlement orders contain a disclaimer to this effect: “The findings herein are made pursuant to [Respondent's] Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.”

22 Division Exhibit 196, listed as pending in the record index, will not be admitted.

Release No. 919 (S.E.C. Release No.), 112 S.E.C. Docket 6264, Release No. ID - 919, 2015 WL 7730856

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873 F.3d 297
United States Court of Appeals,
District of Columbia Circuit.

John M.E. SAAD, Petitioner
v.
SECURITIES AND EXCHANGE COMMISSION, Respondent

No. 15-1430
|
Argued March 16, 2017
|
Decided October 13, 2017

Synopsis
Background: Broker-dealer who, based on violations of professional rules of conduct, had been permanently barred from registration with Financial Industry Regulatory Authority (FINRA) and from working with any of its affiliated members, petitioned for review of order of the Securities and Exchange Commission sustaining the disciplinary action.

Holdings: The Court of Appeals, Millett, Circuit Judge, held that:

mitigating and aggravating factors were appropriately considered, but

issue of whether lifetime ban was punitive, rather than remedial, required remand for Commission to determine in the first instance.

Petition denied in part and remanded in part.

Kavanaugh, Circuit Judge, concurred and filed opinion.

Millett, Circuit Judge, concurred dubitante and filed opinion.

***298** On Petition for Review of an Order of the Securities & Exchange Commission

Attorneys and Law Firms

Sara E. Kropf, Washington, DC, argued the cause for petitioner. With her on the briefs was Steven Nathan Berk.

Dina B. Mishra, Attorney, U.S. Securities and Exchange Commission, argued the cause for respondent. On the brief were Anne K. Small, General Counsel at the time the brief was filed, Sanket J. Bulsara, Deputy General Counsel at the time the brief was filed, John W. Avery, Deputy Solicitor, and Christopher Paik, Special Counsel.

Before: Garland, Chief Judge, and Kavanaugh and Millett, Circuit Judges.

Opinion

Concurring opinion filed by Circuit Judge Kavanaugh.

Dubitante opinion filed by Circuit Judge Millett with respect to Section II.B of the opinion.

Millett, Circuit Judge:

****10** John M.E. Saad, a broker-dealer, unlawfully misappropriated his employer's funds on two separate occasions, and then spent the next seven months misleading investigators in an effort to cover up his wrongdoing. After a lengthy review process, the Securities and Exchange Commission sustained a decision of the Financial Industry Regulatory Authority ("FINRA") permanently barring Saad from membership and from working with any of its affiliated members. Saad challenges the Commission's decision as insufficiently attentive to mitigating factors and argues that the permanent bar is impermissibly punitive rather than remedial. We hold that the Commission reasonably grounded its decision in the record, which extensively evidenced ***299 **11** Saad's acts of misappropriation, his prolonged efforts to cover his tracks through falsehoods, and his repeated and deliberate obstruction of investigators. With respect to the permanent bar on Saad's registration with FINRA and affiliation with its members, the court remands for the Commission to determine in the first instance whether *Kokesh v. SEC*, ––– U.S. ––––, 137 S.Ct. 1635, 198 L.Ed.2d 86 (2017), has any bearing on Saad's case. Accordingly, Saad's petition for review is denied in part and remanded to the Commission in part.

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I

A

FINRA is a private self-regulatory organization that oversees the securities industry, including broker-dealers. *Saad v. SEC*, 718 F.3d 904, 907 (D.C. Cir. 2013); *see**Public Investors Arbitration Bar Ass'n v. SEC*, 771 F.3d 1, 2 (D.C. Cir. 2014). As part of its industry oversight, FINRA sets professional rules of conduct for its members. *See**Saad*, 718 F.3d at 907; *see also*15 U.S.C. § 78*o*–3(b)(2). One such rule—FINRA Rule 2010—requires "[a] member, in the conduct of its business, [to] observe high standards of commercial honor and just and equitable principles of trade."FINANCIAL INDUSTRY REGULATORY AUTHORITY, FINRA MANUAL, FINRA RULES, Rule 2010. [1] The high ethical standards enforced by Rule 2010 are vital because "customers and firms must be able to trust securities professionals with their money." J.A. 111–112. Trustworthiness and integrity thus are essential to the functioning of the securities industry.

1 http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=607.

FINRA has developed "Sanction Guidelines," which elaborate upon the contours of its rules of conduct. As relevant here, the Guidelines provide that conversion and the improper use of funds or securities will violate Rule 2010. J.A. 93. Conversion is defined as "an intentional and unauthorized taking of and/or exercise of ownership over property by one who neither owns the property nor is entitled to possess it." *Id*. In cases of conversion, the Sanction Guidelines provide that "a [lifetime] bar is standard," "regardless of [the] amount converted." *Id*.

In determining the appropriate sanction to be imposed for a violation of its rules, FINRA's Guidelines outline eight factors to be considered: (i) the need for the sanction to be remedial, to deter future misconduct, and to improve business standards in the securities industry, (ii) the violator's status as a repeat or one-time violator, (iii) the appropriateness of the sanction for the specific misconduct, (iv) the need in a particular case either to aggregate or to sanction individually similar violations, (v) the appropriateness of restitution or rescission, (vi) the remediation needed to ensure the individual does not benefit from ill-gotten gains, (vii) the necessity of requalification before permitting continued participation in the securities industry, and (viii) the violator's ability to pay any fine or restitution. J.A. 87–90.

In addition to those general principles, FINRA adjudicators must consider any other mitigating or aggravating factors. J.A. 91. FINRA's Sanction Guidelines provide a non-exhaustive list of nineteen potential aggravating or mitigating factors, including whether the violator (i) accepts responsibility for the misconduct, (ii) took voluntary corrective action prior to detection, (iii) engaged in a pattern of misconduct, (iv) perpetrated the misconduct over an extended period of time, (v) attempted ***300 **12** to conceal the misconduct, (vi) acted intentionally, or (vii) was already disciplined by the FINRA member firm. J.A. 91–92.

The disciplinary process begins when FINRA's Department of Enforcement or Department of Market Regulation files a complaint with the FINRA Office of Hearing Officers. FINRA Rule 9211. A panel of hearing officers then conducts a disciplinary proceeding, FINRA Rule 9213, and issues a final written decision addressing both liability and remedial sanctions, FINRA Rule 9268.

Either FINRA or the violator may appeal to the National Adjudicatory Council, FINRA Rule 9311, which "may affirm, modify, reverse, increase, or reduce any sanction, or impose any other fitting sanction," FINRA Rule 9349(a). The Council then provides a proposed decision to the FINRA Board. FINRA Rule 9349(c). If no Board member calls for review of the Council's decision, it becomes final. *Id.*

The violator may then seek review of FINRA's decision by the Securities and Exchange Commission, FINRA Rule 9370, which superintends the disciplinary decisions of financial industry self-regulatory organizations like FINRA, 15 U.S.C. § 78s(d)–(e). The Commission conducts its own review of the disciplinary action, and may modify, affirm, or set aside the sanction. *Id.* § 78s(e)(1)(A)–(B). The Commission will set a remedial order aside if the order "imposes any burden on competition not necessary or appropriate" to further the purposes of the Securities Exchange Act, or if the sanction "is excessive or oppressive." *Id.* § 78s(e)(2).

B

1

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John Saad was a regional director in the Atlanta Office of Penn Mutual Life Insurance Company, and was a FINRA-registered broker-dealer employed by Penn Mutual's affiliate Hornor, Townsend, & Kent, Inc. *Saad*, 718 F.3d at 906. Hornor, Townsend, & Kent, Inc. is a FINRA member firm. *Id.*

In July 2006, Saad scheduled a business trip from Atlanta, Georgia, to Memphis, Tennessee, but the trip was canceled at the last minute. *Saad*, 718 F.3d at 908; *see also* J.A. 107. Instead of going home to his wife and infant twins, Saad checked into an Atlanta hotel for two days. *Saad*, 718 F.3d at 908. Upon returning to his office, Saad submitted a false expense report for air travel to Memphis and a two-night stay in a Memphis hotel. *Id.* Attached to that false expense report were forged receipts for the fictitious airfare and hotel. *Id.*

Unconnected to the fabricated Memphis trip, Saad submitted another false expense report to his firm for a replacement cellphone. *Saad*, 718 F.3d at 908. Contrary to his representation in the expense report, Saad did not replace his own cellphone but instead purchased the cellphone for a female insurance agent at another firm. *Id.*; *see also* J.A. 62.

Saad's misconduct was soon discovered by an administrator in the Atlanta office of his firm because Saad submitted for reimbursement a receipt for four drinks purchased at an Atlanta hotel lounge on the same date that he was supposedly in Memphis. *Saad*, 718 F.3d at 908. When the administrator confronted him with the receipt, Saad grabbed the receipt and threw it away. *Id.* The administrator retrieved the receipt and sent it to Penn Mutual's home office. *Id.* In September 2006, Saad's employment was terminated. *Id.*

After Saad's termination, investigators from the National Association of Securities Dealers ("NASD")—FINRA's predecessor—questioned him about the false expense reports. *Saad*, 718 F.3d at 908. In a ***301 **13** November 2006 email, Saad falsely told investigators that the fabricated trip report was "for a business trip that had yet to occur[.]" *Id.* Five months later, in April 2007, Saad falsely stated to investigators that he did not know the person for whom he had purchased the cellphone. *Id.* The next month, Saad untruthfully told examiners that he could not remember if he had purchased a plane ticket for the fabricated Memphis trip. *Id.*

In September 2007, FINRA brought a disciplinary proceeding against Saad alleging "Conversion of Funds" in violation of FINRA Rule 2010. *Saad*, 718 F.3d at 908. [2] The hearing panel found that Saad had violated Rule 2010. Saad, in his own defense, explained that he had been experiencing significant personal and professional stress at the time he submitted the false expense reports because his sales had declined and one of Saad's one-year old twins was suffering from a stomach disorder that required frequent hospitalizations. *Id.* The hearing panel imposed a bar that permanently forbade Saad from associating with any FINRA member firm in any capacity. *Id.* at 909.

2 Saad was initially investigated for and charged with violating National Association of Securities Dealers Rule 2110. *See Saad*, 718 F.3d at 909. NASD Rule 2110 is identical to FINRA Rule 2010. *Id.* at 907; *see also*FINANCIAL INDUSTRY REGULATORY AUTHORITY, FINRA MANUAL, NASD RULES, Rule 2110, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=605 ("A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."). At the time Saad's disciplinary proceeding was formally initiated in September 2007, the SEC had "approved the consolidation of NASD with certain functions of the New York Stock Exchange to create" FINRA. *Saad*, 718 F.3d at 907.

Saad appealed, and the National Adjudicatory Council affirmed. *Saad*, 718 F.3d at 909. In reviewing the lifetime ban, the Council concluded that Saad's misconduct involved several aggravating factors, such as "the intentional and ongoing nature of Saad's misconduct, Saad's efforts to deceive [Hornor, Townsend, & Kent] and Penn Mutual, [and] Saad's initial instinct to conceal the extent of his actions from state and FINRA examiners."*Id.* at 909 (second alteration in original and citation omitted). The Council further determined that no mitigating factors counseled a lesser sanction. *Id.*

The Securities and Exchange Commission affirmed, holding that, on this record, FINRA's sanction was not "excessive or oppressive." *Saad*, 718 F.3d at 909.

This court granted Saad's petition for review in part. We upheld the Commission's use of the Sanction Guideline governing conversion as a "starting point" for determining the appropriate sanction for Saad's two acts of misappropriation. *Saad*, 718 F.3d at 911. We remanded only because the Commission's analysis failed to address potentially mitigating factors, such as Saad's termination by his employer and Saad's

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personal and professional stress. *Id.* at 913. We left open the question whether the lifetime bar was an "excessive or oppressive" sanction, noting that the Commission had an obligation on remand to ensure its sanction was remedial rather than punitive. *Id.*

2

On remand, the Commission directed the National Adjudicatory Council to reconsider the imposition of the lifetime bar and, in particular, to address whether (i) a member firm's discipline of a rule violator prior to regulatory detection is a mitigating factor for the alleged violator, the member firm, or both, J.A. 36; (ii) the mitigating effect, if any, of Saad's termination ***302 **14** prior to regulatory detection, J.A. 38; (iii) the mitigating effect, if any, of Saad's personal and professional stress, J.A. 39; (iv) any other mitigating considerations, J.A. 45; and (v) the appropriateness of the lifetime bar for Saad's misconduct, J.A. 49.

The Council determined that (i) prior discipline by a member firm may be mitigating for an individual violator, J.A. 37–38; (ii) Saad's termination prior to regulatory detection was not mitigating on this record, J.A. 39; (iii) neither Saad's personal nor his professional stress was mitigating, J.A. 43–45; (iv) no other relevant mitigating factors existed in the case, J.A. 45–49; and (v) a permanent bar remained the appropriate remedy for Saad's misconduct, J.A. 49–50.

The Commission again affirmed. The Commission determined that Saad's repeated attempts over the course of seven months to conceal his misconduct from his employer and to mislead regulatory investigators were aggravating factors that supported FINRA's imposition of the permanent bar. J.A. 112. The Commission further concluded that the " 'collateral consequences' of misconduct, including loss of employment, reputation, and income, [were] not mitigating" on the facts of this case because they provided " 'no guarantee of changed behavior' and may not be enough to overcome [the Commission's] concern that he * * * 'poses a continuing danger to investors and other security industry participants (including would-be employers).' " J.A. 112–113 (quoting *Denise M. Olson*, Exchange Act Release No. 75838, 2015 WL 5172954, at *5 (Sept. 3, 2015)). The Commission also decided that, "under these circumstances," Saad's claims of professional and personal stress were not mitigating because his misconduct involved multiple instances of deliberate and deceptive conduct spread out over a long period of time, rather than a spontaneous or "unthinking" action triggered by stress and "later redressed." J.A. 113. The Commission found no mitigating value in Saad's arguments that his misconduct was "a series of blunders," his misappropriation did not involve customer funds, and he had a clean disciplinary record before his misappropriation. J.A. 114. Finally, the Commission reasoned that a permanent bar was the appropriate remedy in Saad's case because it "serves important deterrent objectives and reaffirms long-standing FINRA policy that such dishonesty by members or their associated persons will not be tolerated." J.A. 115. Accordingly, the Commission affirmed the permanent bar finding it to be "remedial, not punitive," and "necessary to protect FINRA members, their customers, and other securities industry participants[.]" J.A. 115.

II

We defer to the Commission's sanction decision if it is reasonable and reasonably explained, and will overturn it only if it is "arbitrary, capricious, or an abuse of discretion." *Saad*, 718 F.3d at 910 (quoting *Siegel v. SEC*, 592 F.3d 147, 155 (D.C. Cir. 2010)).

A

This court's prior decision remanded for the Commission to address Saad's mitigating evidence. *Saad*, 718 F.3d at 913–914. Saad now contends that the Commission failed to give his mitigating evidence sufficient heed. We disagree. The Commission reasonably balanced the relevant mitigating and aggravating factors before determining that the gravity of Saad's behavior warranted remedial action.

First, with respect to the mitigating relevance of Saad's termination by his employer for misconduct, the Commission ***303 **15** recognized that a FINRA Sanction Guideline provides that disciplinary action prior to regulatory detection may be considered mitigating. J.A. 112–113 (noting FINRA Principal Consideration in Determining Sanctions #14). But the Commission explained that his termination carried little weight in this case because "Saad repeatedly used dishonest means to overcome personal and professional disappointments and obstacles, and to mislead his employer and regulators." J.A. 113. Given those facts, the Commission reasonably concluded that "termination, while mitigating under certain circumstances, [did not] overcom[e] the threat

[Saad] would pose to investors and other securities industry participants were he to return to the industry." J.A. 113.

Second, the Commission credited Saad's claims of personal and professional stress. The Commission nevertheless found them to lack mitigating force in this case because Saad's conduct was not a momentary or impulsive action driven by stress, but instead involved "deceptive conduct demonstrat[ing] a high degree of intentionality over a long period of time." J.A. 113. The Commission found it particularly significant that (i) Saad had not discussed the professional setbacks he was undergoing with his firm or otherwise sought assistance; (ii) his deception required planning and research; and (iii) he "methodically forg[ed] hotel and airfare receipts that bore logos that he had copied from the internet." J.A. 113. In addition, the Commission stressed that Saad did not own up to his missteps when the firm administrator confronted him about the fabricated expense report, but instead tried to destroy the evidence and repeatedly misled investigators for at least seven more months. J.A. 114. On top of that, Saad engaged in a second act of misappropriation by using firm funds to purchase a cellphone for a person who worked at another firm. J.A. 114. The Commission reasonably concluded that a pattern of such prolonged and repeated misbehavior could not be attributed to stress. J.A. 114.

Third, the Commission fairly addressed Saad's arguments that his misconduct did not involve the misappropriation of *customer* funds, and that he otherwise had a clean disciplinary record. J.A. 114. The Commission explained that it had not differentiated between the source of mistreated funds in the past, upholding bars even though "the underlying dishonesty did not relate directly to customers." J.A. 114; *see also* J.A. 114 n.24 (citing disciplinary proceedings involving misappropriation of non-customer funds). That makes sense. As the Commission previously has explained, it is the deception and fraud in the handling of others' property that endangers the integrity of the securities industry, and that threat remains the same whether the victim is a trusting employer or trusting client. *See* *Richard Dale Grafman*, Exchange Act Release No. 21648, 1985 WL 548687, at *2 (Jan. 14, 1985) (upholding a sanction even though the conduct did not involve public customers because "[t]he securities business presents a great many opportunities for abuse and overreaching, and depends very heavily on the integrity of its participants").

The Commission further noted that it has "repeatedly held that a clean disciplinary record is not mitigating." J.A. 114; *see also* J.A. 114 n.25 (citing a disciplinary proceeding holding that the lack of a disciplinary history is not mitigating); J.A. 91 n.1 (FINRA Sanction Guidelines manual, citing *Rooms v. SEC*, 444 F.3d 1208, 1214–1215 (10th Cir. 2006), for the proposition that disciplinary history can serve only as an aggravating factor and its absence cannot be mitigating). There is nothing unreasonable about the Commission concluding that individuals in a profession that depends ***304 **16** critically on public trust and honesty are already expected to have a clean record, so it is not something for which they get extra credit. *See**Rooms*, 444 F.3d at 1214 (noting that the violator "was required to comply with NASD's high standards of conduct at all times"); *see also**World Trade Fin. Corp.*, Exchange Act Release No. 66114, 2012 WL 32121, at *16 (Jan. 6, 2012) ("[F]irms and their associated persons should not be rewarded for acting in accordance with their duties.").

Accordingly, we hold that the Commission's thoroughgoing decision directly addressed the mitigating evidence, as required by our prior remand order, and provided a careful and comprehensive analysis of Saad's arguments seeking a reduction in his sanction. Its decision reasonably focused on the record of Saad's prolonged pattern of falsehoods and deception, as well as the direct threat that his misconduct posed to customers' and other participants' faith in the integrity of the securities industry.

B

Saad also challenges the Commission's affirmance of FINRA's lifetime bar on his affiliation with FINRA and its members as impermissibly punitive. We remand that question to the Commission to address, in the first instance, the relevance—if any—of the Supreme Court's recent decision in *Kokesh v. SEC*, ––– U.S. ––––, 137 S.Ct. 1635, 198 L.Ed.2d 86 (2017). Accordingly, Saad's petition for review is denied in part and remanded to the Commission in part.

So ordered.

Kavanaugh, Circuit Judge, concurring:
I add this brief concurrence to explain why I believe the Court is correct to remand this case to the SEC.

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Our precedents say that the SEC may approve expulsion or suspension of a securities broker as a remedy, but not as a penalty. Our cases in turn have upheld various expulsions or suspensions as remedial. *See, e.g.*, *PAZ Securities, Inc. v. SEC*, 566 F.3d 1172, 1175–76 (D.C. Cir. 2009). Our use of the term "remedial" to describe expulsions or suspensions finds its roots in a single, unexplained sentence in a 77-year-old Second Circuit case. *SeeWright v. SEC*, 112 F.2d 89, 94 (2d Cir. 1940). Applying those precedents here, the SEC concluded that the lifetime expulsion of Saad from the securities industry was permissible because the sanction was remedial, not punitive.

My fundamental problem with this line of cases is that the term "remedial" makes little sense when describing the expulsion or suspension of a securities broker. Like other punitive sanctions, expulsion and suspension may deter others and will necessarily deter and prevent the wrongdoer from further wrongdoing. Expulsion and suspension may thereby protect the investing public. But expulsion and suspension do not provide a remedy to the victim. Under any common understanding of the term "remedial," expulsion and suspension of a securities broker are not remedial. Rather, expulsion and suspension are punitive.

Of course, as a three-judge panel, we ordinarily must stick with our precedents. But here, the Supreme Court's recent decision in *Kokesh v. SEC*, ––– U.S. ––––, 137 S.Ct. 1635, 198 L.Ed.2d 86 (2017), means that we can no longer characterize an expulsion or suspension as remedial. After the Supreme Court's decision in *Kokesh*, in other words, our precedents characterizing expulsions or suspensions as remedial are no longer good law.

In *Kokesh*, the Supreme Court ruled that disgorgement paid to the Government ***305 **17** is a "penalty" subject to the five-year statute of limitations in 28 U.S.C. § 2462. 137 S.Ct. at 1643–45. The Court reasoned that the disgorged money often does not go to victims and, moreover, is not limited to the amount of harm to victims—both of which would be required if the sanction were truly remedial rather than punitive. *See id.* at 1644–45. The Court stated: "Sanctions imposed for the purpose of deterring infractions of public laws are inherently punitive because deterrence is not a legitimate nonpunitive governmental objective." *Id.* at 1643 (internal quotations omitted). And the Court added: "A civil sanction that cannot fairly be said *solely* to serve a remedial purpose, but rather can only be explained as also serving either retributive or deterrent purposes, is punishment, as we have come to understand the term." *Id.* at 1645 (internal quotations omitted). Notably, the Supreme Court's decision in *Kokesh* overturned a line of cases from this Court that had concluded that disgorgement was remedial and not punitive. *See, e.g.*, *Zacharias v. SEC*, 569 F.3d 458, 471–72 (D.C. Cir. 2009).

As I see it, the *Kokesh* analysis matters here. The Supreme Court's reasoning in *Kokesh* was not limited to the specific statute at issue there. Like disgorgement paid to the Government, expulsion or suspension of a securities broker does not provide anything to the victims to make them whole or to remedy their losses. Therefore, in light of the Supreme Court's analysis in *Kokesh*, expulsion or suspension of a securities broker is a penalty, not a remedy.

Judge Millett's separate opinion cites cases such as *Smith v. Doe*, 538 U.S. 84, 123 S.Ct. 1140, 155 L.Ed.2d 164 (2003), for the proposition that occupational debarments are not punitive. But the question in *Smith v. Doe*, for example, was whether a particular sanction (there, required registration as a sex offender) was civil or criminal for purposes of the Ex Post Facto Clause. Some penalties are civil, and some penalties are criminal. The question of whether a penalty is civil or criminal is distinct from (although overlapping with) the question of whether a sanction is a penalty rather than a remedy. *See* *Hudson v. United States*, 522 U.S. 93, 105, 118 S.Ct. 488, 139 L.Ed.2d 450 (1997) (civil penalty at issue there was not "criminally punitive" for double jeopardy purposes). As I read it, nothing in *Smith v. Doe* or any of the other Supreme Court cases cited by Judge Millett's separate opinion says or suggests that occupational debarment is a remedy.

Judge Millett's separate opinion also states that Saad forfeited any argument that the sanction here was punitive, not remedial. I respectfully disagree. Saad expressly argued both to the SEC and to this Court that the lifetime expulsion in his case was punitive, not remedial. He of course did not cite *Kokesh* because *Kokesh* was not yet decided at the time. In my view, Saad preserved the argument that the sanction imposed on him was a penalty, not a remedy.

Judge Millett's separate opinion distinguishes this case from ordinary civil penalty cases by relying on FINRA's status as a self-regulatory organization. But by statute, FINRA is heavily regulated by the SEC, and a FINRA-sanctioned party has a right to appeal FINRA sanctions to the SEC. *See*15 U.S.C. § 78s; 78s(d).[1] FINRA ***306 **18** is therefore not akin to, for example, a state bar association or the National Football

League—organizations that may impose discipline without statutorily required review by a federal agency.

1 "In their review of disciplinary orders, the federal courts of appeals do not distinguish between SEC orders that affirm FINRA disciplinary sanctions and SEC orders that affirm sanctions imposed through the SEC's administrative hearing system; both are considered SEC orders. Accordingly, parties rarely raise the objection that FINRA is not a government body, and if the objection is raised, courts quickly dispense with it." Barbara Black, *PunishingBad Brokers: Self–Regulation and FINRA Sanctions*, 8 BROOK. J. CORP., FIN. & COMM. L. 23, 41–42 (2013).

In appeals from FINRA sanctions, the SEC must determine whether the FINRA-imposed sanctions are "excessive or oppressive." 15 U.S.C. § 78s(e)(2). Our pre-*Kokesh* cases in turn say that the SEC may uphold FINRA sanctions as not being excessive or oppressive if the sanctions are remedial, not punitive. *See**Siegel v. SEC*, 592 F.3d 147 (D.C. Cir. 2010); *Paz*, 566 F.3d at 1175–76. And our pre-*Kokesh* cases further say that an expulsion or suspension can be considered remedial, not punitive.

My sole point here is to cast doubt on our pre-*Kokesh* cases' characterization of an expulsion or suspension as remedial rather than punitive. My point is not to suggest that FINRA lacks power to impose punitive sanctions such as expulsions or suspensions. After all, FINRA Rule 8310 expressly allows FINRA to impose expulsions and suspensions in appropriate cases. *See also*15 U.S.C. § 78***o***-3(b)(7) (authorizing FINRA to impose expulsions or suspensions). And the SEC may still approve an expulsion or suspension if such a FINRA-imposed sanction is an appropriate (that is, not "excessive or oppressive") penalty in particular cases. The question here therefore is whether the lifetime expulsion of Saad—what our prior opinion in this case called the "securities industry equivalent of capital punishment," *Saad v. SEC*, 718 F.3d 904, 906 (D.C. Cir. 2013)—was a permissible and appropriate penalty under the relevant statutes and regulations.

If FINRA and the SEC can still impose expulsions and suspensions in certain cases, why does the terminological distinction matter? In other words, why should we care that FINRA and the SEC must characterize certain sanctions as punitive rather than remedial? One answer is this: If FINRA and the SEC must justify expulsions or suspensions as punitive (as I believe they must after *Kokesh*), they will have to explain why such penalties are appropriate under the facts of each case. FINRA and the SEC will no longer be able to simply wave the "remedial card" and thereby evade meaningful judicial review of harsh sanctions they impose on specific defendants. Rather, FINRA and the SEC will have to reasonably explain in each individual case why an expulsion or suspension serves the purposes of punishment and is not excessive or oppressive. Over time, a fairer, more equitable, and less arbitrary system of FINRA and SEC sanctions should ensue. *Cf.*18 U.S.C. § 3553(a).[2]

2 Judge Millett's separate opinion suggests that the SEC on remand should not and, indeed, may not change its approach to this issue in the wake of *Kokesh*. To state the obvious, her separate opinion speaks for only one judge, as does my separate opinion. If a majority of the panel agreed with all of the sentiments expressed in Judge Millett's separate opinion, we presumably would not be remanding the case. If a majority of the panel agreed with all of the sentiments expressed in my separate opinion, we presumably would be remanding the case with specific directions about *Kokesh*. Instead, the Court is remanding for the SEC, in the first instance, to address the relevance of *Kokesh*. The *Kokesh* issue remains undecided for now in this Court.

With those observations, I join the Court's decision to remand the case to the SEC for the Commission to address in the first instance whether, in light of *Kokesh*, ***307 **19** the penalty imposed on Saad was excessive or oppressive.

Millett, Circuit Judge, dubitante regarding Part II.B:
I have grave doubts about the propriety of remanding this case to the Commission yet again. This time, the remand seeks the Commission's views on the relevance—if there is any at all—of *Kokesh v. SEC*, ––– U.S. ––––, 137 S.Ct. 1635, 198 L.Ed.2d 86 (2017). But in my view, the Commission amply explained the remedial reasons for sustaining FINRA's permanent bar on Saad's affiliation with it and its members, and there is nothing in *Kokesh* that helps Saad. That presumably is why Saad himself has not whispered a word to this court about *Kokesh* having any bearing upon his case. Not one word. Accordingly, adding another round to this already decade-long saga does not seem worth the candle. Nor does further delay seem fair to FINRA's efforts to protect the integrity of the securities industry from securities brokers who exploit and abuse the trust of their employers and the investing public.

In my view, the Commission did exactly what our earlier decision flagged for remand: It addressed Saad's mitigating evidence and quite reasonably concluded that FINRA's permanent bar on Saad's affiliation with its members is remedial, rather than "excessive or oppressive," 15 U.S.C. § 78s(e)(2). The Commission's affirmance of FINRA's decision about how best to deal with Saad's pattern of serious professional misconduct echoes the Supreme Court's recognition of "how essential it is that the highest ethical standards prevail in every facet of the securities industry." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186–187, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963) (quotation omitted); *see Kokesh*, 137 S.Ct. at 1640 n.1.

In addition, in imposing Saad's bar, FINRA hewed to the remedy its Sanction Guidelines recommend, which we previously held FINRA could properly extend to this case. *See Saad v. SEC*, 718 F.3d 904, 911 (D.C. Cir. 2013) (upholding FINRA's reliance on the Sanction Guideline for conversion or improper use because "misappropriation is doubtless analogous to conversion") (internal quotation marks and citation omitted). That Sanction Guideline reflects a deliberate and objective assessment of the type of remedy needed to protect the securities industry and the investing public from misconduct involving mendacity and the misuse of entrusted property—misdeeds that strike at the heart of the investing public's trust in the securities industry. FINRA's evenhanded application of that prescribed remedy supports the sanction's remedial character.

As the Commission also explained, FINRA's determination in this case to permanently bar Saad from registering with FINRA or affiliating with its members was tailored to the individual circumstances of his case and Saad's serious and serial misconduct. In addition to two separate acts of misappropriating property entrusted to him—the fabricated Memphis trip and the abusive use of employer funds to purchase a cellphone for someone else—Saad forged documents, attempted to hide evidence of his misconduct after it was discovered by the Atlanta administrator, and deliberately deceived and misled regulators for more than half a year as they investigated his misconduct. The Commission thus had an adequate factual foundation to sustain FINRA's judgment that "Saad's actions betray a dishonest character * * * [and] demonstrate that he cannot be entrusted with firm or customer money[.]" J.A. 115. In an industry the functioning of which is predicated on the public trust, "[c]haracter is as important a ***308 **20** qualification as knowledge[.]" *Hawker v. New York*, 170 U.S. 189, 191, 18 S.Ct. 573, 42 L.Ed. 1002 (1898). For the same reason, the Commission reasonably concluded that Saad "would pose a continuing and unacceptable threat to investors and other industry participants if not barred." J.A. 115; *see Kokesh*, 137 S.Ct. at 1640 n.1 (emphasizing the need to "achiev[e] a high standard of business ethics in the securities industry") (quoting *Capital Gains Research Bureau*, 375 U.S. at 186, 84 S.Ct. 275).

Given all of that, *Kokesh* is of no help to Saad. *Kokesh* held only that "[d]isgorgement" ordered by the Commission in "enforcement proceedings" prosecuted by the Commission itself to punish violations of "public law" "operates as a penalty under [28 U.S.C.] § 2462," 137 S.Ct. at 1644, 1645. In multiple respects, that bears no resemblance to FINRA's private decision in this case to disaffiliate from Saad because of his repeated violations of FINRA's own professional rules of conduct.

First, the two cases implicate quite different remedial schemes and materially different statutory standards. As noted, *Kokesh* interpreted the term "penalty" under 28 U.S.C. § 2462, which prescribes a five-year statute of limitations for the imposition of any "civil fine, penalty, or forfeiture, pecuniary or otherwise" in proceedings brought to enforce Acts of Congress.

Commission review in this case, by contrast, does not involve a governmental entity enforcing an Act of Congress, federal regulation, or any other type of public law. Instead, in this case, the Commission is exercising discretionary superintendence over the decisions of a private self-regulatory organization (FINRA) to ensure only that its disciplinary decisions do not "impose[ ] any burden on competition not necessary or appropriate" and are not "excessive or oppressive." 15 U.S.C. § 78s(e)(2). If they are, the Commission "may" alter them. *Id*.

Those distinctions are critical. *Kokesh* is quite explicit that the defining feature of a "penalty" under 28 U.S.C. § 2462 is that it is "imposed as a sanction for violating *federal securitieslaw*." *Kokesh*, 137 S.Ct. at 1639 (emphasis added). Indeed, "violating a *public law*" is a "hallmark[ ] of a penalty." *Id.* at 1644; *see id.* at 1643 ("SEC disgorgement is imposed by the courts as a consequence for violating what we described in *Meeker [v. Lehigh Valley R Co.*, 236 U.S. 412, 35 S.Ct. 328, 59 L.Ed. 644 (1915)] as public laws.") (emphasis added); *id.* ("Sanctions imposed for the purpose of deterring infractions of *public laws* are inherently punitive[.]") (emphasis added); *id.* at 1641 ("The

Commission sought civil monetary penalties, disgorgement, and an injunction barring Kokesh from violating *securities laws* in the future.") (emphasis added).

By contrast, all that Saad is charged with violating—and all that is being remediated in this proceeding—is FINRA's rules of professional conduct. *See* J.A. 109 ("FINRA instituted disciplinary proceedings * * * alleging [a] * * * violation of *NASD Rule* 2110.") (emphasis added); J.A. 110 (" '[P]ersonal problems' could be mitigating if they 'interfered with an ability to comply with *FINRA rules*[.]' ") (emphasis added).

The Supreme Court has ruled time and again that such "occupational debarment" is a "nonpunitive" sanction. *See Hudson v. United States*, 522 U.S. 93, 104, 118 S.Ct. 488, 139 L.Ed.2d 450 (1997) (order forbidding further participation in the banking industry is a nonpunitive sanction); *see also De Veau v. Braisted*, 363 U.S. 144, 156–160, 80 S.Ct. 1146, 4 L.Ed.2d 1109 (1960) (barring certain persons from work as union officials); ***309 **21** *Hawker*, 170 U.S. at 194–200, 18 S.Ct. 573 (permitting the revocation of a medical license); *see generally Smith v. Doe*, 538 U.S. 84, 100, 123 S.Ct. 1140, 155 L.Ed.2d 164 (2003). [1]

1 The Concurring Opinion dismisses the Supreme Court's debarment cases by suggesting that such discipline is, as a matter of law, a civil "penalty," and thus automatically "excessive or oppressive." Concurring Op. 306. But in upholding those measures, the Supreme Court recognized the important remedial role that such debarments can play in protecting the integrity of an industry and those members of the public who interact with it. *See Hudson*, 522 U.S. at 105, 118 S.Ct. 488 (holding that ancillary deterrence effects are not dispositive when a sanction's main purpose is "to promote the stability of the banking industry"); *Hawker*, 170 U.S. at 192, 18 S.Ct. 573 (upholding character requirements for medical licensing because of the "most intimate" relationship between the medical profession and the "life and health" of the general public).

This case is even easier than those Supreme Court cases. The question of whether debarments (or even suspensions, as the Concurring Opinion suggests) are "excessive or oppressive" is, at bottom, a pure question of statutory construction. And on that question, Congress has *mandated* that any securities-industry self-regulatory organization that wishes to register with the Commission include in its rules the ability to "discipline[ ]" members who violate "the rules of the association" by, *inter alia*, "expulsion, suspension, * * * [and] being suspended or barred from being associated with a member." 15 U.S.C. § 78*o*-3(b)(7); *see id*. § 78*o*-3(h)(3). Disciplinary tools required by Congress in Section 78*o*-3 cannot categorically be impermissibly "excessive or oppressive" under Section 78s(e)(2). [2]

2 Section 78*o*-3 does not mention disgorgement.

Second, *Kokesh* involved an order of disgorgement commanding the payment of funds into the United States Treasury. That sanction thus did nothing to protect or to compensate the victims of the crime. *Kokesh*, 137 S.Ct. at 1644 ("When an individual is made to pay a noncompensatory sanction *to the Government* as a consequence of a legal violation, the payment operates as a penalty.") (emphasis added); *id*. ("SEC disgorgement thus bears all the hallmarks of a penalty: It is imposed as a consequence of violating a public law and it is intended to deter, not to compensate.").

By contrast, Saad's offense harmed FINRA's members not just by misappropriating his employer's money, but also by imperiling, through both his fraud and his deceitful cover-up, the trust and confidence of the investing public that is the lifeblood of the securities industry. Saad's seven-month-long obstruction of investigators also squandered FINRA's and its members' resources, forcing them to expend time, personnel, and money unravelling the truth from his falsehoods. Under these circumstances, allowing an industry to protect itself and its clients from Saad's mendacity and purloining by disassociating from him is a remedial measure that protects the industry and its investors. *See* J.A. 115 ("Because we conclude that a bar is necessary to protect FINRA members, their customers, and other securities industry participants, we find that it is remedial, not punitive."); *see also id.* ("[Saad's actions] demonstrate that he cannot be entrusted with firm or customer money, and that therefore he would pose a continuing and unacceptable threat to investors and other industry participants if not barred."). Saad's discipline, unlike Kokesh's, does not surrender anything "to the Government." 137 S.Ct. at 1644. The remedy here thus bears no punitive resemblance to the disgorgement order in *Kokesh*.

***310 **22** *Third*, given the significant differences in the two statutory schemes, Saad cannot wrap himself in *Kokesh* without first establishing that the meaning of "penalty" in 28 U.S.C. § 2462's statute of limitations

governing the enforcement of Acts of Congress both (i) directly dictates the meaning of "excessive or oppressive" under 15 U.S.C. § 78s(e)(2), *and also* (ii) overrides the Commission's discretionary judgment whether to correct a FINRA disciplinary measure, thereby mandating relief in his case, *cf. id*. (Commission "may" correct orders).

Saad, however, has never argued in any way at any point in these proceedings that we should extrapolate the meaning of "penalty" under 28 U.S.C. § 2462 to the determination of whether a sanction is "excessive or oppressive" under 15 U.S.C. § 78s(e)(2). Saad made no such argument before FINRA or the Commission. And before this court—giving Saad every benefit of the doubt—he at most indirectly bumped into the point by citing a case that arose under Section 2462—and even that appeared for the first time in his reply brief. Saad Reply Br. 2 (mentioning a case that involved a proceeding under 28 U.S.C. § 2462, but not citing the statute or arguing its extension to this context); *see*15 U.S.C. § 78y(c)(1) ("No objection to an order or rule of the Commission, for which review is sought under this section, may be considered by the court unless it was urged before the Commission or there was reasonable ground for failure to do so."); *United States v. TDC Mgmt. Corp.*, 827 F.3d 1127, 1130 (D.C. Cir. 2016) (undeveloped arguments are forfeited); *American Wildlands v. Kempthorne*, 530 F.3d 991, 1001 (D.C. Cir. 2008) ("We need not consider this argument because plaintiffs have forfeited it on appeal, having raised it for the first time in their reply brief.").

More to the point, Saad himself apparently sees no relevance to the Supreme Court's decision in *Kokesh* because, in the five months since *Kokesh* was decided, he has not said a single word to this court about that decision or its potential applicability. Because Saad himself does not consider the decision worth mentioning and has never argued at any point that 28 U.S.C. § 2462's definition of "penalty" controls this very different statutory scheme enforcing a different statutory standard ("excessive or oppressive"), he has forfeited any reliance on that argument. Or so the Commission could sensibly conclude.

Fourth, binding circuit precedent—indeed, law of the case —has established that the Commission "may approve 'expulsion not as a penalty but as a means of protecting investors.' " *Saad*, 718 F.3d at 913 (quoting *PAZ Securities, Inc. v. SEC*, 494 F.3d 1059, 1065 (D.C. Cir. 2007)). *See also* *Siegel v. SEC*, 592 F.3d 147, 158 (D.C. Cir. 2010) (consecutive suspensions permissibly imposed "to protect customers") (internal quotation marks omitted); *PAZ Securities, Inc. v. SEC*, 566 F.3d 1172, 1175 (D.C. Cir. 2009) (debarment permissibly imposed "to protect investors" and to redress "a significant harm to the self-regulatory system"); *McCurdy v. SEC*, 396 F.3d 1258, 1265 (D.C. Cir. 2005) (suspension permissibly imposed "to protect the public from [the violator's] demonstrated capacity for recklessness").

This court is not alone in that judgment. *See, e.g.*, *ACAP Fin., Inc. v. SEC,* 783 F.3d 763, 768 (10th Cir. 2015) (Gorsuch, J.) (suspension permissibly imposed where the violator's conduct "cast doubt on his ability to carry out his obligations as a securities professional in any capacity"). The Eighth Circuit, moreover, recently ruled that nothing in *Kokesh* called into question the authority of the Commission to sustain a disciplinary order enjoining the continued ***311 **23** violation of the securities laws. That prospective order remained remedial because it was designed "to protect the public prospectively[.]"*SEC v. Collyard*, 861 F.3d 760, 764 (8th Cir. 2017) (discussing *Kokesh*).

Nothing in *Kokesh* unravels our on-point circuit precedent. *Kokesh* involved a different sanction (disgorgement), imposed under a different statute under an entirely different type of Commission proceeding, to enforce public law not industry professional standards, and involved markedly different remedial and protective implications for private industry and private investors. Accordingly, nothing in *Kokesh* "effectively overrules" or "eviscerates" that binding precedent, which is what we require before abandoning law of the circuit. *See*National Inst. of Military Justice v. Department of Defense*, 512 F.3d 677, 682–683 n.7 (D.C. Cir. 2008) ("[W]hether [a] Supreme Court opinion supersedes Circuit precedent * * * depends on whether [that] opinion 'effectively overrules,' i.e. 'eviscerates' precedent") (quoting *United States v. Williams*, 194 F.3d 100, 105 (D.C. Cir. 1999)).

Accordingly, under settled authority, the Commission's affirmance of a FINRA debarment decision is not "excessive or oppressive" when it is designed, as it was here, to remedially protect the industry and the investing public. This panel, and any panel reviewing the Commission's decision on remand, is bound by that precedent, and (absent an intervening en banc ruling) will continue to be bound by that precedent on review of any subsequent SEC decision. *See*LaShawn A. v. Barry*, 87 F.3d 1389, 1393 (D.C. Cir. 1996) (en banc). [3]

3 The Concurring Opinion says that *Kokesh* overturns circuit precedent characterizing "expulsion[s] or suspension[s]" as remedial. Concurring Op. 304. But the Concurring Opinion cites no language in *Kokesh* that even suggests such a sweeping holding, let alone that clearly "eviscerates" our precedent. Nor does the Concurring Opinion grapple with our strict circuit standard for relying upon intervening Supreme Court precedent to abandon circuit precedent.

The foundational premise of the Concurring Opinion is that only disciplinary sanctions that "provide a remedy to the victim" can qualify as "remedial." Concurring Op. 304; *see id*. at 305. But *Kokesh* does not go anywhere near that far. More to the point, it says nothing at all about what constitutes a remedial sanction in the context of a self-regulatory organization's enforcement of its professional standards, rather than public laws. This circuit has ruled that, in this exact statutory context, a disciplinary sanction that is "purely remedial and preventative" but *not* compensatory —such as a general order to cease-and-desist violating the securities laws—is "not a 'penalty' or 'forfeiture' " within the meaning of 28 U.S.C. § 2462. *Riordan v. SEC*, 627 F.3d 1230, 1234 (D.C. Cir. 2010); *see id*. at 1232 (labeling the cease-and-desist order "remedial"). A prospective cease-and-desist order of that general breadth "does not provide anything to the victims to make them whole or to remedy their losses," as the Concurring Opinion would require. Concurring Op. 305. Yet it certainly is remedial to ensure that, going forward, a harm stops.

The Concurring Opinion says that debarment and even a one-day suspension have to be treated as a penalties because, in its view, they do not "provide a remedy to the victim." Concurring Op. 304. But that argument conflates "remedial" with "compensatory." Victimization and harm entail more than just replacing lost dollars. There can be non-pecuniary harms too. There certainly were here. The harm that Saad inflicted and that FINRA remedied ***312 **24** did not stop with his employer's bank account. His conduct also sowed distrust in the industry, and his seven months of falsehoods and misrepresentations to regulatory investigators stole their time and scarce resources, while compounding the harms he caused to industry integrity.

FINRA's order of debarment directly remedied that full range of harms by making sure they stopped. Ordering the fox out of the henhouse falls comfortably within the "common understanding of the term 'remedial,' " Concurring Op. 304, and indeed provides to Saad's many victims a more comprehensive and realistic remedy than the Concurring Opinion's dollars-only approach.[4]

4 The Concurring Opinion's suggestion that FINRA "may" somehow be able to impose "civil penalt[ies]" is quite puzzling. Concurring Op. 305. Civil penalties punish violations of federal law, not private industry rules. *See*, *e.g.*, *Kokesh*, 137 S.Ct. at 1639, 1644. And nothing in the relevant federal securities laws empowers a *non-governmental* body like FINRA to prosecute and punish violations of *federal law* directly. Nor does federal law provide any avenue by which the Commission "may" be able to review FINRA's prosecution of civil penalties. Concurring Op. 305. More puzzling still is the Concurring Opinion's suggestion that FINRA was supposed to justify Saad's debarment as "punitive." Concurring Op. 306–07. This court remanded this case to the Commission to explain why its disciplinary measures were *not* "punitive." *Saad*, 718 F.3d at 913. Thankfully, law of the case and law of the circuit foreclose the Concurring Opinion's volte-face.

In sum, Saad's repeated turpitudinous misconduct, his nearly year-long venture in misleading and lying to his employer and investigating regulators, and the paramount need for the utmost honesty and integrity in the handling of others' property in the securities industry amply justified the Commission's decision to sustain FINRA's imposition of debarment as a remedy in this case. I do not see anything in *Kokesh* that bears on that decision by a private self-regulatory organization to disaffiliate with someone who repeatedly transgressed industry rules that are necessary to protect the investing public and the integrity of the securities industry. For those reasons, I have deep doubts about the decision to remand this case to the Commission to address a case that is so off-point that Saad himself has paid it no heed, especially because the remedial sufficiency of the Commission's order is controlled by circuit precedent. I have gone along only because nothing in our simple remand order says that *Kokesh* should alter the outcome of Saad's case.

All Citations

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603 F.2d 1126
United States Court of Appeals,
Fifth Circuit.

Charles W. STEADMAN, Petitioner,
v.
SECURITIES AND EXCHANGE COMMISSION, Respondent.

No. 77-2415.
|
Oct. 4, 1979.
|
Rehearing Denied Nov. 27, 1979.

Synopsis

On petition for review of a Securities and Exchange Commission order that petitioner, the sole beneficial owner of an investment advisor, should, because of securities law violations, be permanently barred from associating with any investment adviser and prohibited from affiliating with any registered investment company, the Court of Appeals, Tjoflat, Circuit Judge, held, inter alia, that: (1) scienter need not be proved to establish violations of subsections 17(a)(2) and (3) of the Securities Act, but it is an element of a violation of subsection 17(a)(1), which makes it "unlawful for any person in the offer or sale of any securities * * * to employ any device, scheme, or artifice to defraud," and it is also an element of a violation of section 206(1) of the Investment Advisers Act, which contains similar language; (2) when the SEC imposes the most drastic sanctions at its disposal, it must articulate carefully the grounds for its decision, including an explanation of why lesser sanctions will not suffice; and (3) section 36(a) of the Investment Company Act may not be considered by the SEC in imposing sanctions for violations of other securities laws.

Remanded.

Attorneys and Law Firms

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Paul Gonson, Jacob H. Stillman, Mark B. Goldfus, Frank A. Wilson, Attys., Harvey L. Pitt, Gen. Counsel, Securities & Exchange Comm., Washington, D. C., for respondent.

On Petition For Review of an Order of the Securities and Exchange Commission.

Before WISDOM, GODBOLD and TJOFLAT, Circuit Judges.

Opinion

TJOFLAT, Circuit Judge:

The petitioner in this case, Charles W. Steadman, is the president, chairman of the board, and sole beneficial owner of all the voting stock in Steadman Security Corporation (SSC), an investment adviser registered with the Securities and Exchange Commission (SEC or the Commission). SSC, either directly or through wholly-owned subsidiaries, is the adviser to and manager of several mutual funds known collectively as the Steadman Funds. Steadman petitions for review of the SEC's decision of June 29, 1977, In re Steadman Security Corp., —- S.E.C. —-, (1977-1978 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 81,243 (1977), which found Steadman, SSC, and the subsidiaries in violation of several provisions of the securities laws.[1] Because of these violations, the Commission entered an order that would (1) bar Steadman permanently from associating with any investment adviser, (2) prohibit his affiliation with any registered investment company, and (3) suspend him for one year from associating with any broker ***1129** or dealer. No sanctions were ordered against the corporate respondents, and they do not join in this appeal. Steadman raises several points of error in his petition, most of which we find to be without merit. We grant the petition in part, however, and remand the case to the Commission for reconsideration of the sanctions.

1 The Commission found the following violations:

1. Steadman, SSC, and SSC's wholly-owned broker-dealer subsidiary, Republic Securities Corp. (RSC), violated or aided and abetted violations of section 17(a) of the Securities Act of 1933 (Securities Act), section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and rule 10b-5 thereunder, and sections 206(1) and (2) of the Investment Advisers Act of 1940 (IAA) by failing to disclose that Steadman and SSC had borrowed money from the banks that maintained the custodian accounts for the Steadman Funds;

2. Steadman and SSC violated or aided and abetted violations of sections 20(a), 30, and 34

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of the Investment Company Act of 1940 (ICA) by failing to disclose the bank loans in proxy solicitation materials and annual and quarterly reports;

3. Steadman and SSC violated or aided and abetted violations of section 17(a) of the Securities Act, section 10(b) of the Exchange Act, and rule 10b-5 thereunder, sections 206(1) and (2) of the IAA, and subsection 15(a)(1) of the ICA by failing to disclose that SSC had received compensation from the mutual funds not precisely described in its management contracts;

4. Steadman and RSC violated or aided and abetted violations of section 17(e) of the ICA by receiving tender solicitation fees in connection with the tender of shares held by the funds and not remitting the fees to the funds;

5. Steadman, SSC, and its subsidiaries violated and aided and abetted violations of section 30(a) of the ICA and rules 30a-1 and 30a-2 thereunder, and section 17(a) of the Exchange Act and rule 17a-5 thereunder by failing to file annual reports of three mutual funds and four brokerage firms on time; and

6. Steadman and SSC aided and abetted technical violations of section 17(a) of the ICA by causing one fund under their control to buy and sell securities directly from other funds to which SSC was the adviser.

The violations found by the Commission relate to several different aspects of Steadman's management of the mutual funds through the corporations he controlled. See note 1 Supra. The violations we shall discuss concern Steadman and SSC's loan relationships with the banks used by the funds, the method of repayment to the funds of advisory fee overcharges, the retention by a broker-dealer subsidiary of tender solicitation fees paid for the tender of shares held by the funds, and the failure of Steadman and SSC to file timely reports with the Commission. We shall also examine the burden of proof to be applied in SEC disciplinary proceedings and the factual showing necessary to support the harsh sanctions in this case. As we review each of these areas, the relevant facts will be presented.

I. THE BANKING RELATIONSHIPS

Between 1965 and 1968, Steadman and SSC borrowed substantial amounts of money from the Riggs Bank of Washington, D.C.,[2] the same bank where the Steadman Funds kept their checking accounts.[3] In 1968, SSC began an expansion program to acquire the management rights to additional mutual funds. To finance these acquisitions, SSC applied to the Riggs Bank for a $2 million unsecured loan. The bank turned down the request, finding that the additional debt load on SSC, whose operations had not been profitable, would be too large. Steadman then retained two prominent investment bankers to aid his quest for capital; one of them successfully arranged a $3 million loan to SSC from the Chase Manhattan Bank in New York.

2 The Commission's opinion does not specify any of the banks involved in these dealings, but the Administrative Law Judge's Initial Decision identifies them and their names are not in dispute.

3 The Riggs Bank was the custodian for the securities and other investments owned by the funds and it also kept the funds' cash assets on deposit. Cash assets of a fund include proceeds from the sale of portfolio securities and any judgments realized by the fund. Checking accounts are used by the funds principally to pay dividend distributions and redemptions to fund shareholders.

At about the time the Chase loan was negotiated, Steadman and SSC recommended to the directors of several of the mutual funds that the funds transfer their bank accounts to Chase. The directors were told that the New York bank's custodial fees were lower, that it would be advantageous to be closer to the New York securities market, and that there had been problems with the Riggs Bank. They were not told about the loan to SSC. The transfer of accounts was approved.

Riggs called its personal loans to Steadman when the accounts were transferred (SSC had no loans outstanding from this bank at the time). Steadman obtained a collateralized loan from the First National Bank of Washington to repay the Riggs loans. The First National loan was called in 1970 when the value of the collateral declined, but Steadman received a 90-day extension. Two days later, one of the funds purchased a 90-day certificate of deposit from First National in an amount in excess of the loan. To repay his First National loan, Steadman obtained a loan from yet another bank, the National Bank of Washington. Soon afterwards, the custodial accounts for one of the Steadman funds were transferred from St. Louis to the National Bank. The fund's directors were not told about the loan to Steadman when they approved the transfer.

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Neither Steadman's nor SSC's loans were disclosed in the mutual funds' prospectuses. The Commission found that this was material information that Steadman had a duty to reveal. His failure to do so was in willful violation of section 17(a) of the Securities Act of 1933 (Securities Act), 15 U.S.C. s 77q(a) (1976), section 10(b) of the Securities Exchange Act of 1934 (Exchange ***1130** Act), 15 U.S.C. s 78j(b) (1976), rule 10b-5, 17 C.F.R. s 240.10b-5 (1978), and sections 206(1) and (2) of the Investment Advisers Act of 1940 (IAA), 15 U.S.C. s 80b-6(1), (2) (1976). Steadman contends that the Commission erred in finding the omitted information material, and that even if it were material, he cannot be held in violation of these statutes absent a finding that he acted with scienter, I. e., an intent to deceive or defraud.

A. Materiality

Steadman agrees that TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976), defines the applicable standard of materiality but argues that the Commission misapplied that standard in this case. The TSC case states: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding (the matter before him)" Id. at 449, 96 S.Ct. at 2132. The Commission concluded that Steadman's practice of borrowing heavily, for himself and SSC, from the same banks where the funds had accounts created a potential for subordinating the funds' interests to his own. Deposits are the source of money that banks lend out for interest. Steadman needed large loans. His self-interest in currying the good favor of the banks might have led him, the Commission speculated, to keep unduly large amounts idle in the funds' non-interest-bearing accounts to the benefit of the banks but the detriment of the funds' shareholders. The SEC made no finding that this had in fact occurred and specifically declined to find that the funds' custodial accounts were a quid pro quo for the loans. Regardless of whether there was a connection between the loans and the accounts, the Commission decided that "Steadman had disabled himself from looking at the funds' checking account balances in a wholly disinterested way, with an eye single to the funds' best interest. Investors had a right to know this." —- S.E.C. at —-, (1977-1978 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 81,243, at 88,339-7 (footnote omitted). Therefore, the loans were material under the TSC standard. Id. at —- (1977-1978 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 81,243, at 88,339-9.

Steadman argues that the SEC found only a Potential conflict of interest, and TSC requires an actual conflict before liability may be imposed. This misreads TSC. The relevant part of the TSC opinion involved the nondisclosure of facts that may have indicated possible market manipulation in the context of a proxy solicitation, a completely different context than what is involved here. More importantly, the Court was addressing the sufficiency of the plaintiff's case for summary judgment, I. e., whether the omission was material as a matter of law. The Court was not called upon to decide the quantum of evidence necessary to establish a material omission at trial. The Court reaffirmed in TSC that the issue of materiality is a mixed question of law and fact and that divining the significance of the inferences a reasonable investor would draw from a given set of facts is peculiarly within the competence of the trier of fact. Turning again to the facts of the case before it, the Court said that facts suggesting that one corporation controls another may be material even though in actuality there is no control; the influence of the one company over the affairs of the other would be of importance to shareholders. 426 U.S. at 453 & n.15, 96 S.Ct. at 2134-35. Here, the Commission is the trier of fact. It decided that, under the circumstances of this case, the potential for Steadman's abuse of his influence over where the funds did their banking was sufficiently great that shareholders would want to know about the loans. That finding is not wrong as a matter of law, and we affirm it. [4]

4 McDonough v. Champburger Corp., 488 F.2d 948 (5th Cir. 1974), does not require a contrary result. We there decided that the omitted facts were not material because other disclosed facts adequately revealed the possible conflict of interest, if indeed there was one at all. Id. at 952. Steadman and SSC disclosed no facts concerning their borrowings from the banks.

***1131** B. Scienter

Steadman strenuously urges that scienter an intent to deceive, manipulate, or defraud is a necessary element of any enforcement action by the SEC under the antifraud provisions of the securities laws. Since the Commission failed to find that Steadman acted with the requisite intent, he would have us set aside its decision and order. There is some support for this position. In Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214, 96 S.Ct. 1375, 1391, 47 L.Ed.2d 668 (1976), the Supreme Court decided that scienter must be proved in a private damage action under rule 10b-5. Whether that holding should be extended to Commission enforcement actions under the statutes that Steadman was found to have violated is the

question before us. We turn to an examination of each relevant section.

1. Section 10(b) of the Exchange Act.

The Commission found that Steadman violated section 10(b) of the Exchange Act and rule 10b-5, section 17(a) of the Securities Act, and sections 206(1) and (2) of the IAA. In SEC v. Blatt, 583 F.2d 1325, 1333 (5th Cir. 1978), we held that the Commission must prove scienter in an injunctive action under section 10(b). Steadman contends that this holding compels the conclusion that scienter also is required in a disciplinary enforcement action such as this one.[5] Because the Commission failed to indicate whether it considered the other violations independent and sufficient bases for the sanctions imposed, the argument continues, we should reverse the decision.

5 The Blatt case was brought pursuant to section 21(d) of the Exchange Act, 15 U.S.C. s 78u(d) (1976), which authorizes the Commission to seek injunctive relief in district court for violations of that act. The case before us is an administrative proceeding under section 15(b) of the Exchange Act, 15 U.S.C. s 78O (b) (1976), section 9(b) of the ICA, 15 U.S.C. s 80a-9(b) (1976), and section 203(f) of the IAA, 15 U.S.C. s 80b-3(f) (1976).

We need not decide what state of mind must be shown in a disciplinary action for a violation of section 10(b), for the Commission has indicated to our satisfaction that the section 10(b) violation is mere surplusage in this case. In its opinion, in the context of distinguishing the Hochfelder case, the Commission stated:

> The instant case does not resemble Hochfelder. This is not a private action for money damages. It is a proceeding initiated by a public authority for the prophylactic purpose of preventing future harm to the public interest. Nor does this case rest solely on Rule 10b-5. 30 Indeed, it does not turn on 10b-5 at all. The references to that rule in the order for proceedings and in this opinion are merely cumulative. FP 30 Section 17(a) of the Securities Act and the provisions of the Investment Company Act . . . are independent bases for liability.

—- S.E.C. at —-, (1977-1978 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 81,243, at 88,339-10 (three footnotes omitted) (emphasis added). The clear import of these words is that section 10(b) and rule 10b-5 are not essential to the opinion and order.

2. Section 17(a) of the Securities Act.

Section 17(a) of the Securities Act provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. s 77q (1976). In Hochfelder the Court noted that the language of rule 10b-5 appears to have been derived in significant ***1132** part from this section.[6] Hochfelder held that scienter is required under rule 10b-5. Petitioner argues that this indicates strongly that scienter also is required under section 17(a).

6 Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary

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> in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. s 240.10b-5 (1978).

Hochfelder exposes the sophistry in this argument. The Court imposed a scienter element on rule 10b-5 because the rule can be no broader than its parent statute, section 10(b) of the Exchange Act, whose language the Court interpreted to require an intent to defraud. [7] Section 17(a) is, of course, a congressional enactment, not an administrative rule, and its language is quite different from that of section 10(b). Indeed, in a passage that cuts against Steadman's position, the Court stated:

7 Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. s 78j(b) (1976).

> Viewed in isolation the language of subsection (b), and arguably that of subsection (c) (of rule 10b-5), could be read as proscribing, respectively, any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors, Whether the wrongdoing was intentional or not.

425 U.S. at 212, 96 S.Ct. at 1390 (emphasis added). Subsections (b) and (c) of rule 10b-5 are nearly word-for-word identical with subsections (2) and (3) of section 17(a), respectively. We think that the Court would regard these subsections of section 17(a) as requiring no intent to defraud.

Steadman responds that the Securities Act and the Exchange Act have traditionally been construed in pari materia, and that to impose a scienter requirement under one but not the other would disrupt the "single comprehensive scheme of regulation" that these statutes form. Globus v. Law Research Service, Inc., 418 F.2d 1276, 1286 (2d Cir. 1969), Cert. denied, 397 U.S. 913, 90 S.Ct. 913, 25 L.Ed.2d 93 (1970). But Hochfelder observes that Congress fashioned standards of fault under these acts on a particularized basis. "Ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section." 425 U.S. at 200, 96 S.Ct. at 1384. We turn then to an examination of the language of section 17(a).

We are not the first to travel this road. In SEC v. Coven, 581 F.2d 1020 (2d Cir. 1978), Cert. denied, 440 U.S. 950, 99 S.Ct. 1432, 59 L.Ed.2d 640 (1979), the Second Circuit, in a well-reasoned opinion that included a canvass of the legislative history, concluded that scienter is not required in an SEC injunctive action under subsection 17(a)(2). We adopt that conclusion for the reasons given in the Coven opinion. Accord, SEC v. American Realty Trust, 586 F.2d 1001, 1005-06 (4th Cir. 1978); SEC v. Southwest Coal & Energy Co., 439 F.Supp. 820, 826 (W.D.La.1977), Appeal docketed, No. 78-1130 (5th Cir. Jan. 17, 1978). Moreover, we adopt the further suggestion in Coven that "the clear import of the critical phrase in subsection (3), 'operates ***1133** as a fraud,' is to focus attention on the Effect of potentially misleading conduct on the public, not on the culpability of the person responsible." 581 F.2d at 1026 (emphasis in original) (footnote omitted). When construing identical language in section 206(2) of the IAA, see note 10 Infra, language which was undoubtedly copied from subsection 17(a)(3), the Supreme Court said: "Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit' upon a client, did not intend to require proof of intent to injure . . . ." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195, 84 S.Ct. 275, 284, 11 L.Ed.2d 237 (1963). [8] Steadman objects that Coven is distinguishable as an Injunctive action in which the Commission need only prove that the defendant is about to engage in unlawful conduct, I. e., not every element of a section 17(a) violation need be proved. We think that Coven 's analysis of the statutory language does not depend on the character of relief sought; the words used by Congress carry the same meaning regardless of whether the SEC seeks an injunction or a stronger sanction. As we shall discuss, the severity of the sanctions affects the factual showing necessary to support them, but it does not affect the basic elements of the

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offense. Accordingly, we hold that scienter need not be proved to establish violations of subsections 17(a)(2) and (3). [9]

8 Read literally, subsection 17(a)(3) requires a finding that the course of business in which Steadman engaged operated as a fraud on the funds' shareholders. The Commission made no such finding in this case. A remand for rectification of this lapse would be a wasted gesture, however, because Capital Gains holds that nondisclosure of a material fact is conduct that "operates as a fraud or deceit" within the meaning of section 206(2) of the IAA. 375 U.S. at 198-99, 84 S.Ct. at 286. We think the same conclusion is inescapable under subsection 17(a)(3).

9 Steadman argues that Sanders v. John Nuveen & Co., 554 F.2d 790, 794-96 (7th Cir. 1977), suggests a contrary result. On the assumption that a private right of action for damages exists under subsection 17(a)(2), a question it did not resolve, the Seventh Circuit there commented that scienter must be proved in such an action, for to interpret the subsection otherwise would nullify other sections of the Securities Act that specifically provide for private actions. We cannot agree with Steadman's contention that the logic in Sanders should control in the type of proceeding now before us. Even if scienter may be required to harmonize a hypothetical implied private cause of action with the rest of the act, there is no reason to hold scienter an element of the action specifically contemplated by the statute.

We come now to subsection 17(a)(1). This clause contains the word "device" that the Supreme Court in Hochfelder found to be suggestive of intentional conduct when read together with "manipulative" and "deceptive." 425 U.S. at 197, 96 S.Ct. at 1383. The latter two words do not appear in subsection 17(a)(1), but the three words of that section device, scheme, and artifice must each be read in conjunction with the words "to defraud." The resulting phrases device to defraud, scheme to defraud, artifice to defraud carry strong implications of intentional conduct. We do not think Congress would have used such language if it meant to reach merely negligent actions. The use of the term "employ" further supports our reading of the section. See Hochfelder, 425 U.S. at 199 n.20, 96 S.Ct. at 1384.

In adjudicating a violation of section 17(a), the Commission failed to find that Steadman acted with an intent to defraud, and thus an essential element of a subsection 17(a)(1) violation is missing. There is an indication in a footnote to the Commission's opinion that the section 17(a) infraction rests only on subsections (2) and (3). See —- S.E.C. at —- n.31, (1977-1978 Transfer Binder) Fed.Sec.L.Rep. P 81,243, at 88,339-10. Perhaps this oblique footnote sufficiently conveys the SEC's intent to disclaim reliance upon subsection 17(a)(1). To the extent that the SEC relied upon subsections (2) and (3) of section 17(a), under which scienter is not a requirement, the violations are supported by substantial evidence and we would affirm; nevertheless, since we find other reasons to send this case back for reconsideration, the Commission on remand can clarify its opinion with regard to the subsections of section 17(a) that it considers were violated.

***1134** 3. Sections 206(1) and (2) of the IAA.

What we have said in discussing section 17(a) of the Securities Act applies equally to the language of subsections (1) and (2) of section 206 of the IAA. [10] The wording of these provisions, which make it unlawful for an investment adviser "(1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," is drawn from subsections 17(a)(1) and (3), respectively. As we already have noted, the Supreme Court has ruled that scienter is not required under section 206(2). SEC v. Capital Gains Research Bureau, Inc., 375 U.S. at 195, 84 S.Ct. at 284. The Court in that case said nothing about part (1) of section 206. We think that the language of this subsection must be construed to have the same meaning as subsection 17(a)(1), for to do otherwise would produce a serious anomaly; language copied directly from the Securities Act would have a different meaning under the IAA. We are aware that in Capital Gains, the Court emphasized that the intent of the IAA was to impose fiduciary standards on investment advisers. This general purpose for the statute argues in favor of liability for negligence alone, but "(a) scertainment of congressional intent with respect to the standard of liability created by a particular section . . . must . . . rest primarily on the language of that section." Hochfelder, 425 U.S. at 200, 96 S.Ct. at 1384. The language of section 206(1) clearly connotes intentional conduct and nothing in either the House or Senate Committee reports indicates that this phrase in the IAA is to be interpreted differently than the same phrase in the Securities Act. See H.R.Rep.No.2639, 76th Cong., 3d Sess. (1940); S.Rep.No.1775, 76th Cong.,

3d Sess. (1940). Although the violation of section 206(2) can be supported without a showing of scienter, here the Commission found a violation of section 206(1) without finding the requisite scienter. Because the Commission's findings do not support some of the violations, we remand so that the Commission can reconsider whether it would impose the same sanctions under the violations we uphold.

10 Section 206 provides in part:

> 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 prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> 15 U.S.C. s 80b-6(1), (2) (1976).

II. ADVISORY FEES

SSC's management contract with at least two of the mutual funds limited SSC's annual advisory fee to one percent of each fund's average net assets. Apparently the fee was paid in installments throughout the year based on estimates of the assets under management. At the end of the fiscal year, [11] because of a sharp decline in value of these funds' assets, it became clear that payments to SSC had exceeded the contractual maximum. Thus SSC owed the two funds a total of $260,000. SSC did not refund the money immediately. Instead, it suggested, and the funds' directors agreed, that the overrun would be repaid in installments at six percent interest.

11 The relevant fiscal year ended on June 30, 1970, for one fund and on January 31, 1971, for the other.

On these facts the Commission found that SSC had received "compensation" within the meaning of subsection 15(a)(1) of the Investment Company Act of 1940 (ICA), 15 U.S.C. s 80a-15(a)(1) (1976), because the obligation to refund the fees arose as soon as the fiscal-year-end computations were made, and SSC reaped an economic benefit by stretching out the repayments. Subsection 15(a) (1) prohibits an adviser from receiving "compensation" not "precisely" described in the advisory contract. [12] Because ***1135** SSC's contracts did not provide for extended payment terms for fee overruns, the Commission held SSC in willful violation of the section and found that Steadman had aided and abetted the violations.

12 Section 15(a) provides in part:

> It shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, has been approved by the vote of a majority of the outstanding voting securities of such registered company, and
>
> (1) precisely describes all compensation to be paid thereunder;
>
> 15 U.S.C. s 80a-15(a)(1) (1976).

Steadman attacks these conclusions on several bases. He first argues that the arrangements made between SSC and the funds for repayment of the advisory fee overruns cannot reasonably be considered compensation to SSC. He cites as authority In re Imperial Financial Service, Inc., 42 S.E.C. 717, (1964-1966 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 77,287 (1965), in which the SEC refused to hold that a loan, repaid at seven percent interest, constituted compensation to an affiliated borrower. The Commission responds that it explicitly noted in Imperial that in a given case an interest-bearing loan could be treated as compensation under the ICA, but because seven percent was a very generous rate at the time, the Commission did not decide whether that loan was compensation. Here, it points out, six percent was a very low rate for the time, and even if the interest were at market rate, [13] the funds' forbearance to demand immediate payment of the amount due was a substantial economic benefit to SSC.

13 Steadman and the Commission are unable to agree what the prime rate for commercial loans was at the time. The SEC says eight percent, Steadman says six to six-and-one-half percent. Even taking Steadman's best figure six percent it is clear that he was getting a good deal, because the best rate he was able to negotiate with a commercial bank on the loans discussed in Part I was one-half percent over prime. Moreover, the portfolio manager for one of the funds testified that in November 1970, the same time frame when these overruns were due, the funds could get eight-and-one-half to nine percent by investing in short term commercial paper. Joint App. at 94.

We think the Commission has the better argument. In Imperial, it did not foreclose itself from treating as compensation the type of repayment schedule involved

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here. The question presented is a rather technical one, and substantial deference is due the construction of a statute made by those charged with its execution. E. I. du Pont de Nemours & Co. v. Collins, 432 U.S. 46, 54, 97 S.Ct. 2229, 2234, 53 L.Ed.2d 100 (1977). The Commission's construction is not unreasonable, and we uphold it.

Steadman fares no better with his other contentions. That the arrangement was approved by the funds' directors and on the advice of counsel does not render the violation any less willful, for "willful" in this context simply means that the act constituting the violation was done intentionally; "(t)here is no requirement that the actor also be aware that he is violating one of the Rules or Acts." Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976) (footnote omitted) (quoting Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965)), Cert. denied, 434 U.S. 1009, 98 S.Ct. 719, 54 L.Ed.2d 752 (1978). As to the finding that Steadman aided and abetted the violation, his control of SSC is a substantial ground for the inference that he was involved in every important activity of that company, and there is independent evidence in the record to support this inference.

Finally, Steadman points out that in finding that the failure to disclose the installment repayment arrangement was a violation of the antifraud provisions, see footnote 1, paragraph 3, Supra, the Commission failed to find that the omitted facts were material. It is true that the Commission did not explicitly state in its opinion that these facts were material, but it adopted the Administrative Law Judge's findings that the antifraud statutes had been violated, and we think it sufficiently clear that the SEC also adopted the finding that these facts were material.

***1136** III. TENDER SOLICITATION FEES

In 1969, tender offers were made for securities held by three of the Steadman funds. In accordance with the custom in the industry, the offerors paid tender solicitation fees to brokers who successfully solicited their clients to tender their shares. The funds' shares were tendered through Republic Securities Corporation (RSC), a wholly owned broker-dealer subsidiary of SSC. RSC collected tender solicitation fees equal to two percent of the value of the securities tendered about $32,000. RSC kept half of this amount and paid the other half to the tendering funds.

Subsection 17(e)(1) of the ICA, 15 U.S.C. s 80a-17(e)(1) (1976), prohibits an affiliated person of an investment company from receiving compensation for the sale of the company's property except in the course of his business as a broker.[14] The Commission found that RSC was not acting as a broker in this transaction and therefore should have paid all of the fees it received to the tendering funds:

[14] The full text of section 17(e) provides:

> It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person
>
> (1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker; or
>
> (2) acting as broker, in connection with the sale of securities to or by such registered company or any controlled company thereof, to receive from any source a commission, fee, or other remuneration for effecting such transaction which exceeds (A) the usual and customary broker's commission if the sale is effected on a securities exchange, or (B) 2 per centum of the sales price if the sale is effected in connection with a secondary distribution of such securities, or (C) 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected unless the Commission shall, by rules and regulations or order in the public interest and consistent with the protection of investors, permit a larger commission.
>
> RSC thought it was complying with the one percent limitation of subsection (2) (C) when it remitted half the fee to the funds.

> Where no brokerage is needed, no fee may be collected. These fees paid were to "soliciting brokers." Republic did no soliciting. It merely transmitted the tendered securities. No broker was needed for that.
>
> The decision to tender had already been made by the investment adviser. For making such decisions it received an advisory fee. It could not pocket a second fee for the very same service by donning its broker-dealer hat.

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—- S.E.C. at —-, (1977-1978 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 81,243, at 88,339-15 (footnotes omitted). In support, the SEC cites its decision in In re Provident Management Corp., 44 S.E.C. 442, (1970-1971 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 77,937 (1970), [15] where it found improper the retention of tender solicitation fees by an affiliated broker who performed no "compensable services."

15 Steadman's attack on the precedential value of Provident is without merit. Although that opinion was issued in connection with an offer of settlement, the Commission's construction of the securities laws in settled cases as well as litigated ones is entitled to great weight. E. I. duPont de Nemours & Co. v. Collins, 432 U.S. 46, 54, 97 S.Ct. 2229, 2234, 53 L.Ed.2d 100 (1977).

There is no dispute that RSC is an affiliated person of the tendering funds. Steadman contends, however, that RSC performed substantial services for the funds in gathering the shares and effecting the transfers and that these were brokerage services for which it could collect a fee. Steadman attacks the conclusion that "where no brokerage is needed, no fee may be collected" as novel and unsupported. He also argues that the funds accrued a net benefit on the transaction since the whole two percent fee would have been lost to them if they had used an unaffiliated broker, whereas by using RSC they collected half the fee.

We think that we must defer to the Commission's expertise on this issue also. Its argument that the services performed by RSC were part of what the funds were ***1137** paying their manager, SSC, to do is not unreasonable. Section 17(e) was intended to prohibit conflicts of interest between a fund and affiliated persons advising it on portfolio transactions. United States v. Deutsch, 451 F.2d 98, 109 (2d Cir. 1971), Cert. denied, 404 U.S. 1019, 92 S.Ct. 682, 30 L.Ed.2d 667 (1972). SSC faced such a conflict in advising the funds whether to tender, knowing that its subsidiary would pocket a fee if they did. That the funds might also gain is no answer. Accordingly, the Commission's finding of section 17(e) violations by RSC is affirmed. There is substantial evidence to support the conclusion that Steadman aided and abetted the violations. He personally reviewed the accounting treatment given the transaction and ordered the splitting of the fees between RSC and the funds. Hence, we also affirm the Commission's finding that Steadman violated section 17(e).

IV. REPORTING VIOLATIONS

By the terms of its management contracts with the funds, SSC undertook to see that the funds filed with the SEC reports required by law. The annual reports for at least three funds were filed late for three consecutive years, 1970 to 1972, and the annual reports for Steadman's four broker-dealer companies were late in both 1971 and 1972. In the Commission's view, the principal problem involved the 1971 reports. These were filed more than a year late, " 'so late as to be of minimal value in serving the purposes intended by the requirements for filing the reports.' " —- S.E.C. at —-, (1977-1978 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 81,243, at 88,339-16 (quoting from Administrative Law Judge's Initial Decision).

Steadman does not deny that the reports were late. He does not dispute that the applicable statutes were thus violated, see note 1, paragraph 5, Supra ; he simply contends that there is no evidence that the violations were willful. He points out that it is uncontested that it took seven months to replace SSC's controller after he resigned in 1971, that SSC's independent auditor was changed in the same year, and that SSC sought but was denied extensions for at least some of the reports.

The Commission responds that these facts in mitigation do not excuse the violations or render them less willful. We agree. The record discloses that as early as 1969, SSC's auditors were advising Steadman of serious deficiencies in the accounting procedures and internal organization, including the lack of sufficient personnel, of SSC and its subsidiaries. They warned that the growth in assets under management had not been matched by changes necessary to handle the increased workload. In 1970, under pressure from the banks to meet his loan payments, Steadman implemented a stringent cost-cutting drive that included a significant reduction in personnel. His problems were thus of his own making. On these facts, the Commission was justified in concluding that Steadman was more interested in economizing than in maintaining the organization necessary to manage the funds properly.

V. SANCTIONS AND BURDEN OF PROOF

Steadman's principal argument for reversal of the Commission's order is that the wrong burden of proof was used in the administrative proceedings. We have reserved treatment of this issue for discussion in conjunction with his attack on the severity of the sanctions imposed upon him because, in our view, the two are closely related. We

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conclude that when the Commission chooses to order the most drastic remedies at its disposal, it has a greater burden to show with particularity the facts and policies that support those sanctions and why less severe action would not serve to protect investors.

A. Burden of Proof

The Commission applied a "preponderance of the evidence" standard in this case. Steadman cites Collins Securities Corp. v. SEC, 183 U.S.App.D.C. 301, 562 F.2d 820 (D.C.Cir. 1977), for the proposition that a "clear and convincing evidence" standard is required. In Collins, the defendant was ***1138** charged with manipulating the market for the shares of a particular company in violation of various antifraud provisions of the securities laws. The court acknowledged that the traditional standard of proof in administrative proceedings is the preponderance of the evidence. It expressed concern, however, that in a securities case involving allegations of fraud the evidence is often circumstantial in nature and requires to a significant degree the drawing of inferences to establish the violation. In addition, on the basis of this inferential proof the administrative agency may impose sanctions amounting in effect to a deprivation of livelihood. Thus the court discerned "a need to subject such evidence to a standard which will ensure that any remedial sanctions are imposed only in those circumstances where the evidence is of such a quality as to make the sanctions appear just and reasonable." Id. at 304, 562 F.2d at 823. After noting that the clear and convincing evidence standard has been imposed in certain other types of cases, most notably those involving civil fraud, the court concluded that, for SEC disciplinary proceedings in fraud cases, this standard drew the necessary "realistic correlation between the burden of persuasion and the available remedies." Id. at 307, 562 F.2d at 826.

Other cases cited by petitioner are relevant but not directly on point. In Addington v. Texas, 441 U.S. 418, 99 S.Ct. 1804, 60 L.Ed.2d 323 (1979), the Supreme Court decided that the fourteenth amendment requires at least the clear and convincing evidence standard in civil involuntary commitment proceedings. In a general discussion of the function of a standard of proof, the Court noted:

> One typical use of the (clear and convincing) standard is in civil cases involving allegations of fraud or some other quasi-criminal wrongdoing by the defendant. The interests at stake in those cases are deemed to be more substantial than mere loss of money and some jurisdictions accordingly reduce the risk to the defendant of having his reputation tarnished erroneously by increasing the plaintiff's burden of proof.

Id. at ——, 99 S.Ct. at 1808. The case before the Court did not, of course, involve allegations of fraud, and no holding was made respecting such cases. In requiring more than a mere preponderance of evidence for civil commitment, the Court focused primarily on the deprivation of liberty entailed in confinement; it also noted that "adverse social consequences" can result from involuntary commitment to a mental hospital. Id. at ——, 99 S.Ct. at 1809.

Spevack v. Klein, 385 U.S. 511, 87 S.Ct. 625, 17 L.Ed.2d 574 (1967), and In re Ruffalo, 390 U.S. 544, 88 S.Ct. 1222, 20 L.Ed.2d 117 (1968), also cited by Steadman, both hold that disbarment from the practice of law is a penalty that triggers the minimum protections of due process notice, a hearing, and the right not to testify against oneself. Steadman does not suggest that he was denied these protections in this case; rather, he argues that due process also requires a heightened standard of proof before he may be barred permanently from his profession.

To the extent that Collins rests on a concern that there are particular risks for a respondent in a fraud proceeding because the proof is necessarily circumstantial and inferential, we are not persuaded. In this proceeding, the only fact to which Steadman points as being based on disputed inferences is his state of mind whether he acted with an intent to defraud. But we have held that scienter is not an element of a violation of subsections (2) and (3) of section 17(a) of the Securities Act or of section 206(2) of the IAA, statutes on which the Commission relies to a significant degree in this case. These are commonly called "antifraud" provisions, but the offenses they define are fraud in the broadest "remedial" sense of that term and require no showing of intent to injure or injury. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195, 84 S.Ct. 275, 284, 11 L.Ed.2d 237 (1963). The facts necessary to establish a violation of these sections nondisclosure of a material fact are capable of ***1139** proof by ordinary direct or circumstantial evidence as in any other administrative proceeding.

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We are more impressed by Steadman's argument that the potential for severe sanctions that results from violation of these sections demands a higher burden of proof. Before the Commission, Steadman faced indefinite exclusion from the investment advisory business and the forced sale of all his interest in SSC. The order the Commission rendered is indistinguishable in its effect on the respondent from disbarment from the practice of law. While many jurisdictions use a preponderance standard in disbarment proceedings, many others apply a higher standard. See 7 C.J.S. Attorney & Client s 33a(3) (1937 & Supp.1979); 7 Am.Jur.2d Attorneys at Law s 67 (1963 & Supp.1979) (collecting cases). The higher standard rests in large part on the concern that disbarment means deprivation of livelihood. See, e. g., In re Fisher, 179 F.2d 361, 369-70 (7th Cir.), Cert. denied, 340 U.S. 825, 71 S.Ct. 59, 95 L.Ed. 606 (1950).

We are reluctant to say, however, that in all disciplinary proceedings under the securities antifraud provisions the Commission must prove its case by clear and convincing evidence. Debarment from the industry is not the only sanction the SEC can impose. The available remedies also include mere censure, limitation of the respondent's activities, or suspension for up to twelve months. 15 U.S.C. s 80b-3(f) (1976).[16] Thus, the stakes are not as high for every respondent in a Commission proceeding as they came to be for Steadman.

16 In addition, 15 U.S.C. s 80a-9(b) (1976) permits the permanent or temporary, conditional or unconditional, prohibition of service of an officer, employee, or director of a registered investment adviser.

The burden of proof serves to allocate between the litigants the risk of erroneous decision in a proceeding. Addington v. Texas, 441 U.S. at ——, 99 S.Ct. at 1808. Balanced against the risk to Steadman is the risk that the investing public will be inadequately protected. The public interest in high standards of conduct in the securities business is a great one. If the burden of proof imposed on the Commission is too high, its ability to police the industry is impaired. We cannot say here, as the Court could in Addington v. Texas, id. at ——, 99 S.Ct. at 1810, that "the possible injury to the individual is significantly greater than any possible harm to the state." Accordingly, we do not see why they should not bear the risk of error equally.

We do not wish to minimize the seriousness of the sanctions laid upon Steadman. From his perspective, exclusion from the industry is clearly a penalty. See Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 n. 6 (2d Cir. 1976), Cert. denied, 434 U.S. 1009, 98 S.Ct. 719, 54 L.Ed.2d 752 (1978); Cf. In re Ruffalo, 390 U.S. at 550, 88 S.Ct. at 1226 (disbarment is a penalty). But see Blaise D'Antoni & Associates v. SEC, 289 F.2d 276, 277 (5th Cir.) (revocation of broker registration not a penalty), Cert. denied, 368 U.S. 899, 82 S.Ct. 178, 7 L.Ed.2d 95 (1961). But imposing a high burden of proof to establish the facts of a securities-laws violation is not the only means to protect a respondent. We are empowered to set aside Commission orders that are arbitrary and capricious. 5 U.S.C. ss 551, 702, 706 (1976). We subscribe to the common-sense notion that the greater the sanction the Commission decides to impose, the greater is its burden of justification. Where, as here, the most potent weapon in the Commission's "arsenal of flexible enforcement powers," Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195, 96 S.Ct. 1375, 1382, 47 L.Ed.2d 668 (1976), is used, the Commission has an obligation to explain why a less drastic remedy would not suffice.

We have not lost sight of the limitations on our power to review administrative sanctions. Our role is to decide only whether, under the applicable statute and the facts as found, the agency has made "an allowable judgment in its choice of the remedy." Jacob Siegel Co. v. FTC, 327 U.S. 608, 612, 66 S.Ct. 758, 760, 90 L.Ed. 888 (1946), Quoted in ***1140** Butz v. Glover Livestock Commission Co., 411 U.S. 182, 189, 93 S.Ct. 1455, 1459, 36 L.Ed.2d 142 (1973). The fashioning of an appropriate and reasonable remedy is for the Commission, not this court, and the Commission's choice of sanction may be overturned only if it is found "unwarranted in law or . . . without justification in fact." American Power & Light Co. v. SEC, 329 U.S. 90, 112-13, 67 S.Ct. 133, 146, 91 L.Ed. 103 (1946), Quoted in Butz v. Glover Livestock Commission Co., 411 U.S. at 185-86, 93 S.Ct. at 1458. In our view, however, permanent[17] exclusion from the industry is "without justification in fact" unless the Commission specifically articulates compelling reasons for such a sanction. For example, the facts of a case might indicate a reasonable likelihood that a particular violator cannot ever operate in compliance with the law, See SEC v. Blatt, 583 F.2d 1325, 1334 (5th Cir. 1978), or might be so egregious that even if further violations of the law are unlikely, the nature of the conduct mandates permanent debarment as a deterrent to others in the industry, see p. 1142 Infra. We do not intend to limit the Commission by indicating these possible grounds for debarment, but rather give them as examples of the type

of situation that would seem to justify that penalty.[18] With this in mind, we proceed to examine the sanctions imposed upon Steadman.

17 "Permanent" in this context really means "indefinite" since the Commission retains the power to modify its orders. See In re Steadman Securities Corp., —- S.E.C. at —- n.100, (1977-1978 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 81,243, at 88,339-23. This does not make the sanction less severe, however.

18 The Commission might consider modelling its use of, and explanation for, debarment after the way in which disbarment has been enforced against certain members of the legal profession.

B. The Sanctions

In its brief, the Commission has candidly conceded that Steadman's status as a fiduciary to the funds was "vitally significant" in assessing the seriousness of his conduct. Respondent's Brief at 67. The opinion under review concludes that Steadman was "egregiously faithless" in that role because of (1) his intentional and protracted concealment of his banking relationships and (2) his causing flagrant and intentional breaches of his companies' contractual and fiduciary duties to see that the funds fulfilled their reporting obligations. —- S.E.C. at —- & n.90, (1977-1978 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 81,243, at 88,339-20. Harsh sanctions were imposed because the misconduct in this case was particularly serious, and past misconduct gives rise to an inference of probable future misconduct. Leniency in this case, it was felt, would pollute the ethical climate in the industry and encourage others to act irresponsibly.

We do not agree with Steadman that the Commission has unconstitutionally made a conclusive presumption of future wrongdoing on the basis of past misconduct, but we do agree that a fuller explanation of the need for these sanctions is required. At least the Commission specifically ought to consider and discuss with respect to Steadman the factors that have been deemed relevant to the issuance of an injunction:

> the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

SEC v. Blatt, 583 F.2d at 1334 n.29. To say that past misconduct gives rise to an inference of future misconduct is not enough. What is required is a specific enumeration of the factors in Steadman's case that merit permanent exclusion.

We heartily endorse the Commission's view that while scienter is not required to make out violations of several of the statutory sections involved here, the respondent's state of mind is highly relevant in determining the remedy to impose. ***1141** It would be a gross abuse of discretion to bar an investment adviser from the industry on the basis of isolated negligent violations. More than that was shown here, however. The Commission found that the concealment of Steadman's collateral banking relations was "systematic, calculated and protracted," —- S.E.C. at —-, (1977-1978 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 81,243, at 88,339-11; accordingly, it found that he and his corporate instrumentalities intended to deceive. This conclusion is markedly undercut, though, by the Commission's refusal to adopt the Administrative Law Judge's finding that the funds' custodial accounts were intentionally offered to the banks as an inducement to make the loans.[19] Such a finding by the Commission would have significantly strengthened its conclusion that the failure to disclose the loans was intended to deceive. Use of the funds' custodial accounts as leverage to obtain loans for the adviser and its president would be an obvious and serious breach of fiduciary duty, the concealment of which clearly would have been fraudulent. In the absence of such a finding, we have only the coincidence that Steadman and SSC borrowed from the funds' custodians. We do not retreat from our affirmation that these facts were material, but they are less supportive of an intent to deceive than other conclusions the record arguably permits. We do not say there is a lack of substantial evidence to support the finding of scienter there is such support but in considering what sanctions the Commission's opinion will justify, we think the Commission has not articulated a sufficient justification for expulsion from the industry.

19 There is no satisfactory explanation for the Commission's failure to make this finding except

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> that it was considered unnecessary. The opinion notes that the live testimony at the hearing was against a causal link, and the documentary evidence supporting such a link was received by the Administrative Law Judge over Steadman's objections to its admissibility and probative weight. Therefore, the Commission concluded, "questions of fact are raised. We do not reach them." —- S.E.C. at —-, (1977-1978 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 81,243, at 88,339-13 (footnote omitted).

We also are troubled by the Commission's position that it may consider violations of section 36(a) of the ICA, 15 U.S.C. s 80a-35(a) (1976),[20] in assessing sanctions for violations of other sections of the securities laws.[21] Section 36(a) permits the Commission to apply to a federal district court for an injunction against an officer of an investment adviser who has engaged or is about to engage in acts constituting "a breach of fiduciary duty involving personal misconduct." It gives no power to the Commission, an administrative agency, to adjudicate such breaches, and the Commission has held that it cannot do so. In re Carl L. Shipley, —-S.E.C. —-, (1973-1974 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 79,833 (1974). Here, the Commission reaffirms a position it took in dicta in Shipley : in a proceeding where it finds willful violations of other provisions of the securities laws, on the issue of sanctions it may consider whether the respondent has also violated section 36(a). We agree that section ***1142** 36(a) is a "reservoir of fiduciary obligations imposed upon affiliated persons to prevent gross misconduct or gross abuse of trust not otherwise specifically dealt with in the Act." Brown v. Bullock, 194 F.Supp. 207, 238-39 n.1 (S.D.N.Y.), Aff'd, 294 F.2d 415 (2d Cir. 1961). But responsibility for its enforcement is vested in the courts, not the Commission. The statutory distinction between the functions of the agency and the courts would be effectively read out of the law if the Commission could bring section 36(a) into its own enforcement proceedings through the back door by professing reliance upon it only at the stage of assessing sanctions. We are aware that SEC v. Capital Gains Research Bureau, Inc., 375 U.S. at 191-92, 84 S.Ct. at 282-83, emphasizes that the purpose of the IAA (and, by implication, the ICA, see note 21 Supra) was to regulate the "delicate fiduciary nature of an investment advisory relationship." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. at 191, 84 S.Ct. at 283 (quoting 2 L. Loss, Securities Regulation 1412 (2d ed. 1961)). We do not think this overall purpose is a warrant to read sections 206(1) and (2) of the IAA, the sections found to have been violated here, as the vehicle to reach all breaches of fiduciary trust. The Court in Capital Gains relied on the broad purpose of the statute to hold that section 206(2) does not require a showing of scienter, but that is far from adopting the position the Commission takes here. The Commission may impose sanctions only for violations of the statutes assigned to its jurisdiction, and that does not include section 36(a). This is not to say that in imposing sanctions, the Commission may not consider violations occurring in the context of a fiduciary relationship to be more serious than they otherwise might be. This is not due to any contribution from section 36(a), however, but because the "public interest" the Commission is required to consider in fashioning its orders must be construed liberally to effectuate the prophylactic purpose of the securities laws. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. at 195, 84 S.Ct. at 284-85.

20 15 U.S.C. s 80a-35(a) provides:

> The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts

21 The statutes commonly referred to as the ICA and the IAA were enacted as titles I and II respectively of the Act of August 22, 1940, ch. 686, 54 Stat. 789 (codified at 15 U.S.C. ss 80a-1 to 80a-52, 80b-1 to 80b-21 (1976)). Section 9(b) of title I, 15 U.S.C. s 80a-9(b) (1976), and section 203(f) of title II, Id. s 80b-3(f), both authorize the Commission to bar persons from the investment adviser and investment company business for willful violations of any provision of title I or title II, the Securities Act, or the Exchange Act. The ICA and the IAA therefore overlap, and, as a general matter, it is not improper to refer to violations of one in assessing sanctions under the other. However, as we explain, this does not mean the Commission may poach on the jurisdiction entrusted solely to a federal district court.

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As we have indicated, see p. 1139 Supra, the Commission also may consider the likely deterrent effect its sanctions will have on others in the industry. [22] Permanent debarment, however, is not the only remedy at the Commission's disposal that acts as a deterrent; each of the remedies has that capacity to varying degrees. The Commission should articulate why a lesser sanction would not sufficiently discourage others from engaging in the unlawful conduct it seeks to avoid.

22 Arthur Lipper Corp. v. SEC, 547 F.2d 171 (2d Cir. 1976), Cert. denied, 434 U.S. 1009, 98 S.Ct. 719, 54 L.Ed.2d 752 (1978), is not to the contrary. The court there said, "(t)he purpose of such severe sanctions (as revocation of registration and debarment from the industry) must be to demonstrate not only to petitioners but to others that the Commission will deal harshly with egregious cases." Id. at 184. The court rejected the sanctions because it found that under the circumstances of that case, the violations were not egregious. It did not reject the notion of deterrence as a proper factor for consideration.

We remand this case to the Commission for reconsideration of its order in light of our holdings. We do not hold that the Commission abused its discretion here; we simply say that it impermissibly considered section 36(a) relevant to the issue of sanctions and failed to explain its reasoning in sufficient detail for us to assess the reasonableness of the remedies it ordered. [23]

23 Steadman's argument that the Commission's order violates the ex post facto clause of the Constitution, U.S. Const. art. 1, s 9, cl. 3, is without merit. He correctly notes that prior to 1970, the Commission was without power to sanction persons, as opposed to companies, for violations of the IAA and ICA. These powers were added by the Investment Company Amendments Act of 1970, Pub.L.No.91-547, 84 Stat. 1413 (codified in scattered sections of 15 U.S.C.). Hence, he contends, to the extent the order is based on pre-1970 conduct it is invalid. The Commission provides two answers, either of which is sufficient. First, the violations continued well after 1970 and the same order would have issued if only post-1970 conduct were considered. —- S.E.C. at —- n.93, (1977-1978 Transfer Binder) Fed.Sec.L.Rep. (CCH) P 81,243, at 88,339-21. Second, the amendments went only to remedy; they effected no substantive change in the law. Steadman's conduct was violative of the statute before and after 1970. Since it does not penalize an act innocent when done, the order is not ex post facto. Calder v. Bull, 3 U.S. (3 Dall.) 386, 390, 1 L.Ed. 648 (1798).

***1143** V. CONCLUSION

We summarize here our holdings adverse to the Commission, which will affect the proceedings on remand:

1. Scienter is an element of a violation of subsection 17(a)(1) of the Securities Act, and section 206(1) of the IAA.

2. When the Commission imposes the most drastic sanctions at its disposal, it has a duty to articulate carefully the grounds for its decision, including an explanation of why lesser sanctions will not suffice.

3. Section 36(a) of the ICA may not be considered by the Commission in imposing sanctions for violations of other securities laws.

The petition for review is therefore granted in part and denied in part; the order is set aside and the cause is remanded for reconsideration consistent with this opinion.

REMANDED.

All Citations

603 F.2d 1126, Fed. Sec. L. Rep. P 97,135

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861 F.3d 1239
United States Court of Appeals, Eleventh Circuit.

ZPR INVESTMENT MANAGEMENT INC., Max E. Zavanelli, Petitioners,
v.
SECURITIES AND EXCHANGE COMMISSION, Respondent.

No. 16-15322
|
(June 30, 2017)

Synopsis
Background: Investment firm and its president/sole shareholder petitioned for review of a decision of the Securities and Exchange Commission (SEC), 2015 WL 6575683, which found that firm and president/sole shareholder made material misrepresentations to prospective clients in violation of the Investment Advisers Act of 1940.

Holdings: The Court of Appeals, Martin, Circuit Judge, held that:

finding that investment firm's advertisements made material false claim of compliance with global investment performance standards was supported by substantial evidence;

finding that one of investment firm's newsletters made material false claim of compliance with global investment performance standards was supported by substantial evidence;

finding that investment firm's other newsletter made material false claim of compliance with global investment performance standards was not supported by substantial evidence;

finding that investment firm's president, and thus firm, acted with scienter when making false claim of compliance with global investment performance standards in firm's ads was supported by substantial evidence;

finding that investment firm's president, and thus firm, acted with scienter when making false claim of compliance with global investment performance standards in firm's newsletter was supported by substantial evidence;

finding that investment firm negligently reported to investment-research provider that it was not under investigation by SEC was supported by substantial evidence; and

SEC did not grossly abuse its discretion in imposing industry bar on president, in issuing cease-and-desist order, and in imposing monetary penalties, but amount of penalties needed to be redetermined.

Affirmed in part and vacated in part.

Attorneys and Law Firms

***1244** Philip J. Snyderburn, K. Michael Swann, Snyderburn Rishoi & Swann, LLP, Maitland, FL, for Petitioners.

Emily T.P. Rosen, Theodore Weiman, U.S. Securities & Exchange Commission, Washington, DC, Amie Berlin, Robert K. Levenson, U.S. Securities & Exchange Commission, Miami, FL, for Respondent.

Petition for Review of a Decision of the Securities and Exchange Commission, Agency No. 3–15263

Before MARTIN, JILL PRYOR, and MELLOY,[*] Circuit Judges.

[*] Honorable Michael J. Melloy, United States Circuit Judge for the Eighth Circuit, sitting by designation.

Opinion

MARTIN, Circuit Judge:

Max Zavanelli and his investment firm, ZPR Investment Management, Inc. ("ZPRIM"), are before us seeking review of a final order of the Securities and Exchange Commission ("SEC" or the "Commission").[1] The Commission found that Mr. Zavanelli and ZPRIM (the "petitioners") made material misrepresentations to prospective clients in violation of the Investment Advisers Act of 1940 (the "Advisers Act"), 15 U.S.C. § 80b–1. Based on these violations, the Commission imposed monetary and other sanctions. After careful consideration, and with the benefit of oral argument, we grant the petitioners some, but not all, of the relief they

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seek. We vacate the violations and monetary sanctions related to the newsletter ZPRIM published in December 2009, but we affirm all other violations and sanctions set out in the Commission's order.

1 For clarity, we use "SEC" to refer to the party opposing this appeal and "the Commission" to refer to the administrative tribunal whose decision we are reviewing.

I. BACKGROUND

A. THE FACTS

1. Mr. Zavanelli and ZPRIM

In 1994, Mr. Zavanelli founded ZPRIM, an investment firm registered as an "investment adviser" with the SEC. Mr. Zavanelli was ZPRIM's president and sole shareholder. As such, he "had ultimate authority over all aspects of ZPRIM's advisory business, including its advertising." ZPRIM employed Ted Bauchle as its operations manager from 1999 until early 2013. According to Mr. Bauchle, Mr. Zavanelli was ZPRIM's "boss man." Mr. Zavanelli "made all the decisions" and "was difficult to disagree" with "because he was under the impression that the company should be run his way and that he was always correct."

***1245** 2. Global Investment Performance Standards

The Global Investment Performance Standards ("GIPS") are "universal, voluntary standards to be used by investment managers for quantifying and presenting investment performance that ensure fair representation, full disclosure, and apples-to-apples comparisons." GIPS has two related components, which are the performance standards and the advertising guidelines. The performance standards establish how a firm should calculate and present its investment performance. As you might have guessed, those firms that comply with the GIPS performance standards may represent themselves as being "GIPS-compliant." It is generally understood that compliance with GIPS "provides a level of credibility" to the firm's performance results and gives prospective clients "a greater level of confidence" in the firm's performance presentations.

Under GIPS, if a firm chooses to advertise that it is GIPS compliant, that firm must also comply with the GIPS advertising guidelines.[2] The advertising guidelines require any advertisement claiming GIPS compliance to disclose specific information about the firm's investment returns. Specifically, the firm must provide: "(1) period-to-date composite performance results and (2) either one-, three-, and five-year cumulative annualized composite returns or five years of annual composite returns."

2 The GIPS rules say: "[S]hould a GIPS-compliant FIRM choose to advertise performance results, the FIRM MUST apply ... the GIPS Advertising Guidelines in order to include a claim of compliance with the GIPS standards."

3. ZPRIM Began Claiming It Was GIPS Compliant

Mr. Zavanelli knew that GIPS compliance was "very important" for marketing to institutional clients and he wanted ZPRIM to have those "bragging rights." To that end, ZPRIM hired a GIPS verification firm, Ashland Partners & Company LLP ("Ashland"), to help bring ZPRIM into compliance. In January, February, and April 2008, ZPRIM placed advertisements in financial magazines claiming it was GIPS compliant. Together with the claim of GIPS compliance, and in keeping with GIPS advertising guidelines, the ads included period-to-date returns and at least five years of annual returns.

4. In Fall 2008, ZPRIM Published Ads Omitting Information Required Under GIPS

In the fall of 2008, ZPRIM published three more magazine ads claiming GIPS compliance. But these ads had no period-to-date performance results, nor did they include either one-, three-, and five-year annualized results or five years of annual results. One effect of leaving out this GIPS-required information was that the ads hid ZPRIM's recent poor performance. Had ZPRIM shown its investment returns over the time periods required by GIPS, the ads would have revealed that the firm's performance lagged behind ZPRIM's benchmark index by as much as ten percentage points. Instead of disclosing the called-for returns with the unflattering information, ZPRIM showed its returns over a longer period of time during which ZPRIM outperformed its benchmark index.

Mr. Bauchle testified that before these ads were published, he told Mr. Zavanelli they didn't meet the GIPS requirements for showing investment return information. But Mr. Zavanelli dismissed Mr. Bauchle's concerns, saying it wasn't necessary to put the information in the ads because ZPRIM would give it to prospective clients before ***1246** they invested. Mr.

Zavanelli "wanted to run those ads," so ZPRIM published them even though they did not comply with the GIPS advertising guidelines. Although Ashland had reviewed and approved ZPRIM's earlier ads, ZPRIM never asked Ashland to review the fall 2008 ads.

5. ZPRIM Published Newsletters Omitting Information Required Under GIPS

Mr. Zavanelli wrote a monthly investment newsletter for ZPRIM that contained information about ZPRIM's performance results. This newsletter went to ZPRIM's clients, dozens of investment consultants, and others in the industry.

In November 2008, Ashland told ZPRIM that if "[GIPS] compliance is being claimed" in ZPRIM's newsletters, the "GIPS Advertising Guidelines need to be followed." Ashland then explained precisely how investment returns should be listed in the newsletters in order to comply with the GIPS advertising guidelines. Nevertheless, ZPRIM sent out newsletters in April and December 2009 that claimed GIPS compliance, yet failed to include the required information.

In contrast to the April 2009 newsletter, the December 2009 newsletter contained several corrective statements. Although it is true the December 2009 newsletter said on one page that "[a]ll numbers are GIPS compliant," the next page contained a number of disclaimers. It said, for example: "The investment report you are reading is not GIPS compliant. It was never intended to be nor can it be.... Our report remains not GIPS compliant."

6. The SEC Notified ZPRIM of False Claim of GIPS Compliance

In January 2010, the SEC sent ZPRIM a letter. The letter noted that, while ZPRIM's December 2008 advertisement "claimed compliance" with GIPS, "the [SEC's] examination found that it did not comply with GIPS advertising guidelines." The letter told ZPRIM that "[a]s a result, ZPR[IM] may have violated Section 206 of the Advisers Act and Rule 206(4)-1, thereunder."

ZPRIM responded that it "did not intend to mislead with this ad." Beyond that, ZPRIM assured the SEC that "[w]e have changed our ads" going forward to comply with the GIPS advertising guidelines by including the "1–3–5 year annualized returns" as a "[c]orrective action[ ]."

In August 2010, the SEC sent ZPRIM another letter notifying the firm that the SEC was "conducting an investigation" into ZPRIM.

7. ZPRIM Represented in Two Morningstar Reports that It Was Not Under Investigation

In order to attract institutional clients, ZPRIM regularly gave information about itself to Morningstar, which is a major provider of independent investment research. Using the information it gets from investment firms, Morningstar creates a report about each firm, and investors use these reports to research potential money managers. It was Mr. Bauchle's job to submit ZPRIM's information to Morningstar.

One piece of information included in a Morningstar report is whether or not there are any "[p]ending SEC investigations" of a firm. This is important here because, even though the SEC told ZPRIM in August 2010 that it was investigating the firm, Mr. Bauchle continued to tell Morningstar there were "No" "[p]ending SEC investigations" of ZPRIM. Mr. Bauchle, on behalf of ZPRIM, made this misrepresentation to Morningstar twice: first for the period ending on September ***1247** 30, 2010, and, again, for the period ending on March 31, 2011.

8. In Spring 2011, ZPRIM Published Additional Ads Omitting Information Required Under GIPS

Despite ZPRIM's assurances to the SEC that it would change its ads to comply with the GIPS advertising guidelines, ZPRIM published three more ads—in February, March, and May 2011—claiming GIPS compliance but failing to include the returns required by the GIPS advertising guidelines. Mr. Zavanelli testified that he conceived of and approved these ads.

B. THE ADVISERS ACT

The Advisers Act sets "federal fiduciary standards for investment advisers." Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471 n.11, 97 S.Ct. 1292, 1300 n.11, 51 L.Ed.2d 480 (1977). For our purposes here, we review the antifraud provisions of the Advisers Act—sections 206(1), (2), and (4).[3] In order to establish a violation, each of these sections requires the SEC to show the investment adviser made a material misrepresentation with a culpable mental state. See Steadman v. SEC, 603 F.2d 1126, 1129–34 (5th Cir. 1979) (Steadman I), aff'd, 450 U.S. 91, 101 S.Ct. 999, 67 L.Ed.2d 69 (1981) (interpreting sections 206(1)–(2));[4] SEC v. Steadman, 967 F.2d 636, 643, 647 (D.C. Cir.

1992) (Steadman II) (interpreting section 206(4)). While the material-misrepresentation element is the same for all three sections, the mental-state element for section 206(1) is different than that for sections 206(2) and (4). See Steadman I, 603 F.2d at 1134; Steadman II, 967 F.2d at 647. Section 206(1) requires the SEC to show the adviser acted with scienter. Steadman I, 603 F.2d at 1134. Sections 206(2) and (4) require no showing of scienter, and a showing of negligence is sufficient. See id.; Steadman II, 967 F.2d at 643 & n.5, 647.

3 Section 206 says:

> 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 prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> ...
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

15 U.S.C. §§ 80b–6(1), (2) & (4).

4 In Bonner v. City of Prichard, 661 F.2d 1206 (11th Cir. 1981) (en banc), we adopted as binding precedent all decisions of the former Fifth Circuit handed down before October 1, 1981. Id. at 1209.

C. PROCEEDINGS BEFORE THE COMMISSION

In April 2013, the SEC began administrative proceedings against ZPRIM and Mr. Zavanelli. After a seven-day hearing, the Administrative Law Judge found both had violated the Advisers Act and imposed sanctions. ZPRIM and Mr. Zavanelli appealed to the Commission, which affirmed. [5]

5 There was one finding by the Administrative Law Judge that the Commission reversed, but that issue is not before us.

1. Violations

The Commission found ZPRIM violated sections 206(1), (2), and (4) of the Advisers Act by making false or misleading claims (a) in the fall–2008 and spring–2011 magazine ***1248** ads, and in the 2009 newsletters, that it was GIPS compliant; and (b) in the 2011 Morningstar report that it was not under SEC investigation. The Commission also found ZPRIM violated sections 206(2) and (4), which, again, require only a showing of negligence, for the 2010 Morningstar report.

As for Mr. Zavanelli, the Commission found him liable under sections 206(1) and (2) for all the charges involving misrepresentations of GIPS compliance. The Commission found him liable both directly and for aiding and abetting ZPRIM. It found him not liable for ZPRIM's misrepresentations in the Morningstar reports.

2. Sanctions

The Commission also affirmed the sanctions imposed on ZPRIM and Mr. Zavanelli. First, the Commission placed an "industry bar" on Mr. Zavanelli, which prohibits him from associating "with any investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, and nationally recognized statistical rating organization." Second, the Commission ordered ZPRIM and Mr. Zavanelli to cease and desist their misconduct. Third, the SEC imposed civil penalties of $570,000 against Mr. Zavanelli and $250,000 against ZPRIM. ZPRIM and Mr. Zavanelli timely petitioned this Court for review.

II. STANDARD OF REVIEW

When the Commission makes findings of fact, we must affirm them if they are "supported by substantial evidence." Orkin v. SEC, 31 F.3d 1056, 1063 (11th Cir. 1994). Substantial evidence is "such relevant evidence as a reasonable mind might accept as adequate to support a conclusion." Universal Camera Corp. v. NLRB, 340 U.S. 474, 477, 71 S.Ct. 456, 459, 95 L.Ed. 456 (1951) (quotation omitted). We review de novo the Commission's legal conclusions. Orkin, 31 F.3d at 1063.

"The fashioning of an appropriate and reasonable remedy is for the Commission, not this court...." Steadman I, 603 F.2d at 1140. "We may overturn the [Commission's] decision to impose a particular sanction only upon finding a gross abuse of discretion." Orkin, 31 F.3d at 1066.

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III. DISCUSSION

Petitioners challenge the Commission's order on two grounds. First, they say the Commission's factual findings about both materiality and mental state are not supported by substantial evidence. More specifically, they say substantial evidence does not support the Commission's findings that: (1) the false claims of GIPS compliance in ZPRIM's advertisements were material; (2) the false claims of GIPS compliance in ZPRIM's newsletters were material; (3) the false claims of GIPS compliance in ZPRIM's ads and newsletters were made with scienter; and (4) the false claims in the Morningstar reports that ZPRIM was not under investigation were made with the required mental state. Second, petitioners argue the Commission abused its discretion in imposing sanctions. We address each argument in turn.

A. MATERIALITY OF ZPRIM'S ADVERTISEMENTS

1. The Materiality Requirement

A false or misleading statement by an investment adviser violates the antifraud provisions of the Advisers Act only if the fact misrepresented or omitted is "material." See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 200–01, 84 S.Ct. 275, 287, 11 L.Ed.2d 237 (1963); Steadman I, 603 F.2d at 1129–34. An "omitted fact is material if there is a substantial likelihood that a reasonable [investor] would consider ***1249** it important." Basic Inc. v. Levinson, 485 U.S. 224, 231, 108 S.Ct. 978, 983, 99 L.Ed.2d 194 (1988) (quotation omitted). "[T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Id. at 231–32, 108 S.Ct. at 983 (quotation omitted).

2. Materiality as to ZPRIM's Advertisements

ZPRIM published ads claiming GIPS compliance but omitted the investment return information required by the GIPS advertising guidelines. ZPRIM's claim of GIPS compliance was therefore false, and petitioners do not say otherwise. Rather, they argue their omission of the GIPS-required information was not material. We conclude to the contrary. Substantial evidence showed that reasonable investors would find it important that ZPRIM's ads did not actually comply with GIPS even while they claimed compliance.

To begin, the evidence showed that the status of being "GIPS compliant" is important to investors. Mr. Zavanelli himself testified that being able to market oneself as GIPS compliant "is very important" for attracting institutional clients. Mr. Bauchle explained that institutional clients "screen[ ]" for GIPS compliance and will not even consider firms that are not compliant. Given the significance of GIPS compliance as a marker in the industry, reasonable investors would have wanted to know that ZPRIM's claim of GIPS compliance was false.

Beyond the value of the label itself, the false claim of GIPS compliance was also material because it caused prospective clients to wrongly believe the performance results in ZPRIM's ads adhered to the GIPS advertising guidelines. As the Commission explained, the purpose of the advertising guidelines is to give investors the assurance that any GIPS-compliant firm will present its performance data in a way that is "complete, fair[ ], and comparable to those of other firms." The guidelines' requirements for presenting performance data provide "uniformity and comparability among investment managers." That meant investors looking at the ZPRIM ads could have believed they were looking at the uniform, standardized set of returns required by GIPS, when in fact ZPRIM was deviating from the standardized presentation and putting its investment performance in a more favorable light. ZPRIM presented its numbers as an "apples-to-apples comparison" with the data posted by other GIPS-compliant firms, when its numbers were not actually comparable. This discrepancy is something a "reasonable [investor] would consider [ ] important." Basic, 485 U.S. at 231, 108 S.Ct. at 983 (quotation omitted).

For the ads published in fall 2008, the showing of materiality was even stronger. If ZPRIM had listed its investment returns in those ads as required by GIPS, the information would have revealed that ZPRIM was significantly underperforming its benchmark. Certainly, a prospective investor would have wanted to know about those undisclosed, negative results. See SEC v. Merch. Capital, LLC, 483 F.3d 747, 769 (11th Cir. 2007) (holding that defendants made material omissions by marketing interests in their company to investors "without disclosing the poor performance of the interests that had already been sold").

Petitioners argue that ZPRIM's failure to disclose the GIPS-required information in its ads was not a material omission because the firm provided the information later. Petitioners say ZPRIM sent a fact sheet that disclosed the performance

data ***1250** required by GIPS to every prospective client who responded to a ZPRIM ad. Petitioners also point to data the firm posted on its website. Because ZPRIM eventually gave prospective clients the GIPS-required information, petitioners say that information was "part of the total mix of information provided," and therefore its omission from the ads was not material. See Basic, 485 U.S. at 231–32, 108 S.Ct. at 983.

These after-advertisement disclosures do not carry the day. Materiality is "determined in light of the circumstances existing at the time the alleged misstatement occurred." Ganino v. Citizens Utils. Co., 228 F.3d 154, 165 (2d Cir. 2000) (emphasis added); see also SEC v. Morgan Keegan & Co., 678 F.3d 1233, 1253 (11th Cir. 2012) (per curiam) (holding that disclosures made "after the alleged oral misrepresentations" do not render the misrepresentations immaterial). Because our inquiry is limited to what investors knew at the time the false statements were made, ZPRIM's later disclosures cannot negate the materiality of the earlier misrepresentations. [6] See Morgan Keegan, 678 F.3d at 1253.

6 It could be argued that ZPRIM's publishing of the GIPS-required information on its website was not a subsequent disclosure, since the website was available at the same time as the ads. But, even assuming that ZPRIM put the correct information on its website, that would not render immaterial the false claims of GIPS compliance in ZPRIM's ads. That is because the ads never alerted investors that they needed to look to ZPRIM's website for the GIPS-required disclosure; neither did the website alert investors that it contained the GIPS-required information omitted from ZPRIM's ads. See Morgan Keegan, 678 F.3d at 1252 (finding disclosure of accurate information on firm's website did not render immaterial earlier misrepresentations where there was "no evidence that brokers directed customers" to the information on the web page).

Focusing the materiality inquiry on the time when the misrepresentations were made is especially important where, as here, the context of the false statements is advertising to attract new investors. A later disclosure would not have cured the misrepresentation that already occurred at the advertising stage because, again, many institutional investors "screen[ ]" for GIPS compliance. ZPRIM's false claims of GIPS compliance likely resulted in interest from investors who would not otherwise have considered or contacted ZPRIM. As the Commission explained, "[t]he adviser's false statement has succeeded because it has garnered interest, regardless of whether the adviser later provides enough information for an astute individual to detect its misstatement." The problems caused by a false ad cannot be cured by passing along corrected information to the very customers the company attracted through the misinformation in the first place. See id. at 1252 (holding that "adequate written disclosures" provided after a false statement did not render the false statement immaterial because the disclosure was "given to customers only upon a customer's request").

Petitioners also say the First Circuit's decision in Flannery v. SEC, 810 F.3d 1 (1st Cir. 2015), supports their argument. But the conduct at issue in Flannery was less egregious than the conduct we consider here. In Flannery, the Commission found that an investment firm made a material misrepresentation in a slide presentation to investors in which one slide said that a fund typically was 55% invested in a certain type of security, when the investment was actually around 100%. Id. at 5. The First Circuit reversed. Id. at 15. The court found the record supported only a "thin" showing of materiality because, among other things, (1) "the slide was clearly labeled 'Typical,' " and (2) the firm ***1251** had already distributed the correct data to clients six weeks before the presentation with the inaccurate slide. Id. at 10–11.

ZPRIM did not label its return information "typical," which would have cautioned a reasonable investor he should conduct further research. See id. at 11 n.8. ZPRIM claimed it was presenting the actual, complete set of performance returns required by GIPS. By claiming GIPS compliance, ZPRIM falsely signaled to investors there was no need to look any further for the performance data GIPS requires. Also, here the GIPS-required figures were distributed only after ZPRIM made the misrepresentations—not weeks before—and then only to those prospective clients who came forward.

As the Flannery court explained, "the mere availability of accurate information" does not "negate[ ] an inaccurate statement." Id. And it does not do so here. This record contains substantial evidence to support the Commission's finding that ZPRIM's false claim of GIPS compliance in its ads was material.

B. MATERIALITY OF ZPRIM'S NEWSLETTER STATEMENTS

Petitioners also challenge the Commission's finding of materiality for the false claims of GIPS compliance in

ZPRIM's April and December 2009 newsletters. They argue that the two newsletters did not actually claim to be compliant with GIPS. We reject this argument with respect to the April 2009 newsletter. However, the record supports petitioners' argument that the December 2009 newsletter sufficiently disclaimed GIPS compliance. The Commission's finding of materiality for that publication cannot therefore stand.

1. The April 2009 Newsletter

The April 2009 newsletter unmistakably asserted GIPS compliance. A footnote to a table listing ZPRIM's investment returns said that ZPRIM's "compliance with the Global Investment Performance Standards (GIPS®) has been verified firm-wide by Ashland Partners & Company LLP from December 31, 2000 through September 30, 2008." The table listed investment returns for periods falling within this window of purported GIPS compliance, but omitted the GIPS-required information. This false claim of GIPS compliance in the newsletter was material for the same reasons the false claims of GIPS compliance in the advertisements were material. Thus for the April 2009 newsletter as well, substantial evidence supported the Commission's finding of materiality.

2. The December 2009 Newsletter

The December 2009 newsletter is different. On page three of the December 2009 newsletter, at the bottom of a list of ZPRIM's investment returns, the newsletter said: "All numbers are GIPS compliant." But on the next page, under a section titled "GIPS COMPLIANCE," the newsletter said: "The investment report you are reading is not GIPS compliant. It was never intended to be nor can it be.... Our report remains not GIPS compliant." Petitioners say these statements "disavowed a claim of GIPS compliance," rendering the initial false claim immaterial. We agree.

There is no question the newsletter's initial statement—"[a]ll numbers are GIPS compliant"—was not true. But our rule is that when a misrepresentation is "accompanied by meaningful cautionary statements and specific warnings ..., that language may be sufficient to render the alleged omissions or misrepresentations immaterial as a matter of law." Saltzberg v. TM Sterling/Austin Assocs., Ltd., 45 F.3d 399, 400 (11th Cir. 1995) (per curiam); see also Merch. Capital, 483 F.3d at 767 (stating the "well-established principle ***1252** that a statement or omission must be considered in context, [because] accompanying statements may render it immaterial as a matter of law" (quotation omitted)). While "general cautionary language" is not sufficient to render a misrepresentation immaterial, see Morgan Keegan, 678 F.3d at 1253, the disclaimer in the December 2009 newsletter did not use generic or vague language. It expressly and unequivocally said: "The investment report you are reading is not GIPS compliant." This statement was then followed by two more that reiterated the point. And these statements were all below a bold, underlined header titled "GIPS COMPLIANCE," which would have alerted reasonable investors that ZPRIM was calling attention to a GIPS compliance issue that investors should be aware of. Like the cautionary statements in Saltzberg, ZPRIM's disclaimer was "no[t] boilerplate and was not buried among too many other things, but was explicit, repetitive and linked to the [statement] about which [the SEC] complain[s]." See 45 F.3d at 400. In light of the clear cautionary statements in the December 2009 newsletter, we conclude that the Commission's finding of materiality for that newsletter is not supported by substantial evidence. We therefore reverse the Commission's finding that ZPRIM and Mr. Zavanelli violated sections 206(1), (2), and (4), and sections 206(1) and (2), respectively, based on the December 2009 newsletter.

C. SCIENTER FOR ZPRIM'S ADS AND NEWSLETTERS

1. The Scienter Requirement

To prove a violation of section 206(1) of the Adviser's Act, the SEC must show the adviser acted with scienter. Steadman I, 603 F.2d at 1134. Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 48, 131 S.Ct. 1309, 1323, 179 L.Ed.2d 398 (2011) (quotation omitted). "Scienter may be established by a showing of knowing misconduct or severe recklessness." SEC v. Monterosso, 756 F.3d 1326, 1335 (11th Cir. 2014) (per curiam) (quotation omitted). Scienter can be established through direct or circumstantial evidence. Id. The scienter of a corporation is established by showing that the corporation's officers or directors acted with scienter. See Thompson v. RelationServe Media, Inc., 610 F.3d 628, 635 (11th Cir. 2010) ("Corporations have no state of mind of their own; rather, the scienter of their agents must be imputed to them.").

2. Scienter as to ZPRIM's Ads and Newsletters

The Commission found that Mr. Zavanelli (and thus ZPRIM) acted with scienter in publishing the false claims of GIPS compliance in ZPRIM's ads and newsletters. Petitioners

challenge this finding. Because the facts underlying each set of publications differ, we discuss the issue of scienter separately for each, and conclude the scienter findings are supported by substantial evidence.

a. Scienter as to the Fall 2008 Ads

Substantial evidence supported the Commission's finding that Mr. Zavanelli (and thus ZPRIM) acted with scienter in making misrepresentations of GIPS compliance in the fall 2008 ads. In short, the evidence showed that Mr. Zavanelli knew the claims of GIPS compliance in the fall 2008 ads were false but approved them anyway. See SEC v. Carriba Air, Inc., 681 F.2d 1318, 1324 (11th Cir. 1982) (holding that scienter is established when the defendant "engaged in the dissemination of a known falsehood" (quotation omitted)).

***1253** The record supports a finding that Mr. Zavanelli knew exactly what was required of an ad that claimed GIPS compliance. He testified that he read the GIPS requirements, including its advertising guidelines, "[n]umerous times ... forward and backwards." He even described himself as "an expert" on GIPS. Beyond that, Mr. Zavanelli clearly knew how to present GIPS-compliant investment returns in advertisements because he was responsible for "ensuring that marketing materials [were] GIPS compliant." Indeed, from January to April 2008, ZPRIM published ads that contained the GIPS-required information.

Then in the fall of 2008, Mr. Zavanelli approved the new, non-compliant ads. Mr. Bauchle testified that before these ads were published, he told Mr. Zavanelli they didn't contain the return information required by GIPS. Yet Mr. Zavanelli ran the ads anyway. Indeed, he affirmatively directed Mr. Bauchle to leave the statement that ZPRIM is GIPS-compliant in the ad, even though he knew the investment returns in the ad did not comply with the GIPS advertising guidelines. In doing so, he "engaged in the dissemination of a known falsehood." Carriba Air, 681 F.2d at 1324 (quotation omitted).

There is also a strong inference of "intent to deceive" because the omitted GIPS-required returns resulted in covering up ZPRIM's poor investment performance. Matrixx, 563 U.S. at 48, 131 S.Ct. at 1323. There is certainly sufficient evidence to support the Commission's finding that the petitioners knowingly made false claims of GIPS compliance in the fall 2008 ads.

b. Scienter as to the Spring 2011 Ads

Substantial evidence also supported the Commission's finding of scienter for ZPRIM's false claims of GIPS compliance in the ads published in spring 2011. After the 2008 ads were published, the SEC notified ZPRIM that its ads falsely claimed compliance with GIPS and might violate the Advisers Act. With this letter, the SEC expressly put Mr. Zavanelli on notice that he needed to change the information on ZPRIM's ads to meet the GIPS advertising guidelines. In response, ZPRIM made clear it understood what was required of it. The firm told the SEC it would take "[c]orrective action[ ]" by "chang[ing] our ads" to include the investment returns required by GIPS. Yet despite ZPRIM's assurances, the firm published its 2011 ads without the GIPS-required information. Mr. Zavanelli concedes this omission made the claim of GIPS compliance "untrue," and also concedes he conceived of and approved the spring 2011 round of "untrue" ads. This establishes that he acted with scienter. See Carriba Air, 681 F.2d at 1324.

c. Scienter as to the April 2009 Newsletter

It is similarly clear that Mr. Zavanelli acted with scienter in publishing the April 2009 newsletter. [7] Of course he had the same knowledge of the GIPS requirements in April 2009 as he had when he decided to publish the false claims of GIPS compliance in the fall 2008 ads. Beyond that, by this time ZPRIM had received an express warning from Ashland that if "[GIPS] compliance is being claimed" on ZPRIM's newsletters, "the GIPS Advertising Guidelines need to be followed." Despite this direct admonition from the firm's GIPS verifier, Mr. Zavanelli—who wrote "most of the newsletter"—failed to include the GIPS-required data in the April 2009 newsletter. This is sufficient to support the ***1254** SEC's finding that the petitioners knowingly published the false claim of GIPS compliance in the April 2009 newsletter. See id.

7 We do not address scienter for the December 2009 newsletter because, as discussed earlier, substantial evidence did not support a finding of materiality for that newsletter.

D. REQUIRED MENTAL STATE FOR THE MORNINGSTAR REPORTS

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The Commission found ZPRIM liable for falsely stating in two Morningstar reports that it was not under SEC investigation. ZPRIM (through Mr. Bauchle) made this false statement in the report for the period ending September 30, 2010, and, again, in the report for the period ending March 31, 2011. The Commission found ZPRIM acted with negligence for the 2010 report and scienter for the 2011 report. ZPRIM challenges both findings. We conclude that both are supported by substantial evidence.

1. Negligence as to the 2010 Morningstar Report

As set out above, violations of sections 206(2) and (4) can be established by a showing of negligence. Negligence requires a showing that the investment adviser failed to exercise "reasonable care." Capital Gains, 375 U.S. at 194, 84 S.Ct. at 284 (quotation omitted). This record supports finding that Mr. Bauchle failed to act with reasonable care when he falsely reported to Morningstar in September 2010 that ZPRIM was not under SEC investigation.

Mr. Bauchle was responsible for submitting ZPRIM's information to the Morningstar database. He acknowledged he knew the Morningstar reporting form asked whether the firm was under SEC investigation. Thus, once the SEC sent ZPRIM a letter in August 2010 notifying it that the SEC was "conducting an investigation" into ZPRIM, Mr. Bauchle had a duty to update the Morningstar database to show the pending investigation. See Finnerty v. Stiefel Labs., Inc., 756 F.3d 1310, 1317 (11th Cir. 2014) ("[A] duty exists to update prior statements if the statements were true when made, but misleading or deceptive if left unrevised."). Mr. Bauchle did not do this. As a result, the Morningstar report for the period ending September 2010 falsely showed investors that there were "No" "[p]ending SEC investigations" of ZPRIM. A person exercising a reasonable degree of care would have updated the form once the firm received express notice from the SEC of the pending investigation. Id. Thus, the record supports the finding that ZPRIM's misrepresentation in the 2010 Morningstar report was negligent.

2. Scienter as to the 2011 Morningstar Report

The record also supports the Commission's finding that ZPRIM (through Mr. Bauchle) acted with scienter in failing to disclose the investigation in the 2011 Morningstar report. In October 2010, Mr. Bauchle gave investigative testimony as part of the SEC's proceedings in this case, and counsel for the SEC specifically informed him that he was testifying in connection with the SEC investigation into ZPRIM. This shows Mr. Bauchle had direct, personal knowledge of the SEC investigation yet failed to disclose it in the 2011 report. He thus "engaged in the dissemination of a known falsehood." Carriba Air, 681 F.2d at 1324 (quotation omitted). Also, Mr. Bauchle testified that the reason he "didn't go back and change the [pending investigation] box" on the Morningstar form was "[b]ecause whenever we would get a new letter from the SEC, we would have a meeting and it was downplayed as [ ] being anything significant and so that box wasn't changed." The fact that Mr. Bauchle made a deliberate decision not to disclose the SEC investigation because the ***1255** firm "downplayed" its significance supports a finding of an "intent to deceive" investors. Matrixx, 563 U.S. at 48, 131 S.Ct. at 1323. Thus, there is substantial evidence to sustain the finding of scienter regarding the 2011 Morningstar report.

E. SANCTIONS

The Commission imposed sanctions against both Mr. Zavanelli and ZPRIM. First, the Commission imposed an industry bar against Mr. Zavanelli. Second, the Commission ordered both petitioners to cease and desist their misconduct. Third, the Commission imposed civil penalties. Petitioners challenge each of these sanctions. For the reasons that follow, we affirm the Commission's sanctions except those imposed for the violations related to the December 2009 newsletter.

1. The Industry Bar Against Mr. Zavanelli

Under the Advisers Act, the Commission may impose an industry bar on an adviser if the Commission finds: (1) that the bar "is in the public interest," and (2) that the adviser "willfully violated" or "willfully aided, abetted, counseled, commanded, induced, or procured the violation" of federal securities law. 15 U.S.C. §§ 80b–3(e)(5), (6) & (f). To determine whether a bar is in the public interest, the Commission considers the following:

> [T]he egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's

occupation will present opportunities for future violations.

Steadman I, 603 F.2d at 1140 (quotation omitted). As for the willfulness prong, a violation is "willful" if the adviser "intentionally commit[ed] the act which constitutes the violation." Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000) (quotation omitted). The adviser need not "also be aware that he is violating one of the Rules or Acts." Id. (quotation omitted).

The Commission did not commit a "gross abuse of discretion" in imposing the industry bar on Mr. Zavanelli. Orkin, 31 F.3d at 1066. In assessing the "public interest" prong, the Commission analyzed the Steadman factors and found that each factor showed the bar would be in the public interest. In particular, the Commission found Mr. Zavanelli "acted with a high degree of scienter" because "[d]espite his knowledge and familiarity with GIPS, [he] flouted the requirements of the GIPS Advertising Guidelines"; his "conduct was recurrent," continuing after "ZPRIM promised the previous year to take corrective action"; he "does not genuinely recognize the wrongfulness of his conduct"; and his "assurances against future misconduct" were not convincing because he "continues to provide investment advisory services." The Commission then made the required finding of willfulness. The Commission found the "willfulness standard is satisfied because Zavanelli intentionally authored or approved the advertisements and investment reports containing the misrepresentations at issue." Each of these findings is supported by the record. Thus, the Commission did not grossly abuse its discretion when it imposed the industry bar. Id.

2. Cease and Desist Order

Under the Advisers Act, the Commission may issue a cease and desist order against any person it found to have violated the Act. See 15 U.S.C. § 80b–3(k)(1). Because the Commission found petitioners violated the antifraud provisions, the Commission was entitled to issue the cease and ***1256** desist order against them. Id. The Commission also explained that a "cease-and-desist order will play a substantial remedial role with respect to ZPRIM considering that we have not revoked its registration as an investment adviser." In light of these findings, it was not a "gross abuse of discretion" to issue the order. Orkin, 31 F.3d at 1066.

3. Monetary Penalties

The standard for imposing monetary penalties is the same as for industry bars. See 15 U.S.C. § 80b–3(i)(1)(A). However, the factors for determining whether it would be "in the public interest," id., are different from the Steadman factors. The Advisers Act lists the following factors for making the public interest determination:

(A) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

(B) the harm to other persons resulting either directly or indirectly from such act or omission;

(C) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

(D) whether such person previously has been found by the Commission, another appropriate regulatory agency, or a self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization ...;

(E) the need to deter such person and other persons from committing such acts or omissions; and

(F) such other matters as justice may require.

Id. § 80b–3(i)(3).

The Act also establishes a three-tier system of civil penalties, with each tier addressing increasingly serious misconduct and imposing progressively higher maximum penalties. Id. § 80b–3(i)(2). If the Commission applies the public interest factors listed in the Act and determines that some monetary penalty is warranted, the Commission must then decide which tier is appropriate. In this case, the Commission imposed second-tier penalties, which apply when the wrongdoing involves fraud or deceit. Id. § 80b–3(i)(2)(B). Specifically, the Commission imposed a maximum second-tier penalty on Mr. Zavanelli for each of his eight violations, totaling $570,000, and a single below-maximum second-tier penalty of $250,000 on ZPRIM. [8]

8 The maximum penalty for corporations is considerably higher than for "natural person[s]." 15 U.S.C. § 80b–3(i)(2)(B).

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Petitioners have not shown these penalties were a "gross abuse of discretion." Orkin, 31 F.3d at 1066. In deciding whether to impose the monetary penalties, the Commission discussed each of the public interest factors. The Commission found, among other things, that the petitioners "repeatedly violated the antifraud provisions with scienter"; the misconduct was "especially serious because it involved attempts to promote their firm through false claims"; and "[t]here is a need to deter [petitioners] from committing future" violations. These findings are supported by the record, and the Commission appropriately gave them significant weight. Also, while acknowledging that the SEC did not offer evidence to quantify the harm caused by the petitioners' misrepresentations, the Commission found the market was harmed insofar as the misrepresentations "denied investors the ability to make direct comparisons ***1257** between ZPRIM's performance and that of other investment advisers." On this record, we cannot say the Commission grossly abused its discretion in its choice of monetary penalties. See id.

Although we generally affirm the Commission's imposition of monetary penalties, the amount of the penalties imposed here must be reduced by any amounts related to the December 2009 newsletter violations, which we vacate. Because the Commission's order makes clear it assessed a $75,000 penalty on Mr. Zavanelli for the December 2009 newsletter, we vacate that portion of his monetary sanction. For ZPRIM, however, the Commission did not impose penalties for each violation, but instead a single $250,000 penalty. As a result, we vacate the ZPRIM penalty and remand for the Commission to determine the amount, if any, by which that penalty should be reduced.

IV. CONCLUSION

We affirm the Commission's finding that ZPRIM violated sections 206(1), (2), and (4) of the Advisers Act by making false or misleading claims (a) that it was GIPS compliant in the fall–2008 and spring–2011 magazine ads and in the April 2009 newsletter; and (b) that it was not under SEC investigation in the 2011 Morningstar report. We also affirm the Commission's finding that ZPRIM violated sections 206(2) and (4) for the 2010 Morningstar report. We vacate the Commission's finding that ZPRIM violated sections 206(1), (2), and (4) of the Advisers Act for the December 2009 newsletter. In light of that holding, we also vacate the monetary penalty against ZPRIM and remand this case to the Commission for it to determine whether the penalty should be reduced in light of our decision, and if so by how much.

We affirm the Commission's finding that Mr. Zavanelli violated sections 206(1) and (2) of the Advisers Act by making false or misleading claims that ZPRIM was GIPS compliant in the fall–2008 and spring–2011 magazine ads and in the April 2009 newsletter. We vacate the Commission's finding that Mr. Zavanelli violated sections 206(1) and (2) for the December 2009 newsletter. We therefore also vacate the $75,000 penalty the Commission imposed on Mr. Zavanelli for the December 2009 newsletter.

PETITION GRANTED AND REMANDED IN PART AND DENIED IN PART.

All Citations

861 F.3d 1239, Fed. Sec. L. Rep. P 99,808, 26 Fla. L. Weekly Fed. C 1658

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United States Code Annotated
Title 15. Commerce and Trade
Chapter 2D. Investment Companies and Advisers
Subchapter II. Investment Advisers (Refs & Annos)

15 U.S.C.A. § 80b-3

§ 80b-3. Registration of investment advisers

Effective: January 3, 2019
Currentness

(a) Necessity of registration

Except as provided in subsection (b) and section 80b-3a of this title, it shall be unlawful for any investment adviser, unless registered under this section, to make use of the mails or any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser.

(b) Investment advisers who need not be registered

The provisions of subsection (a) shall not apply to--

(1) any investment adviser, other than an investment adviser who acts as an investment adviser to any private fund, all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange;

(2) any investment adviser whose only clients are insurance companies;

(3) any investment adviser that is a foreign private adviser;

(4) any investment adviser that is a charitable organization, as defined in section 80a-3(c)(10)(D) of this title, or is a trustee, director, officer, employee, or volunteer of such a charitable organization acting within the scope of such person's employment or duties with such organization, whose advice, analyses, or reports are provided only to one or more of the following:

(A) any such charitable organization;

(B) a fund that is excluded from the definition of an investment company under section 80a-3(c)(10)(B) of this title; or

(C) a trust or other donative instrument described in section 80a-3(c)(10)(B) of this title, or the trustees, administrators, settlors (or potential settlors), or beneficiaries of any such trust or other instrument;

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(5) any plan described in section 414(e) of Title 26, any person or entity eligible to establish and maintain such a plan under Title 26, or any trustee, director, officer, or employee of or volunteer for any such plan or person, if such person or entity, acting in such capacity, provides investment advice exclusively to, or with respect to, any plan, person, or entity or any company, account, or fund that is excluded from the definition of an investment company under section 80a-3(c)(14) of this title;

(6)(A) any investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading advisor whose business does not consist primarily of acting as an investment adviser, as defined in section 80b-2(a)(11) of this title, and that does not act as an investment adviser to--

(i) an investment company registered under subchapter I of this chapter; or

(ii) a company which has elected to be a business development company pursuant to section 80a-53 of this title and has not withdrawn its election; or

(B) any investment adviser that is registered with the Commodity Futures Trading Commission as a commodity trading advisor and advises a private fund, provided that, if after July 21, 2010, the business of the advisor should become predominately the provision of securities-related advice, then such adviser shall register with the Commission;

(7) any investment adviser, other than any entity that has elected to be regulated or is regulated as a business development company pursuant to section 80a-53 of this title, who solely advises--

(A) small business investment companies that are licensees under the Small Business Investment Act of 1958;

(B) entities that have received from the Small Business Administration notice to proceed to qualify for a license as a small business investment company under the Small Business Investment Act of 1958, which notice or license has not been revoked; or

(C) applicants that are affiliated with 1 or more licensed small business investment companies described in subparagraph (A) and that have applied for another license under the Small Business Investment Act of 1958, which application remains pending; or

(8) any investment adviser, other than an entity that has elected to be regulated or is regulated as a business development company pursuant to section 80a-53 of this title, who solely advises--

(A) rural business investment companies (as defined in section 2009cc of Title 7); or

(B) companies that have submitted to the Secretary of Agriculture an application in accordance with section 2009cc-3(b) of Title 7 that--

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(i) have received from the Secretary of Agriculture a letter of conditions, which has not been revoked; or

(ii) are affiliated with 1 or more rural business investment companies described in subparagraph (A).

(c) Procedure for registration; filing of application; effective date of registration; amendment of registration

(1) An investment adviser, or any person who presently contemplates becoming an investment adviser, may be registered by filing with the Commission an application for registration in such form and containing such of the following information and documents as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors:

(A) the name and form of organization under which the investment adviser engages or intends to engage in business; the name of the State or other sovereign power under which such investment adviser is organized; the location of his or its principal office, principal place of business, and branch offices, if any; the names and addresses of his or its partners, officers, directors, and persons performing similar functions or, if such an investment adviser be an individual, of such individual; and the number of his or its employees;

(B) the education, the business affiliations for the past ten years, and the present business affiliations of such investment adviser and of his or its partners, officers, directors, and persons performing similar functions and of any controlling person thereof;

(C) the nature of the business of such investment adviser, including the manner of giving advice and rendering analyses or reports;

(D) a balance sheet certified by an independent public accountant and other financial statements (which shall, as the Commission specifies, be certified);

(E) the nature and scope of the authority of such investment adviser with respect to clients' funds and accounts;

(F) the basis or bases upon which such investment adviser is compensated;

(G) whether such investment adviser, or any person associated with such investment adviser, is subject to any disqualification which would be a basis for denial, suspension, or revocation of registration of such investment adviser under the provisions of subsection (e) of this section; and

(H) a statement as to whether the principal business of such investment adviser consists or is to consist of acting as investment adviser and a statement as to whether a substantial part of the business of such investment adviser, consists or is to consist of rendering investment supervisory services.

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(2) Within forty-five days of the date of the filing of such application (or within such longer period as to which the applicant consents) the Commission shall--

(A) by order grant such registration; or

(B) institute proceedings to determine whether registration should be denied. Such proceedings shall include notice of the grounds for denial under consideration and opportunity for hearing and shall be concluded within one hundred twenty days of the date of the filing of the application for registration. At the conclusion of such proceedings the Commission, by order, shall grant or deny such registration. The Commission may extend the time for conclusion of such proceedings for up to ninety days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the applicant consents.

The Commission shall grant such registration if the Commission finds that the requirements of this section are satisfied and that the applicant is not prohibited from registering as an investment adviser under section 80b-3a of this title. The Commission shall deny such registration if it does not make such a finding or if it finds that if the applicant were so registered, its registration would be subject to suspension or revocation under subsection (e) of this section.

(d) Other acts prohibited by subchapter

Any provision of this subchapter (other than subsection (a) of this section) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce are used in connection therewith shall also prohibit any such act, practice, or course of business by any investment adviser registered pursuant to this section or any person acting on behalf of such an investment adviser, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

(e) Censure, denial, or suspension of registration; notice and hearing

The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any investment adviser if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such investment adviser, or any person associated with such investment adviser, whether prior to or subsequent to becoming so associated--

(1) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this subchapter, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein.

(2) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any felony or misdemeanor or of a substantially equivalent crime by a foreign court of competent jurisdiction which the Commission finds--

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(A) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, any substantially equivalent activity however denominated by the laws of the relevant foreign government, or conspiracy to commit any such offense;

(B) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, investment adviser, bank, insurance company, government securities broker, government securities dealer, fiduciary, transfer agent, credit rating agency, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent statute or regulation;

(C) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities or substantially equivalent activity however denominated by the laws of the relevant foreign government; or

(D) involves the violation of section 152, 1341, 1342, or 1343 or chapter 25 or 47 of Title 18, or a violation of [1] substantially equivalent foreign statute.

(3) has been convicted during the 10-year period preceding the date of filing of any application for registration, or at any time thereafter, of--

(A) any crime that is punishable by imprisonment for 1 or more years, and that is not described in paragraph (2); or

(B) a substantially equivalent crime by a foreign court of competent jurisdiction.

(4) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction, including any foreign court of competent jurisdiction, from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, transfer agent, credit rating agency, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent statute or regulation, or as an affiliated person or employee of any investment company, bank, insurance company, foreign entity substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent statute or regulation, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

(5) has willfully violated any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, subchapter I of this chapter, this subchapter, the Commodity Exchange Act, or the rules or regulations under any such statutes or any rule of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

(6) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, subchapter I of this chapter, this subchapter, the Commodity Exchange Act, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such

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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.

(7) is subject to any order of the Commission barring or suspending the right of the person to be associated with an investment adviser;

(8) has been found by a foreign financial regulatory authority to have--

(A) made or caused to be made in any application for registration or report required to be filed with a foreign securities authority, or in any proceeding before a foreign securities authority with respect to registration, any statement that was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to a foreign securities authority any material fact that is required to be stated therein;

(B) violated any foreign statute or regulation regarding transactions in securities or contracts of sale of a commodity for future delivery traded on or subject to the rules of a contract market or any board of trade; or

(C) aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any foreign statute or regulation regarding transactions in securities or contracts of sale of a commodity for future delivery traded on or subject to the rules of a contract market or any board of trade, or has been found, by the foreign finanical [2] regulatory authority, to have failed reasonably to supervise, with a view to preventing violations of statutory provisions, and rules and regulations promulgated thereunder, another person who commits such a violation, if such other person is subject to his supervision; or

(9) is subject to any final order of a State securities commission (or any agency or officer performing like functions), State authority that supervises or examines banks, savings associations, or credit unions, State insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency (as defined in section 1813(q) of Title 12), or the National Credit Union Administration, that--

(A) bars such person from association with an entity regulated by such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or

(B) constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct.

(f) Bar or suspension from association with investment adviser; notice and hearing

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The Commission, by order, shall censure or place limitations on the activities of any person associated, seeking to become associated, or, at the time of the alleged misconduct, associated or seeking to become associated with an investment adviser, or suspend for a period not exceeding 12 months or bar any such person from being associated with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act or omission enumerated in paragraph (1), (5), (6), (8), or (9) of subsection (e) or has been convicted of any offense specified in paragraph (2) or (3) of subsection (e) within ten years of the commencement of the proceedings under this subsection, or is enjoined from any action, conduct, or practice specified in paragraph (4) of subsection (e). It shall be unlawful for any person as to whom such an order suspending or barring him from being associated with an investment adviser is in effect willfully to become, or to be, associated with an investment adviser without the consent of the Commission, and it shall be unlawful for any investment adviser to permit such a person to become, or remain, a person associated with him without the consent of the Commission, if such investment adviser knew, or in the exercise of reasonable care, should have known, of such order.

(g) Registration of successor to business of investment adviser

Any successor to the business of an investment adviser registered under this section shall be deemed likewise registered hereunder, if within thirty days from its succession to such business it shall file an application for registration under this section, unless and until the Commission, pursuant to subsection (c) or subsection (e) of this section, shall deny registration to or revoke or suspend the registration of such successor.

(h) Withdrawal of registration

Any person registered under this section may, upon such terms and conditions as the Commission finds necessary in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any person registered under this section, or who has pending an application for registration filed under this section, is no longer in existence, is not engaged in business as an investment adviser, or is prohibited from registering as an investment adviser under section 80b-3a of this title, the Commission shall by order cancel the registration of such person.

(i) Money penalties in administrative proceedings

(1) Authority of Commission

(A) In general

In any proceeding instituted pursuant to subsection (e) or (f) against any person, the Commission may impose a civil penalty if it finds, on the record after notice and opportunity for hearing, that such penalty is in the public interest and that such person--

(i) has willfully violated any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, subchapter I of this chapter, or this subchapter, or the rules or regulations thereunder;

(ii) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;

(iii) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this subchapter, or in any proceeding before the Commission with respect to registration, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which was required to be stated therein; or

(iv) has failed reasonably to supervise, within the meaning of subsection (e)(6), with a view to preventing violations of the provisions of this subchapter and the rules and regulations thereunder, another person who commits such a violation, if such other person is subject to his supervision; [3]

(B) Cease-and-desist proceedings

In any proceeding instituted pursuant to subsection (k) against any person, the Commission may impose a civil penalty if the Commission finds, on the record, after notice and opportunity for hearing, that such person--

(i) is violating or has violated any provision of this subchapter, or any rule or regulation issued under this subchapter; or

(ii) is or was a cause of the violation of any provision of this subchapter, or any rule or regulation issued under this subchapter.

(2) Maximum amount of penalty

(A) First tier

The maximum amount of penalty for each act or omission described in paragraph (1) shall be $5,000 for a natural person or $50,000 for any other person.

(B) Second tier

Notwithstanding subparagraph (A), the maximum amount of penalty for each such act or omission shall be $50,000 for a natural person or $250,000 for any other person if the act or omission described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.

(C) Third tier

Notwithstanding subparagraphs (A) and (B), the maximum amount of penalty for each such act or omission shall be $100,000 for a natural person or $500,000 for any other person if--

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(i) the act or omission described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and

(ii) such act or omission 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 or omission.

(3) Determination of public interest

In considering under this section whether a penalty is in the public interest, the Commission may consider--

(A) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

(B) the harm to other persons resulting either directly or indirectly from such act or omission;

(C) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

(D) whether such person previously has been found by the Commission, another appropriate regulatory agency, or a self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted by a court of competent jurisdiction of violations of such laws or of any felony or misdemeanor described in subsection (e)(2);

(E) the need to deter such person and other persons from committing such acts or omissions; and

(F) such other matters as justice may require.

(4) Evidence concerning ability to pay

In any proceeding in which the Commission may impose a penalty under this section, a respondent may present evidence of the respondent's ability to pay such penalty. The Commission may, in its discretion, consider such evidence in determining whether such penalty is in the public interest. Such evidence may relate to the extent of such person's ability to continue in business and the collectability of a penalty, taking into account any other claims of the United States or third parties upon such person's assets and the amount of such person's assets.

(j) Authority to enter order requiring accounting and disgorgement

In any proceeding in which the Commission may impose a penalty under this section, the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations,

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and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.

(k) Cease-and-desist proceedings

(1) Authority of Commission

If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this subchapter, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. Such order may, in addition to requiring a person to cease and desist from committing or causing a violation, require such person to comply, or to take steps to effect compliance, with such provision, rule, or regulation, upon such terms and conditions and within such time as the Commission may specify in such order. Any such order may, as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with such provision, rule, or regulation with respect to any security, any issuer, or any other person.

(2) Hearing

The notice instituting proceedings pursuant to paragraph (1) shall fix a hearing date not earlier than 30 days nor later than 60 days after service of the notice unless an earlier or a later date is set by the Commission with the consent of any respondent so served.

(3) Temporary order

(A) In general

Whenever the Commission determines that the alleged violation or threatened violation specified in the notice instituting proceedings pursuant to paragraph (1), or the continuation thereof, is likely to result in significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest, including, but not limited to, losses to the Securities Investor Protection Corporation, prior to the completion of the proceedings, the Commission may enter a temporary order requiring the respondent to cease and desist from the violation or threatened violation and to take such action to prevent the violation or threatened violation and to prevent dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest as the Commission deems appropriate pending completion of such proceedings. Such an order shall be entered only after notice and opportunity for a hearing, unless the Commission, notwithstanding section 80b-11(c) of this title, determines that notice and hearing prior to entry would be impracticable or contrary to the public interest. A temporary order shall become effective upon service upon the respondent and, unless set aside, limited, or suspended by the Commission or a court of competent jurisdiction, shall remain effective and enforceable pending the completion of the proceedings.

(B) Applicability

This paragraph shall apply only to a respondent that acts, or, at the time of the alleged misconduct acted, as a broker, dealer, investment adviser, investment company, municipal securities dealer, government securities broker, government securities

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dealer, or transfer agent, or is, or was at the time of the alleged misconduct, an associated person of, or a person seeking to become associated with, any of the foregoing.

(4) Review of temporary orders

(A) Commission review

At any time after the respondent has been served with a temporary cease-and-desist order pursuant to paragraph (3), the respondent may apply to the Commission to have the order set aside, limited, or suspended. If the respondent has been served with a temporary cease-and-desist order entered without a prior Commission hearing, the respondent may, within 10 days after the date on which the order was served, request a hearing on such application and the Commission shall hold a hearing and render a decision on such application at the earliest possible time.

(B) Judicial review

Within--

(i) 10 days after the date the respondent was served with a temporary cease-and-desist order entered with a prior Commission hearing, or

(ii) 10 days after the Commission renders a decision on an application and hearing under subparagraph (A), with respect to any temporary cease-and-desist order entered without a prior Commission hearing,

the respondent may apply to the United States district court for the district in which the respondent resides or has its principal office or place of business, or for the District of Columbia, for an order setting aside, limiting, or suspending the effectiveness or enforcement of the order, and the court shall have jurisdiction to enter such an order. A respondent served with a temporary cease-and-desist order entered without a prior Commission hearing may not apply to the court except after hearing and decision by the Commission on the respondent's application under subparagraph (A) of this paragraph.

(C) No automatic stay of temporary order

The commencement of proceedings under subparagraph (B) of this paragraph shall not, unless specifically ordered by the court, operate as a stay of the Commission's order.

(D) Exclusive review

Section 80b-13 of this title shall not apply to a temporary order entered pursuant to this section.

(5) Authority to enter order requiring accounting and disgorgement

In any cease-and-desist proceeding under paragraph (1), the Commission may enter an order requiring accounting and disgorgement, including reasonable interest. The Commission is authorized to adopt rules, regulations, and orders concerning

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payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this subsection.

(l) Exemption of venture capital fund advisers

(1) In general

No investment adviser that acts as an investment adviser solely to 1 or more venture capital funds shall be subject to the registration requirements of this subchapter with respect to the provision of investment advice relating to a venture capital fund. Not later than 1 year after July 21, 2010, the Commission shall issue final rules to define the term "venture capital fund" for purposes of this subsection. The Commission shall require such advisers to maintain such records and provide to the Commission such annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors.

(2) Advisers of SBICS

For purposes of this subsection, a venture capital fund includes an entity described in subparagraph (A), (B), or (C) of subsection (b)(7) (other than an entity that has elected to be regulated or is regulated as a business development company pursuant to section 80a-53 of this title).

(3) Advisers of RBICS

For purposes of this subsection, a venture capital fund includes an entity described in subparagraph (A) or (B) of subsection (b)(8) (other than an entity that has elected to be regulated as a business development company pursuant to section 80a-53 of this title).

(m) Exemption of and reporting by certain private fund advisers

(1) In general

The Commission shall provide an exemption from the registration requirements under this section to any investment adviser of private funds, if each of[4] such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150,000,000.

(2) Reporting

The Commission shall require investment advisers exempted by reason of this subsection to maintain such records and provide to the Commission such annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors.

(3) Advisers of SBICS

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For purposes of this subsection, the assets under management of a private fund that is an entity described in subparagraph (A), (B), or (C) of subsection (b)(7) (other than an entity that has elected to be regulated or is regulated as a business development company pursuant to section 80a-53 of this title) shall be excluded from the limit set forth in paragraph (1).

(4) Advisers of RBICS

For purposes of this subsection, the assets under management of a private fund that is an entity described in subparagraph (A) or (B) of subsection (b)(8) (other than an entity that has elected to be regulated or is regulated as a business development company pursuant to section 80a-53 of this title) shall be excluded from the limit set forth in paragraph (1).

(n) Registration and examination of mid-sized private fund advisers

In prescribing regulations to carry out the requirements of this section with respect to investment advisers acting as investment advisers to mid-sized private funds, the Commission shall take into account the size, governance, and investment strategy of such funds to determine whether they pose systemic risk, and shall provide for registration and examination procedures with respect to the investment advisers of such funds which reflect the level of systemic risk posed by such funds.

CREDIT(S)

(Aug. 22, 1940, c. 686, Title II, § 203, 54 Stat. 850; Pub.L. 86-750, §§ 2 to 5, Sept. 13, 1960, 74 Stat. 885, 886; Pub.L. 91-547, § 24, Dec. 14, 1970, 84 Stat. 1430; Pub.L. 94-29, § 29(1) to (4), June 4, 1975, 89 Stat. 166 to 169; Pub.L. 96-477, Title II, § 202, Oct. 21, 1980, 94 Stat. 2290; Pub.L. 99-571, Title I, § 102(m), Oct. 28, 1986, 100 Stat. 3220; Pub.L. 100-181, Title VII, § 702, Dec. 4, 1987, 101 Stat. 1263; Pub.L. 101-429, Title IV, § 401, Oct. 15, 1990, 104 Stat. 946; Pub.L. 101-550, Title II, § 205(b), (c), Nov. 15, 1990, 104 Stat. 2719, 2720; Pub.L. 104-62, § 5, Dec. 8, 1995, 109 Stat. 685; Pub.L. 104-290, Title III, §§ 303(b), (d), 305, Title V, § 508(d), Oct. 11, 1996, 110 Stat. 3438, 3439, 3448; Pub.L. 105-353, Title III, § 301(d)(1), Nov. 3, 1998, 112 Stat. 3237; Pub.L. 106-554, § 1(a)(5) [Title II, § 209(b)], Dec. 21, 2000, 114 Stat. 2763, 2763A-436; Pub.L. 107-204, Title VI, § 604(b), (c)(2), July 30, 2002, 116 Stat. 796; Pub.L. 109-291, § 4(b)(3)(C), Sept. 29, 2006, 120 Stat. 1337; Pub.L. 111-203, Title IV, §§ 403, 407, 408, Title IX, §§ 925(b), 929P(a)(4), 985(e)(1), July 21, 2010, 124 Stat. 1571, 1574, 1575, 1851, 1864, 1935; Pub.L. 114-94, Div. G, Title LXXIV, §§ 74001, 74002, Dec. 4, 2015, 129 Stat. 1786; Pub.L. 115-417, § 2, Jan. 3, 2019, 132 Stat. 5438.)

Footnotes

1 So in original. Probably should be “of a”.

2 So in original. Probably should be “financial”.

3 So in original. The semicolon probably should be a period.

4 So in original. The word “of” probably should not appear.

15 U.S.C.A. § 80b-3, 15 USCA § 80b-3
Current through P.L. 117-262. Some statute sections may be more current, see credits for details.

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End of Document

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SEC's Fraud Case Against Silicon Valley-Based Headspin, Inc.'s Former CEO Is Ongoing

Litigation Release No. 25320 / January 28, 2022

Securities and Exchange Commission v. HeadSpin, Inc., No. 5:22-cv-00576 (N.D. Cal.) filed January 28, 2022

The Securities and Exchange Commission announced settled fraud charges without a penalty against HeadSpin, Inc., a private technology company that made significant remedial efforts in the wake of an internal investigation into misconduct by its now former CEO.

➤ SEC Complaint

The SEC's complaint, filed in the U.S. District Court for the Northern District of California, alleges that from at least 2018 through 2020, HeadSpin, through its former CEO Manish Lachwani, engaged in a fraudulent scheme to propel the Silicon Valley-based company's valuation to over $1 billion by falsely inflating its key financial metrics and doctoring internal sales records.

According to the complaint, Lachwani controlled all important aspects of HeadSpin's financials and sales operations, significantly inflated the value of numerous customer deals, and concealed this inflation by creating fake invoices and altering real invoices to make it appear as though customers had been billed higher amounts. Lachwani's fraud unraveled after the company's Board of Directors conducted an internal investigation which led to the CEO's removal, a revised valuation down to $300 million, and remedial efforts including repaying investors.

HeadSpin's remedial actions also included hiring new senior management, expanding its board, and instituting processes and procedures designed to ensure transparency and accuracy of deal reporting and associated revenues.

The SEC's complaint alleges that HeadSpin violated the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Without admitting or denying the allegations, HeadSpin agreed to be permanently enjoined from violations of these provisions. The settlement is subject to court approval.

The SEC's investigation was conducted by Erin E. Wilk and Ellen Chen, and supervised by Jennifer J. Lee and Monique C. Winkler of the San Francisco Regional Office. The SEC's litigation against HeadSpin's former CEO is ongoing and is being led by Marc Katz, David Zhou, and Ms. Wilk.

Modified: January 28, 2022

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Press Release

Investment Advisers Paying Penalties for Advertising False Performance Claims

FOR IMMEDIATE RELEASE
2016-167

Washington D.C., Aug. 25, 2016 — The Securities and Exchange Commission today announced penalties against 13 investment advisory firms found to have violated securities laws by spreading the false claims made by an investment management firm about its flagship product.

An SEC enforcement sweep of investment advisers found that the 13 firms accepted and negligently relied upon claims by F-Squared Investments that its AlphaSector strategy for investing in exchange-traded funds (ETFs) had outperformed the S&P Index for several years. The firms repeated many of F-Squared's claims while recommending the investment to their own clients without obtaining sufficient documentation to substantiate the information being advertised. F-Squared later admitted in an SEC enforcement case that what was purportedly its real, historical track record was only back-tested performance that turned out to be substantially inflated.

The penalties assessed against the firms range from $100,000 to a half-million dollars based upon the fees each firm earned from AlphaSector-related strategies.

"When an investment adviser echoes another firm's performance claims in its own advertisements, it must verify the information first rather than merely accept it as fact," said Andrew J. Ceresney, Director of the SEC Enforcement Division. "These advisers negligently passed many of F-Squared's claims onto their own clients, who were consequently relying upon false and misleading information when making investment decisions."

Anthony S. Kelly, Co-Chief of the SEC Enforcement Division's Asset Management Unit, added, "The Asset Management Unit continues to investigate and pursue similar enforcement actions against other advisers that potentially misled investors and others with advertisements containing F-Squared's false historical performance data."

Without admitting or denying the findings, the 13 investment advisers consented to the entry of orders finding that they violated Sections 204 and 206(4) of the Investment Advisers Act of 1940 and Rules 204-2(a)(16) and 206(4)-1(a)(5).

The SEC's investigations have been conducted by Robert Baker, William Donahue, John Farinacci, Jeffrey Finnell, Corey Schuster, Naomi Sevilla, Rory Alex, Marc Jones, Alicia Reed, and Sonia Torrico.

* * *

SEC Orders and Penalties

AssetMark – $500,000

BB&T Securities – $200,000

Banyan Partners – $200,000

Congress Wealth Management – $100,000

Constellation Wealth Advisors – $100,000

Executive Monetary Management – $100,000

HT Partners – $100,000

Hilliard Lyons – $200,000

Ladenburg Thalmann Asset Management – $200,000

Prospera Financial Services – $100,000

Risk Paradigm Group – $100,000

Schneider Downs Wealth Management Advisors – $100,000

Shamrock Asset Management – $200,000

###

Press Release

Remediation Helps Tech Company Avoid Penalties

SEC's fraud case against Silicon Valley-based HeadSpin, Inc.'s former CEO is ongoing

FOR IMMEDIATE RELEASE
2022-14

Washington D.C., Jan. 28, 2022 — The Securities and Exchange Commission today announced settled fraud charges without a penalty against HeadSpin, Inc., a private technology company that made significant remedial efforts in the wake of an internal investigation into misconduct by its now former CEO.

"For companies wondering what types of remedial actions and cooperation might be credited by the Commission after a company uncovers fraud, this case offers an excellent example," said Gurbir S. Grewal, Director of the SEC's Division of Enforcement. "HeadSpin's remediation and cooperation included not just its internal investigation and revised valuation, but also repaying harmed investors and improving its governance—all of which were factors that counseled against the imposition of a penalty in this case."

The SEC's complaint, filed in the U.S. District Court for the Northern District of California, alleges that from at least 2018 through 2020, HeadSpin, through its former CEO Manish Lachwani, engaged in a fraudulent scheme to propel the Silicon Valley-based company's valuation to over $1 billion by falsely inflating its key financial metrics and doctoring internal sales records.

According to the complaint, Lachwani controlled all important aspects of HeadSpin's financials and sales operations, significantly inflated the value of numerous customer deals, and concealed this inflation by creating fake invoices and altering real invoices to make it appear as though customers had been billed higher amounts. Lachwani's fraud unraveled after the company's Board of Directors conducted an internal investigation which led to the CEO's removal, a revised valuation down to $300 million, and remedial efforts including repaying investors.

HeadSpin's remedial actions also included hiring new senior management, expanding its board, and instituting processes and procedures designed to ensure transparency and accuracy of deal reporting and associated revenues.

The SEC's complaint alleges that HeadSpin violated the antifraud provisions of the federal securities laws. Without admitting or denying the allegations, HeadSpin agreed to be permanently enjoined from violations of these provisions. The settlement is subject to court approval.

The SEC's investigation was conducted by Erin E. Wilk and Ellen Chen, and supervised by Jennifer J. Lee and Monique C. Winkler of the San Francisco Regional Office. The SEC's litigation against HeadSpin's former CEO is ongoing and is being led by Marc Katz, David Zhou, and Ms. Wilk.

###

EXHIBIT C

1 UNITED STATES OF AMERICA
Before the
2 SECURITIES AND EXCHANGE COMMISSION
3 ~~~~~~~~~~~~~~~~~~~~
4 Admin. Proc. File No. 3-20531
____
5
6 In the Matter of
7
HORTER INVESTMENT MANAGEMENT, LLC
8 And DREW K. HORTER
9
10
~~~~~~~~~~~~~~~~~~~~
11
Zoom Deposition of
12 JESSICA VIERLING
13
14 March 29, 2022
10:09 a.m.
15
16
17 Tracy Morse, RPR
18
19
20
21
22
23
24
25
~~~~~~~~~~~~~~~~~~~~

1 Q. What did you mean by, "Some of his
2 clients had sent checks out"?
3 A. They had sent checks to somebody
4 other than themselves through the distribution
5 request with the Trust Company of America.
6 Q. So did they do that without filling
7 out a distribution form?
8 A. No.
9 - - - - -
10 (Thereupon, Deposition Exhibit D,
11 3/21/2017 Email To Jason Long From
12 Jessica Vierling, Bates Numbers
13 SEC-InvTestimony-000791-000792, was
14 marked for purposes of
15 identification.)
16 - - - - -
17 Q. Okay. So I'm going to show you
18 what I have marked as Exhibit Vierling Depo D.
19 And you testified about this exhibit and it was
20 marked Exhibit 9 at your previous deposition.
21 It is Bates SEC-InvTestimony-000790-Vierling.
22 Do you see that?
23 A. Yes.
24 Q. Okay. And I'm not going to ask you
25 about the email, but I will show it to you so

1 you can see. This is an email from you to
2 Jason Long dated Tuesday, March 21, 2017. Do
3 you see that?
4 A. Yes.
5 Q. And then you have a sentence down
6 here at the bottom that says, "I have attached
7 the spreadsheet with Kimm's distribution, now
8 labeling the IAR Support for each request."
9 A. Yes.
10 Q. Okay. So the spreadsheet. Do you
11 see that?
12 A. Yes.
13 Q. Did you create this spreadsheet?
14 A. Yes.
15 Q. Okay. Do you know if any of these
16 distributions were done via check?
17 A. I don't remember.
18 Q. Okay. If I showed you the
19 distribution forms that correspond to each of
20 these and we walked through them, would you be
21 able to tell me whether they were via check or
22 wire?
23 A. Yes.
24 Q. So let me do this --
25 Before we do this, Ms. Vierling, do you

1 need a break to use the restroom or grab some
2 water?
3 A. No.
4 MS. WOODS: Anybody else? Does
5 anybody else need a break? We're good.
6 Hearing nothing, I will push forward. We'll
7 take a quick break here in 15, 20 minutes just
8 because we've been going about an hour, but I
9 will start going through these distribution
10 forms.
11 - - - - -
12 (Thereupon, Deposition Exhibit F,
13 Distribution Requests, Bates Numbers
14 HORTER-SEC051716-051719, was marked
15 for purposes of identification.)
16 - - - - -
17 Q. Let me pull them up. Okay. I'm
18 going to try something. Let me know if it
19 works on your end. Do you see the distribution
20 spreadsheet right now?
21 A. Yes.
22 Q. And if I flip tabs, can you see the
23 new tab with the distribution form?
24 A. Yes.
25 Q. Perfect. All right. So pardon me.

1 Going back here, let's go through the
2 Heinzman's first. This is small, but I will
3 try to blow it up. This first one here is
4 for $50,000, correct?
5 A. Yes.
6 Q. Can you tell if this is by wire or
7 by check?
8 A. Wire.
9 Q. This next one is for $45,500,
10 correct?
11 A. Yes.
12 Q. Is this by wire or by check?
13 A. Wire.
14 Q. Okay. This one is $4,500. Do you
15 see that?
16 A. Yes.
17 Q. Is this one by wire or by check?
18 A. Wire.
19 Q. Okay. This is another one
20 for $45,000. Is this by wire or by check?
21 A. Wire.
22 Q. That's it for the Heinzman's. So I
23 didn't see any checks on here. Do you know
24 which of his clients you believe sent checks
25 out to him?

1 A. I don't remember.
2 Q. And when you say, just to confirm,
3 you believe they submitted distribution
4 requests on the custodian's form for
5 distributions via check to Hannan Properties --
6 A. Yes.
7 Q. -- but you're not sure which client
8 it was?
9 A. Correct.
10 Q. And who told you that the changes
11 to the procedure made in October of 2017, were
12 being made due to Kimm Hannan's clients sending
13 checks out?
14 A. I don't remember.
15 - - - - -
16 (Thereupon, Deposition Exhibit G,
17 Distribution Requests, Bates Numbers
18 HORTER-SEC051739-051751, was marked
19 for purposes of identification.)
20 - - - - -
21 Q. We'll switch over to Maletich's.
22 Can you see these forms?
23 A. Yes.
24 Q. This first one is $35,000. Do you
25 see that?

1 A. Yes.
2 Q. Is this by wire or by check?
3 A. Wire.
4 Q. This next one is for $20,000. Is
5 this by wire or by check?
6 A. Wire.
7 Q. And $45,000, again, is this by wire
8 or by check?
9 A. Wire.
10 Q. This one is for $15,000. Is this
11 wire or check?
12 A. Wire.
13 Q. Again for $15,000, wire or check?
14 A. Wire.
15 Q. I missed the amount on this one.
16 There it is. It looks to be $18,255, I
17 believe. Does that look right to you?
18 A. Yes.
19 Q. Okay. Can you tell if this one is
20 by wire or by check?
21 A. Wire.
22 Q. This next one is for -- again, it's
23 very tiny. It looks to be $6,746. Do you see
24 that?
25 A. Yes.

1 Q. And is this by wire or by check?
2 A. Wire.
3 - - - - -
4 (Thereupon, Deposition Exhibit H,
5 Distribution Requests, Bates Numbers
6 HORTER-SEC051764-051768, was marked
7 for purposes of identification.)
8 - - - - -
9 Q. All right. That is the end of the
10 Maletich's. We'll jump over to the Ruth's.
11 This is actually from JR Freedom Properties.
12 Do you see that at the top?
13 A. Yes.
14 Q. The gross amount is $150,000. Is
15 this by wire or check?
16 A. Wire.
17 Q. Next one is for $9,000. Is this
18 wire or check?
19 A. Wire.
20 Q. The next one is for $24,000. Is
21 this wire or check?
22 A. Wire.
23 Q. Another for $150,000. Is this wire
24 or check?
25 A. Wire.

1 MS. WOODS: Okay.
2 Off the record.
3 (Recess taken.)
4 BY MS. WOODS:
5 Q. So in your previous testimony, you
6 explained what you did, when you would call
7 clients, to put the information on the
8 distribution log. I just want to kind of walk
9 through some of that. I want to go back and
10 look at Exhibit D, which we were just looking
11 at, but I want to look at the email portion.
12 In your email here to Jason, you said --
13 you outlined the process of third-party
14 distribution and then your third bullet point
15 here --
16 Can you see this okay? Do you need me to
17 blow it up any?
18 A. I can see it.
19 Q. -- it says, "When I speak with the
20 client I verify the following information: The
21 Client's social security number; the date of
22 birth; I make the client tell me the amount of
23 the distribution; I make the client tell me
24 where the funds are being sent; and then, I do
25 explain to them that is required to confirm the

1 wire, since the client is not...receiving the
2 funds." Is that correct?
3 A. Yes.
4 Q. So you did not ask the clients
5 about who was receiving the funds, right?
6 A. Correct.
7 Q. Why not?
8 A. I was never told to.
9 Q. And you did not ask why they were
10 transferring the funds to the third party,
11 correct?
12 A. No. Correct.
13 Q. Why didn't you ask that question?
14 A. Because I wasn't told to.
15 Q. So it was not part of the policy?
16 A. Correct.
17 Q. And you did not ask whether the
18 transferee offered the client anything in
19 return for the transfer, right?
20 A. Correct.
21 Q. Why didn't you ask that question?
22 A. I was never told to.
23 Q. That was not part of the policy?
24 A. Correct.
25 Q. You did not ask whether the

1 transferee made any promises to the client,
2 correct?
3 A. Correct.
4 Q. Why not?
5 A. I was not told to.
6 Q. And it was not part of the policy?
7 A. Correct.
8 Q. You would agree with me that there
9 was no reason to ask those questions, correct?
10 A. Correct.
11 Q. And what the client did with his or
12 her money was not Horter's business?
13 A. Correct.
14 Q. Would you agree with me that it's
15 not Horter's job to prevent clients from making
16 poor investments?
17 A. Correct.
18 Q. And the clients can ultimately do
19 whatever they want with their own money?
20 A. Yes.
21 Q. Based on your conversations with
22 Kimm Hannan's clients, when you would call to
23 talk to them about their third-party
24 distribution forms, would you agree with me
25 that each of those clients knew exactly where

1 their money was going?
2 A. Yes.
3 Q. None of Kimm Hannan's clients told
4 you that the information on the distribution
5 request was wrong, correct?
6 A. Correct.
7 Q. So it was not an error that their
8 money ended up with Kimm Hannan?
9 A. Correct.
10 Q. And you were simply following the
11 client's instructions to send the money to Kimm
12 Hannan, when you processed the distribution
13 form?
14 A. Correct.
15 Q. You don't think you did anything
16 wrong in processing those forms, do you?
17 A. Correct.
18 Q. And there's nothing about Horter's
19 third-party distribution policy that makes
20 processing those distribution forms wrong,
21 correct?
22 A. Correct.
23 - - - - -
24 (Thereupon, Deposition Exhibit E,
25 Client Distribution Request Log,

1 distribution request forms that were not
2 reflected on the log, even if you made the
3 call, correct?
4 A. Correct.
5 Q. And in fact, there were six
6 transfers for Kimm Hannan's clients that did
7 not make it to the log, even though you called
8 them, correct?
9 A. I don't remember exactly.
10 Q. Let's see. All right. I'm going
11 to show you, again, a copy of your previous
12 testimony. This is found on page 0079. Can
13 you see that on your screen?
14 A. Yes.
15 Q. Okay. So you were going through
16 here, the transfers in the log. I can scroll
17 through and tell me if you're ready for the
18 next page, but let me know if you see six
19 distributions listed on the log. And then
20 there was a bunch of, okays, where I assume you
21 were checking it. And you said, "No, they were
22 not listed."
23 Question: "Okay. Those, the six
24 transfers, the two on August 18, the August 26,
25 2016, November 3, 2016, and the two on

1 December 29, 2016, were not listed in the log."
2 And you said, "Correct."
3 "And you do not have any understanding as
4 to why they were not logged?"
5 And you said, "No."
6 Do you have any reason to believe that
7 those six transfers that you said were not
8 listed on the log have now been listed on the
9 log?
10 A. No.
11 Q. Okay. Those should have been
12 reflected on the log, though, correct?
13 A. Yes.
14 Q. And you understood Horter's
15 third-party distribution policy?
16 A. Yes.
17 Q. And you knew how to follow the
18 policy?
19 A. Yes.
20 Q. And it was part of your job to
21 complete the log, correct?
22 A. Yes.
23 Q. And no one at Horter instructed you
24 not to complete the log regarding those six
25 transfers?

1 A. Correct.
2 Q. And omitting those transfers from
3 the log was solely your doing?
4 A. Yes.
5 Q. Not including them on the log was
6 not intentional, correct?
7 A. Correct.
8 Q. It was just human error?
9 A. Yes.
10 Q. And just because you didn't
11 complete the log, that doesn't mean you didn't
12 otherwise follow the policy, right?
13 A. Correct.
14 Q. You testified previously that other
15 than creating the log, Horter did nothing to
16 review or monitor distributions from clients to
17 third parties. Do you remember that?
18 A. Yes.
19 Q. Okay. How do you know that?
20 A. Because I was the one processing
21 the majority of the distributions.
22 Q. So other than creating the log and
23 completing the log, you didn't do anything else
24 to review or monitor distributions, correct?
25 A. Correct.

1 REPORTER'S CERTIFICATE
2 The State of Ohio,)
3 SS:
4 County of Cuyahoga.)
5
6 I, Tracy Morse, a Notary Public
7 within and for the State of Ohio, duly
8 commissioned and qualified, do hereby certify
9 that the within named witness, JESSICA
10 VIERLING, was by me first duly sworn to testify
11 the truth, the whole truth and nothing but the
12 truth in the cause aforesaid; that the
13 testimony then given by the above-referenced
14 witness was by me reduced to stenotypy in the
15 presence of said witness; afterwards
16 transcribed, and that the foregoing is a true
17 and correct transcription of the testimony so
18 given by the above-referenced witness.
19 I do further certify that this
20 deposition was taken at the time and place in
21 the foregoing caption specified and was
22 completed without adjournment.
23
24
25

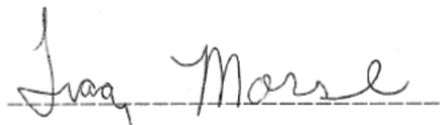
1 I do further certify that I am not
2 a relative, counsel or attorney for either
3 party, or otherwise interested in the event of
4 this action.
5 IN WITNESS WHEREOF, I have hereunto
6 set my hand and affixed my seal of office at
7 Cleveland, Ohio, on this 11th day of
8 April, 2022.
9
10
11 
12
13 ________________________________
14 Tracy Morse, Notary Public
15 within and for the State of Ohio
16
17 My commission expires 1/26/2023.
18
19
20
21
22
23
24
25

EXHIBIT D

1 UNITED STATES OF AMERICA

2 Before the

3 SECURITIES AND EXCHANGE COMMISSION

4 --o0o--

5 ADMINISTRATIVE PROCEEDING
File No. 3-20531

6

7 In the Matter of)
)
8 Horter Investment Management LLC)
and Drew K. Horter,)
9)
)
10 Respondents.)
_______________________________________)
11

12

13

14

15 VIDEOTAPED DEPOSITION OF

16 KEVIN HETZER

17 VIA REMOTE VIDEOCONFERENCE

18 WEDNESDAY, FEBRUARY 9, 2022

19

20

21

22

23
Stenographically Reported by:
24 Victoria L. Valine, CSR, RMR, CRR, RSA
California CSR License No. 3036
25 Job No. 220209VV

1 Q. Now, is that reflected in item number 5?
2 A. Yes.
3 Q. Okay. So the -- how did it work where the --
4 what did the trader do with the log?
5 A. So once they identified that the distribution
6 request was, in fact, going to a third party, we had a
7 log that had different -- different columns of
8 information that they had to gather. So they would fill
9 in the log with all that information, call the client,
10 make sure they verified everything -- their social or
11 their address, and the amount of money, and that they,
12 in fact, wanted this request, and that it was
13 legitimate.
14 Q. Mmmm-hmmm.
15 A. And once they did that, they would bring the
16 log -- the trader would bring the log to a manager who
17 would sign off on the log to allow the distribution to
18 go out.
19 Q. Okay. And which manager would sign -- was
20 authorized to sign -- counter-sign the log?
21 A. I believe there were several.
22 Q. Okay. Were you one of them?
23 A. Yes.
24 Q. And what did you do to verify the accuracy of
25 the items -- or the item on the log when you

1 counter-signed it?
2 A. I would question the trader to make sure they,
3 in fact, got ahold of the client. What did they say?
4 What was the answer?
5 And once they verified that it was the client,
6 and answered my questions, and I was okay with it, I
7 would sign off on it.
8 Q. And, at that time, when you were asking those
9 questions, was the entry on the log already made by
10 the -- the trader?
11 A. Yes.
12 Q. Okay. And then they would present that to you
13 and then you would ask the questions?
14 A. Yes.
15 Q. And if you were satisfied with the answers,
16 you would then counter-sign; is that right?
17 A. Yes.
18 Q. Did you ever look at any underlying documents
19 to support the entry by the trader?
20 A. I may have. I don't recall.
21 Q. Okay. And if you turn to the second page of
22 this exhibit, is there -- there's a section called
23 "Proposed New Procedures Starting in October 2017."
24 Do you see that?
25 A. Yes.

1 client? What did you ask them? She would answer.
2 Did you confirm that the -- the amount and
3 that they -- that this was a legitimate request and that
4 they were aware of it?
5 BY MS. QUALLS:
6 Q. Okay. And, if she answered yes to those
7 questions, you would then counter-sign the log?
8 A. Correct.
9 Q. Did you also read the log entry?
10 A. Yes.
11 Q. Did you notice the name Hannan Properties
12 listed as the third-party payee?
13 A. Not that I recall.
14 Q. That didn't stand out to you as unusual?
15 A. No.
16 Q. That the third-party payee and the advisor had
17 the same name?
18 A. No.
19 Q. Is there any other place in this log where the
20 third-party payee has the same name as the advisor?
21 MR. FORNSHELL: We would have to look.
22 MS. QUALLS: Okay.
23 MR. FORNSHELL: Would you like him to look
24 through the log?
25 MS. QUALLS: No, I won't, but I'll say that I

1 STENOGRAPHIC SHORTHAND REPORTER'S CERTIFICATION

2 - - -

3 I, VICTORIA L. VALINE, CSR NO. 3036, RMR, CRR,

4 RSA, certify: That the foregoing proceedings were

5 remotely taken before me via videoconference at the time

6 herein set forth; at which time the witness was duly

7 sworn; that a record of the proceedings was made by me

8 using machine shorthand which was thereafter transcribed

9 under my direction; and that the transcript is a true

10 record of the testimony so given.

11 Further, the foregoing pertains to the

12 original transcript of a deposition in a federal case

13 and before completion of the proceedings, review of

14 transcript was requested.

15 The dismantling, unsealing, or unbinding of

16 the original transcript will render the Stenographer's

17 Certificate null and void.

18 I further certify that I am not financially

19 interested in the action, and I am not a relative or

20 employee of any attorney of the parties, nor of any of

21 the parties.

22 Dated this 14th day of February, 2022.

23

24

Victoria L. Valine, CSR License #3036

25

EXHIBIT E

0001

1 THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION:
2
3 In the Matter of:)
4) File No. C-08631-A
5 HORTER INVESTMENT)
6 MANAGEMENT, LLC)
7
8 WITNESS: Jason D. Long
9 PAGES: 1 through 143
10 PLACE: Securities and Exchange Commission
11 175 W. Jackson Blvd., Suite 1450
12 Chicago, Illinois 60604
13 DATE: Thursday, January 21, 2021
14
15 The above-entitled matter came on for hearing,
16 pursuant to notice, at 9:05 a.m. CST.
17
18
19
20
21
22
23
24 Diversified Reporting Services, Inc.
25 (202) 467-9200

0002

1 APPEARANCES:
2
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23

10 was -- was getting Smarsh for social media and
11 website archiving and review. In 2015 was getting
12 INTACT in place, which was a document management
13 system, and that was because we were -- not only
14 did we have everything on the compliance side when
15 I started using physical hard copy files, all of
16 our client documents were in these rows and rows
17 of file cabinets. Everything was physical. So,
18 in 2015 that was a big initiative was to implement
19 INTACT and get all of our client documents
20 electronic.
21 MR. LEAR: Hey, Jason. I'm sorry, sorry
22 to interrupt. I just want to make sure you're
23 addressing Jonathan's question which I believe was
24 focused specifically on the compliance
25 department's oversight, to use his term, of
0042
1 investment advisor reps. So, you know -- so,
2 essentially, what was the compliance department
3 doing to keep tabs on the reps.
4 THE WITNESS: Okay.
5 MR. LEAR: You mentioned -- you
6 mentioned the Smarsh system for social media
7 review.
8 THE WITNESS: Yeah. Yeah.
9 MR. LEAR: So, what -- what else?
10 A Yeah. So, we -- we did Smarsh. In 2017
11 we had implemented Basis Code compliance
12 automation software. And -- so, Basis Code is a
13 tool that kind of allows us to -- to more
14 effectively manage our compliance program. So, we
15 knew the results of all of our testing. We can do
16 our risk assessment in Basis Code, do all of our
17 testing in Basis Code. We were able to convert
18 all of our advisors certifications into Basis
19 Code.
20 So, for example, an annual review of
21 the -- the code of ethics, instead of sending out
22 e-mail and -- and requiring advisors to hard copy
23 sign and send them back we can do all of those
24 through the Basis Code software now.
25 In 2017, we also implemented branch
0043
1 audits. And so, we were -- we hired a gentleman
2 to do branch audits in 2017. In 2018, we -- we --
3 2017, 2018 we engaged Smarsh for e-mail monitoring
4 and archiving. And so, that -- that was a much
5 better tool to allow us to monitor advisor e-mails
6 more effectively.
7 Q Mr. Long, real quick, I thought you

8 earlier said you began using Smarsh in 2016. Was
9 it -- when -- when was it?
10 A We -- in -- in 2016 we used -- we used
11 Smarsh for social media and website monitoring and
12 archiving. So, basically, all of our advisors
13 would have to provision all of their social media
14 accounts and any websites. And then, we were able
15 to create our lexicons. And then, essentially any
16 social media posts or website changes that -- that
17 triggered our lexicon review would come up for --
18 for review. And then -- and then it also did all
19 of the archiving. And then -- and then later we
20 added on the e-mail archiving.
21 Q And that was 2017 or 2018?
22 A Yes. Yeah. I believe -- I believe that
23 was 2017. And then -- and then in -- I don't know
24 if this would count, but in 2018 we also
25 implemented Symantec Endpoint Protection for all
0044
1 of our advisors which, basically, ensures that --
2 and we did this for part of our data security,
3 that any devices that the advisors use that --
4 that they may access confidential information or
5 client information would be on our -- our Symantec
6 Endpoint Protection program which is -- basically,
7 ensures that all patches and fixes are up-to-date,
8 fire walls are done. It's kind of a spam filter
9 and some other things, but making sure that --
10 that all of their devices were on there.
11 Q Let me -- just to make sure I'm clear on
12 this, was -- prior to using Smarsh in 2017 or 2018
13 for e-mail monitoring was HIM monitoring
14 investment advisor reps' e-mail prior to that?
15 A The only way we could do it prior to
16 that was to, like, basically, physically log into
17 an advisor's e-mail. And so, we would, basically,
18 control the -- the password and then assign it to
19 the advisor. And then, if we wanted to monitor
20 e-mail we would have to essentially log into their
21 e-mail individually. And so, I had just flagged
22 that as a -- as an issue. And it also made it
23 difficult from an archiving standpoint that we
24 would have to pull e-mails individually from, kind
25 of, each -- each device. And so, that was the --
0045
1 the impetus for Smarsh.
2 Q So, I guess my question is specifically,
3 prior to Smarsh did compliance actually monitor
4 IARs e-mails?
5 A I know sporadically it was done. Judy

6 did -- Judy did, on occasion, would randomly
7 review advisor e-mails. And then -- kind of
8 that's when I -- by 2015, '16 it was, like, you
9 know, that's just -- this is just a horrible
10 system in place. You know, we need to find a
11 better way.
12 Q So, prior to employing Smarsh to monitor
13 e-mails how often would you say these -- a review
14 of -- or IARs e-mails was done?
15 A Very sporadically. It was my
16 understanding if there was -- if there was maybe
17 a -- a specific question or issue with an advisor
18 they might go -- Judy would go in and -- and look
19 at their e-mails, but it wasn't a -- a formal or
20 regular activity.
21 Q Which -- and again, not to be to soon,
22 you say sporadically, is that once a month, once a
23 year, once a quarter? Like, how -- how
24 sporadically?
25 A Yeah. Maybe five times a year.
0046
1 Q And that was under Judy as CCO --
2 A Right.
3 Q -- is that correct?
4 A Right.
5 Q What about when you became CCO, how
6 often would it be done?
7 A I did it a couple of times, but not very
8 often. And I think it was a similar thing, if we
9 had a question on -- on an advisor that we might
10 go in and look. But, you know, I had kind of
11 flagged that as, you know, this is -- this is not
12 a -- a process that we can leverage by any means.
13 You know, this is not an effective tool to have
14 to, you know, individually log into 200 different
15 accounts.
16 But we were -- at this point we had to
17 make some infrastructure changes to be able to --
18 to utilize Smarsh for e-mail archiving. So, I
19 believe we ended up having -- because we had to
20 bring e-mail hosting in-house because we were
21 using GoDaddy and GoDaddy didn't work with Smarsh.
22 And so, we ended up having to -- I believe we made
23 an investment of close to $100,000.00 in -- in
24 servers and network equipment to bring e-mail --
25 e-mail hosting in-house so that we could implement
0047
1 Smarsh.
2 Q And you had said Smarsh reviewed -- for
3 review of e-mail you said it was 2017 or 2018; is

4 that correct?
5 A Yeah. I believe it was 2017 'cause --
6 'cause I think Symantec Endpoint Protection was
7 2018.
8 Q Would that have been before -- before or
9 after Kimm Hannan was terminated?
10 A I want to say it was probably after.
11 Q And again, we'll get to this, but I
12 believe he was terminated in March of 2017.
13 A Okay, yeah. I would have -- I would
14 have to look back at my records to be exact on
15 when we did that.
16 Q Okay. If you could put a note to check
17 that, that would be great.
18 MR. LEAR: Jason, we'll -- we'll make
19 the note and circle back with you.
20 THE WITNESS: Okay.
21 MR. LEAR: You can focus on Jonathan's
22 questions.
23 Q One last thing, Mr. Long, on the
24 compliance oversight of IARs. Were there specific
25 analysts assigned to IARs?

1 A That was something that -- that I had
2 implemented. Again, I don't know the -- the exact
3 date of this, but kind of had this vision of -- as
4 an advisor comes on board that they're kind of
5 well supported by this -- by this team around them
6 which would be their -- what we called an IAR
7 support specialist which essentially is somebody
8 that would process all of their client paperwork
9 and would teach them how to use all of the
10 custodian forms and the Horter forms. And then,
11 they would have a vice president of advisor
12 development around them who would help them with
13 kind of growing and building their practice, would
14 help them with case management and kind of general
15 practice management type questions. And then,
16 they would be assigned a compliance analyst who
17 would be their -- their main point of contact for
18 compliance. And we -- we implemented that, I want
19 to say, in 2015 or 2016.
20 Q Let me turn specifically now to Kimm
21 Hannan. Who was or who is Kimm Hannan? What was
22 his relationship to Horter Investment Management?
23 A Kimm Hannan was an investment advisor
24 representative that we had on boarded in November
25 of 2014.

1 Q What was your professional relationship

EXHIBIT F

Expert Report of Lisa Roth

In the Matter of Horter Investment Management, LLC

and Drew K. Horter

Administrative Proceeding File No 3-20531

May 11, 2022

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1) INTRODUCTION

This report is written to express opinions reached by Lisa Roth in response to allegations made by the US Securities & Exchange Commission (SEC) in Administrative Proceeding File No. 3-20531, In the Matter of Horter Investment Management, LLC and Drew K. Horter.

a) Qualifications and Experience of Lisa Roth

I have more than 30 years of experience in the financial and investment services industry. I am the President of Monahan & Roth, LLC, a regulatory compliance company providing services including professional consultations regarding regulatory compliance for broker-dealers, investment advisers and other financial services firms; audit/independent testing; due diligence; drafting and implementation of written procedures and training; and other compliance services.

I am also the President of XTON Financial (formerly Tessera Capital Partners), a broker-dealer and investment adviser offering new business development, financial intermediary relations, client services and marketing support to investment managers and financial services firms.

I am actively registered with and licensed by the Financial Industry Regulatory Authority ("FINRA") and the State of California. I hold the following FINRA Series qualification exams: 4 (Registered Options Principal), 7 (General Securities Representative), 14 (Compliance Officer), 24 (General Securities Principal), 53 (Municipal Securities Principal), 63 (Uniform Securities Agent State Law), 65 (Uniform Investment Adviser Law), and 99 (Operations Professional).

In 2003, I founded ComplianceMAX Financial Corp. ("CMAX"), a regulatory compliance company offering technology and consulting services to more than 1,000 registered investment advisers and approximately 200 broker-dealers, ranging in size from 1-10,000 associated persons and investment advisers. CMAX was a subsidiary of Monahan & Roth, LLC. Among my duties at

CMAX and continuing to the present day, I have assisted more than 100 investment advisers in the development of their documents and processes, including drafting and implementation of Compliance Programs, Disclosures, Regulatory Filings and related activities relevant to state and federally regulated financial services firms and their associated persons.

From 2001 until 2012, I was the Chief Executive Officer, Chief Compliance Officer and majority owner of Keystone Capital Corporation, a FINRA member firm and registered investment adviser. I managed its mission critical departments, including compliance and operations, and I implemented and tested policies and procedures relative to the company's established supervisory chain of command.

I have been appointed to the Financial Industry Regulatory Authority (FINRA) National Arbitration and Mediation Committee (NAMC) for a second 2-year term. I also serve on the FINRA Series 14 Item Writing Committee, a committee that develops test questions for the industry's Compliance Officer credentialing examinations. I served on FINRA's Membership Committee, a standing advisory committee, from 2015-2017. From 2008-2012 I served on FINRA's Small Firm Advisory Board, including one year as its chairperson. In that capacity I participated in the consideration of new and amended rules and regulations for broker dealers, investment advisers and their associated persons.

In 2012 and 2013, I served a two-year term on the Standing Advisory Group of the Public Company Accounting Oversight Board ("PCAOB"). The PCAOB was established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the financial audits of brokers and dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

Beginning in 1995, I have been engaged as an expert witness on more than 260 occasions. Approximately 85 of these engagements has been related to a matter brought in federal or state

court, and I have testified at trial or deposition in more than 25 of the court matters. The remainder of the matters on which I have served as an expert were FINRA, AAA or JAMS arbitrations. I have never failed to qualify as an expert.

I am a member of the FINRA Board of Arbitrators and have been named as a hearing officer on more than 20 FINRA arbitration panels.

I have had no publications in the last four years.

I charge an hourly rate for services rendered in connection with my service engagement in this matter as follows: $325 per hour for research and analysis; $400 per hour for testimony including depositions.

2) HIM'S COMPLIANCE WITH SECTION 204A AND RULE 206(4)-7

a) SEC Standards

At all times relevant to this report, Horter Investment Management (the firm, or HIM) HIM was a federally regulated investment adviser, subject to the Investment Advisers Act of 1940 (the Advisers Act) and rules promulgated by the SEC under the Act. Under the Advisers Act Section 204A HIM was required to supervise its investment advisory associates (IARs) with respect to activities performed on its behalf.[1]

The Advisers Act is a principles-based regulation that applies a reasonableness standard for compliance with its rules. The Advisers Act generally outlines the criteria that would satisfy the supervision requirement. Providing what has been described as a "safe harbor"[2] for firms carrying out their supervisory duties, the Advisers Act states that reasonableness is achieved if the firm establishes "procedures and a system for applying such procedures, which would

---

[1] See the summary found at https://www.sec.gov/divisions/investment/iaregulation/memoia.htm

[2] Robert Plaze (2013), Regulation of Investment Advisers by the U.S. Securities & Exchange Commission, page 39.

reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person." The Advisers Act adds that the firm "shall reasonably discharge its duties and obligations without reasonable cause to believe that such procedures and system were not being complied with."[3]

Rule 206(4)-7 (the Compliance Program Rule) is the most current and relevant SEC rulemaking regarding the compliance framework required of investment advisers. The rule has three components. It requires investment advisers to draft and implement written policies and procedures, to review the policies and procedures annually, and to appoint a supervised person to serve as the Chief Compliance Officer.

i) Policies and Procedures

The Compliance Program Rule requires advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Adviser's Act and rules thereunder. The SEC requires that an adviser's policies and procedures be *reasonably* designed (emphasis in the original) to prevent violations of the Advisers Act.[4] Consistent with the principles-based framework and taking into account the wide variety in structure, size, services and other characteristics among investment advisory firms, the SEC does not prescribe a set of specific elements required in an adviser's policies and procedures, and instead has enumerated what it considers to be minimum guidelines, to the extent any given topic is relevant to a particular adviser.[5]

Rule 206(4)-7 does not require advisers to consolidate all compliance policies and procedures into a single document nor does it require an adviser to memorialize every action that must be

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[3] Investment Advisers Act of 1094, 203(e)(6), found at https://40act.com/laws-rules/investment-advisers-act-of-1940-statute/section-203-registration-of-investment-advisers

[4] See Section II A. 1, Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Securities & Exchange Commission, Release Nos. IA-2204; IC-26299; File No. S7-03-03, found at https://www.sec.gov/rules/final/ia-2204.htm#P66_13177

[5] Section II A. 1. Final Rule (n 1)

taken in order to remain in compliance with the Advisers Act. Instead, SEC guidance states that the allocation of responsibility within the organization for the timely performance of many obligations may be adequate to achieve compliance.[6]

The SEC guidance is consistent with my observation of effective industry standard practices. In my experience, it is customary and effective for an investment adviser to allocate responsibility among personnel and throughout departments of the firm. Often, the persons carrying out the tasks will perform their duties as a matter of course throughout their workday consistent with their understanding of the expectations of their supervisors. Over time the procedures may be reduced to writing and/or they may find their way to the firm's centralized policy manual. At other times, the desktop procedures may remain internal to the departments or with the personnel whose job it is to perform the task. In my experience, any of these methods can be effective to achieve compliance with the firm's policies and procedures and with the Compliance Program Rule.

ii) Annual Review

The Compliance Program Rule requires advisers to review the adequacy and effectiveness of their policies and procedures at least annually. The rule does not require that a particular individual perform the review, nor does it prescribe a framework for documenting the review. The rule does not require the CCO of an adviser to prepare a report that summarizes the results of the annual review.[7]

In my experience, the annual review process varies greatly among firm ranging from formalized testing to ad hoc reviews. Commonly, reviews result in revisions to compliance and supervisory practices and/or policies and procedures amendments. It is far more likely that the annual review is performed by personnel in the compliance department than by the firm's executive

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[6] Ibid
[7] Section I D, CCO Outreach (2009), page 4 found at https://www.sec.gov/info/iaiccco/iaiccco-focusareas.pdf

management. Except in a very small firm where the top-ranking senior executive also serves as the CCO, it is very uncommon for the executive to perform the annual review.

iii) Chief Compliance Officer

The Compliance Program Rule requires advisers to designate an individual for administration of the policies and procedures. Most commonly the individual carries the title CCO. The Compliance Program Rule requires that the CCO be competent, knowledgeable and empowered with authority to develop and enforce appropriate policies and procedures for the firm. To meet this standard, the SEC has advised that the individual should have the ability to discern areas in which compliance is of concern, to identity conflicts of interest that may be present, and to recognize activities through which the firm may be exposed to regulatory risk.[8] The CCO need not be an employee who does not have other duties.[9]

The following report will describe how Mr. Horter and HIM complied with the SEC rules and guidance.

b) HIM's Compliance Program was Compliant with Rule 206(4)-7

HIM implemented reasonably drafted procedures, subjected the policies and procedures to ongoing review and designated a CCO with adequate authority and qualifications. HIM allocated responsibility within the organization for the timely performance of fundamental obligations. I believe that HIM established a sufficient framework for a successful supervisory program and achieved compliance with the Advisers Act and Rule 206(4)-7. The evolution of HIM's compliance program from 2014 to 2017 demonstrates the firm's attention to risk mitigation and a reasonable compliance culture. The firm's investment in personnel, third party resources and technology illustrate the extent to which the firm enhanced its support system in response to internal and external initiatives, guidance, requirements and recommendations.

[8] Section I C. 1. Final Rule (n 1)
[9] Plaze (2013) page 40 (n 2)

In 2015, the culture of compliance at HIM was evaluated by Evan Rosser, a compliance consultant employed by Oyster Consulting, LLC who was engaged to perform a third-party assessment of HIM's compliance program. Mr. Rosser reported, "My interviews with Firm management revealed that addressing compliance and supervisory systems, procedures, and staffing is a foremost concern. Significant compliance progress has been made during 2014 as the Assistant CCO has drafted new procedures, initiated new Firm-wide committees and Compliance Department meetings, and added formal compliance training for his Compliance staff."[10]

Each aspects of the firm's compliance culture will be addressed in the report that follows.

i) Policies and Procedures

HIM complied with the first prong of Rule 206(4)-7 by developing comprehensive and clear policies and procedures reasonably designed to achieve compliance with SEC rules and guidance.

HIM engaged the services of National Regulatory Services (NRS), a reputable third-party compliance services provider, to provide a framework for HIM's policies and procedures manual. HIM produced at least one updated version of its policies and procedures manual annually. Each version was thorough, drafted in plain English and developed with the benefit of input from a professional nationally recognized compliance services provider. Each version addresses the areas outlined by the SEC as minimally required if applicable, in compliance with SEC Rule 206(4)-7.

HIM's manual makes it clear that the policies and procedures apply to all principals, all employees, advisors, agents and representatives (collectively "associated persons" or "IARS") who are subject to [the firm's] supervision and control.[11] And, the manual establishes

[10] Oyster Consulting, LLC RIA Compliance Program Review Report to Ice Miller LLP Counsel to Horter Investment Management (2015), page 9.
[11] Introduction Section I, Horter Investment Management, LLC Policies and Procedures Manuals (2013 – 2019), page 2

that each individual with management responsibilities is responsible for monitoring those individuals and departments he or she supervises "to detect, prevent and report any activities inconsistent with the firm's procedures, policies, high professional standards, or legal/regulatory requirements."[12] In HIM's manual, associated persons are advised of their obligation to comply and to escalate any questionable activity or potential violation to the CCO.

In addition to the primary policies and procedures manual, HIM drafted and implemented more than 25 written procedures addressing the major responsibilities of the compliance, sales and operations departments. The supplementary procedures included Policies and Procedures for Approval and Use of Advertising and Marketing Materials, New Advisor On-Boarding Procedures, Client File & Suitability Review Procedures, and Prospective Advisor Due Diligence Procedures.[13]

The combination of formalized policies and procedures in the manual and targeted directives deployed throughout the organization provided a solid framework for a successful compliance program.

ii) Annual Review

HIM complied with the second prong of Rule 206(4)-7 by reviewing its policies and procedures annually to determine their adequacy and the effectiveness of their implementation. The rule does not require that a particular individual perform the review, and in the time frame relevant to this matter, the SEC did not prescribe a framework for documenting the review. The rule did not require the CCO of an adviser to prepare a report that summarized the results of the annual review.[14]

For each of the years relevant to this report, HIM undertook activities that fulfilled its requirement for an annual review.

[12] Ibid, Page 6
[13] Exhibit 23, Drew Horter Examination Transcript (2021)
[14] CCO Outreach (2009) (n 7)

In early 2014, HIM hired Jason Long, a qualified and experienced individual to eventually to lead its compliance program. Under Mr. Long's leadership in 2014, HIM engaged in enhanced diligence to satisfy the annual review requirement. Mr. Long formed a Risk Committee and undertook the development of a Risk Assessment and related activities. The process undertaken by Mr. Long was the equivalent of and satisfied the obligation for an annual review.

In early 2015, HIM hired the reputable compliance company Oyster Consulting, LLC (Oyster), to review its compliance program and make recommendations. The result (the Oyster Report) fulfilled the requirement for an annual review.

In 2016 and 2017, Mr. Long performed annual reviews that yielded objective observations and resulted in meaningful remediation. For example, in the 2016 annual review, Mr. Long observed a need for more effective compliance supervision of IAR Support Department and Trading, including the drafting and implementation of written procedures along with monitoring and testing to ensure procedures are being followed; initiation of IAR branch compliance visits to supplement existing procedures; and insufficient written procedures regarding Outside Business Activities (OBA's). The gaps identified through the testing were addressed, and relevant risks were mitigated.

Among the steps taken in response to the 2016 testing were the following:

- New policies and procedures for the IAR Support and Trading personnel were established by Mr. Kirk and Mr. Long.
- A full-time employee was hired to design and implement a branch exam program.
- Written procedures for outside business activities were substantially amended and implemented including the adoption of a new Outside Business Activities chapter in the manual. The chapter incorporated procedures that required associated persons to make initial and ongoing disclosures of outside activities and describe the scope of activities requiring disclosure. The chapter described the review process including that the CCO could render approval, conditional

approval, or denial of any disclosed activity. The chapter assigned responsibility for administration of the policies and procedures to the CCO.

It is important to note while the goal of a compliance program is to prevent compliance problems from occurring, it is understood that some compliance breaches still may occur. An effective CCO seeks to identify gaps and weaknesses for purposes of risk mitigation and continuous improvement. SEC examiners are trained to expect to find exception reports, compliance checklists, and management reports that identify problems and issues like the records created by Mr. Long. SEC examiners are advised to treat not the presence but the absence of any compliance problems during examinations with skepticism.[15] In this context, Mr. Long's identification of weaknesses and opportunities for improvement through his reviews reflected a meaningful and objective compliance testing process.

Beginning with Mr. Long's risk assessments in 2014, including the Oyster Report and continuing through 2017 HIM's annual reviews reflect thoughtful consideration of relevant criteria for identifying and addressing opportunities for compliance and supervisory enhancements.

iii) Chief Compliance Officer

At all times relevant to this report, HIM designated an individual who was responsible for the administration of its compliance program. The designations were formally recorded on the HIM Organizational Charts and identified in its Form ADV. Each individual serving as CCO is/was adequately familiar with relevant rules and regulations. Each was a supervised person of the firm, authorized with adequate authority to implement change if desired.

Important to the context of this report, the firm's CCO had a direct line of reporting to Mr. Horter, thereby formalizing the position of the CCO as senior in the organization and establishing a culture of compliance. The organizational framework implemented by HIM, which empowered

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[15] Legal Update: SEC's OCIE Publishes Risk Alert Providing Its Observations of Investment Adviser Compliance Programs (2020) found at https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/12/llsecs-ocie-publishes-risk-alert-providing-its-observations-of-investment-adviser-compliance-programs.pdf

the CCO in a senior position of authority, is favored by the SEC.[16] The SEC has stated that the designation of a single officer will increase the coordination with which distributed compliance functions are executed.[17]

The Organizational Charts illustrate a well thought-out system for supervision, compliance and the overall operation of the firm. Each department head had a direct line of reporting to Mr. Horter, the firm's top-ranking executive.

In February 2014, when Mr. Long was hired to join the firm as Assistant CCO under Ms. Helmes-Sneed, he brought substantial additional experience to the department. Mr. Long's contributions to the firm's compliance program are notable and are discussed throughout this report. From February 2015 through April 2016 HIM hired Oyster's Evan Rosser as its CCO. Hiring Mr. Rosser as CCO further increased the level of experience and qualifications to the compliance and supervisory program at HIM. Importantly, Mr. Horter's decision to hire Mr. Long and Mr. Rosser demonstrated his commitment to enhance the compliance program at HIM. Alongside other department heads, Mr. Rosser was placed in a position of authority as a direct report to Mr. Horter.[18] Ultimately in April 2016, after approximately one year of orientation, Mr. Long stepped into the role of CCO. The progression of Mr. Long into the role of CCO reveals thoughtful and material improvement in the compliance framework at HIM over the course of time. Even after Mr. Long was escalated to the CCO role, Mr. Rosser continued to provide compliance consulting services to HIM through March 2018.

The investment Mr. Horter and HIM made in personnel and resources is indicative of a firm that cares about compliance.

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[16] See the comments made by Peter Driscoll, Director, SEC Office of Compliance inspection and Examinations, (2020), Opening Remarks at the CCO Outreach found at https://www.sec.gov/news/speech/driscoll-role-cco-2020-11-199898

[17] Section IV A 1, Final Rule (n1)

[18] Organizational Chart, Horter Investment Management LLC (1/31/2015)

3) HORTER'S IMPLEMENTATION OF ITS COMPLIANCE AND SUPERVISORY PROGRAM

a) SEC Standard for Compliance and Supervision

The SEC rules governing the format for an investment adviser's compliance program and its supervisory system are not prescriptive. Instead, the rules and regulations under the Advisers Act are principles-based leaving the prescription for implementation to the interpretation of the firm itself. There are no SEC rules for investment advisers that require cyclical examinations of branches, oversight of associated persons' outside activities, or mandatory methods for supervision including heightened supervision or other such requirements. There is no principal license that serves as a prerequisite to acting in a supervisory capacity, nor is there a requirement to create a formalized supervisory chain of command.

The SEC has issued guidance indicating that to implement a compliance program reasonably designed to prevent violations of the Advisers Act and rules thereunder, an investment adviser should identify the risks and conflicts of interest that are relevant to its business, noting that the identification process should be repeatable and firm-wide. The process should not be static.[19]

In summary, the SEC's guidance consistently centers around a compliance process that reasonably evolves to conform to address perceived risk in the firm. There is no SEC rule, requirement or guidance that would suggest that perfection is a mandatory component or even a reasonable expectation. In fact, in an assessment of whether a surveillance and compliance person had failed to supervise, the Commission found that the individual's conduct, although not exemplary, was reasonable in that he had taken diligent efforts to perform assigned tasks.[20]

[19] CCO Outreach (2009) (n 7). Note that a subsequent CCO Outreach event in 2014 cited to the 2009 agenda. Please see also: https://www.sec.gov/info/cco/ccons2014-handouts.htm

[20] Section IV, "The Role of Compliance Personnel" (1995), Remarks of Richard Y. Roberts, Commissioner

b) HIM’s System of Compliance and Supervision Complied with SEC Rules, Regulations and Guidance

Under the principles-based rule regime for investment advisers, HIM did what is consistent and aligned with the industry standard: HIM developed a compliance and supervisory program with structure and depth that could reasonably be expected to detect and prevent wrongdoing.

Between 2014-2107 HIM’s compliance and supervisory program was structured to align and interact with the firm’s other departments including marketing, sales and operations.

HIM’s compliance program was tailored to its business model.

HIM's compliance program exhibited the components of an activist compliance program, a term coined by Lori Richards, the former Director of the SEC’s Office of Inspections and Examinations to describe that a compliance program should be “living and breathing” within a firm.[21] Among the components of HIM’s compliance program that conformed to the model described by Ms. Richards were Mr. Horter’s support from the top of the organization, a compliance program well-resourced and staffed and the presence of professional skepticism regarding the program’s implementation.

i) Formalized, Risk-Based Compliance Program

HIM’s Compliance Program was formalized, tailored to its business model and evolved with the growth of the Firm.

As for any top-ranking firm executive, Drew Horter had ultimate authority over the firm’s business decisions, including when and how to invest in compliance and supervisory personnel,

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[21] Speech by SEC Staff: Remarks before the Investment Adviser Compliance Best Practices Summit: Compliance Programs: Our Shared Mission (2005), Lori Richards, found at https://www.sec.gov/news/speech/spch022805lar.htm

systems and other resources to support the firm's growth. Leveraging his industry experience which spanned 25 years prior to founding HIM, Mr. Horter created a compliance and supervisory program that reasonably leveraged tenured personnel alongside and reputable third-party resources.

Despite his status in the firm, throughout the relevant time frame covered by this report, Mr. Horter did not work alone as the firm's singular authoritative figure. Mr. Horter led HIM with an open-door management style that fostered open communications with and among his management team. The extent to which Mr. Horter closely collaborated with his management team is notable and will be discussed in more detail below.

Mr. Horter took a substantial step in enhancing the compliance program in February 2014, when he hired Jason Long as Assistant CCO. Long, who served in the CCO role at previous employer, was hired to help manage the day-to-day operation of the Compliance Department. Mr. Horter found that Mr. Long had the right experience and ability to enhance the compliance infrastructure at HIM.

During the months following his employment, Mr. Long drafted new procedures, instituted new practices, and began holding regular meetings with the Compliance Department staff. Mr. Long organized a Risk Committee consisting of the firm's senior managers and initiated a risk assessment process. Looking back over Mr. Long's efforts in 2014, the Oyster Consulting Report distributed in early 2015 recognized the value of this contribution noting, "The Compliance Department and representatives of Horter management should continue with the development of a Firm-wide risk assessment that was started in June 2014. The Firm recognizes this need and has taken steps over the past year by summarizing all exam findings from prior regulatory exams in a table and sharing those findings with compliance staff."[22] Also in its report issued March

[22] Oyster Consulting LLC Report (2015) (n 10), page 5

2015, Oyster noted that corrective actions were well underway reporting, “Additionally, many of the enhancements had already been identified by the Firm and are being remedied.”[23]

By January 2015 Mr. Horter hired Evan Rosser as the firm’s Interim CCO. Mr. Rosser was a Senior Consultant with Oyster Consulting, LLC. Mr. Rosser’s 25 years of regulatory compliance experience contributed to further and ongoing development of HIM’s compliance program in the role of CCO for slightly more than a year. Even after Mr. Long was promoted to fill the CCO role, Mr. Rosser stayed on in a consulting capacity to ensure that the momentum achieved in the compliance department was sustained. The engagement of Mr. Rosser was evidence of Mr. Horter’s commitment to the culture of compliance at HIM.

By March of 2015, when Mr. Rosser’s report was delivered, the firm’s compliance team had accumulated a comprehensive inventory of risks. Retained in the format of a compliance calendar, the inventory included more than 150 items reflecting the ongoing input by compliance analysts.[24] By that time, Mr. Rosser had spent several months assessing and administering the compliance program at HIM, including while service as its CCO.

Mr. Rosser’s hands-on role ensured that findings and recommendations were made in the context of HIM’s business model. Mindful of the composition and demographics of HIM’s IARS, Mr. Rosser identified priority recommendations, which included the deployment of technology and automation to enhance HIM’s supervision of its remotely located IARs. Mr. Rosser noted that much of the surveillance could be performed from the headquarters office in Cincinnati provided the firm invest in enhanced supervisory tools such as surveillance technologies. In particular, the Oyster Report recommended that HIM implement email surveillance technology.[25]

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[23] Ibid, page 2
[24] Ibid, page 5
[25] Oyster Consulting LLC Report (2015) (n 10), page 8

In response to this recommendation, Mr. Horter authorized the enterprise-wide deployment of Smarsh, a nationally recognized provider of email surveillance and archive. This was a substantial step in enhancing the firm's compliance technology.

The investment in Smarsh was not a stand-alone investment. In fact, Mr. Horter never declined a request for additional compliance resources. This is significant because cuts in budgets and resources in compliance are warning signs to SEC examiners.[26] In contrast, Mr. Horter's continuous and substantial investments in compliance tools and resources are a material consideration in my opinion that HIM's compliance and supervisory program was well administered with Mr. Horter's full support.

HIM's response to recommendations in the Oyster Report was methodical and ongoing. Throughout the time frame 2014-2017 (and continuing to the present), new technologies including Smarsh, Sweet Process, BasisCode, RiskAnalyze, Orion, Zephyr and Black Diamond were adopted and deployed. Where necessary to support compliance staff with personnel, HIM engaged third parties. For instance, in 2015, HIM expanded its engagement with NRS to the highest level of its service platform to assist the compliance team in reviewing a backlog of advertising materials.

The investment in technologies and third-party services was significant and demonstrated a concerted and continuing effort to achieve compliance. These are the types of material actions that demonstrate that Mr. Horter and HIM were serious about achieving compliance.

ii) Enterprise Level Implementation of the Compliance Program

Mr. Horter took an enterprise-level collaborative approach in his management of HIM. Mr. Horter's was approach was measured, strategic, and effective.

[26] Driscoll CCO Outreach (2020) (n 11)

At all times relevant to this report Mr. Horter was HIM's top-ranking executive officer, but Mr. Horter was not the CCO nor was he required to be. Mr. Horter could not have, and should not have, been responsible for oversight of every day-to-day task and responsibility of the compliance program.

Mr. Horter appointed individuals to lead mission critical departments of the company. Mr. Horter reasonably relied on his management team to perform their duties. He selected individuals as managers based on their ability to know the job and to do the job. And, Mr. Horter supported his managers with meaningful resources. In his selection of Jason Long, for example, he based his compliance hiring decision on Mr. Long's prior experience as a CCO with an investment adviser, his related experience as a CFO, and his academic credentials which included an MBA. But Mr. Horter did not blindly rely on Mr. Long's background and experience and empower him to perform the duties of CCO on day one. Notwithstanding Mr. Long's solid credentials, Mr. Horter initially placed Mr. Long in subordinate position, first to Ms. Helmes-Sneed, then under the more experienced Oyster Senior Consultant Evan Rosser. As noted earlier, even when Mr. Long was promoted to the role of CCO, Mr. Horter retained the Oyster Consulting group and Mr. Rosser for an extended period of time.

The importance of physical proximity of supervisors to Mr. Horter cannot be overstated. At all times relevant to this matter, Mr. Horter and his supervisory team were never more than a staircase away from one another. The managers leveraged the office layout through structured in -person weekly meetings, supplemented by ad hoc meetings as and when issues arose throughout the business day.

Mr. Horter relied on his management team to inform him of issues they encountered on a day-to-day basis. Asked "what it means for you to be primarily responsible for the supervision [of an IAR]" Mr. Horter responded, "compliance would bring to me any concerns they have about any

advisors."[27] Mr. Horter's response reflects that he is/was receptive to discussions of risk, including concerns about IARS, and that he relied on qualified personnel to identify issues.

HIM's administrative procedures included logs, blotters and other processes administered according to desktop procedures or reasonably performed by individuals who understood their duties under the oversight of their supervisors. Naturally, Mr. Horter could not have and should not have personally performed the day-to-day duties and supervision he had responsibly delegated to qualified managers.

HIM's organizational charts reveal an orderly and logical distribution of job functions and reporting chains of command. The senior managers in departments including compliance, sales, trading and operations each had a direct line of reporting to Mr. Horter. This explains why regulatory disclosures, such as Form ADV Part 2B disclose Mr. Horter as the ultimate supervisor. However, these disclosures do not claim and should not be taken to claim that Mr. Horter was the only supervisor of any IAR or the firm.

Important in the context of HIM's business model, management functions were powered by technology that made processing large volumes of data possible. These technologies contributed to the efficient operation and compliance obligations of the company. Some of the tools such as Smarsh, Orion and BasisCode were deployed specifically in response to compliance initiatives.

Importantly, IARs were informed of the Firm's supervisory structure through orientation materials that communicated the supervisory program. The IAR Welcome Packet in use as of 2014 included information regarding supervisory contacts and resources, record-keeping requirements, training, compliance disclosure calendar, advertising pre-approval requirements,

[27] Deposition of Drew Horter, Buddy Scott et. al v Horter Investment Management (05/16/2019), p 61

use and disclosure of social media, use of professional designations, scope and IAR responsibility for accuracy of regulatory disclosures and more.[28]

iii) Branch Examinations Were Not Required in 2014-2017

The SEC considers a branch to be any office or place of business other than the adviser's principal office.[29] HIM operated through numerous branch offices geographically dispersed throughout the country. The SEC first highlighted potential risk associated with multi-branch advisers in 2016 when it published the SEC Office of Compliance Inspections and Examination (OCIE) 2016 Examination Priorities.[30] Later, in 2017, the SEC priority became reality when the SEC launched its Multi-Branch Initiative[31] which will be discussed in more detail in a later section of this report. This is notable since the conduct alleged here ended in 2017.

In the context of the overall supervisory system at HIM it is important to state that HIM was not required to perform branch inspections of its remote offices at any time relevant to Mr. Hannan's affiliation with the firm or to the current day. The fact that HIM did not conduct field examinations between 2014 and 2017 is not evidence of a lack of supervision or of non-compliance with the Compliance Program Rule.

This is not to mean that branch examinations were not considered at HIM. Mr. Long and Mr. Rosser identified the geographically dispersed IARs as a potential for risk and discussed means for mitigation as early as 2014. Again, this is notable since the SEC's initiative was not undertaken until 2016.

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[28] SEC-HORTER 000483

[29] See definitions found in Rule 222-1 under the Investment Advisers Act of 1940 ("Advisers Act").

[30] OCIE, "Examination Priorities for 2016" (01/11/2016), found at chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/viewer.html?pdfurl=https%3A%2F%2Fwww.sec.gov%2Fabout%2Foffices%2Focie%2Fnational-examination-program-priorities-2016.pdf&clen=82811&chunk=true

[31] Observations from OCIE's Examination of Investment Advisers: Supervision, Compliance and Multiple Branch Offices, (11/069/2017), found at https://www.sec.gov/files/Risk%20Alert%20-%20Multi-Branch%20Risk%20Alert.pdf

Regarding the feasibility of branch examinations, Mr. Rosser cited the logistical challenges and high cost of performing branch exams, and suggested that instead of branch examinations the firm could deploy meaningful supervision through enhancements including technology administered from the Cincinnati headquarters.[32] As noted earlier, HIM responded to this recommendation by making investments in technology and personnel designed to mitigate risk associated with geographically dispersed offices.

In 2016 Mr. Long hired a new employee to head a branch examination effort, and within approximately one year HIM rolled out a branch exam program. As such, in 2016, as the SEC was rolling out its Multi-Branch Initiative to assess the state of the industry, Mr. Long was actually developing a program for branch exams. It warrants repeating that Mr. Long's initiative occurred prior to the completion of the SEC's exam initiative and years before the publication of SEC guidance that resulted from its Multi-Branch Initiative and related examination sweep, which was not released to the industry until 2019.

Although there was no rule or relevant regulatory guidance regarding branch examinations, HIM's compliance department designed a program in direct relevance to its business model.

4) DELEGATION OF DUTIES AND RESPONSIBILITIES

a) SEC Standard for Systems of Supervision

As noted earlier in this report, in the Advisers Act and Rule 206(4)-7, the SEC clarified that "supervision would be deemed to be reasonable provided

(i) the adviser had adopted procedures reasonably designed to prevent and detect violations of the federal securities laws;

(ii) the adviser had a system in place for applying the procedures; and

[32] Oyster Consulting LLC Report (2015) (n 10), page 4

(iii) the supervising person had reasonably discharged his supervisory responsibilities in accordance with the procedures and had no reason to believe the supervised person was not complying with the procedures."[33]

Further, the SEC guidance established that the cornerstones of a framework for a successful supervisory system are

- assigning responsibility
- to persons with demonstrated ability and
- granting the individuals the authority to perform their duties.[34]

This was clearly the model adopted by Mr. Horter and HIM.

b) Mr. Horter Delegated Authority Reasonably and Effectively.

Mr. Horter and HIM complied with the Advisers Act and Rule 206(4)-7 by adopting reasonably designed procedures, designating reasonably qualified individuals to administer them, and through routine communications that informed the executives of the firm and its personnel's compliance. Consistent with the SEC guidance, Mr. Horter assigned responsibility to qualified persons in senior positions and gave them the resources to perform their jobs.

Consideration of the firm's business model was at the core of the supervisory system deployed by Mr. Horter and HIM. In 2016 the vast majority of US investment advisers had fewer than 50 employees, and the industry median was 9 employees.[35] HIM did not, and should not have, conducted itself like a small firm where it is customary for all decision-making emanate from the senior-most executive. HIM's supervisory system had to be tailored to its own model, and it was.

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[33] Advisers Act

[34] Driscoll CCO Outreach (2020) (n 11)

[35] NRS and IAA's 16th Annual Evolution Revolution (August 23, 2016), found at https://www.nrs-inc.com/about/press-room/nrs-iaas-16th-annual-evolution-revolution-study/

The substantial investment in technical and administrative infrastructure is one example of how Mr. Horter's model was tailored to its business model. Leveraging technology to fulfill HIM's supervisory strategy was effective and was in line with recommendations made by Mr. Rosser in the Oyster Consulting Report. Independent IARs operating from remote locations could leverage the HIM systems to carry out their day-to-day business including placing transactions, attaining product approvals, opening accounts, communicating with clients, approving advertising and other routine activities that were centralized under the HIM model. At the same time that the centralization provided efficiencies for the IARs it also provided an oversight mechanism for the firm, as the firm's business flowed through the central home office.

Mr. Horter's delegation of duties to qualified individuals was the cornerstone of HIM's supervisory system. In a manner consistent with SEC guidance, Mr. Horter assigned responsibility for oversight of the firm's primary departments to qualified and experienced individuals. Mr. Horter conducted routine meetings in which the senior managers collectively shared issues, updates and current events. This collaborative strategy was designed to achieve a successful system of supervision of the firm's IARs. I believe the strategy was successful.

Mr. Horter's delegation of supervisory responsibilities to the CCO was in line with recommendations made in the 2015 Oyster report. The Report recommended that HIM "develop a more detailed procedure for supervising the activities of its remote IARs" and that "As part of this supervisory program, Oyster recommends that all IARs have an assigned supervisor." The Oyster Report also advised, "Most of this remote location supervision can be performed in the Cincinnati headquarters."[36]

In response to the recommendation, Mr. Long assigned each IAR to a compliance analyst. The compliance analysts worked in close physical proximity to Mr. Long, who was accessible to them at any time during the workday. In most instances, the compliance analyst responsible for onboarding the IAR continued as the IAR's supervisor.

[36] Oyster Consulting LLC Report (2015) (n 10), page 4

Mr. Horter assigned the performance of an annual review of the Compliance Program to the CCO. It is appropriate and customary for the CCO to carry out this responsibility. It would be highly unusual for the top-ranking executive in a firm the size and model of HIM to perform this task.

Mr. Horter's delegation of duties to the CCO should not be taken to imply that Mr. Horter took a hands-off approach. Reasonably relying on Mr. Rosser then Mr. Long to lead the compliance and supervisory efforts, Mr. Horter could have stepped away from compliance entirely, but he did not. Mr. Horter stayed in close contact with his management team in general and Mr. Long in particular.

Mr. Horter assembled HIM's leadership team in one building. Senior managers were in attendance at regular weekly meetings that were conducted according to a structured agenda followed by an open format give each manager an opportunity to discuss open or pressing matters. Between meetings and throughout the workday, Mr. Horter's door was open. Over the course of his employment, Mr. Long has interacted with Mr. Horter at least once daily. Mr. Horter is consistently informed of open topics through these open and productive communications. Mr. Horter's awareness of compliance initiatives was recognized in the Oyster Report which stated, "My interviews with Firm management revealed that addressing compliance and supervisory systems, procedures, and staffing is a foremost concern."[37] Supervision and compliance were not treated as ad hoc matters, but rather involved strategic decision making and routine collaboration.

Mr. Long created and maintained an internal worksheet that recorded the assignment of each IAR to a support team that included a member of the compliance team. Mr. Long also created a task list table that detailed the duties and responsibilities of the personnel.[38] Mr. Long

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[37] Oyster Consulting LLC Report (2015) (n10) page 9
[38] Ibid, page 5

developed a training plan for compliance personnel which he administered in routine meetings he held at least monthly.

Because delegation of authority was important to the success of HIM's supervisory program, it was important that IARs were informed of the structure. Materials distributed by HIM to IARs provided meaningful information as to how the firm delegated authority for purposes of their day-to-day activities and business processing. HIM specifically informed personnel of the supervisory delegation in the onboarding Welcome Packet which included descriptions of the fundamental organization model deployed by HIM through a department structure that included Compliance, Sales, Operations, and IAR Support. The Welcome Packet provided to Hannan was dated December 3, 2014.[39]

The 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) HORTER SUPERVISION RELEVANT TO HANNAN

a) SEC Standard - Hiring Practices, High Risk Advisers

In 2016, notably nearly 2 years after Kimm Hannan's registration with HIM, the SEC announced a Supervision Initiative.[40] This was the SEC's first substantive initiative targeting "high risk" advisers. The initiative was directed at firms that employed supervised persons with disciplinary events that occurred during the individual's employment with the adviser and in prior employments.[41]

To carry out its initiative, the SEC's OCIE leveraged the Multi-Branch Initiative discussed earlier in this report, conducting "sweep" examinations of firms. Firms in the target group had similarities to HIM, as they were all retail firms, and each had 10 or more branch locations. In the

[39] SEC-HORTER000482
[40] https://www.sec.gov/files/ocie-2016-risk-alert-supervision-registered-investment-advisers.pdf
[41] https://www.sec.gov/files/ocie-2016-risk-alert-supervision-registered-investment-advisers.pdf

sweep, OCIE examined approximately 40 investment adviser home offices, and one or more branches of each adviser.[42]

To identify participants, OCIE targeted firms that had hired "high risk" individuals. OCIE focused on individuals with significant disclosure events: criminal/civil events, administrative proceedings, regulatory proceedings and/or licenses revoked due to violation of professional conduct).

OCIE's characterization of "high risk" was consistent with other regulators such as FINRA,[43] and is the standard commonly applied to this day across the industry.

To gather its target participants, OCIE used the SEC's database searching for firms reporting proportionately high:

- Disciplinary information that is reported on an advisor's Form ADV.
- Information about other legal actions (e.g., private civil actions) not required to be reported on Form ADV, but which is nonetheless relevant to the advisory services offered to clients.
- Information from SEC enforcement actions that barred or suspended individuals from certain financial industries.[44]

HIM's IARS did not have proportionately high legal actions and regulatory enforcement actions. Despite its demographic similarities to the target group, HIM was not identified as a sweep participant.

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[42] SEC Risk Alert, Observations from OCIE's Examinations of Investment Advisers: Supervision, Compliance and Multi-Branch Offices. November 9. 2020, found at https://www.sec.gov/ocie/announcements/risk-alert-multi-branch
[43] FINRA Regulatory Notice: FINRA Adopts Rules to Address Brokers With a Significant History of Misconduct, September 1, 2021, found at https://www.finra.org/rules-guidance/notices/21-09
[44] SEC to Sweep Advisors Who Hire Those With Disciplinary History, Melanie Waddell, Think Advisor, September 12, 2016, found at https://www.thinkadvisor.com/2016/09/12/sec-to-sweep-advisors-who-hire-those-with-disciplinary-history/?slreturn=20220025121421

The SEC did not publish guidance resulting from the high risk sweep and supervisory initiative until 2019.[45] This is important to note, because the release of relevant guidance resulting from the SEC initiative was published well after the actions alleged in this matter occurred.

b) How Horter Complied – Hiring Practices and "High Risk" IARs

Beginning in 2014, HIM deployed centralized policies and procedures to govern its hiring practices using a 4-page step-by-step checklist and a Prospective New Advisor Scorecard. Mr. Long compiled data resulting from the centralized processes and provided monthly status summaries to Mr. Horter.[46]

The onboarding practices were newly in place when Hannan was onboarded in late November 2014, and each of the hiring documents were utilized to onboard Hannan.[47]

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i) Hannan Was an Attractive Candidate in 2014.

In November 2014 when Mr. Hannan was being considered as an IAR by HIM, he was not a "high risk" adviser as characterized by the SEC. Leading up to his December 1, 2014 registration date with HIM, Hannan had none of disclosure events in the SEC of FINRA's "high risk" categories.

When Hannan submitted his application to HIM in November 2014, Kimm Hannan had 44 years of financial industry experience. He had spent the majority of his career at Ameriprise, a reputable firm. Prior to joining HIM, Mr. Hannan was a dual registrant which means that in addition to his licensing as an investment advisory representative, he was also previously licensed as a registered representative of a FINRA member broker-dealer firm. Because of the prescriptive compliance and supervisory regime for broker-dealers, prior experience as a

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[45] Observations from Examinations of Investment Advisers: Compliance, Supervision and Disclosure of Conflicts of Interest (2019, found at https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Supervision%20Initiative.pdf

[46] Exhibit 45, Horter depo

[47] SEC-HORTER000534-000537, 4-page checklist (11.22.2014); PHORTER-SEC000522, Prospective New Advisor Scorecard (11.26.2014)

registered representative is generally seen as a favorable quality in a prospect to an investment adviser.

Mr. Hannan was a credentialed candidate. Mr. Hannan's Professional Designations including Chartered Financial Consultant (ChFC). The ChFC is a professional credential recognized as adequate to exempt him from Series 65 testing requirement as an IAR. He had also earned the Chartered Life Underwriter. Both professional designations were granted by the American College to individuals with demonstrated prior experience, upon completion of coursework, and after passing a final exam. The professional credentials required Mr. Hannan to complete 30 hours of continuing education every 2 years. In addition to the CE requirement, the CLU requires the candidate to pledge to comply with the American College Code of Ethics and Procedures.

Mr. Hannan was also awarded the Life Underwriter Training Council Fellow (LUTCF administered by American College and National Association of Insurance and Financial Advisors (NAIFA). To maintain the designation, Hannan was required to complete 1 required course and 5 electives, then pass o final examination. Once awarded, Hannan was required to complete 3 ethics related CPE credits every 2 years.

And, Mr. Hannan held the Chartered Retirement Planning Counselor (CRPC), sponsored by College for Financial Planning. Hannan was required to complete the coursework focused on pre-and post-retirement needs, planning and related asset management skills and techniques within one year of enrollment and pass a final examination. Once awarded, Hannan was required to maintain the credential by completing 16 hours of CE every 2 years.

Mr. Hannan had a single customer complaint as of November 2014. The matter was resolved with no monetary contribution made by Mr. Hannan. Mr. Hannan had no other regulatory disclosures.

On November 21, 2014, when Hannan completed his Form U4 for application to Horter, his separation was characterized as a "voluntary resignation." The IAPD report generated by HIM on November 21, 2014[48] and the BrokerCheck report generated on the same day[49] reflect only the singular customer-related disclosure event. There was no reason to second guess the accuracy and completeness of the separation documents filed by the prior firm, which was a reputable broker-dealer and an investment adviser.

Based on these facts about Hannan at the time he was being considered by HIM, Hannan's application was relatively strong.

ii) Hannan Was Onboarded Under Recently Amended Procedures.

When Mr. Long joined HIM in 2014, he found the onboarding process to be inefficient. Mr. Long observed that onboarding an IAR took 30-40 days. As Deputy CCO at the time, Mr. Long undertook to enhance the onboarding process including the time frame.

Under the new program IARs were subject to centralized pre-hire diligence and uniform routine steps recorded on a checklist and mandatory for the IAR's approval. A Compliance Analyst was assigned to each prospective IAR. The Compliance Analyst was required to adhere to series of steps which were detailed in checklist format providing an orderly roadmap to coordinate the process.

The onboarding involved numerous members of personnel, requiring that information and documentation be shared with other departments and supervisors. The checklists provided meaningful controls for tasks that were delegated away from the Compliance Analyst. Except in limited circumstances, the Compliance Analyst assigned to the prospect was authorized to approve a new RR subject to Mr. Long's final review and consent.[50]

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[48] HORTER-SEC000558 –000565
[49] HORTER-SEC000795-000806
[50] Checklist HORTER-SEC 000534-537

As they were designed to do, Mr. Long's improvements to the onboarding process led to efficiencies.

Hannan was one of the first IARs to undergo the new procedures. Although Hannan's onboarding was expedient, there is no evidence that his application was rushed. Hannan's onboarding file was complete and robust. Each step of the onboarding checklist was addressed. It is likely that the timeliness of Hannan's onboarding reflects efficiencies, which was the desired outcome of the new onboarding process.

Taken as a whole, the onboarding process improvements coupled with Hannan's relatively strong application, it is reasonable to expect that Hannan's application could be processed quickly.

iii) Hannan's December 2014 Disclosure Event and FINRA Inquiry

On December 10, 2014, shortly after he was registered with HIM, Hannan forwarded notice of a FINRA inquiry to Mr. Long.[51] The communication included a copy of the FINRA letter, and evidence that Hannan's prior employer, LPL, had filed a Termination Disclosure reporting its internal investigation into compliance irregularities. The Termination Disclosure and FINRA inquiry do not trigger "high risk" status under SEC criteria. Nonetheless, this was the first notice that HIM had that there were issues that had arisen at the prior employer regarding Hannan.

It is unknown whether Hannan knew of the Termination Disclosure at the time he completed a U4 to apply for employment at HIM on November 21, 2014. On that document, Hannan answered "no" to the relevant question about his separation from LPL.[52] Hannan's onboarding file includes a retained copy of the IAPD report reviewed by HIM on November 21, 2014.[53] This version of the IAPD report does not include a Termination Disclosure and reports Hannan's separation from LPL as "voluntary." Having reviewed these documents, one filed by LPL on the

[51] SEC-InvTestimony-000132-Long
[52] HORTER-SEC000425
[53] HORTER_SEC000561-000565

regulatory system and one completed by hand by Hannan, HIM would have had no reason to question the circumstances of Hannan's separation from LPL at the time he was hired.

Nonetheless, on receipt notice of the FINRA inquiry a few days later, Mr. Long questioned whether Hannan knew that the regulatory inquiry was forthcoming but chose not to disclose the matter to HIM. Suspicious of the circumstances, Mr. Long made a recommendation to Mr. Horter to immediately terminate Hannan. In response, Mr. Horter's available courses of action included immediate termination (Mr. Long's recommendation), contacting the prior broker-dealer (unlikely to yield a substantive response), or wait for the outcome of the FINRA investigation.

Mr. Horter chose to wait for the FINRA inquiry to conclude. This was a reasonable response.

FINRA is a self-regulatory organization with no lack of objectivity and no motive other than to identify violations of securities laws, rules and regulations in the interest of investors. FINRA's rules require any subject of an inquiry to make available the books, records, and account involved.[54] Failure to cooperate fully with a FINRA inquiry in and of itself is a violation that leads to a bar.[55]

Reliance on FINRA to fully examine the circumstances regarding checks written to Hannan's dba meant that Hannan would be required to meet FINRA's specific demands. According to the terms of the FINRA demand, Hannan was required to provide FINRA a signed statement regarding the receipt of checks, nature of the checks, the amount and names of individuals who wrote each check, the number of occasions checks were written, copies of the checks, where and when the checks were deposited and all relevant documentation related to Hannan's receipt of checks to a dba. These were all the records imaginable that could support a thorough investigation.

[54] FINRA Rule 8210(a)(2) 8210 (c), Supplementary Material 8210.01
[55] FINRA Sanction Guidelines (October 2021, page 33 found at https://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf

It could be reasonably concluded that FINRA's inquiry would be performed by qualified, experienced and objective regulators and would leave no stone unturned.

If the inquiry led to further action HIM would be notified of status of the inquiry through a regulatory filing on Form U6 through FINRA's Central Registration Depository, or CRD. In the event the investigation led to an enforcement action, HIM's contractual terms with Mr. Hannan permitted HIM to terminate Hannan automatically and without notice.[56]

Because of the scope and content of the FINRA inquiry, Mr. Horter and Mr. Long could be certain that

- Hannan would be required to fully comply with FINRA's inquiry,
- a thorough investigation would be performed and
- they would be informed of any outcome if FINRA determined that a violation had occurred.

Ultimately, FINRA did not issue a Form U6. From this result, it was reasonable for Mr. Horter and Mr. Long to conclude that Mr. Hannan had fully complied with the request, FINRA had thoroughly reviewed the documents and information provided, and the matter did not escalate to enforcement of any sanctions against Hannan. To this date, no further disciplinary action resulted relative to the FINRA investigation of Hannan's activities as investigated following his separation from LPL. No action on the part of FINRA was a reliable sign that Hannan's response was satisfactory to the regulator.

Mr. Horter's decision to wait and see was a measured and logical response to the post-hire information HIM received regarding Mr. Hannan. The fact that Mr. Horter did not immediately accept Mr. Long's recommendation, which was to immediately release Mr. Hannan, is not a sign of failure or of a weakness in the compliance and supervisory system. Mr. Horter's decision was sound and provides evidence of his leadership and professional experience. Mr. Long as well

[56] HORTER-SEC000539-000540

could reasonably rely on the outcome of the investigation in moving ahead with Mr. Hannan's licensure.

iv) HIM's Classification of Hannan as "High Risk" Was Subjective

The SEC's definition of risk in its supervisory initiative included regulatory, financial, and legal disclosure events. There was no wonder that HIM was not targeted on the SEC's 2016 sweep because at that time and through the present, these types of events simply were not prevalent among HIM's IARs. Hannan who had no such disclosure events at any time relevant to his registration with HIM.

Still, beginning in 2014, HIM took steps to identify risk in terms which it deemed to be meaningful. Had Mr. Long applied the criteria used by FINRA or by the SEC to identify high risk IARs at the onset of his project in 2014, fewer than 10 IARs might have made the high-risk list.[57] and Hannan would not have been among them. By comparison, the Oyster Report characterized as "higher risk" those IAR's with previous disclosures and without IAR experience.[58] Notably, neither the SEC criteria nor Mr. Rosser's criteria applied to Mr. Hannan.

The events considered in the HIM analysis included an IAR's customer complaint disclosure, the IAR's prior years of experience, the term of employment with an IAR's prior firm(s) and the number of predecessor firms with which the IAR had been previously employed. These were matters more likely to present themselves in HIM's business model.

Mr. Long had discretion to determine the criteria for high risk on an IAR-by-IAR basis, and he did so, including for Hannan who was added to the list following the separation event discussed above. But other than the separation event, Hannan had only one customer complaint and none of the other triggers on Mr. Long's rating scale.

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[57] See for instance Jeff Gollehon, 60-day suspension, Bergen 1- year suspension, spreadsheet of high and moderate IARs

[58] Oyster Consulting LLC Report (2015) (n 10), page 4

Three factors in this analysis bear repeating:

1)HIM's low-medium-high risk categorization preceded the SEC High Risk initiative by at least 2 years, and the SEC's publication of results by 6 years,

2)Hannan was never "high risk" in terms of the SEC or the Oyster Report criteria, and

3) the FINRA inquiry that led to Hannan's high risk classification ended in no action by the regulator.

v) Hannan Had a Duty to Comply.

Hannan bore individual responsibility for compliance with the laws, rules and regulations of the industry, and the HIM's policies and procedures. His responsibility was reinforced in signed documents and agreements including the Investment Adviser Representative Agreement,[59] and the Horter investment Management LLC Portfolio Offerings Compensation Agreement.[60] Terms and conditions of the Investment Adviser Representative Agreement between Hannan and HIM dated November 21, 2014 were contingent upon Hannan's "faithful performance" of his duties which included strict adherence to all of HIM internal policies and procedures. HIM's Policies and Procedures Manuals required Mr. Hannan to provide truthful and to comply with the HIM's Code of Ethics.[61] HIM's Compliance manual stressed, "Compliance with the firm's IA Policies and Procedures is a requirement and a high priority for the firm and each person,"[62] that "every employee has a responsibility for knowing and following the firm's policies and procedures."[63] Training required to maintain his professional credentials reinforced his compliance obligations. Compliance materials Acknowledgement signed by Hannan confirms Hannan's receipt of Compliance Training PowerPoint, Compliance Manual, Code of Ethics and Form ADV Part 2A, stating "Understanding these documents is critical to understanding the regulatory environment in …and to ensure that you follow all policies and procedures implemented by the organization to comply with the requirements of the Investment Advisers Act of 1940."[64]

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[59] HORTER-SEC000539-000543
[60] HORTER-SEC000544
[61] Horter Investment Management Policies and Procedures Manual, page 2
[62] Ibid, page 2
[63] Ibid, page 6
[64] HORTER-SEC001013

The Welcome Packet delivered to Hannan reinforced his responsibility for full and fair disclosure including statements regarding Form ADV Part 2B by stating, "The Investment Advisers Act places a large emphasis on the concept of full and fair disclosure to clients and prospective clients." The Welcome Packet noted that the compliance team relies "on the adviser to notify us when a disclosure document has incorrect or inaccurate information."[65]

The Fiduciary and Suitability Acknowledgement, required Hannan to acknowledge by signing that "[he will serve] in a fiduciary capacity and as such you agree to act in the best interest of your client(s) and will abide by the investment Advisors [sic] Act of 1940," and "[b]y signing this acknowledgement you are confirming that you have reviewed and understand the responsibilities of your fiduciary duty and suitability while registered with Horter Investment Management, LLC."[66]

Collectively, the documents demonstrate HIM's efforts to communicate the importance of compliance and supervision to Mr. Hannan, and to require Mr. Hannan's acknowledgement of compliance with the industry and HIM's policies and procedures. It was reasonable for HIM to rely on Mr. Hannan to provide truthful and honest information and to comply with the firm's compliance program.

Hannan was required to comply with HIM's compliance program and HIM took reasonable steps to be sure he knew it.

vi) Review, Approval and Disclosure of Hannan's Outside Business Activities

As a fiduciary, Mr. Hannan was required to provide sufficiently specific facts regarding his conflicting business interests. He was required to disclose information even if it was not

[65] HORTER-SEC000517-519
[66] HORTER-SEC001012.

specifically required by a request.[67] The rules of the industry required Mr. Hannan to provide scrupulous, complete and truthful information to the SEC and to HIM.[68]

HIM reinforced the importance of Hannan's role through numerous documents and agreements as discussed in the earlier section. In addition to those previously noted, Hannan was personally responsible to provide accurate disclosure of outside activities on regulatory filings including his Form U4 and Form ADV Part 2B. Hannan appeared to cooperate with these requirements. It was reasonable for HIM to rely on Hannan, an industry veteran in good standing with nationally recognized professional credentialing organizations subject to more than 100 hours of annual ethics training who had undergone a FINRA investigation to understand and abide by his obligations as a licensee.

Overtime it was learned that Hannan did not comply with his disclosure obligations regarding his outside business activities because he did not disclose his operation of Hannan Properties.

Hannan had disclosed that Hannan Properties was a business entity for tax purposes only while at his prior employer.[69] Hannan disclosed other outside business activities at his prior employer as well including two "dbas" and three non-investment related businesses.[70] Of these, when he joined HIM, Hannan disclosed only Landowner Financial (later Hannan and Associates, Inc.),[71] Hannan Quality Properties and Town and Country (both dry cleaning businesses).[72] There was no apparent reason for HIM to suspect that Hannan was telling anything other than the truth based on the facts and circumstances regarding the prior disclosures. Each of the outside business activities Hannan disclosed to HIM was subsequently reported on Hannan's U4 and Part 2B.[73]

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[67] https://www.sec.gov/rules/interp/2019/ia-5248.pdf
[68] SEC Rule 204A-1 (Code of Ethics) found at https://www.sec.gov/rules/final/ia-2256.htm
[69] HORTER-SEC000800 (BrokerCheck) 340 and HORTER-SEC000563 IAPD around as of 11/21/2014 – 100)
[70] HORTER-SEC000563
[71] HORTER-SEC001000
[72] HORTER-SEC000422
[73] HORTER-SEC000552 p 92 of 577 IAPD as of 12.14.2022 and HORTER-SEC000604 (144 of 577 (this is the U4)

There was no reason for HIM to question the discontinuation of the business which was previously an inactive entity "for tax purposes only." If Hannan had intended to use Hannan Properties for any business purpose at any point in time during his registration with HIM, he was obligated to fully inform HIM. Hannan never informed HIM that he intended to continue operate an outside activity under the name Hannan Properties.

Hannan attested to the accuracy of his disclosures under penalty of perjury when he signed his U4s on 12/01/2014,[74] 07/27/2015,[75] 09/02/2015[76] and 11/16/2015.[77]

In the fall of 2016 Jason Long, Kirk Horter, Jack Peters and Drew Horter learned that Hannan was interested in pursuing a new business venture: HR Resources. The managers and Hannan engaged in an ongoing dialogue until January 2017. The communications were forward-looking including terminology such as "proposal" and "brainstorming" and "interested in hearing more."[78] Hannan described his idea as a potential "value proposition," suggesting "what you and we can capitalize on" without providing the name or specifics regarding an entity.[79] For all intents and purposes, Hannan's intentions seemed to be rational. He was apparently successful in garnering interest from reputable industry leading firms including RiskAlyze [80] a financial technology company that provides software tools for analyzing investment risk, delivering 401 plans, and building and implementing investment portfolios to some of the industry's leading firms. Principals of RiskAlyze were known to and respected by Mr. Horter.

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[74] HORTERSEC000747 p 287

[75] HORTER-SEC000687, p225 of 577

[76] HORTER-SEC000629 p 169 or 577 and 189

[77] HORTER-SEC000609 p 149 or 577

[78] HORTER-SEC061496

[79] HORTER-SEC061495-6

[80] HIM-SEC005083

In January 2017, Amy Bishoff, a Compliance Analyst, advised Hannan of the firm's requirement to disclose outside business activities.[81] As of that time, fundamental components of Hannan's proposed business such as his website, plans for distribution and terms of compensation remained undefined.[82] Nonetheless, if Hannan intended to proceed with the business of HR Resources, he was on notice of his disclosure obligation.

Communications regarding the business proposal through February 2017 indicate that the proposed business venture were still prospective. For instance, Mr. Horter requested an updated business plan and continued to question the essential terms and conditions of the business proposal in a February 2017 email.[83] Throughout the review, Mr. Horter reinforced that he was not going to approve Hannan's proposal without the consent of Mr. Long. Mr. Horter wrote, "….we need to have a call with Jason and Jack to talk about what we can do or not."[84] Hannan never did present the proposal to Jason Long for approval under the firm's disclosure requirements, and as of March 2017 Mr. Long was of the understanding that Hannan had abandoned the project.[85]

Based on the communications and the fact that business activities under HR Resources never commenced, I believe it is reasonable to conclude that HR Resources never materialized as an outside business activity.

It bears mentioning that the Advisers Act Section 204A requires HIM to supervise its investment advisory associates (IARs) with respect to activities performed on its behalf.[86] Therefore even if Hannan Properties, HR Resources or any other outside entity were disclosed as outside business activities, there was no obligation for HIM to supervise the underlying activity.

vii) HIM's Policies for Third Party Distributions

[81] HORTER-SEC062190
[82] HORTER-SEC075149
[83] HORTER-SEC 034991
[84] HORTER-SEC027228
[85] HORTER-SEC032479
[86] See the summary found at https://www.sec.gov/divisions/investment/iaregulation/memoia.htm

Before Hannan was registered with HIM, the firm had a policy that governed third-party distributions. Like most financial services firms, HIM's custodian, Trust Company of America (TCA), dictated the documentation required to process a distribution request.
TCA required HIM to present a customer-signed form to make a distribution. HIM adhered to the TCA process without exception. Even though the TCA form allowed for wire transmission without customer signature under certain circumstances,[87] HIM required a customer signature in all instances.

HIM's procedures supplemented TCA's form in another important aspect because HIM also required the IAR to verbally confirm the distribution with the client prior to submission of the request to TCA. HIM's Trading Supervisor Jessica Vierling was required to verify with the IAR that the client verbally confirmed each distribution. The three controls implemented by HIM at the time (customer signature, IAR confirming call to the client, verification by a HIM employee with the IAR) met or exceeded the industry standard of the time.

When circumstances changed, HIM's policies changed.

In June 2016, HIM experienced a substantial loss due to a phishing incident (a cyber attack perpetrated by a criminal actor).[88] Phishing was a topic of concern that was of regulatory interest at the time Relevant in the fall of 2016, the growth in numbers of fraudulent third-party distributions had the attention of the regulators and government agencies, including the Financial Crimes Enforcement Network (FINCEN). In guidance to the industry FINCEN focused on business email compromise and email account compromise as sources of phishing incidents. FINCEN recommended that a multi-faceted transaction verification process was meaningful for financial institutions to guard against business and other email fraud.[89]

HIM's response to the phishing incident was swift, appropriately proportionate to the severity of

[87] See Exh 31, TCA Form page 2
[88] Vierling testimony says IAR did not call, but J Long email says trading supervisor di not call dated May 31 2016
[89] https://www.fincen.gov/resources/advisories/fincen-advisory-fin-2016-a003

the incident and in line with the regulatory guidance at the time.[90] HIM's response was specifically designed to prevent future phishing incidents. Senior managers including Mr. Long, Mr. Herzer, Kirk Horter and Ms. Helmes-Sneed collaborated on the resolution within days of the incident. They considered a range of responses including new policies and procedures.[91] Informed of the incident and the management team's proposed responses, Mr. Horter specifically required that the final resolution include accountability in the form of a supervisor's signature on each and every distribution.[92]

Mr. Horter and his senior management team collaborated to address the threat of phishing ultimately agreeing on 3 new controls: [93]

1. Beginning June 2016, HIM no longer relied on the IAR to make verbal contact with the client and instead required an employee in its Trading department to verify the customer instructions.
2. A distribution log was created to provide a centralized record of distributions through a collaborative effort among Mr. Long, Kirk Horter, Kevin Hetzer, Ms. Helmes-Sneed Jessica Vierling, the Trading Supervisor. A log entry was required to be made by Ms. Vierling or her subordinate for each third-party distribution. The log was implemented June 1, 2016.
3. During the time frame relevant to this matter each line item recording a wire transfer was required to be signed by Ms Vierling and a supervisor.[94]

HIM distributed written notice of the new policies to IARS on June 1, 2016. Mr. Long informed the compliance analysts by forwarding the email.

From the time of their implementation in 2016 until March 2017, Ms. Vierling was responsible for implementation and documentation of the third-part distribution procedures.[95] Ms. Vierling knew that it was her responsibility to implement the procedures.[96] And, Ms. Vierling was aware

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[90] Exhibit 7, Vierling, SEC-Inv Testimony-000777-000780
[91] Exhibit 8, Vierling, SEC-Inv Testimony
[92] SEC-InvTestimony-000783-Vierling
[93] Vierling, Jessica, deposition transcript, page 31, lines 24-25
[94] Vierling Exhibit 11, SEC-Inv Testimony-000809-000811-Vierling
[95] Vierling, Jessica, page 48, line 15-16
[96] Vierling P45, page 4, line 14

of her responsibility to attain approval from a supervisor prior to approving any distribution.[97] Ms. Vierling had adequate resources to fulfill her obligations. For purposes of the required supervisory approval, Ms. Vierling could request review by Mr. Hetzer, Kirk Horter or Ms. Helmes-Sneed, depending on their availability.[98]

For each distribution relevant to this report, Ms. Vierling was responsible for making verbal contact with the client. In the calls, she verified the client's date of birth, social security number and a third factor such as their address. She also verified the amount and destination of the proceeds.[99]

Ms. Vierling's calls to clients were not recorded, and were not required to be, but Ms. Vierling rejected any distribution request that did not provide a client phone number. Consistent with this practice, each form in evidence in this matter includes a phone number.[100] Ms. Vierling understood that if she did not speak with the client, she could not process the distribution.[101] Ms. Vierling understood that it was important to ensure that the client knew that they were sending funds to a third party, the amount of the distribution and where the proceeds were directed.[102] Each of Hannan's clients signed a distribution form, validated the transfer amount and the recipient of their funds and confirmed their instructions to Ms. Vierling.

The information gathered by HIM was designed to facilitate the instructions of the client. Interfering with a client's instruction to distribute monies from their account is a conflict of interest because an investment adviser is compensated by AUM retained at the firm. The information gathering was not intended to, nor should it have been, 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.

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[97] Vierling p 60, lines 7-12
[98] Vierling p 61, lines 22-24
[99] Vierling, p 48, lines 5-11
[100] Exh 9 Vierling SEC-Inv Testimony-000790-Vierling
[101] Vierling 55, lines 14-15
[102] Vierling 55-56 lines 24, 25

Of the distributions relevant to this matter, Ms. Vierling made one exception to the strict policy in which she left a voicemail in lieu of a personal call. In this instance, Ms. Vierling waited for the return message prior to processing the distribution. While not compliant with the firm's policy, the return message is evidence of the client's consent to the distribution. Ms. Vierling admitted to other instances in which she may have processed a distribution without adhering to the policy requiring verbal contact with a client of the firm.[103] Ms. Vierling has admitted that she also failed to record each transaction on the log as was required.[104] 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.

HIM's response to the phishing incident and ultimately to the discovery of the distributions relevant to this matter, demonstrates the firm's compliance culture. The policy was not designed to root out what Hannan allegedly 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. The new procedures worked. From the date of their implementation, there has been no subsequent phishing incident.

When a risk became apparent, senior management adjusted policies and the policies worked. When Hannan's clients' distributions were discovered, Hannan was immediately fired.

These are the actions of a firm that cares about compliance.

The foregoing report summarizes my opinions as of the date noted above.

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[103] Vierling p 80, lines 22-25
[104] Vierling p 57, line2 1-12

EXHIBIT G

1 UNITED STATES OF AMERICA
before the
2 SECURITIES AND EXCHANGE COMMISSION

3

4 ADMINISTRATIVE PROCEEDING
FILE NO. 3-20531

5

6 IN THE MATTER OF)
)
7 Horter Investment)
Management, LLC and)
8 Drew K. Horter,)
)
9 Respondents.)
________________________________)
10

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13

14 VIDEOTAPED REMOTE DEPOSITION OF DREW K. HORTER

15 Wednesday, May 25, 2022

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23 Reported By:

24 Denise Sankary, RPR, RMR, CRR,

25 Job No. 220525DSA

10:30 1 you manage or supervise?

2 A. Compliance department, the trading and

3 operations department, the marketing department, and

4 business support, adviser support.

10:30 5 Q. And what are your responsibilities with

6 regard to firm policies and procedures?

7 A. I work with Jason Long on this, CCO, and

8 Becky Hartsuck, the senior compliance analyst, and

9 Leslie Green and Patrick Hayes from Calfee, who

10:31 10 support the compliance department.

11 Q. And was that the case in the period from

12 2014 to 2017?

13 A. No.

14 Q. How was it different?

10:31 15 A. Well, we've done some changes to bolster

16 and upgrade the compliance department at Horter.

17 Q. Okay. What changes have you made in the

18 compliance department?

19 A. In the last six months or so, we brought

10:31 20 on Calfee Halter & Griswold as a compliance

21 supervisory firm to help with policies and

22 procedures, code of ethics, and the overall

23 compliance department. And that's Patrick Hayes,

24 lead counsel, and Leslie Green, who is also in

10:32 25 charge of our compliance committee charter as well

10:32 1 as the new branch office supervision program.
2 Q. Could you give me the name of the firm
3 that you've engaged one more time and maybe spell
4 it.
10:32 5 A. Yeah, Calfee, which is C-A-L-F-E-E; and I
6 guess Halter, H-A-L-S-T-E-R (sic); and Griswold.
7 Q. And what time -- when were they retained?
8 A. I think we signed with them back in late
9 October of last year.
10:32 10 Q. And that's October 2021?
11 A. Correct.
12 Q. And what -- you named, I think, two
13 individuals from Calfee that you were working with.
14 What are their names?
10:32 15 A. Yes. Patrick Hayes is the senior counsel
16 that's kind of overseeing the whole opportunity with
17 them. And Leslie Green is in charge of the
18 compliance committee charter as well as the branch
19 office supervisory program.
10:33 20 Q. And are those two individuals physically
21 located at Horter Investment?
22 A. No.
23 Q. They're off-site somewhere?
24 A. Yes.
10:33 25 Q. In their own offices; is that right?

10:34 1 Q. Okay. And anybody else?
2 A. No. Those four.
3 Q. I just wanted to get -- you've been
4 mentioning two different names or functions, the
10:34 5 charter and the branch office. Can you tell me
6 about the charter first?
7 A. Yeah. The charter is to review all
8 policies and procedures, code of ethics, EB, all
9 operations within the compliance department.
10:35 10 Q. Okay. And what's the full name of the
11 charter?
12 A. Compliance committee charter.
13 Q. Okay. And is the compliance committee
14 charter doing sort of a top-down review or bottom-up
10:35 15 review of all of your compliance policies?
16 A. Yes.
17 Q. And did that start in late October 2021?
18 A. Actually, by the time we got it
19 implemented, it was roughly about February, I
10:35 20 believe, of 2022.
21 Q. And do you have an estimate for how long
22 that process will take?
23 A. It's permanent. It's not -- it's an
24 ongoing concern.
10:35 25 Q. Okay. Is there a -- as part of the

10:36 1 compliance committee charter, are they reviewing
2 each and every one of the existing Horter policies
3 and procedures?
4 A. Yes.
10:36 5 Q. And is there an expectation when they will
6 finish that initial review of every one of the
7 policies and procedures that are now existing?
8 A. They've had two meetings so far, so I'm
9 not sure. I haven't received an exact report, but I
10:36 10 think it's an ongoing process. There's no
11 determination of an end to it. It's just
12 continuous.
13 Q. All right. And is -- the second aspect of
14 the compliance program is called the branch office;
10:36 15 is that right?
16 A. Branch office supervisory program.
17 Q. Okay.
18 A. BOSP, that's what we refer to it.
19 Q. Great. So the branch office supervisory
10:36 20 program, what is that?
21 A. That's for supervision of our advisers in
22 the field, and there's -- I think there's four parts
23 to that. One is the ongoing management of our
24 IRAs -- IARs in the field. And there's also
10:37 25 pre-questionnaires that the -- they have developed

10:37 1 before they do a, either virtual or on-site visit of
2 an IAR. And then the fourth part would be the
3 ongoing training, certification, and also that they
4 have to, you know, have to attend one of our
10:37 5 trainings. And then they also have to participate
6 in our continuous compliance training.
7 Q. And was there a fourth one, or that is the
8 fourth one?
9 A. That is the fourth one.
10:37 10 Q. Okay. So -- and did this also just get
11 started in February 2022?
12 A. Yes.
13 Q. Okay. And for the folks you mentioned,
14 Patrick Hayes, Leslie Green, Jason Long,
10:38 15 Kevin Hetzer, and Becky Hartsuck, are they involved
16 in both the charter group and the branch office
17 group?
18 A. Yes, let me make a clarification.
19 Patrick Hayes is the nonvoting member of
10:38 20 that committee. So there's four of them. And he is
21 the overseer of it as counsel, but he's listed as a
22 nonvoting member.
23 Q. I see. And is -- are there -- is there
24 any hierarchy amongst those four individuals?
10:38 25 A. Leslie Green is in charge of both --

10:38 1 Q. Okay.
2 A. -- as the lead. And as a note to that, if
3 I may, we are also working with Foreside.
4 Q. What's Foreside?
10:38 5 A. Foreside is a consulting firm, to do an
6 assessment of the firm. They have not finished
7 their report yet.
8 Q. And when were they engaged?
9 A. Let's see. Probably back in November-ish.
10:39 10 Same time frame. Last six months.
11 Q. And do you have an expectation as to when
12 they will complete their assessment?
13 A. I don't have an ETA on that, but hopefully
14 in the next month or two.
10:39 15 Q. And will they be issuing a report?
16 A. Yes.
17 MS. WOODS: And, Alyssa, Foreside was
18 retained by counsel, not by Horter.
19 MS. QUALLS: Oh, thank you for that
10:39 20 clarification.
21 BY MS. QUALLS:
22 Q. Was -- and just to be clear, the Calfee
23 firm was retained by Horter.
24 A. Correct.
10:39 25 Q. And I think you mentioned that

10:41 1 recently.

2 Q. How often do they meet?

3 A. Once a quarter is the general rule or as

4 needed.

10:41 5 Q. And are there -- in their review of all of

6 Horter's existing policies and procedures, how are

7 they prioritizing what -- which ones to look at

8 first?

9 A. I guess as a group, they're deciding that.

10:42 10 Q. Okay. So you don't have any knowledge of

11 that?

12 A. Not of the process or the priority.

13 Q. So now with the existence of this group,

14 you have stepped away from all compliance-related

10:42 15 functions; is that right?

16 A. Yes. Except for when they need any

17 questions of me.

18 Q. And you don't have a vote on the

19 committee.

10:42 20 A. Correct.

21 Q. And I think in your answer, I think you

22 said there were 55 IARs currently at Horter; is that

23 right?

24 A. Yes.

10:42 25 Q. Is that still true today?

10:44 1 Q. So it continued until February 2022?
2 A. Yes.
3 Q. Now, during the time period from 2014
4 through 2017, you had overall supervisory
10:44 5 responsibility for Horter Investment; is that right?
6 A. Correct.
7 Q. And in 20 -- and now -- well, withdraw
8 that.
9 Who currently has the overall supervisory
10:45 10 authority for Horter Investments' IARs?
11 A. That would be Leslie Green with her
12 committee.
13 Q. Okay. And back in 2014 to 2017, you had
14 the final authority to hire, fire, and discipline
10:45 15 IARs, right?
16 A. Correct.
17 Q. And now currently, who at Horter
18 Investment has the final authority to hire, fire,
19 and discipline IARs?
10:45 20 A. That would be Leslie Green with Jason Long
21 and the committee.
22 Q. And from the 2014 to 2017 time frame, you
23 were -- who had oversight of Horter Investment's
24 daily operations?
10:46 25 A. For compliance or overall of the company?

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10:46 1 Q. Let's go with compliance.
2 A. Well, Jason Long had the day-to-day
3 operations, and I managed Jason Long as CCO.
4 Q. And what about operations?
10:46 5 A. During that time period, Kirk Horter was
6 in charge of operations with Kevin Hetzer as his
7 assistant.
8 Q. And now in 2022, who has oversight of
9 Horter Investment's daily operations?
10:46 10 A. For compliance would be Leslie Green,
11 Jason Long, Becky Hartsuck, and Kevin Hetzer. For
12 operations, it would be Kevin Hetzer.
13 Q. So what is -- what is your current role at
14 Horter Investment Management?
10:47 15 A. I'm still the CEO and president of the
16 overall management of the business.
17 Q. You're not responsible for the day-to-day
18 operations; is that right?
19 A. I'm not -- the department heads have the
10:47 20 day-to-day operations, and they report to me on a
21 weekly basis, if not daily. But on a regular basis
22 we have meetings, manager meetings.
23 Q. So Kevin Hetzer reports to you?
24 A. Correct.
10:47 25 Q. And do you -- and are you ultimately --

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4 **CERTIFICATE OF OATH**
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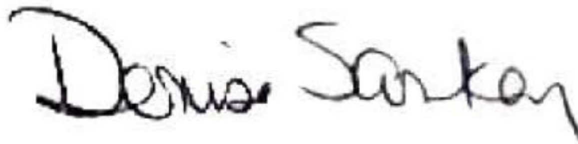
6
7 **STATE OF FLORIDA**
8
9
10 I, the undersigned authority, certify
11 that DREW K. HORTER, appeared remotely before me
12 and was duly sworn on the 25th day of May, 2022.
13 Signed this 3rd day of June, 2022.
14
15 
16
17 *DENISE SANKARY, RPR, RMR, CRR*
Notary Public, State of Florida
My Commission No. GG 944837
18 Expires: 1/27/24
19
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1 **CERTIFICATE OF REPORTER**

2

3 **STATE OF FLORIDA**

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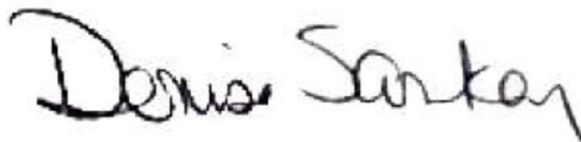
5

6 I, *DENISE SANKARY*, Registered Merit
7 Reporter, do hereby certify that I was authorized
8 to and did stenographically report the foregoing
9 videotaped remote deposition of DREW K. HORTER,
10 pages 1 through 86; that a review of the
11 transcript was requested; and that the transcript
12 is a true record of my stenographic notes.
13 I FURTHER CERTIFY that I am not a
14 relative, employee, attorney, or counsel of any
15 of the parties, nor am I a relative or employee
16 of any of the parties' attorneys or counsel
17 connected with the action, nor am I financially
18 interested in the action.
19 Dated this 3rd day of June, 2022.
20
21 
22 ______________________________
23 *DENISE SANKARY, RPR, RMR, CRR*
24
25