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REPORT OF INVESTIGATION

UNITED STATES SECURITIES AND EXCHANGE COMMISSION OFFICE OF INSPECTOR GENERAL

Case No. OIG-487

Allegations of Retaliatory Action by SEC Division of Enforcement Staff

Introduction and Results of Investigation

On April 6, 2008, the Securities and Exchange Commission ("SEC" or "Commission") Office of Inspector General ("OIG") opened an investigation into allegations by [redacted] (b)(7)(C) a shareholder of the company JagNotes.com, Inc. ("JagNotes.com") that the SEC's Division of Enforcement ("Enforcement") staff engaged in misconduct in its investigation of suspicious trading activity in JagNotes.com stock. Specifically, [redacted] (b)(7)(C) alleged that: (1) the Enforcement staff's investigation of JagNotes.com's former CEO, President and Chairman, Gary Valinoti ("Valinoti"), for improprieties in the trading of JagNotes.com stock was conducted in retaliation for [redacted] (b)(7)(C) and Valinoti having complained about naked short selling in JagNotes.com stock; and (2) the Enforcement staff improperly sought the disbarment of an attorney, [redacted] (b)(7)(C) [redacted] (b)(7)(C) in retaliation for [redacted] (b)(7)(C) having assisted Valinoti transfer JagNotes.com stock.

The OIG investigation found that the Enforcement staff's investigation into JagNotes.com securities trading was prompted by a referral from the National Association of Securities Dealers Regulation ("NASDR") that predated the complaints by [redacted] (b)(7)(C) and Valinoti concerning naked short selling and thus, did not find evidence substantiating the complaint. The OIG investigation also found no evidence that the staff sought [redacted] (b)(7)(C) disbarment.

Scope of Investigation

The OIG took the sworn testimony of [redacted] (b)(7)(C) on June 6, 2008, and [redacted] (b)(7)(C) [redacted] (b)(7)(C) on September 14, 2009. The OIG also interviewed a representative of the State Bar of [redacted] (b)(7)(C)

In addition, the OIG reviewed the following items: (1) the November 4, 1999 Action Memorandum seeking formal order authority for the investigation titled In the

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Matter of Trading in the Securities of JagNotes.com, Inc. ("Jagnotes.com Investigation"); (2) the September 8, 2005 Action Memorandum for the Jagnotes.com Investigation; (3) an October 16, 2003 draft document subpoena from [redacted] to Computershare Trust Company, Inc.; (4) the Hub Case Report for the Jagnotes.com Investigation (HO-7392); (5) the SEC's Name Relationship Search Index ("NRSI")¹ Report for the JagNotes.com investigation; (6) the Commission's litigation release pertaining to its civil action against Valinoti; (7) the Form 10-K filed by JAG Media Holdings, Inc. ("JAG Media")² on November 13, 2002; (8) an article published in *Forbes* magazine on June 10, 2002 regarding lawsuits by companies against short sellers; (9) an e-mail attaching an article purportedly published in the *New York Post* on May 18, 2003 regarding JAG Media's lawsuit against brokerage firms for improperly closing short trades; and (10) on-line databases of the State Bar of [redacted] and the Board of Professional Responsibility of the Supreme Court of [redacted]

Relevant Legal Standard

Commission Canons of Ethics

17 CFR § 200.59 Relationship with persons subject to regulation. "In all matters before him, a member should administer the law without regard to any personality involved, and with regard only to the issues."

Commission Conduct Regulation

17 CFR § 200.735-2 Policy

(a) The Securities and Exchange Commission has been entrusted by Congress with the protection of the public interest in a highly significant area of our national economy. In view of the effect which Commission action frequently has on the general public, it is important that members, employees and special Government employees maintain unusually high standards of honesty, integrity, impartiality and conduct. They must be constantly aware of the need to avoid situations which might result either in actual or apparent misconduct or conflicts of interest and to conduct themselves in their official relationships in a manner which commands the respect and confidence of their fellow citizens.

¹ NRSI is used by the SEC's Enforcement staff to research whether a person or entity is involved in an open investigation.

² JagNotes.com changed its name in 2002 to JAG Media Holdings, Inc.

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Results of the Investigation

I. The Enforcement Staff's Investigation of Valinoti's trading

In July 1999, the NASDR referred suspicious activity in JagNotes.com stock to the SEC for investigation of possible insider trading. September 8, 2005 Action Memorandum for HO-7392 (9/8/05 Action Memo), attached hereto as Exhibit 1, at ii. *See also* November 4, 1999 Action Memorandum for HO-7392 (11/4/99 Action Memo), attached hereto as Exhibit 2, at 1; Transcript of September 14, 2009 testimony of [redacted] (b)(7)(C) [redacted] Tr.), attached hereto as Exhibit 3, at 11. The referral was based on suspicious trading volumes in JagNotes.com stock prior to JagNotes.com's announcement of a reverse merger.³ [redacted] (b)(7)(C) Tr. at 25-26; 11/4/99 Action Memo at 4.

In August 1999, the SEC staff opened a Matter Under Investigation in response to the NASDR referral. 11/4/99 Action Memo at 2 (stating, "Source Of Case: Referral from NASD Regulation, Inc."). Shortly after [redacted] (b)(7)(C) started working at the SEC as a staff attorney in Enforcement in September 1999, he was assigned to the JagNotes.com investigation. [redacted] (b)(7)(C) Tr. at 10, 38. In November 1999, the SEC staff sought and received a formal order in connection with its investigation, titled In the Matter of Trading in the Securities of Jagnotes.com, Inc., HO-7392. 9/8/05 Action Memo at 2. *See also* 11/4/99 Action Memo at 1.

In the course of investigating possible insider trading of JagNotes.com securities, the SEC staff, including [redacted] (b)(7)(C) took the testimony of Gary Valinoti on April 29, 2002, as a potential tipper of nonpublic information. [redacted] (b)(7)(C) Tr. at 26. *See also* 9/8/05 Action Memo at 4; Hub Case Report, attached hereto as Exhibit 4. Valinoti was president and CEO of New Jag, Inc., from 1992 until the reverse merger in March 1999, and was president, CEO, and chairman of the board of directors for Jagnotes.com from March 1999 through April 2004. 9/8/05 Action Memo at 2. In the course of Valinoti's testimony, Valinoti testified that he had received 250,000 shares of JagNotes.com stock at the time of the reverse merger and subsequently transferred the shares. [redacted] (b)(7)(C) Tr. at 26-31.

³ New Jag, Inc., a privately held New Jersey corporation that provided financial news and investment information, was acquired in March 1999 in a reverse merger by Professional Perceptions, Inc. 9/8/05 Action Memo at 3; 11/4/99 Action Memo at 2. Pursuant to this merger, the new company changed its name to JagNotes.com. 9/8/05 Action Memo at 2.

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After Valinoti's April 29, 2002 testimony, the Enforcement staff obtained documents confirming that Valinoti purchased 250,000 unregistered "free-trading" shares, with no clause in the stock purchase agreement identifying the shares as restricted or cautioning that the shares were subject to resale restrictions. 9/8/05 Action Memo at 3. The staff also learned that Valinoti made unregistered sales of 130,000 of these shares in March and April of 1999, generating proceeds of approximately \$1,831,875. *Id.* Valinoti transferred another 118,000 shares to third parties. *Id.* One of the people to whom Valinoti transferred unregistered shares was (b)(7)(C).

(b)(7)(C) 9/8/05 Action Memo at 3. See also (b)(7)(C) Tr. at 17-18. Valinoti transferred shares of JagNotes.com stock to (b)(7)(C) in exchange for an investment in (b)(7)(C) 9/8/05 Action Memo at 3-4.

The SEC staff subpoenaed Valinoti for further testimony concerning these unregistered shares of stock. (b)(7)(C) Tr. at 32-33. On January 13, 2004, Valinoti invoked his Fifth Amendment privilege against self-incrimination in response to all questions from the staff about the unregistered shares. *Id.* See also 9/8/05 Action Memo at 4; Hub Case Report.

The staff concluded that Valinoti had violated Section 5 of the Securities Act of 1933⁴ by selling or transferring 248,000 shares of JagNotes.com stock that he had purchased in an unregistered private transaction. 9/8/05 Action Memo at 5. The staff informed Valinoti that it intended to recommend that the Commission file a civil action against Valinoti in connection with these violations. *Id.* at ii. Settlement negotiations between the SEC staff and Valinoti began in March 2004. *Id.* at 1. On September 8, 2005, the staff circulated an action memorandum to the Commission recommending that the Commission file a civil action against Valinoti and accept Valinoti's offer to settle the action by consenting to the entry of a permanent injunction from future violations of Section 5. *Id.* at i. As part of this settlement offer, Valinoti agreed to disgorge illicit gains of \$2,937,040 and pay pre-judgment interest of \$1,399,977.⁵ The Commission

⁴ 15 U.S.C. § 77e.

⁵ Pursuant to this settlement offer, Valinoti agreed to satisfy \$571,707 of this obligation by paying \$50,000 in cash disgorgement, cancelling his 3,514,229 shares of JAG Media stock, and cancelling his options to buy one million shares of JAG Media stock. 9/8/05 Action Memo at 1-2. The staff allowed Valinoti to satisfy his obligation to disgorge \$50,000 by paying \$20,000 within thirty days of the date of the entry of final judgment, and the remaining \$30,000 within one year of the date of the entry of final judgment. *Id.* at 8-9. The staff did not recommend to the Commission that it seek a civil penalty against Valinoti. *Id.*

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accepted this settlement offer and the staff filed the settled complaint against Valinoti on September 29, 2005. Litigation Release No. 19407, attached hereto as Exhibit 5.

II. Valinoti's and [redacted] Complaints Concerning Naked Short Selling

[redacted] of Valinoti who has invested in various stocks, including JagNotes.com. Transcript of September 14, 2009 testimony of [redacted] [redacted] attached hereto as Exhibit 6, at 5-7, 20. In November 2003, [redacted] [redacted] created a website called InvestigateTheSEC.com to air his concerns regarding what he viewed as the SEC's failure to address naked shortselling. [redacted] Tr. at 7-9. Beginning in 2000, [redacted] [redacted] sent thousands of e-mails over a period of several years to the SEC Chairman, Commissioners, the Director of Enforcement, and news entities such as the New York Times and FOX News.⁶ [redacted] Tr. at 13, 46; [redacted] Tr. at 52-54. [redacted] e-mails discussed his concerns about naked short selling, with a small percentage of these e-mails discussing his concerns about naked short selling of JagNotes.com stock. [redacted] Tr. at 14; [redacted] Tr. at 53. These e-mails also included allegations that the SEC Commissioners were conspiring with Wall Street to protect naked short sellers. *Id.* at 15.

[redacted] testified that he believed that the SEC staff initiated an investigation of Valinoti because Valinoti and [redacted] had publicly complained about naked short selling. [redacted] Tr. at 24, 40-44. On June 20, 2002, almost three years after the Enforcement staff opened the JagNotes.com investigation, JAG Media and Valinoti filed a lawsuit against over 150 brokerage firms alleging, among other thing, a conspiracy to short sell JAG Media stock. See excerpt from Form 10-K filed by JAG Media on November 13, 2002, attached hereto as Exhibit 7. This lawsuit was also filed after the Enforcement staff had taken Valinoti's testimony and learned that Valinoti had received and transferred approximately 250,000 unregistered shares of JagNotes.com stock. [redacted] Tr. at 26-31.

[redacted] also testified that Valinoti had complained about naked short selling in articles in *Forbes* and the *New York Post*. [redacted] Tr. at 40. A *Forbes* article regarding actions taken by companies against short sellers, including a recapitalization by JagNotes.com, was published on June 10, 2002, and a *New York Post* article concerning

⁶ [redacted] did not testify with certainty as to when his e-mail complaints began, but he testified that it was "probably" between 2000 and 2003. [redacted] Tr. at 52-54. Consequently, the OIG found that any complaints sent by [redacted] in this time period would have occurred after the SEC's investigation of JagNotes.com securities trading had begun in 1999.

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the JAG Media lawsuit against brokerage firms discussed above was published in 2003.⁷ See June 10, 2002 *Forbes* article, "Sinking Fund," attached hereto as Exhibit 8; December 5, 2008 e-mail to OIG, attached hereto as Exhibit 9. As with JAG Media's lawsuit against brokerage firms, the OIG investigation found that these articles were published several years after the Enforcement staff had begun its investigation into trading of JagNotes.com securities, and after the Enforcement staff had learned from Valinoti's testimony that he had transferred unregistered shares of stock.⁸

(b)(7)(C) testified that, after the investigation into JagNotes.com securities trading had been opened, he received some e-mails from (b)(7)(C) about naked short selling, but it did not impact his investigation, which did not concern short selling. (b)(7)(C) Tr. at 16. (b)(7)(C) also testified that he did not receive or read any e-mails, documents or websites about naked short selling of JagNotes.com until after the SEC's JagNotes.com investigation had been opened. *Id.* at 46-47.

III. (b)(7)(C) State Bar Membership

As discussed above, (b)(7)(C) was one of the people to whom Valinoti transferred unregistered shares of JagNotes.com. On April 24, 1999, Valinoti transferred 50,000 unregistered shares of JagNotes.com to (b)(7)(C) in return for a 25 percent interest in (b)(7)(C). 9/8/05 Action Memo at 3-4.

As part of the investigation of Valinoti's JagShares.com trading, the SEC staff took the testimony of (b)(7)(C) on January 28, 2004, to learn more about this stock transfer. (b)(7)(C) Tr. at 18-19; Hub Case Report. Prior to (b)(7)(C) testimony, (b)(7)(C) called the Board of Professional Responsibility of the Supreme Court of (b)(7)(C) to verify (b)(7)(C) status as a lawyer. (b)(7)(C) Tr. at 21-22.⁹ (b)(7)(C)

⁷ (b)(7)(C) testified that he did not recall seeing any articles about naked short selling related to JAG Media. (b)(7)(C) Tr. at 46-47.

⁸ As an alternative to his theory that the SEC action against Valinoti was retaliation for Valinoti's and (b)(7)(C) complaints about naked short selling, (b)(7) also claimed in his testimony that the SEC staff believed JagNotes.com was a pump and dump operation, and had harassed Valinoti and others because of that belief. (b)(7) Tr. at 31-36. (b)(7) offered no evidence to support his alternative theory of retaliation. (b)(7)(C) testified that he did not suspect and was not aware of any allegations of pump and dump activity at any point during this investigation. (b)(7)(C) Tr. at 35-36. The action memoranda for this investigation made no mention of pump and dump allegations or concerns. See 11/4/99 Action Memo; 9/8/05 Action Memo.

⁹ (b)(7)(C) testified that he believed he had called the State Bar of (b)(7)(C) (b)(7)(C) Tr. at 21-22. However, the State Bar of (b)(7) has no record of any individual with the name (b)(7)(C).

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testified that he learned from this telephone call that [redacted] license to practice law had been suspended. *Id.* The records of the Board of Professional Responsibility of the Supreme Court of [redacted] indicate that [redacted] license to practice law was suspended on April 1, 2002.¹⁰ See Board of Professional Responsibility of the Supreme Court of [redacted] Release of Information, attached hereto as Exhibit 10. According to those records, [redacted] license is suspended; he has not been disbarred. *Id.*

[redacted] testified that [redacted] had told [redacted] that [redacted] had contacted the [redacted] Bar Association and informed the [redacted] Bar Association that [redacted] was involved in the sale of unregistered securities and should be disbarred.¹¹ [redacted] Tr. at 31. [redacted] offered no evidence to support the allegation that [redacted] had sought [redacted] disbarment and the fact, discussed above, that [redacted] had been suspended almost two years before he testified in the JagNotes.com investigation is inconsistent with the allegation.

ever being a member. Consequently, the OIG concluded that it was more likely that [redacted] had called the State Bar of [redacted] and was mistaken about having called the State Bar of [redacted]

[redacted]

¹¹ [redacted] allegation regarding [redacted] is part of his broader belief that the SEC "used the power of the federal government to scare individuals away" who were affiliated with JAG Media. [redacted] Tr. at 44-50. Similar to his claim regarding [redacted], [redacted] believes that the SEC staff pressured [redacted] [redacted] of Computershare Trust Company, Inc. ("Computershare"), to stop serving as the transfer agent for JagNotes.com's stock. *Id.* [redacted] testified that Valinoti told him that an SEC staff member called [redacted] in 2003 and told [redacted] to "get a good lawyer" because Computershare's handling of JagNotes.com's stock was illegal, and that an SEC staff member told [redacted] in 2004 not to do business with JAG Media. *Id.* at 44-50. [redacted] testified that he has never spoken to [redacted] that his only communication with any individuals at Computershare was to give advance notice of a subpoena for documents to identify where Valinoti had transferred his unregistered JagNotes.com stock, and that he had no knowledge of the SEC Enforcement staff having anything to do with Computershare dropping JAG Media as a client. [redacted] Tr. at 52-56.

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(b)(7)(C) testified that his only contact with any state bar entities concerning (b)(7)(C) was to verify the status of (b)(7)(C) license to practice law as part of his due diligence prior to (b)(7)(C) testimony. (b)(7)(C) Tr. at 20-24. (b)(7)(C) also testified that (b)(7)(C) was never a subject of the JagNotes.com investigation. *Id.*

Accordingly, we did not find evidence substantiating (b)(7)(C) claim.

Conclusion

The OIG investigation did not find evidence substantiating the claim that the complaints by (b)(7)(C) and Valinoti concerning naked shortselling led to, or influenced, the SEC staff's JagNotes.com investigation. In fact, we found evidence that the investigation was opened because of a referral by the NASDR. Moreover, we found that the NASDR referral and the opening of the JagNotes.com investigation in 1999 predated (b)(7)(C) and Valinoti's earliest complaints about naked short selling.

Furthermore, the OIG investigation found no evidence to support the allegation that (b)(7)(C) attempted to have (b)(7)(C) disbarred. The records of the Board of Professional Responsibility of the Supreme Court of (b)(7)(C) evidence the fact that (b)(7)(C) license was suspended for reasons unrelated to the JagNotes.com investigation long before (b)(7)(C) contacted the Board in connection with (b)(7)(C) testimony.

Consequently, the OIG is closing this matter. A copy of this report is being provided for informational purposes to the Deputy Chief of Staff to the Chairman and the Director of Enforcement.

Submitted:

(b)(7)(C)

Date: 11/19/09

Concur:

Date: 11/19/09

Approved:



H. David Kotz

Date: 11/19/09