

UNITED STATES DISTRICT COURT  
NORTHERN DISTRICT OF ILLINOIS  
EASTERN DIVISION

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MICHAEL W. DOBBINS  
CLERK, U.S. DISTRICT COURT

JUDGE KOCORAS  
MAGISTRATE JUDGE MASON

CASE NO. 07C

4684

JURY DEMANDED

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UNITED STATES SECURITIES  
AND EXCHANGE COMMISSION,

Plaintiff,

v.

SENTINEL MANAGEMENT GROUP, INC.

Defendant.

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**MEMORANDUM IN SUPPORT OF PLAINTIFF'S EMERGENCY MOTION FOR A  
TEMPORARY RESTRAINING ORDER AND OTHER ANCILLIARY RELIEF**

Plaintiff United States Securities and Exchange Commission ("SEC" or "Commission"), respectfully submits this Memorandum in support of its Emergency Motion for a Temporary Restraining Order and Other Ancillary Relief ("Emergency Motion").

**SUMMARY**

This action involves misappropriation, misuse and improper commingling of client assets by the investment advisory firm Sentinel Management Group, Inc. ("Sentinel"). Sentinel, which prior to filing for bankruptcy protection last week claimed to have \$1.2 billion in assets under management, defrauded its clients by improperly commingling, misappropriating and leveraging their securities without their knowledge in violation of the Investment Advisers Act of 1940 ("Advisers Act"). Among its improper activities, Sentinel transferred at least \$460 million in securities from client investment accounts to Sentinel's proprietary "house" account. Sentinel also used securities from client accounts as collateral to obtain a \$321 million line of credit as

well as additional leveraged financing. Sentinel did not disclose to its clients its practices of commingling, transferring and misappropriating their assets, or inform them that their investment portfolios were highly-leveraged as a result of Sentinel's financing activities. To the contrary, Sentinel provided its clients with assurances that their investment accounts were in order by issuing daily account statements that contained no mention of the improper activities.

Sentinel's fraudulent conduct has placed its clients at risk of serious and irreparable loss. For example, the bank that extended the \$321 million line of credit to Sentinel has informed the firm that it is in default under the loan agreement and therefore the bank intends to sell securities in the "house" account that were pledged as collateral for the loan, beginning as soon as August 22, 2007. Information obtained by the SEC indicates that the securities to be sold off by the bank include securities that were fraudulently transferred to the "house" account from client accounts. At the very least, Sentinel has not kept accurate records necessary to verify the ownership of the securities in its various client and "house" accounts and to prevent the firm from selling assets that it is not entitled to sell and distributing the sale proceeds to persons not entitled to receive them.

Accordingly, the SEC brings its Emergency Motion to halt further violations of the federal securities laws and to prevent further dissipation of client assets by Sentinel. In its Motion, the SEC respectfully requests that the Court enter an Order: (1) temporarily restraining Sentinel from future violations of the Advisers Act; (2) requiring Sentinel to provide an immediate accounting of all funds and assets received from its clients, as well as its own assets and liabilities; (3) prohibiting the destruction of records; (4) requiring Sentinel immediately to produce certain records necessary properly to account for its client assets; (5) allowing expedited discovery; and (6) granting such further relief as the Court may deem appropriate. In addition,

the SEC intends to file separately a motion seeking appointment of a receiver to assume control of the assets in Sentinel's client accounts in order to manage and preserve those assets. The ancillary relief requested in the Emergency Motion also will supplement and assist the role of the receiver.

### **STATEMENT OF FACTS<sup>1</sup>**

Sentinel is a registered investment adviser that primarily manages investments of short-term cash for various advisory clients, including futures commodities merchants, hedge funds, financial institutions, pension funds, and individuals. (Gracia Dec., ¶ 2) Sentinel's website claims that since 1979, Sentinel has "never lost a dime of client funds, or delayed even one day in returning the full amount of a client's cash regardless of prevailing market conditions." (*Id.*, Ex. C) Additionally, Sentinel states that it "buys only the highest quality and most liquid securities." (*Id.*, Ex. C) Sentinel's objective "is to achieve the highest yield consistent with preservation of principal and daily liquidity, not simply the highest yield." As of August 13, 2007, Sentinel claimed to have \$1.2 billion of client assets under management. (*Id.*, ¶ 2)

On August 13, 2007, Sentinel sent a letter to clients announcing that it was halting all redemptions due to the "liquidity crisis" in the credit markets. (*Id.* ¶ 6, Ex. A) According to Sentinel the "liquidity crisis" prevented Sentinel from meeting redemption requests "without selling securities at deep discounts to their fair value and therefore causing unnecessary losses" to clients. (*Id.* ¶ 6, Ex. A) In fact, the clients' exposure to loss was exacerbated by the undisclosed use of leverage and apparent commingling and misappropriation of investors' securities. (*Id.*, ¶ 6) Moreover, at the time the August 13 letter was sent to clients, the securities Sentinel reported on account statements provided to clients listed millions of dollars in securities

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<sup>1</sup> The facts set forth in this Memorandum are supported by the Declaration of Lou Gracia in Support of Plaintiff's Emergency Motion for a Temporary Restraining Order and Ancillary Relief ("Gracia Dec."), and attached exhibits.

that were not held in client custodial accounts. (*Id.* ¶¶ 7, 17-21) Many were not held by Sentinel, but were pledged as collateral, as explained below.

**A. The Programs**

Sentinel offered clients the opportunity to participate in a variety of investment programs, each of which had its own investment policy designed to meet the requirements and preferences of different types of investors. (*Id.*, ¶ 8) Regardless of which investment program a particular client chose, Sentinel pooled the client's assets with those of similar types of investors in one of three segregated custodial brokerage accounts, Seg 1, Seg 2 and Seg 3:

- Seg 1 contained assets of registered future commission merchants or "FCMs" with only domestic customer deposits. FCMs are futures brokers that are members of the NFA and investments are subject to the rules of the CFTC.
- Seg 2 contained assets of FCMs with foreign customer deposits.
- Seg 3 contained assets of all other types of investors, including hedge funds, trust accounts, endowments and individuals.

(*Id.*, ¶ 9)

**B. Sentinel's Representations to Investors**

Sentinel made written representations to its clients through at least four means: an advisory agreement with clients; client account statements provided daily to clients; its investment policies on Sentinel's website; and Part II of Sentinel's Form ADV filed with the Commission. (*Id.*, ¶ 11)

From at least July 2005, in its standard investment advisory agreement with investors, Sentinel represented that the investors in each segregated portfolio owned an indirect, pro rata interest in their particular segregated investment portfolio. (*Id.* ¶ 12, Ex. B) The Agreement also

provided discretionary authority to Sentinel to buy and sell securities without requesting authority from investors before executing the trades. (*Id.* ¶ 13, Ex. B) The Agreement often had an Addendum specifying the investment policy that was to be used to invest the client's funds. (*Id.*, ¶ 13, Ex. B) For example, the Addendum for the largest client in Seg 3 stated that its funds would be invested consistent with the limitations of CFTC Rule 1.25. (*Id.*, ¶ 14) This rule restricted investment to highly rated debt instruments and other highly rated and relatively liquid investments. (*Id.*, ¶ 14)

The version of the Agreement provided to investors prior to 2005 did not state that any form of leverage would be utilized by Sentinel in managing the investors' accounts. (*Id.*, ¶ 13, Ex. B) At some point in late 2004 or early 2005, Sentinel typically added to the Agreement a provision allowing the use of leverage, but did not disclose to what extent it would be used. (*Id.*, ¶ 15)

Sentinel represented on its Website that "Sentinel clients receive a daily account statement (by email or fax), which shows, down to the penny, precisely what securities they own." This was on Sentinel's website as late as August 14, 2007. (*Id.* ¶ 16)

### **C. Undisclosed Misappropriation and Commingling of Investor Assets**

On August 13, 2007, Sentinel e-mailed customer account statements to investors in Seg 3, as well as investors in other Seg accounts. (*Id.*, ¶ 17) One investor received a statement purporting to reflect a \$360 million interest in securities held by that investor in Seg 3. (*Id.*, ¶ 17) A representative of that investor told the staff that he asked Sentinel to transfer the securities held in the client account to his firm, but Sentinel refused. (*Id.*, ¶ 17)

Sentinel provided examination staff with customer statements reflecting that the total value of securities interests reported to all Seg 3 investors was approximately \$674 million. (*Id.*,

¶ 18) However, the Bank of New York custodial statement for the Seg 3 account showed only approximately \$94 million of securities held by all Seg 3 investors. (*Id.*, ¶ 19) When examination staff asked about the discrepancy between the customer statements and the custodial statement, Sentinel's representatives admitted that the customer accounts would not "tie out" because Sentinel had moved securities among the Seg accounts and its own "house" account. (*Id.*, ¶ 20)

Sometime before August 13, 2007, Sentinel placed at least \$460 million of investors' securities properly belonging in segregated customer accounts in Sentinel's "house" account. (*Id.*, ¶ 21, Ex. G) The "house" account also contained securities owned by Sentinel. (*Id.*, ¶ 21) The transfers of these clients' securities were never disclosed to investors on the client account statements. (*Id.*, ¶ 21) When the SEC examination staff asked Sentinel to identify which securities in the "house" account were owned by investors or Seg accounts, Sentinel representatives responded that it could not determine who owned those securities. (*Id.*, ¶ 22)

Sentinel's records concerning investors' securities holdings are unreliable, at least in part, due to the commingling and misappropriation of those securities. (*Id.*, ¶ 24) Sentinel purported to reconcile the securities inventory to what was in client accounts, but the starting inventory balance on the reconciliation bore no relation to the actual securities balance reflected on the custodial brokerage records. (*Id.*, ¶ 24) A reconciliation dated August 13, 2007 and signed by a representative of Sentinel, shows an opening inventory balance of \$700 million for Seg 3, while custodial brokerage records show only approximately \$94 million. (*Id.*, ¶ 24)

#### **D. Undisclosed Leveraging of Investors Assets**

Sentinel pledged securities owned by the investors as collateral in order to obtain a \$321 million line of credit from the Bank of New York for its own benefit.<sup>2</sup> (*Id.*, ¶ 25) Among other things, the investor account statements, which should have accurately reflected the portfolio holdings, the value of the portfolio and all transactions in the portfolio, did not reflect the fact that the securities had been encumbered in this manner. (*Id.*, ¶ 25) In other words, the investors had no way of knowing that their assets had been used by Sentinel to obtaining financing. (*Id.*, ¶ 25)

Sentinel used investor assets to obtain additional leveraged financing. (*Id.*, ¶ 27) Since 2004 Sentinel had used \$1.5 billion in securities owned by the investors to obtain financing totaling three times the value of those securities. (*Id.*, ¶ 27) The financing was used at least in part to purchase additional securities. (*Id.*, ¶ 27) The investor account statements prepared and distributed by Sentinel never reflected any of this activity. (*Id.*, ¶ 28)

#### **E. Recent Events**

On August 17, Sentinel sold approximately \$312 million of securities to Citidel. (*Id.* ¶ 30) Despite the unreliability of Sentinel's records, its inability to verify the ownership of particular securities by its particular clients, its commingling of client securities, its failure to disclose its significant leveraging of clients' assets to its clients, and its allegations of "misconduct" by its trader, Sentinel has stated that it intends to distribute the proceeds of its securities sale to Citadel to meet redemption demands of selected clients. (*Id.*, ¶ 30) On August 17, 2007, the U.S. District Court partially enjoined the sale to Citadel.

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<sup>2</sup> Sentinel representatives stated that it used money obtained through the line of credit to purchase additional securities and in some cases to cash out investors from the different Seg accounts. (*Id.*, ¶ 26)

## ARGUMENT

### **I. The Court Should Grant The SEC's Request for Emergency Relief Notwithstanding Sentinel's Bankruptcy Petition.**

As an initial matter, this Court should grant the SEC's Emergency Motion notwithstanding the fact that Sentinel has filed for bankruptcy protection. On August 17, 2007, Sentinel filed a voluntary petition under Chapter 11 of the U.S. Bankruptcy Code.<sup>3</sup> Under some circumstances, the presence of Bankruptcy Court oversight might be sufficient to safeguard against the dissipation of assets held by a debtor that is also a defendant in an SEC enforcement action. In this case, however, Sentinel intends to distribute funds that it claims belong to its clients, and therefore are not part of the bankruptcy estate. These funds include the proceeds of the sale of client assets to Citadel, which Sentinel intends to distribute notwithstanding its bankruptcy petition. (*Id.* ¶ 30) As discussed above, due to the improper commingling of client assets and Sentinel assets, and the general unreliability of Sentinel's recordkeeping, the firm has not been able to verify the source of the assets that it sold to Citadel and specifically whether the assets were owned by the clients to whom Sentinel proposes to distribute the sale proceeds. (*Id.* ¶ 30) Once the funds have been distributed, it will be extremely difficult, if not impossible, to reclaim them. Since these and other client funds may not be subject to the jurisdiction of the Bankruptcy Court, emergency action by the District Court is necessary adequately to protect client interests.

### **II. Sentinel Should Be Temporarily Restrained From Further Violations of the Securities Laws.**

Section 209(d) of the Advisers Act expressly authorizes the SEC to seek such temporary injunctive relief in the federal courts to prohibit violations of the federal securities laws. 15

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<sup>3</sup> The SEC's action against Sentinel is not subject to the automatic stay provision of the U.S. Bankruptcy Code because it falls under the exception for regulatory enforcement actions by governmental entities. See 11 U.S.C. § 362(b)(4).

U.S.C. §80b-9(d). The SEC may obtain such relief by making a “proper showing” of volatile activity. *See* 15 U.S.C. § 78(u)(d)(1). The required “proper showing” has been described as “a justifiable basis for believing, derived from reasonable inquiry or other credible information, that such a state of facts probably existed as reasonably would lead the SEC to believe that the defendants were engaged in violations of the statutes involved.” *SEC v. General Refractories Co.*, 400 F. Supp. 1248, 1254 (D.D.C. 1975). The SEC satisfies this burden when it makes a substantial showing of (i) a current violation and (ii) the risk of repetition. *See e.g., SEC v. Cavanagh*, 155 F.3d 129, 132 (2d Cir. 1998).<sup>4</sup> As discussed below, the SEC satisfies this standard in this case because there is substantial evidence that Sentinel has violated Sections 206(1), 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-2 promulgated thereunder, and that Sentinel may continue to engage in such violations in the future.

**A. Sentinel Violated Sections 206(1) and 206(2) of the Advisers Act.**

Section 206(1) of the Advisers Act prohibits any investment adviser from, directly or indirectly, employing any device, scheme or artifice to defraud any client or prospective client. 15 U.S.C. § 80b-6(1). Section 206(2) of the Advisers Act further prohibits any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client. 15 U.S.C. § 80b-6(2). Scienter is required for a violation of Section 206(1) but not for Section 206(2). *See Steadman v. SEC*, 603 F.2d 1126, 1134 (5<sup>th</sup> Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981); *see also SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 184, 191-92 (1963).

The Supreme Court has held that the Advisers Act establishes a statutory fiduciary duty for investment advisers to act for the benefit of their clients. *Transamerica Mortgage Adviser*,

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<sup>4</sup> Because the SEC is a government agency seeking an injunction in the public interest, it is not required to prove irreparable injury, a balance of the equities in its favor or the unavailability of remedies at law. *SEC v. Unifund Sal*, 910 F.2d 1028, 1035-36 (2d Cir. 1990).

*Inc. v. Lewis*, 444 U.S. 11, 17 (1979). An adviser's fiduciary duties include "an affirmative duty of utmost good faith, and full and fair disclosure of all material facts." *Capital Gains*, 375 U.S. at 191-94. A fact is considered material if there is a substantial likelihood that a reasonable investor would consider it important. *Basic, Inc. v. Levinson*, 485 U.S. 224, 233 (1988).

In this case, Sentinel violated Sections 206(1) and 206(2) by making material misrepresentations and omissions to its clients regarding the holdings in their investment accounts. Sentinel provided its clients with daily account statements that purported to provide the client with a listing of portfolio holdings, the value of the portfolio and all transactions in the portfolio. (Gracia Dec. ¶ 25) These account statements provided to clients were materially false and misleading in two key respects. First, the client account statements did not accurately reflect the securities held in the client accounts. The securities listed on a particular account statement were not necessarily held in the client account or may have been transferred to other accounts and commingled with other assets. (*Id.* ¶¶17-21) Second, the account statements did not reflect the fact that the client accounts were heavily leveraged. (*Id.* ¶ 28) Based on a review of the account statements, a client would have no way of knowing that their assets had been used by Sentinel to obtain financing and that, as a result, a third-party might in fact have a lien on the assets. By providing clients with account statements containing material misrepresentations and omissions regarding fundamental aspects of their investment accounts, Sentinel violated Sections 206(1) and 206(2) of the Advisers Act.

**B. Sentinel Violated Section 204(4) and Rule 206(4)-2 Promulgated Under The Advisers Act.**

Sentinel also violated Section 206(4) of the Advisers Act and Rule 206(4)-2 promulgated thereunder. Section 206(4) prohibits any investment adviser from, directly or indirectly, engaging in any act, practice or course of business which is fraudulent, deceptive or

manipulative. 15 U.S.C. § 80b-6(4). Rule 206(4)-2 defines prohibited practices for investment advisers under Section 206(4) to include taking custody of client funds and assets unless those funds and securities are held (i) in separate accounts for each client under that client's name or (ii) in accounts that contain only client funds and securities under the name of the investment adviser as agent or trustee for the clients. 17 C.F.R. § 275.206(4)-2. Under Rule 206(4)-2, Sentinel was required to keep client assets in segregated accounts that held only clients' funds and securities. Sentinel routinely violated this requirement by commingling and transferring client funds and securities between various client segregated accounts and between client accounts and a "house" account, which also contained securities owned by Sentinel. (Gracia Dec. ¶ 10) Sentinel's indiscriminate commingling and transfers among its various client accounts violated Section 206(4) and Rule 206(4)-2.

**C. Sentinel is Likely to Continue its Illegal Conduct in the Absence of a Restraining Order.**

In determining whether there is a likelihood of future violations, courts consider the totality of circumstances. *SEC v. Holschuh*, 694 F.2d 130, 144 (7th Cir. 1982). It is well established that the existence of past violations is highly suggestive of the likelihood of future violations. *See SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 807 (2d Cir. 1975). "The Commission is entitled to prevail when the inferences flowing from the defendant's prior illegal conduct, viewed in light of present circumstances, betoken a 'reasonable likelihood' of future transgressions." *SEC v. Zale Corp.*, 650 F.2d 718, 720 (5th Cir. 1981). Other relevant factors include (1) the gravity of the harm caused by the offense; (2) the extent of the defendant's participation and his degree of scienter; (3) the isolated or recurrent nature of the infraction and the likelihood that the defendant's customary business activities might again involve him in such

