

INITIAL DECISION RELEASE NO. 958
ADMINISTRATIVE PROCEEDING
FILE NO. 3-16498

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of

RUSSELL C. SCHALK, JR.

INITIAL DECISION
February 10, 2016

APPEARANCES: John J. Bowers and Eugene H. Bull for the Division of Enforcement,
Securities and Exchange Commission

Russell C. Schalk, Jr., *pro se*

BEFORE: James E. Grimes, Administrative Law Judge

Summary

The Securities and Exchange Commission instituted this proceeding in April 2015 when it issued an order instituting proceedings (OIP). In the OIP, which was issued under Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, and Section 9(b) of the Investment Company Act of 1940, the Commission accepted the offer of settlement submitted by Respondent Russell C. Schalk, Jr. The Commission also made findings, imposed remedial sanctions, and issued a cease-and-desist order. Finally, the Commission set this matter for a hearing to determine Schalk's ability to pay the amounts imposed in the OIP. Following consideration of the materials submitted by the parties, I determine that Schalk currently has an ability to pay \$20,000 per year.

Procedural history

I held a prehearing conference in this matter on June 9, 2015. During the conference I discussed with the parties whether to hold a hearing or to decide Schalk's ability to pay based only on written submissions. The Division of Enforcement voiced no objection to either option. After the conference, Schalk informed my office that he wished to proceed without an in-person hearing. As a result, I set a prehearing schedule under which Schalk presented evidence in support of his claimed inability to pay, the Division filed an opposition, and Schalk filed a reply.

See Russell C. Schalk, Jr., Admin. Proc. Rulings Release No. 2820, 2015 SEC LEXIS 2410 (ALJ June 16, 2015).¹

After the conclusion of briefing, I asked the parties to confirm whether the OIP contemplated a simple yes-or-no decision as to whether Schalk has the ability to pay or a decision that he has the ability to pay less than that imposed in the OIP. *Russell C. Schalk, Jr.*, Admin. Proc. Rulings Release No. 3282, 2015 SEC LEXIS 4504 (ALJ Nov. 2, 2015). After the Division responded², I held another prehearing conference to discuss the matter on December 17, 2015.

Background

The OIP details the Commission's findings to which Schalk has agreed. Schalk agreed that "he will be precluded from arguing that he did not violate the federal securities laws described in this [OIP]"; "he may not challenge the validity of this [OIP], including amounts lost by investors and misappropriated by [Schalk] as stated in this [OIP]"; and "solely for the purposes of such additional proceedings, the allegations of the [OIP] shall be accepted as and deemed true by the [administrative law judge]." OIP at 13.

According to those findings, at all relevant times, Schalk was the sole control person of Raintree Racing, LLC, and Raintree Thoroughbred Farm, Inc. OIP at 2. He was a one-third owner of Raintree Racing and the president, CEO, and secretary-treasurer of Raintree Farm. *Id.* at 2. Raintree Racing bought and sold thoroughbred horses. *Id.* at 2-3. Raintree Farm bought and sold horses and also raced them. *Id.* at 3.

Neither Raintree Racing nor Raintree Farm has ever registered with the Commission. OIP at 3. Raintree Racing has never registered an offering of securities under the Securities Act. *Id.* In 2007 and 2010, Raintree Farm submitted filings under Rule 506 of Regulation D under the Securities Act for the private offering of its securities.³ *Id.*

¹ This initial schedule was later amended. *See Russell C. Schalk, Jr.*, Admin. Proc. Rulings Release No. 3132, 2015 SEC LEXIS 3785 (ALJ Sept. 15, 2015); *Russell C. Schalk, Jr.*, Admin. Proc. Rulings Release No. 2907, 2015 SEC LEXIS 2787 (ALJ July 8, 2015).

² The Division responded that I could order Schalk to "pay nothing, pay a reduced amount, or pay the full amount." Letter from John J. Bowers (Nov. 6, 2015). It also said that I possess the "discretion to establish a payment schedule." *Id.*

³ Section 4(a)(2) of the Securities Act exempts nonpublic offerings from the registration requirement of Section 5 of the Securities Act. *See* 15 U.S.C. § 77d(a)(2). Rule 506 sets forth certain criteria a transaction must meet to "be deemed to be [a] transaction[] not involving any public offering within the meaning of [S]ection 4(a)(2)." 17 C.F.R. § 230.506. In short, Rule 506 allows for offerings of any size, as long as (1) there are no more than thirty-five purchasers, not including certain classes of individuals and accredited investors in that number; (2) non-accredited investors are sophisticated investors and certain disclosure obligations are met when non-accredited investors participate in the offering; (3) resale of the securities is restricted; and

Between January 2007 and March 2012, Schalk sold nearly \$2 million of Raintree Racing securities through unregistered offerings. OIP at 2, 4, 10. The offerings, which involved sixteen investors, were not registered with the Commission and did not comply with the exemption in Securities Act Section 4(a)(2) or the safe harbors of Regulation D. *Id.* at 10-11. In connection with these sales, Schalk issued unregistered “bonus” shares of Raintree Farm common stock to Raintree Racing investors, which constitutes a “sale” under Securities Act Section 2(a)(3) because they were part of the investors’ purchase of the Raintree Racing securities and thus were offered and sold for value. *Id.* at 11; *see* 15 U.S.C. § 77b(a)(3).

During the same time period, Schalk also sold over \$360,000 of Raintree Farm securities through unregistered offerings to three investors. OIP at 11. In making unregistered offerings of Raintree Farm securities, Schalk purported to rely on the Regulation D exemption under Rule 506 and represented that sales would be made only to accredited investors. *Id.* The “bonus” Raintree Farm securities and the securities sold in this offering, however, were issued to non-accredited investors. *Id.* at 11-12. Schalk knew or should have known that these investors to whom he made the offerings did not qualify as accredited investors. *Id.* at 12. Additionally, the non-accredited investors were not provided with the required disclosure documents. *Id.*

In connection with the sales of the Raintree entities’ securities, Schalk misrepresented or failed to disclose material facts. OIP at 2. Raintree Racing investors were told that they would receive a twenty percent return and that their invested principal would be returned in one year or less. *Id.* at 4. Investors thus thought their investments were protected. *Id.* at 3-5. Without authorization, however, Schalk transferred \$668,000 from Raintree Racing to Raintree Farm to pay the latter’s expenses. *Id.* at 5. With respect to Raintree Farm, Schalk failed to tell investors that Raintree Farm had operated at a loss since its inception in 2002, had minimal assets, and was dependent on Raintree Racing to fund its operations. *Id.* at 8. At one point, Schalk sent investors account statements reflecting that Raintree Farm’s net asset value was \$3.34 per share. *Id.* at 9. Schalk knew that there was no basis for his valuation. *Id.* Without telling investors or obtaining authorization, Schalk transferred \$220,000 from the Raintree entities to himself. *Id.*

Based on these facts, the Commission determined that Schalk willfully violated the registration requirements in Section 5(a) and (c) of the Securities Act and the antifraud provisions in Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5. OIP at 12. “Pursuant to” the OIP, Schalk agreed “to disgorgement of \$1,472,959, prejudgment interest of \$280,271.55, and a . . . civil penalty of \$1,600,000.” *Id.* at 13. Schalk also agreed to this proceeding for purposes of “determin[ing] his ability to pay” the above amounts. *Id.* He additionally agreed that his ability to pay could be determined without an in-person hearing. *Id.*

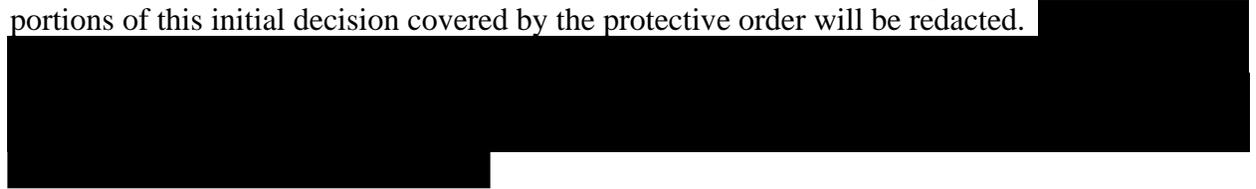
During a prehearing conference in this matter on June 9, 2015, the parties addressed the fact that Schalk bears the burden to demonstrate his inability to pay the amounts ordered by the Commission. Tr. 12-13. Based on further discussion and Schalk’s request to proceed by motion

(4) the issuer takes reasonable steps to verify accredited investor status. 17 C.F.R. §§ 230.502, .506.

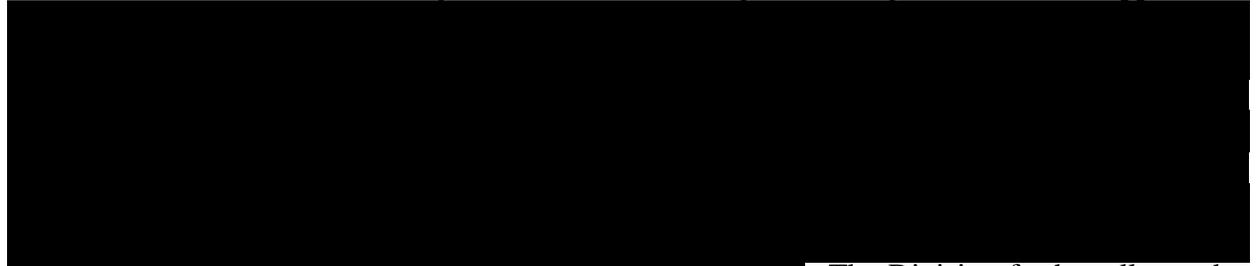
rather than an in-person hearing, I set a briefing schedule. Tr. at 13-19; *Russell C. Schalk, Jr.*, 2015 SEC LEXIS 2410, at *2.

Arguments of the Parties

In August 2015, Schalk submitted a sworn financial disclosure statement and attached explanation, together with his tax returns for tax years 2007 through 2014. I issued a protective order over this statement, attached explanation, and tax returns. *Russell C. Schalk, Jr.*, Admin. Proc. Rulings Release No. 3045, 2015 SEC LEXIS 3375 (ALJ Aug. 17, 2015). As such, portions of this initial decision covered by the protective order will be redacted.



The Division filed an opposition. According to the Division, Schalk's submission is inconsistent with information he gave the Division during its investigation in 2014. Opp. at 2-3.



The Division further alleges that because Raintree Farm's website remains active, Schalk is "apparently" still operating that entity. Opp. at 3; Ex. 2A-C.

Relying on the public interest factors enunciated in *Steadman v. SEC*, the Division argues that the sanctions ordered by the Commission "are entirely appropriate." Opp. at 4-6; see *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). The Division also argues that Schalk has not convincingly shown his inability to pay disgorgement because he has not accounted for the money he diverted from the Raintree entities and continues to operate Raintree Farm. Opp. at 8. Finally, the Division argues that in light of Schalk's conduct and the public interest, he should be required to pay the penalties imposed. *Id.* at 9-10.

Schalk filed a timely reply with supporting evidence. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Schalk denied that he is still operating Raintree Farm, asserting that he does not know why its website is still active. *Id.* at 3. With regard to the \$220,000 he diverted from the Raintree entities, Schalk states that he contributed \$350,000 to one or perhaps both of the entities. *Id.* at 4. He asserts that his attorney told him that he “could recoup those monies.” *Id.* According to Schalk, the \$220,000 represents a portion of the funds he “recoup[ed]” with his counsel’s blessing. *Id.* Schalk did not submit a declaration from his counsel in support of this assertion.

Discussion

In cases, such as this one, that are instituted under Section 8A of the Securities Act and Section 9(b) of the Investment Company Act, the Commission must consider the public interest before imposing a monetary penalty.⁴ *See* 15 U.S.C. §§ 77h-1(g)(1)(B), 80a-9(d)(1)(A). A respondent’s alleged inability to pay is one of the factors considered in assessing whether the

⁴ This proceeding was also instituted under Section 21C of the Exchange Act. OIP at 1. In cases instituted under that section, the Commission is not required to consider the public interest before imposing a monetary penalty. *See* 15 U.S.C. § 78u-2(a)(2).

public interest supports imposing a penalty. *Charles Trento*, Securities Act Release No. 8391, 2004 SEC LEXIS 389, at *14 & n.22 (Feb. 23, 2004); *see* 15 U.S.C. §§ 77h-1(g)(3), 78u-2(d), 80a-9(d)(4); 17 C.F.R. § 201.630. The respondent has the burden to show inability to pay penalties or disgorgement. *Philip A. Lehman*, Exchange Act Release No. 54660, 2006 SEC LEXIS 2498, at *16 (Oct. 27, 2006); *Terry T. Steen*, Exchange Act Release No. 40055, 1998 SEC LEXIS 1033, at *21 (June 1, 1998). Because inability to pay is merely a factor that may be taken into account in determining an appropriate penalty, even if a respondent demonstrates an inability to pay, the Commission may nonetheless impose a financial penalty. *Johnny Clifton*, Securities Act Release No. 9417, 2013 SEC LEXIS 2022, at *66 n.116 (July 12, 2013). Notably, the financial harm that befalls a respondent as a result of misconduct “is not a mitigating factor.” *Id.*

During a prehearing conference held in December 2015, I noted that the Commission normally considers a respondent’s alleged inability to pay in the course of assessing whether the public interest supports imposing a monetary penalty. Tr. 42. Indeed, in this proceeding, the Commission conducted its public interest analysis before assessing disgorgement and civil penalties. OIP at 13 (“[T]he Commission deems it appropriate in the public interest to impose the [following] sanctions.”). The Commission then “institute[d] [these] proceedings to determine Respondent’s ability to pay.” *Id.*

The Division nevertheless argues that, regardless of Schalk’s purported inability to pay, I could, and should, still order him to pay the full amount of disgorgement and penalties assessed by the Commission. Opp. at 4-6. This is because the Respondent’s inability to pay is only one factor in the public interest analysis, and the other factors outweigh any purported inability to pay. *Id.* at 4-6, 8. In other words, the Division contends that I am permitted to reweigh the public interest factors and conduct my own public interest analysis.⁵ Tr. 43-44.

I disagree with the Division’s argument. The language of the OIP is clear. The Commission “deem[ed] it appropriate *in the public interest* to impose the sanctions agreed to in the [settlement] [o]ffer, and to institute proceedings to determine Respondent’s ability to pay,” and therefore directed me to “determine Respondent’s ability to pay in additional proceedings.” OIP at 13-14 (emphasis added). In other words, the Commission already found it was in the public interest to accept the agreed-upon sanctions *and* to take Schalk’s ability to pay into account. Nowhere in the OIP did the Commission direct me to perform a public interest analysis or to reevaluate whether it was in the public interest to consider ability to pay. Instead, as is made clear in the OIP, the Commission has already assessed the public interest. *Id.* at 13. If the Commission wanted me to conduct a public interest analysis, it would have specified so, as it has

⁵ During a prehearing conference, Schalk appeared to agree with the Division’s argument. Tr. 48 (when asked if he disagreed with the Division’s argument, he replied “no.”). It is evident from his statements immediately following his supposed agreement, however, that Schalk did not understand the questioning or the Division’s argument. Tr. 48-49 (“I don’t – I don’t think I know enough to say no . . . I don’t have any – I mean, I don’t think I’d know enough to say that I – I wouldn’t know whether I could or I – I don’t have any problem with what [Division counsel] said.”).

done on many occasions.⁶ Accordingly, as directed by the Commission, my sole task is to determine whether Schalk has demonstrated an inability to pay the disgorgement and civil monetary penalties assessed.

Schalk's evidence

I disregard Schalk's assertion that the \$220,000 he took from the Raintree entities represents a portion of the funds he "recoup[ed]" with his counsel's blessing. The OIP recites that he diverted these funds without authorization. OIP at 9. Schalk agreed not to contest the amount that he took and further agreed to accept the OIP's allegations as true. *Id.* at 13. Schalk has therefore failed to account for the \$220,000 he took from the Raintree entities.

[REDACTED]

I do doubt, however, that he needs what most people would view as a luxury vehicle. This is especially so in light of the fact that he is liable for disgorgement of \$1,472,959 and prejudgment interest of \$280,271.55.

It may be that Schalk signed this lease before the Commission issued the OIP. But, as he has agreed, by the time he signed the lease, he had already fraudulently induced investors to invest over \$2 million. Crediting the cost of a luxury vehicle against Schalk's obligations would effectively encourage people in Schalk's situation to spend extravagantly. I therefore disregard half the amount of Schalk's lease.

[REDACTED]

Schalk, however, has provided no evidence concerning what he purchased when he incurred his credit card debt. Because Schalk bears the burden to prove inability to pay, his failure to explain how he incurred his credit card debt means that I will not consider that debt on the question of his ability to pay.

[REDACTED] That debt, however, was incurred for services counsel rendered during the Division's investigation of Schalk related to his admitted misconduct. In other words, but for the misconduct for which

⁶ See *Daniel R. Bartholomew*, Exchange Act Release No. 75999, 2015 SEC LEXIS 3953, at *16-17 (Sept. 28, 2015) (ordering a public hearing to determine what "civil penalties pursuant to Section 21B(a) of the Exchange Act against Respondents are in the public interest"); *Richard Krill*, Exchange Act Release No. 74994, 2015 SEC LEXIS 1987, at *18-20 (May 19, 2015) (ordering public hearing to determine what "disgorgement, prejudgment interest, and civil penalties . . . are in the public interest"); see also *Middlebury Secs. LLC*, Securities Act Release No. 9672, 2014 SEC LEXIS 4172, at *17-19 (Oct. 31, 2014) (same); *Toney Anaya*, Securities Act Release No. 9613, 2014 SEC LEXIS 2568, at *11-14 (July 16, 2014) (same).

Schalk concedes responsibility, Schalk would not have incurred this debt. The fact of this debt, therefore, is not mitigating.

[REDACTED]

[REDACTED]

[REDACTED]

Schalk does not explain the basis for his hope and has supplied no information relating to whether he has received commissions in 2015 or the likelihood of receiving them in 2016.

[REDACTED]

Based on these facts, I find that is more likely than not that he will earn commissions in the future.

Precisely predicting the amount of Schalk's future commissions is not possible, mostly because the sample size in evidence is small. He has not addressed whether he has earned any commissions this year or whether he expects to earn any in the future. *See* Reply at 5 (“[f]uture commissions are possible”). Because Schalk has the burden of proof, this failure cannot weigh in his favor.

The fact that Schalk earned commissions in the past and likely will in the future suggests that last year was an aberration. [REDACTED]

I therefore conclude that, currently, Schalk's ability to pay the disgorgement and civil monetary penalties is limited to \$20,000 a year.

Conclusion

In accordance with the Commission's direction in the OIP, I determine that Schalk's current ability to pay disgorgement and civil monetary penalties is limited to \$20,000 a year.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule of Practice 360, 17 C.F.R. § 201.360. Under 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 of Practice 111, 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 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 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.

James E. Grimes
Administrative Law Judge