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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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ADMINISTRATIVE PROCEEDING
File No. 3-15255

In the Matter of

JOHN THOMAS CAPITAL MANAGEMENT GROUP, LLC, d/b/a PATRIOT28, LLC,

GEORGE R. JARKESY JR.,

JOHN THOMAS FINANCIAL, INC.,

ANASTASIOS "TOMMY' BELESIS,

Respondents.

THE DIVISION OF ENFORCEMENT'S POST-HEARING REPLY MEMORANDUM OF LAW PURSUANT TO RULE OF PRACTICE 340

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

ARGUMENT 1

A. The Commission did not Prejudge this Case and the Division did not Violate its Internal Procedures in Connection with Other Respondents' Settlement 1

B. The Division's Document Production was not only Procedurally Sufficient, but also Exceeded the Rule of Practice Requirements; the Division Fully Complied with its *Brady* Obligations 2

C. Selection of the Administrative Proceeding as a Forum was Proper and the Absence of a Jury does not Violate Respondents' Constitutional Rights 5

D. The Overwhelming Evidence Details Respondents' Fraudulent Conduct 8

1. The Representations of the PPM were False 9
2. Respondents Dictated all Representations Made to Investors 11
3. Respondents are Liable for the False Representations in the Marketing Materials and the Updates to Investors 14
4. The Valuations Were Without any Factual Basis 17
5. The Division Demonstrated Respondents' Improper Relationship with JTF 20
6. Respondents Never Changed their Investment Strategy 24

E. The Relief Sought by the Division is Authorized and Warranted 26

1. Penalties are Authorized in Administrative Actions 26
2. The Statute of Limitations does not Preclude the Requested Sanctions 29
3. Loss Causation is not a Requirement in Enforcement Actions 31
4. Respondents' Losses in the Fund do not Impact Disgorgement 32
5. The Sanctions Sought are not Excessive 32

CONCLUSION 35

TABLE OF AUTHORITIES

Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972) 13
Arjent v. SEC, 2014 U.S. Dist. LEXIS 37622 (S.D.N.Y. Mar.18, 2014) 6
Atlas Roofing Co. v. Occupational Safety & Health Comm'n, 430 U.S. 442 (1977) 7
Gabelli v. SEC, 133 S. Ct. 1216 (2013) 29
Gebhart v. SEC, 595 F.3d 1034 (9th Cir.), *cert. den.*, 561 U.S. 1008 (2010) 32
Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) 31
Henning v. Wachovia Mortg., FSB, 969 F. Supp.2d 135 (D. Mass. 2013) 28
IKB International S.A. v. Bank of America, 2014 U.S. Dist. LEXIS 45813 (S.D.N.Y. Mar. 31, 2014) 18
In re Ross Securities, Inc., 1963 SEC LEXIS 571 (Apr. 30. 1963) 16
In the Matter of Bandimere, 2013 SEC LEXIS 3142 (Initial Decision, Oct. 8, 2013) 25
In the Matter of Brokaw, 2013 SEC LEXIS 3583 (Op. of the Commission, Nov. 15, 2013) 23
In the Matter of Calais Resources, Inc., 2012 SEC LEXIS 20212 (Op. of the Commission June 29, 2012) 9
In the Matter of Clifton, 2013 SEC LEXIS 2022 (Op. of the Commission, July 12, 2013) 24
In the Matter of Ferrer, 2012 SEC LEXIS 3420 (Order on Evid. Issue Nov. 2, 2012) 9
In the Matter of Harding Advisory LLC, 2014 SEC LEXIS 938 (Order Den. Pet. for Interlocutory Review, Mar. 14, 2014). 6-7
In the Matter of Hausmann-Alain Banet, 2014 SEC LEXIS 361 (Initial Decision, Jan. 30, 2014) 8
In the Matter of John Thomas Capital Mgmt. Group LLC, 2013 SEC LEXIS 3860 (Order Den. Pet. for Interlocutory Appeal, Dec. 6, 2013) 4
In the Matter of John Thomas Capital Mgmt. Group LLC, 2014 SEC LEXIS 308 (Order Den. Pet. for Interlocutory Appeal, Jan. 28, 2014) 2
In the matter of Kenny, 2003 SEC LEXIS 1170 (Op. of the Commission, May 14, 2003) 14
In the Matter of Leaddog Capital Markets, LLC, 012 SEC LEXIS 2918 (Initial Decision, Sept. 14, 2012) 15
In the Matter of Montelbano, 2003 SEC LEXIS 153 (Op. of Commission, Jan. 22, 2003) 23
In the Matter of Pelosi, 2012 SEC LEXIS 48 (Initial Decision, Jan. 5, 2012) 15, 24
In the Matter of Raymond J. Lucia Cos., Inc., 2013 SEC LEXIS 3856 (Initial Decision, Dec. 6, 2013) 15
In the Matter of Vindman, 2006 SEC LEXIS 862 (Op. of the Commission, Apr. 14, 2006) 8, 28
In the Matter of Zubkis, 2005 SEC LEXIS 3125 (Op. of the Commission Dec. 2, 2005) 28
Lieberman v. City of Rochester, 2014 U.S. App. LEXIS 4347 (2d Cir. Mar. 7, 2014) 7
Riordan v. SEC, 627 F.3d 1230 (D.C. Cir. 2010) 29
Rochester Funds Group Sec. Litig., 838 F. Supp.2d 1148 (D. Colo. 2012) 26
Ruston v. Town Bd. for Town of Skaneateles, 610 F.3d 55 (2d Cir.), *cert. den.*, 131 S.Ct. 824 (U.S. 2010) 7
SEC v. Bolla, 550 F. Supp.2d 54 (D.D.C. 2008) 29

SEC v. Credit First Fund, LP, 2006 U.S. Dist. LEXIS 96697, (C.D. CA, Feb. 13, 2006) 17
SEC v. Czarnik, 2010 U.S. Dist. LEXIS 125463 (S.D.N.Y. Nov. 29, 2010) 14
SEC v. Delphi Corp., 2008 U.S. Dist. LEXIS 78671 (E.D. Mich. Oct. 8, 2008)..........................13
SEC v. e-Smart Techs., Inc., 2014 U.S. Dist. LEXIS 31629 (D.D.C. March 12, 2014)................14
SEC v. Gabelli, 2010 U.S. Dist. LEXIS 27613, *30 (S.D.N.Y. Mar. 17, 2010), *rev'd in part on different grounds*, 653 F.3d 49 (2d Cir. 2011), *rev'd on different grounds*, 133 S.Ct. 1216 (2013); *aff'd in part, re'vd in part on different grounds,* 2013 U.S. App. LEXIS 9128 (2d Cir. 2013) 29
SEC v. Goble, 682 F.3d 934 (11th Cir. 2012) 32
SEC v. J.W. Barclay & Co., 442 F.3d 834 (3d Cir. 2006)..28
SEC v. Kelly, 663 F. Supp. 2d 276 (S.D.N.Y. 2009)...29
SEC v. Lauer, 2008 U.S. Dist. LEXIS 73026 (S.D. Fla. Sept. 24, 2008), *aff'd*, 201 U.S. App. LEXIS 7889 (11th Cir.); *cert. den.*, 133 S. Ct. 545 (U.S. 2012) 14
SEC v. McCaskey, 56 F. Supp. 2d 323 (S.D.N.Y. 1999)...29
SEC v. Merchant Capital, 483 F.3d 747 (11th Cir. 2007)..10
SEC v. Merkin, 2012 U.S. Dist. LEXIS 155679 (S.D. Fla. Oct. 3, 2012)....................................13
SEC v. Monterosso, 2014 U.S. App. LEXIS 3891 (11th Cir. March 3, 2014)..............................33
SEC v. Pirate Investor LLC, 580 F.3d 233, 239 (4th Cir. 2009), *cert. den.*, 130 S.Ct. 3506 (U.S. 2010) 32
SEC v. Quinlan, 2010 U.S. App. LEXIS 8205 (6th Cir. 2010)...29
SEC v. Rana Research, Inc., 8 F.3d 1358 (9th Cir. 1993)...17
SEC v. Razmilovic, 822 F. Supp.2d 234, 281 (E.D.N.Y. 2011), *aff'd in all relevant parts*, 738 F.3d 14 (2d Cir. 2013), *cert. den.*, (March 26, 2014) 34
SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. den.*, 394 U.S. 976 (1969)...13
SEC v. Zandford, 535 U.S. 813 (2002)...13
Semerenko v. Cendant Corp., 223 F.3d 165 (3rd Cir. 2000), *cert. den.*, 531 U.S. 1149 (U.S. 2001) 13
Teicher v. SEC, 177 F.3d 1016 (D.C. Cir. 1999)..28
United States v. Moore, 543 F.3d 891 (7th Cir. 2008) 7
VanCook v. SEC, 653 F.3d 130 (2d Cir. 2011), *cert. den.*, 132 S.Ct. 1582 (U.S. 2012)..............33

Pursuant to the Commission's Rule of Practice 340, the Division of Enforcement ("Division") submits the following post-hearing reply memorandum of law, which further outlines its case against George R. Jarkesy, Jr. ("Jarkesy") and John Thomas Capital Management Group LLC, d/b/a Patriot28, LLC ("John Thomas") (collectively "Respondents") and the legal theories upon which the Division relies. This memorandum also addresses the arguments raised by Respondents in their post-hearing memorandum of law and response to the Division's proposed findings of fact and conclusions of law.[1]

ARGUMENT

A. The Commission did not Prejudge this Case and the Division did not Violate its Internal Procedures in Connection with Other Respondents' Settlement.

The first eleven pages of Respondents' post hearing memorandum of law are simply a repetition of their same unpersuasive arguments that in connection with the settlement of Respondents Anastasios "Tommy" Belesis ("Belesis") and John Thomas Financial, Inc. ("JTF"), the Commission prejudged its case against them. Respondents also continue to assert that the Division engaged in improper *ex-parte* communications with the Commission. This Hearing Officer previously called these arguments "frivolous," and the Commission also strongly rejected them. As the Commission ruled:

> The Commission has rejected arguments similar to those raised by JTCM and Jarkesy in an unbroken line of decisions. These decisions establish that "consideration of [certain respondents'] offer of settlement while the proceedings were still pending against. . . other respondents [is] proper and [does] not violate the Administrative Procedure Act... or our rules regarding *ex parte* communications." In particular, the Commission has determined previously that no prejudgment of a non-settling respondent's case occurs especially when--as took place here--the order accepting an offer of settlement "expressly state[s] that it was not binding on other [non-settling] respondents."

[1] The facts upon which this reply memorandum of law is based are generally described in the Division's proposed findings of fact previously submitted. To the extent that additional facts from the record are required to respond to Respondents' arguments, the Division provides record citations.

In the Matter of John Thomas Capital Mgmt. Group LLC, 2014 SEC LEXIS 308, *6 (Order Den. Pet. for Interlocutory Appeal, Jan. 28, 2014) (internal citations omitted). Indeed, the Commission strongly reprimanded Respondents' counsel, stating :

> Although JTCM and Jarkesy are "entitled to make a good-faith argument for a change in the law, they [are] obligated to acknowledge that they were doing just that and to deal candidly with the obvious authority that is contrary to [their] position." In their disqualification motion filed before the law judge, JTCM and Jarkesy did not address the Commission's "precedent. . . that **settles the issue at hand**," failed to show that the precedent should be reconsidered, and therefore did not demonstrate that there is a "substantial ground for difference of opinion" as to the law judge's denial of that motion.

Id. at *8 (emphasis added). Respondents continue to ignore the Commission's precedent that settles the issue at hand and instead criticize the Commission's "affinity for its own decisional decrees." (Op. Br. at 11, n.2).

Because this Hearing Officer and the Commission have already rejected these arguments in this case, the Division does not address the merits here but incorporates by reference its previously submitted letter briefs and other memoranda of law, which address these issues in detail. Upon request, the Division will provide additional briefing.

B. The Division's Document Production was not only Procedurally Sufficient, but also Exceeded the Rule of Practice Requirements; The Division Fully Complied with its *Brady* Obligations

Respondents next argue that the Division violated its own procedures and violated Respondents' due process rights by providing its investigative file in what they term a "document dump." Respondents further argue that the Division's document production was a deliberate attempt to hide *Brady* material. These arguments were also previously rejected by this Hearing Officer and by the Commission and should be given no further consideration.

First, noting that the files were produced to Respondents in the same way that the Division keeps the documents and were supplied in the electronically searchable Concordance database format, the Commission rejected Respondents' arguments that the production was improper or that they did not have sufficient time to review the documents prior to the hearing. In particular, the Commission stated that "JTCM and Jarkesy's estimates for how long it would take to conduct a page-by-page review of the materials are irrelevant; they can use Concordance's search capabilities to home in on the documents that they need to prepare for the hearing." *In the Matter of John Thomas Capital Mgmt. Group LLC*, 2013 SEC LEXIS 3860, *22, n37 (Order Den. Pet. for Interlocutory Appeal, Dec. 6, 2013).[3] The Commission similarly rejected Respondents' *Brady* argument, stating:

> [T]he Division's "open file" production would satisfy its disclosure obligations. It is settled that the government is not required to direct a defendant to specific items of potentially exculpatory evidence within a larger body of disclosed material. Indeed, the Supreme Court has made clear that the government may satisfy its Brady obligations through an "open file" policy, which the Court reasoned could well "increase the efficiency and the fairness of the criminal process." JTCM and Jarkesy fail to grapple with this authority.

Id. at *23. Moreover, the Commission found that Respondents' reliance on an unpublished district court decision (upon which Respondents continue to reply) was misplaced, and held that:

> the overwhelming weight of authority holds that *Brady* is not violated when, as here, the government turns over its investigative file—voluminous though it might be—in an electronically searchable format and there is no suggestion of bad faith (such as the burying of known exculpatory evidence within a production deliberately padded with irrelevant documents). Nothing in either Rule 230(b)(2) or *Brady* requires the Division to go further and prepare a "roadmap" of the documents for the respondent's benefit.

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[3] Indeed, the Rules of Practice require only that the Division make available for inspection and copying the documents obtained by the Division prior to the institution of proceedings in connection with its investigation. (Rule 230(a)(1).) The Rules of Practice do not require that the Division actually to provide the documents to the Respondents (as the Division did here) much less provide the documents in a searchable database.

Id. at *26. Because this Hearing Officer and the Commission have already rejected these arguments in this case, the Division does not address the merits here but incorporates by reference its previous letter briefs and other memoranda of law, which address these issues in detail. The Division will provide additional briefing at the Hearing Officer's request.

The Division, however, notes several facts that might otherwise not necessarily be clear from the record. First, the Commission specifically reviewed the staff's interview notes from investor Steven Benkovsky's interview and held that those interview notes contained no undisclosed exculpatory material. *Id.* at *18. Second, the Hearing Officer reviewed *in camera* several of the Division's handwritten interview notes of the witnesses that testified and, like the Commission, concluded that the notes, in fact, did not contain any exculpatory material. (Tr. at 1730 [Savage notes]; Tr. at 1415 [Fullhardt notes]).[4] Consequently, Respondents' statement that the Hearing Officer refused to review the notes *in camera* is false. And the fact that both the Commission and the Hearing Officer found that none of the withheld handwritten notes that they examined contained undisclosed *Brady* material supports the Division's representations that none of the other unexamined withheld notes contain undisclosed *Brady* material.

Second, the investigative file was produced to Respondents in April 2013. The hearing in this matter did not start until February 2014. As such, Respondents had more than nine months to review the documents with the searchable database. It is unclear what, if anything Respondents' counsel did during this period of time to prepare for the hearing. For example, rather then identifying specific documents as exhibits, Respondents simply identified ranges of thousands of documents from the production as exhibits. This lack of preparation was

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[4] Normal practice is for the Hearing Officer to accept the Division's representations that interview notes do not contain exculpatory material (including impeachment material).

particularly manifest with respect to Respondents' fraudulent representations that Deutsche Bank was the prime broker for the Funds and that KPMG was the auditor for the Funds. This was an issue that arose early in the investigation and was one of the subjects of the "Wells call" made on or about April 4, 2012 and was also specifically discussed in the Wells Submission the Respondents filed on May 8, 2012. (DX-642 at 1.) On March 14, 2014 – at the end of the hearing and nearly two years after their Wells submission – Respondents' counsel made the surprise announcement that "over the last 48 hours" their purported forensic computer expert found dozens of Deutsche Bank files and KPMG files.[5] Consequently, Respondents once again asked for the hearing to be adjourned. While the Hearing Officer properly denied this request, the real question that should have been asked is, why did Respondents delay until mid-March to look through the files for Deutsche Bank and KPMG documents?[6] Respondents' attempt to blame the Division for their own failure to properly prepare for the hearing rings hollow.

C. Selection of the Administrative Proceeding as a Forum was Proper and the Absence of a Jury does not Violate Respondents' Constitutional Rights

The third argument made in Respondents' post-hearing memorandum is that the selection of the administrative forum was arbitrary (thus violating their rights to equal protection under the law) and also deprived them of their right to a jury trial. Both arguments were recently rejected by the Commission in *In the Matter of Harding Advisory LLC*, 2014 SEC LEXIS 938, *35 n.46 (Order Den. Pet. for Interlocutory Review, Mar. 14, 2014). In that case the Commission held that respondents' constitutional claim was facially defective because respondents "identify no

[5] Notably, counsel did not represent whether those files were in Respondents' files or in the files of any of the other persons and/or entities that produced documents in this case.

[6] Respondents' counsel also repeatedly argued (even after they had received additional time) that their recent engagement in this matter warranted that more additional time be granted to them. The fact that Respondents consciously chose to engage new counsel who were unfamiliar with the facts after having had competent counsel represent them throughout the investigation, cannot now be used as a sword to assert that their rights have been prejudiced.

evidence to support their allegations that, by bringing this case as an administrative hearing, the Division **intentionally deprived them** of procedural safeguards afforded to similarly situated persons ...." (emphasis added). *Id.* Respondents here likewise fail to identify any evidence that the intention of the Division when bringing this case against them as an administrative proceeding ("AP"), was to deprive them of procedural safeguards afforded to other persons.[7]

In *Harding*, the Commission also rejected the respondents' equal protection argument on the grounds that respondents failed to demonstrate that they were similarly situated to defendants in other cases involving collateralized debt obligations ("CDO") that were brought in federal court. Notably, the respondents in *Harding* at least attempted to demonstrate the factual similarity between themselves and the defendants in the other CDO cases. In the instant case, notwithstanding Respondents' claim that their comparators "are easily identified from public records," there is no factual discussion of how those purported comparators were similarly situated (except for the assertion that the comparators were not SEC registrants and were charged under the same statutory provisions). Indeed, Respondents' counsel's email of May 1, 2014 sending the brief and factual findings to the Division (as well as to the ALJ's office), did not even include Exhibit A, which purportedly lists the comparators. Parties asserting "class-of-one" equal protection claims (as Respondents assert) must show an "**extremely high degree of similarity** between themselves and the persons to whom they compare themselves." *Lieberman v. City of Rochester*, 2014 U.S. App. LEXIS 4347 (2d Cir. Mar. 7, 2014) (emphasis added) (citing *Ruston v. Town Bd. for Town of Skaneateles*, 610 F.3d 55, 59 (2d Cir.), *cert. den.*, 131

[7] Respondents cite an October 6, 2013 New York Times article for the proposition that in fiscal year 2011, the SEC was successful in only 63% of its federal court cases. Without citation, Respondents state that in the last three years, the Division has enjoyed a success rate in "similar actions" approaching 100%. Studies such as these do not create a plausible claim of bias. *See Arjent v. SEC*, 2014 U.S. Dist. LEXIS 37622, *14-15 (S.D.N.Y. Mar.18, 2014).

S.Ct. 824 (U.S. 2010)).[8] Finally, the existence of similar actions brought as APs would conclusively demonstrate that there is no disparate treatment between the Respondents and other persons, and Respondents admit that "similar actions" have been brought as APs. (Op. Br. at 16, n.5).

With respect to the issue of a jury trial, in *Harding*, 2014 SEC LEXIS 938 at *35 n.46, the Commission held that "the Seventh Amendment does not prohibit Congress from assigning the fact finding function and initial adjudication to an administrative forum with which the jury would be incompatible." (*quoting Atlas Roofing Co. v. Occupational Safety & Health Comm'n*, 430 U.S. 442, 450 (1977)). This is a continuation of an unbroken line of Commission cases holding the same. *See In the Matter of Vindman*, 2006 SEC LEXIS 862, *43-44 (Op. of the Commission, Apr. 14, 2006) (rejecting argument that ALJ's imposition of the civil penalty violated respondent's Seventh Amendment right to a jury trial); *In the Matter of Tennenbaum*, 1982 SEC LEXIS 2434, *21-22 (Op. of the Commission, Jan. 19, 1982) (finding respondent's argument that the ALJ could not assert "clearly penal sanctions" without affording the procedural safeguards of a jury trial "wholly lacking in merit"). There are no jury trials in administrative proceedings. *See, e.g., In the Matter of Hausmann-Alain Banet*, 2014 SEC LEXIS 361 (Initial Decision, Jan. 30, 2014). Respondents discuss none of this binding authority in their post-hearing memorandum of law.

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[8] Respondents' class-of-one theory also does not apply to cases involving prosecutorial discretion. *United States v. Moore*, 543 F.3d 891 (7th Cir. 2008) ("an exercise of prosecutorial discretion cannot be successfully challenged merely on the ground that it is irrational or arbitrary; in the realm of prosecutorial charging decisions, only invidious discrimination is forbidden" and rejecting "class of one" doctrine in case concerning decision to prosecute defendant in federal court as opposed to similarly situated defendants who were prosecuted in state court).

D. <u>The Overwhelming Evidence Details Respondents' Fraudulent Conduct</u>

After spending the first twenty-four pages of their post-hearing memorandum describing the alleged procedural defects of this AP, Respondents spend a mere seven pages of their brief addressing the merits of this case. In this section of the brief (along with their response to the Division's proposed findings of fact), Respondents appear to be making the following arguments: (1) the Division did not demonstrate that the representations in the private placement memorandum ("PPM") were false when made; (2) JTF – not Respondents – made the false representations and owed the duties to the investors (as opposed to them); (3) the Division failed to demonstrate that the false statements (particularly those in the marketing materials and investor updates) were made to investors or relied upon by the investors; (4) the Division failed to demonstrate that the valuations were fraudulent because it did not call a expert witness to dispute Respondents' valuations; (5) the Division failed to demonstrate that Respondents favored Belesis and JTF to the detriment of the Funds; (6) the Division failed to demonstrate scienter because Jarkesy invested his life savings in the Funds and therefore would not have engaged in reckless or even negligent conduct; and (7) the PPM adequately warned the investors of the risks involved and also gave Respondents the ability to change the strategy as well as discretion in valuing the Funds' assets. None of these arguments is supported by the facts or the law.[9]

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[9] Respondents also mention in their preliminary statement that the evidentiary rulings made during the hearing were inconsistent and unfair, reflecting bias against Respondents. Notably, Respondents do not discuss any of the so-called inconsistent rulings in the text of their brief or explain why such rulings were improper. In fact, both the Division and Respondents were allowed to move into evidence limited amounts of investigative testimony. And both the Division and Respondents were precluded from introducing documents into evidence without either an authenticating witness or a business records declaration. The Hearing Officer's evidentiary rulings generally reflected the Commission's view that the Federal Rules of Evidence do not govern Commission proceedings although they are often used as a reference point. *In the Matter of Ferrer*, 2012 SEC LEXIS 3420 *5 n.1 (Order on Evid. Issue Nov. 2, 2012); *In the Matter of Calais Resources, Inc.*, 2012 SEC LEXIS 20212 (Op. of the Commission June 29, 2012) ("Hearsay is admissible in administrative proceedings, and 'we evaluate such evidence based on its probative value, its reliability and the fairness of its use.') (internal citations omitted). To the extent that the Hearing Officer's evidentiary rulings were inconsistent, the Division has already addressed this issue in its initial pre-hearing

1. The Representations of the PPM were False

As described in the Division's post-hearing brief, the PPM and Limited Partnership Agreement for Fund I, dated June 1, 2007, contained the following representations: (1) the Funds would purchase insurance policies with face value of 117% of the investor capital; (2) half of all investor capital would be used to purchase the insurance policies and set aside and segregated to pay premiums on those policies; (3) Respondents would mitigate life expectancy risk; (4) the insurance policies would be transferred to the Master Trust; (5) the total investment of the partnership in any one company at any one time would not exceed 5% of the aggregate capital commitments; (6) the General Partner (Jarkesy) would utilize good faith; (7) fair value would be used to value securities; (8) the Funds' financial statements would be prepared according to generally accepted accounting practices ("GAAP"); and (9) the management of the partnership would be vested exclusively in Jarkesy, the General Partner.

It is true that the Division did not attempt to demonstrate that when the PPM and Limited Partnership Agreement were first utilized in 2007, Respondents believed that these representations were false or did not intend to comply with their promises. However, the PPM and Limited Partnership Agreement (with one amendment in August 2007 that does not concern any of the above) were in force during the entire life of the partnership and the partnership sold interests in Fund I through at least 2010. Thus, even if the representations in the PPM were true in 2007, starting in 2008 – when Respondents knew that they had invested more than 5% of capital in one company – the representations in the PPM were false. In 2009, when Respondents knew that they were not in compliance with the 117% face value requirement and knew that the

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memorandum where it requested that on consistency grounds the Hearing Officer admit into evidence certain documents that were previously excluded.

valuations of the insurance policies were inflated, the representations in the PPM were false. Other representations in the PPM likewise became false over time. Respondents could not continue to use this same PPM when they knew the representations were now false. *See, e.g.* *SEC v. Merchant Capital*, 483 F.3d 747, 759 (11th Cir. 2007) ("what may once have been a good faith projection became, with experience, a materially misleading omission of material fact".)

In their response to the Division's proposed findings of fact and conclusions of law, Respondents argue that the Division has not shown that Respondents did not amend the PPM after August 2007. If such an amendment existed, it was never produced by Respondents in response to the numerous subpoenas issued to them. (Declaration of Todd D. Brody, dated May 12, 2014 ("Brody Decl."), attached hereto as Exhibit "A.")[10] Nor did Respondents include any such amendment in their book of proposed exhibits for this hearing. (*Id.*) Jarkesy did not recall any amendment to the PPM. (Jarkesy Tr. at 92, 94, 159). During the hearing, Juan Padilla ("Padilla"), the Funds' auditor, testified that he did not recall if the PPM or Limited Partnership Agreement was amended. Padilla noted that in connection with the annual audits, the auditing firm would have requested any changes or amendments to the PPM and that if they had received changes to the PPM it would be reflected in the audit file. (Padilla Tr. at 1002-1003). The audit files for 2009 and 2010 contain the same June 1, 2007 PPM. (Brody Decl.). In fact, there was no amendment after August 2007. Respondents essentially demand that the Division prove the negative – that no amendment was made – which is not required. As this Hearing Officer repeatedly stated during the hearing, if Respondents want to demonstrate that DX 206 (the PPM) was not authentic, they can try to do so.

[10] In the ordinary course, the Division would not submit this additional declaration. However, the fanciful assertion that the PPM for Fund I might have been amended post-August 2007 is an argument that was not raised by Respondents during the Wells process, in any of the pre-hearing briefing, or during the hearing itself. Had this issue been raised previously, the Division would have had a witness testify that no such amendment was produced by Respondents and that no such amendment was found in MFR's audit work papers.

2. <u>Respondents Dictated all Representations Made to Investors</u>

Respondents argue that they somehow cannot be held responsible for the misrepresentations made to investors because those misrepresentations were made by JTF representatives and not by themselves. This argument distorts the facts.

The evidence at the hearing is that Jarkesy directly spoke with investors to solicit their investment in the Funds. Jarkesy met with investor Steven Benkovsky ("Benkovsky") before he invested and told Benkovsky that the Fund was a "secure investment" that would not invest more than 5% of its assets in any one company. Jarkesy also showed Benkovsky a power point presentation that highlighted the 117% requirement. Jarkesy likewise participated in a conference call with investor Robert Fullhardt ("Fullhardt") before he invested and told Fullhardt that the Fund would purchase life insurance policies that would cover the principal amount in the Fund and that the Fund would not invest more than 5% in a single company.

In May 2009, Respondents sent a podcast to the Fund investors in which they stated that: (1) the Fund's charter required it to have 117% of investor cash in life settlement policies; (2) the purpose of the life settlement portfolio was to assure investors that at the end of the Fund's life they would get their money back; (3) half of all money invested would go towards the life settlement component of the Fund, and that 70% of that money would be set aside to pay premiums on the policies; (4) the Fund had had purchased fourteen different life insurance policies from fourteen different companies; (5) the Fund had grown significantly in April 2009 (without disclosing that the appreciation was due to Jarkesy writing up the value of the life insurance policies purchased that month in contravention of GAAP); (6) they were surprised by the change in the actuarial numbers (without disclosing that Steve Boger, a policy valuation authority, had told them about the change months before); and (7) Jarkesy had invested $500,000 in the Fund (without disclosing his $100,000 withdrawal immediately prior to the write down of the insurance policies based on the change in the actuarial numbers).

In addition to the false representations that Respondents made directly to the investors, the representations made by JTF personnel to potential investors to solicit investment in the Fund were based exclusively on information provided by Respondents. Jarkesy personally made several trips to New York to meet with the JTF registered representatives. During these meetings with the representatives, Jarkesy used a power point presentation he made and explained that the life insurance policies would cover the amount invested in the Fund so that investors could get their money back. Jarkesy also told that the JTF representatives that he would not invest more than 5% of the Fund's assets in any one position. Jarkesy further told the sales force that the power point presentation was all that they needed to sell the Fund and if they had additional questions, they could ask him. In addition to the power point presentation, Respondents sent additional marketing materials to help JTF sell Fund interests. It is simply untrue and contrary to the wealth of evidence that Respondents did not make any representations to the investors; they dictated what was provided and said to prospective investors. Indeed, the agreement between Respondents and JTF specifically required Respondents' approval for any document given and any statement made by JTF to investors. (DX-501 at Section 1.2(c)).

While Respondents are liable for their own false statements to the investors, they are also liable for the false statements that they made to JTF even if no one at JTF was themselves a purchaser or seller of the securities. This is for two reasons. First, Respondents made the representations to JTF knowing that those representations would eventually be passed along to prospective investors – that was the entire reason why Respondents had engaged JTF. *SEC v.*

Delphi Corp., 2008 U.S. Dist. LEXIS 78671 *240-41 (E.D. Mich. Oct. 8, 2008) ("in connection with" requirement satisfied where defendant knows that his representation would eventually reach investors). To meet the "in connection with" requirement, the SEC need only show that "the misrepresentations in question were disseminated in a medium upon which a reasonable investor would rely." *Semerenko v. Cendant Corp.*, 223 F.3d 165, 175-76 (3rd Cir. 2000), *cert. den.*, 531 U.S. 1149 (U.S. 2001); *SEC. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860-62 (2d Cir. 1968), *cert. den.*, 394 U.S. 976 (1969) (misrepresentations are made "in connection with" the purchase of sale of securities when the statements are made "in a manner reasonably calculated to influence the investing public"). Indeed, the Supreme Court has instructed that Section 10(b) of the Exchange Act and its "in connection with" requirement be construed "flexibly to effectuate its remedial purposes." *SEC v. Zandford*, 535 U.S. 813, 819, 122 S. Ct. 1899, 1903, 153 L.Ed.2d 1 (2002) (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151, (1972)); *SEC. v. Goble*, 682 F.3d 934, 945 (11th Cir. 2012). Thus, in *SEC v. Merkin*, 2012 U.S. Dist. LEXIS 155679 *22 (S.D. Fla. Oct. 3, 2012), dissemination of the false statements on a website was held sufficient to meet the "in connection" with requirement. By providing the false information to their placement agent, a registered broker dealer, Respondents knew that this false information would be disseminated to investors. Second, Respondents representations to JTF themselves met the "in connection" requirement, which does not require that the representation be made to an investor. *SEC v. Czarnik*, 2010 U.S. Dist. LEXIS 125463 *14-15 (S.D.N.Y. Nov. 29, 2010) (fraudulent statements made to transfer agent met the in connection with requirement). Indeed, any activity "touching the sale of securities" will suffice. *SEC v. e-Smart Techs., Inc.*, 2014 U.S. Dist. LEXIS 31629 (D.D.C. March 12, 2014).[11]

[11] As described in the Division's initial brief, the Division's claims under Section 206 of the Advisers act do not

3. **Respondents are Liable for the False Representations in the Marketing Materials and the Updates to Investors**

Respondents state in their post-hearing memorandum that "[t]he Division places lesser reliance on the 'marketing materials' that repeat some of the statements in the PPM, perhaps recognizing that it failed to prove either the provenance of these materials, the timing of their claimed publication, or that any of these documents were actually read by investors prior to their investments in the Funds." (Op. Br. at 27.) It is unclear how Respondents could have reached the conclusion that the Division is placing less reliance on these materials, given that these documents are the subject of page after page in the Division's proposed findings of fact.

From a legal standpoint, Respondents are wrong as to whether the Division has to demonstrate that these representations were read by investors. While reliance is a factor in private litigation, it is not a factor in SEC enforcement actions. *In the matter of Kenny*, 2003 SEC LEXIS 1170, *27, n.32 (Op. of the Commission, May 14, 2003) ("Kenny asserts that the Division was required to demonstrate that Kaufman and another customer, Smith, relied on his statements. The Commission does not have to demonstrate reliance in an enforcement action."); *In the Matter of Leaddog Capital Markets, LLC*, 012 SEC LEXIS 2918, *42 (Initial Decision, Sept. 14, 2012) (Foelak, ALJ) ("It is not necessary to prove that any particular investor viewed the information; reliance is not an element of an enforcement action for securities fraud.") *In the Matter of Raymond J. Lucia Cos., Inc.*, 2013 SEC LEXIS 3856, *120 (Initial Decision, Dec. 6, 2013) ("the Commission is not required to prove reliance in an enforcement action and the lack

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contain an "in connection with" requirement. *See, e.g., SEC v. Lauer*, 2008 U.S. Dist. LEXIS 73026 *90-91 (S.D. Fla. Sept. 24, 2008), *aff'd*, 201 U.S. App. LEXIS 7889 (11th Cir.); *cert. den.*, 133 S. Ct. 545 (U.S. 2012). Consequently, even if the Division did not show that Defendants' representations were in connection with the sale, purchase or offer of securities (which it did), the Division's claims under Section 206 based upon Respondents' misrepresentations would be unaffected.

of reliance is, therefore, not a defense"); *In the Matter of Pelosi*, 2012 SEC LEXIS 48, *56 (Initial Decision, Jan. 5, 2012).

Moreover, from a factual standpoint, Respondents are wrong when they claim that the Division did not prove that this information came from Respondents or that the information did not go to the investors and prospective investors. (*See e.g.*, DX-637 ("Have the Brokers use these updates for the fund"; DX-641 (email from Jarkesy attaching "one page"); DX-600 (email from Jarkesy attaching "pitchbook"); DX-608 (attaching Fund II "presentation material"); DX-611 (attaching "one page"); DX-211 (attaching quarterly newsletter); DX-258 (email from Jarkesy to JTF attaching DDQ); DX-259 (attaching March 2010 monthly report); DX-260 (attaching one page); DX-261 (attaching one page and pitchbook); DX-263 (email from Jarkesy to Belesis stating that "we will have one page handouts printed for brokers"). The investor witnesses recognized the documents. (Benkovsky Tr. at 734-740; Fullhardt Tr. at 1362-1375). Patty Villa, the Respondents' administrative assistant, testified that she would send the periodic quarterly and monthly updates to Alphametrix/Spectrum, the Funds' administrator, so that they could send them to the investors. (Villa Tr. at 572-574). Arthur Coffey, a JTF representative, testified that all information that he used to sell the fund (including the power point presentation and the one page information sheets) came from Jarkesy's office. (Coffey, Tr. at p. 1829-30, 1837). In sum, the Division has proven through ample evidence that the marketing materials and periodic investor updates came from Respondents and were provided to investors.

Respondents also appear to argue that because the PPM and Limited Partnership Agreement stated that the Fund interests were being sold pursuant to those documents alone, any false representations appearing in the power point presentation or other marketing materials and/or investor updates are irrelevant. This argument is also legally baseless. Respondents cannot use the PPM to immunize themselves from subsequent misrepresentations regarding the Funds and their operations. In analogous cases involving broker-dealers, the Commission and federal courts have prohibited initial disclosure documents from shielding individuals and entities from liability for subsequent misrepresentations. In *In re Ross Securities, Inc.*, 1963 SEC LEXIS 571, *4 (Apr. 30. 1963), the Commission stated:

> At the expense of restating the obvious ... a prospectus or offering circular does not, however, license broker-dealers or their salesmen to indulge in false or fanciful oral representations to their customers. The anti-fraud provisions of the Securities Act and the Securities Exchange Act apply to all representations whether made orally or in writing, during or after the distribution ... Those who sell securities by means of representations inconsistent with [the offering document] it do so at their peril.

The Commission has found that even optimistic or enthusiastic representations -- such as Jarkesy's views on certain portfolio companies' prospects, his valuation of the Funds' holdings, or his view of the likelihood of future repayment of short-term notes by failing companies -- must be reasonable, "whether couched in terms of opinion or fact" because the "obligations of fair dealing borne by those who sell securities to the public" require nothing less. *See id.* at *13.

Federal courts have similarly rejected arguments like the Respondents' that would allow a PPM to cure subsequent misrepresentations. Responding to the defendants' assertion that the PPM clarified the basis of a distribution, a District Court wrote, "[e]ven assuming that Defendants clearly disclosed the nature of the distribution in the PPM, this does not cure their misrepresentations or omissions. Even if the PPMs completely cured Defendants' alleged oral misrepresentations, '[n]ot every mixture with the true, will neutralize the deceptive.'" *SEC v. Credit First Fund, LP*, 2006 U.S. Dist. LEXIS 96697, *26 n.17 (C.D. CA, Feb. 13, 2006) (*citing SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1363 (9th Cir. 1993) (citation omitted)).

4. <u>The Valuations Were Without any Factual Basis</u>

Respondents argue that in the absence of the testimony of any expert to dispute their valuations, the Division did not demonstrate that the valuations were not fair value or were not in good faith. Respondents do not cite any case law for this proposition. Indeed, Respondents' valuations on their face were not fair value, which is defined as the price at which those securities could have been sold in an arm's length transaction. No valuation expert was required to demonstrate what is patently evident to all.

With respect to the restricted stock, it is unquestionable that there was no basis to value the restricted stock at the same price as the free-trading shares. According to GAAP, "the valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except for the most unusual situations, be improper." (DX-104 at 88-89.) Even Padilla, the auditor, stated that he could not conceive of a scenario where this would have been appropriate. (Padilla Tr. at 1050:4-6, 1053:5-9.) The Division demonstrated numerous instances where Respondents valued the restricted stock at the same price as the free-trading stock and in the case of Red Roller, actually valued the restricted stock higher.

With respect to the insurance policies, the Division demonstrated that in 2009, Jarkesy understood that the appropriate discount rate was <u>at least</u> 15%. Jarkesy's insurance brokers told him that the Fund had purchased policies in 2009 with implied discount rates greater than 15%. And in their April 2009 monthly report, Respondents told their investors that "[t]he Fund had purchased five life insurance policies with a yield to life expectancy (LE) averaging 15%." (DX-219.) In the May 2009 podcast, Jarkesy stated that the he was purchasing policies with higher yields than he had in 2008. (DX-203 at 24). In an email to Belesis, Jarkesy wrote that he had purchase at policy with an 18.7% yield. (DX-600). Nothwithstanding all of the above, Jarkesy valued the policies using a 12% discount rate, which resulted in the Funds being overvalued by millions of dollars. And when the auditors questioned the valuations, Respondents failed to turn over the materials that demonstrated that 12% was not the appropriate discount rate.

Respondents argue that their valuation was supported by their valuation consultants. In fact, the valuation consultants all provided Respondents with valuations based upon a 15% discount rate (which reflected the market at that time) and provided Jarkesy with analyses using the 12% discount rate only when Jarkesy specifically requested an analysis based on that assumption. Jarkesy could not have believed that he could have sold the policies using an implied discount rate of 12% when he had been able to purchase the same policies based on an implied discount of greater than 15%. For example, there was no reasonable basis for Jarkesy to believe that he could have sold the Rubinson policy in May 2009 for almost $490,000 (the value assigned at 5/31/09), when he purchased the policy the prior month for $280,000. There was no reasonable basis for Jarkesy to believe that he could have sold the Koperweis policy in May 2009 for $635,000 (the value assigned at 5/31/09), when he purchased the policy the prior month for $130,000. Opinions are actionable if the speaker knows them to be false or knows they have no reasonable basis. *IKB International S.A. v. Bank of America*, 2014 U.S. Dist. LEXIS 45813, *2-3 (S.D.N.Y. Mar. 31, 2014).

With respect to the Galaxy Media & Marketing, Inc. ("Galaxy") shares, Respondents admit that Gary Savage, the CEO of Galaxy, "[a]ll along … had conversations with Jarkesy concerning the value of the company's shares, telling Jarkesy that the shares weren't worth anything because the company had no real assets and no funding." (Resp. to Division's Proposed Findings of Fact at ¶89.) As Respondents knew, Galaxy had few assets, millions of dollars of operating losses, and a business plan that required millions of dollars of additional financing with no means of obtaining such financing other than the Funds (which Jarkesy testified he was not prepared to make). Nevertheless, during 2010 Respondents valued the shares at prices as high as $3.30. The third-party valuations that Respondents obtained in July 2011 (shortly after receiving the first investigative subpoena) demonstrate that Respondents valuations were grossly overstated. Based on the same financial information and projections that were available to Jarkesy in September 2010, the discounted cash flow analyses performed by these individuals demonstrate that the shares were not worth more than $0.29. Respondents, however, valued the shares at $1.00 and $0.80 during this time. Likewise, the information Jarkesy received from Galaxy's chief financial officer demonstrated that the Respondents' valuation in early 2010 was excessive. The Hearing Officer does not need an expert to tell her that Respondents knowingly overstated the Galaxy valuations.

Similarly, the Hearing Officer does not need an expert to tell her that Respondents knew that the share price of Radiant Oil & Gas, Inc. and America West Resources, Inc. ("America West") had been inflated as a result of the promotional campaigns that Respondents conceived and ran. Nor does the Hearing Officer require an expert to tell her that notes that were in default, including unsecured notes to America West and Galaxy, could not be sold at par value and, consequently, should not have been valued at par.

Respondents claim that they had considerable discretion to value the securities in the portfolio. This is simply false. They did not have unfettered discretion to value the securities as they pleased. The PPM required Respondents to value the positions using GAAP and "fair value." Fair value is a defined term, which is the amount at which the asset could be bought or sold in a current transaction between willing parties. The Funds' audited financial statements stated that "fair value" was the "price that the Partnership would receive upon selling an investment in an orderly transaction to an independent buyer in the principal of most advantageous market for the investments." (DX-315 at Note 2). The valuations that Respondents pulled out of thin air did not meet the fair value standard.

5. <u>The Division Demonstrated Respondents' Improper Relationship with JTF</u>

Respondents argue that the Division failed to show that they favored Belesis' and JTF's pecuniary interests over those of the Funds. In so doing, they claim that the only evidence that Division submitted is that Jarkesy negotiated and/or approved investment banking agreements that provided excessive fees and fees for performing no services. By making such an argument, Respondents grossly understate the efforts undertaken by Jarkey to find investment banking business for Belesis and JTF coupled with Jarkesy's promise to Belesis that "we will always try to get you as much as possible. **Every time without exception**." (emphasis added.)

Jarkesy negotiated the investment banking agreement with JTF purportedly on behalf of America West. Jarkesy understood that any money that went to JTF was money that America West would not have to execute its business plan and that it was in the interests of both America West <u>and the Funds</u> to have JTF's compensation set as low as possible. Jarkesy, however, made no effort to negotiate lower fees. Moreover, even though he had the ability to negotiate a non-exclusive investment banking contract (as he did in other instances), the agreement with JTF was exclusive. As a result, America West had no alternative but to pay JTF fees for investments they did not introduce, including money invested by the Funds. JTF even received fees for the conversion of loans into equity – which involved no new money coming into America West and diluted the Funds' shares. And while Respondents claim that the fees charged, while high, were in line with the market, they totally understate the breadth of the compensation paid to JTF, which not only included the 13% commission, but also included warrants to purchase 15 million shares at $0.01/share. The investment banking agreement further required America West to use JTF for other, unrelated services, including insurance (even though America West was happy with its insurance broker), consulting, and brokerage services for some of the officers.

JTF was ineffective at raising money for America West after 2008, as reflected by America West's default on numerous loan obligations. Moreover, JTF threatened to withhold money that it had raised for America West unless Belesis received 10 million additional shares that were personally owned by one of the directors. And America West fired JTF at least twice.

JTF also was an ineffective placement agent for the Funds – neither Fund I nor Fund II ever reached their intended investment goal. And JTF repeatedly threatened to stop selling interests in the Funds. Notwithstanding JTF's disappointing performance for the Funds Jarkesy managed and for the company for whom he served as director, Jarkesy was unreasonably loyal to Belesis (to the detriment of the Funds) and continued to introduce JTF to other portfolio companies, including Radiant Oil & Gas ("Radiant Oil"). The investment banking agreement for Radiant Oil that Jarkesy approved was so favorable to JTF that Radiant Oil warned in its public filings that the 3 million shares that the company issued to JTF "may be considered an overhang on the market and could depress any market that may develop for the Company common stock as well as the offering price of our equity securities in subsequent financings." The 3 million shares made JTF the second-largest shareholder in Radiant Oil – even greater than the Funds. Similarly, Respondents were involved in the negotiations over the investment banking agreement between Galaxy and JTF, pursuant to which JTF was going to receive 1% of all of Galaxy's future revenues.[12]

Respondents represented on their website that they were independent from JTF. This was proven false when a JTF representative disclosed that the firm and Respondents were partners and "tied at the hip." Moreover, Respondents were actively trying to build JTF's investment banking business. Jarkesy (along with Merrill Wilgrubs an employee or agent of John Thomas) solicited and negotiated investment banking contracts on JTF's behalf and served as Belesis's proxy when Belesis did not want to meet with the companies. This undisclosed relationship occurred with several companies including Enterconnect, ICOP, and Hankings.

Moreover, Respondents improperly delegated their control over the Funds' investments to JTF. While Respondents' disclosures stated that Respondents were solely responsible for the Funds, Jarkesy allowed Belesis and JTF to make decisions regarding portfolio companies, including removing directors from Galaxy's board. Jarkesy also allowed Belesis to make decisions as to how Fund money would be spent. As one example, on December 17, 2010, Belesis told Jarkesy to get Galaxy money "ASAP" to meet its payroll obligations. The next day, the Funds bought $40,000 of additional Galaxy stock, providing that Belesis-directed cash infusion. As another example, Belesis promised that Galaxy's attorney would be paid $49,000 from the Funds for work done on the registration statement. Jarkesy wired the money a few days later. As Galaxy's CEO testified, everyone understood that Belesis was making the decisions.

[12] Respondents claim that the portfolio companies were desperate for funding and, therefore, JTF was able to negotiate higher compensation. Respondents cannot have it both ways. If these companies were so desperate – and their financial condition so dire – that they had to resort to using JTF, than Respondents should have taken that same financial condition into consideration when valuing these positions (both the notes and the common stock) and written down the values, which they did not do.

Respondents argue that all of the money paid was in the Funds' interest. This argument misses the point. Even if money paid was not contrary to the Funds' interests, the fact that Belesis was allowed to make the decisions was contrary to Respondents' representations.

Respondents further argue that the Division cannot demonstrate scienter as Jarkesy – who invested his life savings in Fund I – was entirely motivated to act in the Funds' bests interests and not Belesis' interest.[13] Motive, however, is not a requirement under the securities laws; the requirement is scienter. Thus, in *In the Matter of Montelbano*, 2003 SEC LEXIS 153, *91 (Op. of Commission, Jan. 22, 2003), the Commission specifically rejected the same argument raised by Respondents here, stating: "[Respondents] contend that, without 'clear evidence' of their motive, the findings against them must be set aside. This contention lacks merit. Since, as we have determined, applicants participated in the … scheme with the requisite scienter, the personal motivation is irrelevant." *See also, e.g., In the Matter of Brokaw*, 2013 SEC LEXIS 3583, *42 (Op. of the Commission, Nov. 15, 2013) (proof of motive not required where there is direct evidence of scienter); *In the Matter of Pelosi*, 2012 SEC LEXIS 48, *59-60 (Initial Decision Jan. 5, 2012) (finding scienter "even if Pelosi's motive for underreporting was not adequately explained by either party"). The Division has amply shown that Jarkesy knew or was reckless that the representations that Respondents made and were continuing to make were false. His personal motive is irrelevant.

Nevertheless, the Division introduced evidence that explains Jarkesy's motive, further demonstrating his scienter. While capital commitments from inception of Fund I through the end

[13] Not only is this argument legally deficient but it is also factually baseless. While Jarkesy claims to have invested his life savings in Fund I, he was somehow able to come up with another $100,000 to invest in America West shortly thereafter. (DX-627 at p. 2 of 10.) Moreover, Jarkesy was receiving undisclosed income from his interests in Marathon Advisors, which he placed at several of the portfolio companies. (*Id.*) Outside of his self-serving testimony that this was his life-savings, Jarkesy has submitted no evidence to support his claim.

of 2008 were more than $16.5 million (DX-315 at F805), capital contributions during 2009 and 2010 had slowed to approximately $2 million for each year (DX-316 at 4, note 10; DX-317 at 4, note 10). During the recession, when Respondents were unlikely to receive incentive fees, the only way that they would be paid was through management fees, which were based on assets under management. Since the value of the Funds was stagnant (if not negative), the only way to grow assets under management – and therefore their own management fees – was to bring in additional investors. For this, the Respondents needed Belesis and JTF's sales force. Belesis, however, repeatedly threatened to stop selling interests in the Funds. Jarkesy was therefore motivated to favor Belesis' interests in order to persuade JTF to keep selling Fund interests and sent Belesis numerous emails suggesting ways in which additional commissions and fees could be generated. (*e.g.*, DX-511; DX-509 ("we are all going to make so much f*****g money this year, the clients of John Thomas are going to have a banner year. Write yourself a check and get ready to cash it for $45 million). Jarkesy's hoped for financial gain is clear motive for his fraud. *See, e.g., In the Matter of Clifton*, 2013 SEC LEXIS 2022, *39 (Op. of the Commission, July 12, 2013) (finding respondent "stood to gain financially from his fraudulent conduct [and] further reinforces our finding that he acted with a high degree of scienter"); *In the Matter of Bandimere*, 2013 SEC LEXIS 3142, * 179 (Initial Decision, Oct. 8, 2013) (motive demonstrated because compensation tied to money brought it).

6. <u>Respondents Never Changed their Investment Strategy</u>

Respondents argue that pursuant to the terms of the PPM, they were allowed to change their investment strategy. Consequently, they claim that the fact that they invested more than 5% in a single company or did not purchase 117% face value of life insurance policies cannot serve as the basis for a fraud claim because they could just change the strategy.[14] This argument has no factual basis. First, pursuant to the terms of the PPM, if Respondents wanted to modify the investment strategy they had to amend the limited partnership agreement. (DX-206 at 34.) There is no evidence that Respondents ever amended the limited partnership agreement to adjust the strategy for the Funds.

To the contrary, Respondents continually represented throughout the life of the Funds that they were investing half of the money in insurance policies and that they had purchased policies with face value of at least 117% of capital invested. *See, e.g.*, DX-260 (March 2009); DX-220 (May 2009); DX-262 (June 2009); DX-637 (July 2009); DX-221 (March 2010); DX-259 (June 2010); DX-248 (August 2010). During the podcast, Respondents emphatically reiterated the 117% coverage requirement: "Our charter required that we have 117 percent of the value of our investor cash in face value life settlement policies. We do this not to make money. We do it, because at the end of the fund, we want our investors to have some assurance that they get their money back." (DX-203 at 3.) Likewise, Respondents repeated that they were limited to a 5% investment in a single company. (DX-214; DX-215; DX-216; DX-217; DX-258).

Second, there is a fundamental difference between an investment strategy and an "investment limitation" such as the 5% limitation. If "investment limitations" could be changed at will, then they really would not be limitations at all. *See Rochester Funds Group Sec. Litig.*, 838 F. Supp.2d 1148, 1171-72 (D. Colo. 2012) (rejecting defendants' interpretation of the

[14] While Respondents do not contest that the PPM clearly states under the heading "investment limitation" that "the total investment of the Partnership in any one company at any one time will not exceed 5% of the aggregate Capital Commitments," Respondents state in their Response to the Division's Proposed Findings of Fact that the PPM actually allowed them to invest up to 10% in a single company. Tellingly, Respondents did not raise this issue at the hearing. Indeed, all of the subsequent investor updates and marketing materials that discuss this issue describe the 5% limitation. And the investors who testified as well as Coffey, the JTF representative, all state that they were told that the limitation was 5%.

limitation, stating that such an interpretation would "convey[] no meaningful information and certainly no meaningful assurances to prospective investors. Yet the statements clearly suggest that something real is being warranted").

E. <u>The Relief Sought by the Division is Authorized and Warranted</u>

The final pages of Respondents' post-hearing brief concern the relief that the Division seeks in this case. Respondents contend that: (1) penalties have only been authorized in APs since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 and that the Division is seeking an improper retroactive application of that law; (2) the Division has not demonstrated which investors put money into the Funds during the statutory period and, therefore, the Division cannot obtain penalties; (3) the Division has not demonstrated that the loss resulted from their actions as opposed to the "credit crunch" or the failure of JTF to raise money for the portfolio companies; (4) Respondents lost money in their investment in the Fund and, consequently, the Division cannot obtain disgorgement; and (5) the relief sought against them are excessive when compared to the amount of investor losses or the relief obtained by the Division in the settlement with Belesis and JTF. Respondents' arguments are contrary to law as well as the facts established at the hearing.

1. <u>Penalties are Authorized in Administrative Actions</u>

Respondents claim that that the Division is unable to seek penalties in this action because to do so would be an improper retroactive application of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 11-203, H.R. 4173) ("Dodd-Frank"), which was enacted in July 2010, as "most of the actions taken by Respondents of which the Division complains, and seeks penalties, happened prior to the effective date of Dodd-Frank." (Op. Br. at 33).

Respondents appear to misunderstand that the Division has been authorized to seek penalties in administrative proceedings since 1990. As a threshold matter, as the OIP makes clear, this action is both an "Administrative Proceeding" (brought under Section 15(b) of the Exchange Act, Section 9(b) of the Investment Company Act, and Sections 203(e)-(f) of the Advisers Act) as well as a "Cease and Desist Proceeding" (brought under Section 8A of the Securities Act, Section 21C of the Exchange Act, and Section 203(k) of the Advisers Act).

In 1990, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act (Pub. L. No. 101-429, 104 Stat. 931, 949-51) ("Remedies Act"). The Remedies Act amended the Exchange Act, the Investment Company Act, and the Investment Advisers Act to authorize the Commission to impose civil penalties in APs (as well as in actions brought in federal court). As an Example, Section 202 of the Remedies Act provides:

> **SEC. 202. CIVIL REMEDIES IN ADMINISTRATIVE PROCEEDINGS.**
>
> (a) The Securities Exchange Act of 1934 is amended by inserting after section 21A (15 U.S.C. 78u-1) the following:
>
> **CIVIL REMEDIES IN ADMINISTRATIVE PROCEEDINGS**
>
> SEC. 21B. (a) COMMISSION AUTHORITY TO ASSESS MONEY PENALTIES- In any proceeding instituted pursuant to sections 15(b)(4), 15(b)(6), 15B, 15C, or 17A of this title against any person, the Commission or the appropriate regulatory agency may impose a civil penalty if it finds, on the record after notice and opportunity for hearing, that such person--
> (1) has willfully violated any provision of the Securities Act of 1933, the Investment Company Act of 1940, the Investment Advisers Act of 1940, or this title, or the rules or regulations thereunder, or the rules of the Municipal Securities Rulemaking Board;
> (2) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;

In July 2010, Congress passed Dodd-Frank. Section 929P of Dodd-Frank contained new provisions concerning penalties, including authorizing the Commission to seek penalties in Cease and Desist Proceedings[15]

If this action were solely a Cease and Desist Proceeding, then perhaps Respondents could assert that the Division was seeking retroactive application of Dodd-Frank.[16] However, because this action is also an AP, the Division is seeking remedies that have been available since 1990, twenty years before the enactment of Dodd-Frank. Thus, in *Vindman*, the Commission affirmed this Hearing's Officer authority to issue a penalty against a non-registered stock promoter. *See also SEC v. J.W. Barclay & Co.*, 442 F.3d 834, 847 (3d Cir. 2006) (pre-Dodd Frank case noting that the SEC can assess monetary penalties in administrative proceedings), *SEC v. Gabelli*, 2010 U.S. Dist. LEXIS 27613, *30 (S.D.N.Y. Mar. 17, 2010) (noting that the Remedies Act allows the Commission to seek civil penalties in administrative proceedings), *rev'd in part on different grounds*, 653 F.3d 49 (2d Cir. 2011), *rev'd on different grounds*, 133 S.Ct. 1216 (2013); *aff'd in part, re'vd in part on different grounds,* 2013 U.S. App. LEXIS 9128 (2d Cir. 2013); *SEC v. Bolla*, 550 F. Supp.2d 54, 60 (D.D.C. 2008) ("Remedies Act ... which governs monetary penalties in administrative proceedings before the SEC's administrative law judges – explicitly provides such penalties").

[15] To the extent that Respondents are suggesting that the Division could not have brought an AP against them prior to Dodd-Frank because they were not registered investment advisers (and therefore, could not have obtained penalties against them prior to Dodd-Frank), that would also be incorrect. *See Teicher v. SEC*, 177 F.3d 1016, 1017-19 (D.C. Cir. 1999) (affirming the Commission's authority to bring APs against all investment advisers, whether registered or unregistered); *In the Matter of Vindman*, 2006 SEC LEXIS 862 (Op. of the Commission, Apr. 14, 2006) (penalty against unregistered stock promoter); *In the Matter of Zubkis*, 2005 SEC LEXIS 3125 (Op. of the Commission Dec. 2, 2005) (barring an unregistered associated person of an unregistered broker-dealer from association with a broker or dealer).

[16] The only case cited by Respondents for the proposition that Dodd-Frank penalties cannot retroactively be applied is *Henning v. Wachovia Mortg., FSB,* 969 F. Supp.2d 135 (D. Mass. 2013). *Henning*, actually says nothing of the sort. Rather, the court in that case held that the provisions of Dodd Frank that limit the preemption of state law claims under the Home Owner's Loan Act (HOLA) could not retroactively be applied.

2. <u>The Statute of Limitations does not Preclude the Requested Sanctions</u>

Related to their misguided Dodd-Frank argument, Respondents argue that because the Division did not introduce evidence to show when the investors invested their money, "it [is] impossible to determine which investors' funds were tendered within the limitations period." (Op. Bt. at 22.) This argument is flawed because, as described below, Respondents' fraud impacted even those investors who put money into the Fund prior to the limitations period.

Pursuant to 28 U.S.C. § 2642, the statute of limitations in "an action ... for the enforcement of any civil fine, penalty, or forfeiture shall not be entertained unless commenced within five years from the date when the claim first accrued." While the Division cannot obtain penalties for fraudulent conduct that occurred more than five years from the occurrence of the fraudulent conduct, *see Gabelli v. SEC*, 133 S. Ct. 1216, 1220 (2013), the great weight of case law is that equitable remedies are exempted from Section 2462's limitations period. In *SEC v. Kelly*, 663 F. Supp. 2d 276, 286-87 (S.D.N.Y. 2009), the court held that although Section 2462 applies to the Commission's request for civil penalties, it did not apply to its request for permanent injunctive relief, disgorgement, or an officer and director bar. *See also SEC v. Quinlan*, 2010 U.S. App. LEXIS 8205, *21 (6th Cir. 2010); *Riordan v. SEC*, 627 F.3d 1230,1234 (D.C. Cir. 2010) (Section 2462 does not apply to disgorgement); *SEC v. McCaskey*, 56 F. Supp. 2d 323, 326 (S.D.N.Y. 1999) ("[n]o statute of limitations applies to the SEC's claims for equitable remedies . . . and thus, the [defendants' statute of limitations] defense fails as a matter of law and fact") (citations omitted). Thus, the five-year limitations period has no impact on the Division's claims for disgorgement, pre-judgment interest, the officer and director bar and/or any of the collateral bars.

The only issue that can be affected by the statute of limitations is the penalty. The OIP in this case was filed on March 22, 2013. Consequently, the start of the limitations period for purposes of the penalty was March 22, 2008. The vast majority of the fraud in this case took place after then. (Fund I had only commenced operations in September 2007.) The insurance policies were fraudulently overvalued using 12% NPV beginning in 2009. America West defaulted on its notes in December 2009 (and, as such, Respondents' failure to write down the value of those notes did not start until that time). The baseless valuation of Radiant Oil shares began in March 2009, and the overvaluation of America West and Radiant Oil shares based on promotional campaigns' temporary price spike started at the end of 2010. Galaxy did not even exist as a company until 2010 and Respondents' baseless valuations of that company took place in 2010 and 2011. And virtually all of the overvaluation of restricted stock took place after March 2008.[17] Similarly within the limitations period, with one exception (DX-214), were all of the investor updates and marketing materials that stated that Fund I had, in fact, purchased life settlement policies with at least 117% face value of investor capital, that half of the investor capital had been set aside and segregated to purchase policies and to pay for premiums, and that Fund I could not exceed 5% in a single company. All of the documents sent to investors and prospective investors that stated that Deutsche Bank was the prime broker and that KPMG was the auditor were within the limitations period.

Furthermore, the improper relationship between Jarkesy and Belesis was within the limitations period that began in March 2008. Jarkesy negotiated the investment banking agreement between America West and JTF that was contrary to the interest of Funds in October 2008. In August 2010, Jarkesy approved the investment banking agreement between Radiant Oil

[17] The fraudulent valuation of Redroller's restricted stock began in February 2008.

and JTF that resulted in Radiant Oil having to warn the public that the shares it granted to JTF could depress any market for the company's common stock. And Jarkesy's improper delegation of control over the Funds' investment in Galaxy took place in 2010 and continued into 2011.

Because Respondents' fraud since March 2008 impacted the Funds, and the Respondents' owed a fiduciary duty to the Funds, it is beside the point that some investors bought Fund shares prior to March 2008. *See Goldstein v. SEC*, 451 F.3d 873, 881-82 (D.C. Cir. 2006) (finding that adviser's fiduciary duty is owed to the fund, not its shareholders). Nonetheless, insofar as the Respondents' conduct defrauded and harmed the Funds, even investors who bought shares prior to March 2008 were harmed by the fraud that took place after they invested. (Indeed, because Fund I had a long lock-up period, all of the investors who put money into Fund I prior to March 2008 were still investors in March 2008 and going forward.)[18]

3. <u>Loss Causation is not a Requirement in Enforcement Actions</u>

In their memorandum of law, Respondents argue that the Division cannot obtain monetary relief in this case because "the evidence established that the losses to date experienced by investors – including Jarkesy – were caused by the failure of the portfolio companies to thrive – not by misconduct on the part of Mr. Jarkesy ...."[19] (Op. Br. at 32). This is a classic loss causation argument. Loss causation, however, is not an element of Commission enforcement actions. *See, e.g., SEC v. Goble*, 682 F.3d 934, 942 (11th Cir. 2012); *Gebhart v. SEC*, 595 F.3d 1034, 1041 (9th Cir.), cert. den., 561 U.S. 1008 (2010) (loss causation in applicable in SEC actions); *SEC v. Pirate Investor LLC*, 580 F.3d 233, 239 (4th Cir. 2009), *cert. den.*, 130 S.Ct.

[18] DX-231 indicates that more than 60 investors put money into the Funds from 2008 going forward. (With respect to the admissibility of DX 231 see the Division's initial moving brief at p. 1, n.1.)

[19] Respondents also argue that the many of the Funds' positions were successful. (Op. Br. at 32). Respondents, however, do not cite any evidence in the record for this proposition.

3506 (U.S. 2010). The investor losses, however, were in fact, directly caused by Jarkesy. By failing to purchase sufficient insurance policies and by failing to set aside the proper amount of money to pay for the premiums (resulting in the Funds allowing most of the policies to lapse), Jarkesy vitiated the hedge that was supposed to ensure the return of capital to investors. Moreover, Jarkesy admitted that the losses in the Funds were due in large part to the investments in three companies – America West, Radiant Oil, and Galaxy – all positions in which the Funds were over concentrated in further violation of Respondents' representations.

4. Respondents' Losses in the Fund do not Impact Disgorgement

Respondents further argue that the Division cannot obtain any disgorgement from them because they lost money in the Funds and therefore did not have any profits. First, the Division's disgorgement claim is not based upon their investment of money in the Funds – it is based on the receipt of management fees and incentive fees. Second, the Division has demonstrated that these fees were inflated by Respondents' overvaluation of the positions in the Funds by millions of dollars. Moreover, the investor witnesses testified that they would not have invested in the Funds had they known the truth about the manner in which the Funds were invested. Because Respondents lied to entice investors to put money into the Funds (creating the incentive fees and management fees), the fees were directly connected to the violation.[20]

5. The Sanctions Sought are not Excessive

Respondents argue that the penalties the Division seeks are excessive. As evidence, they point to the Commission's settlement with Belesis and JTF. There is no basis to compare these

[20] Respondents argue in their response to the Division's proposed findings of fact that the Division did not submit any evidence to support its claim concerning the incentive fees earned by Respondents. To the contrary, DX-309 substantiates much of the claimed incentive fees.

litigating Respondents to the settling respondents. First, the alleged facts against each are different. Respondents engaged in valuation fraud in which Belesis and JTF had no role. The misrepresentations in the sales and marketing materials were also prepared by Respondents, not Belesis or JTF. Second, Belesis and JTF were charged as aiders and abettors alone while Respondents were charged as primary violators in addition to aiders and abettors. Third, Belesis and JTF settled their claims, while Respondents chose to litigate and it is well-established that it is inappropriate to compare remedies pursuant to a settlement and remedies sought in a litigated matter. Thus, in *SEC v. Monterosso,* 2014 U.S. App. LEXIS 3891 *30 (11th Cir. March 3, 2014), the court rejected the defendant's disproportionate penalty argument, stating that "[t]his argument is unavailing, because Lynch chose not to settle with the SEC as to penalties and he had a different role in the scheme than his co-defendants." *See also VanCook v. SEC*, 653 F.3d 130, 144 (2d Cir. 2011), *cert. den.*, 132 S.Ct. 1582 (U.S. 2012) (affirming Commission's order on penalties stating that "other individuals chose to settle with the SEC, whereas VanCook chose to litigate"); *SEC v. Razmilovic*, 822 F. Supp.2d 234, 281 (E.D.N.Y. 2011) ("the compromised amount of the civil penalties imposed upon Razmilovic's co-defendants in this case have no bearing upon the appropriate amount of any penalty imposed upon him"), *aff'd in all relevant parts*, 738 F.3d 14 (2d Cir. 2013) ("we reject Razmilovic's proportionality challenge because we see no other similarly situated codefendant"), *cert. den.*, (March 26, 2014)

Respondents make additional arguments in connection with their claim that the penalties sought by the Division are excessive and disproportionate. They argue that Jarkesy lost money on the venture because he personally invested more than $600,000 in the Funds. Respondents, however, have never provided any evidence that Jarkesy loaned money to the Funds. And while Jarkesy initially invested $500,000 in Fund I, he withdrew $100,000 immediately prior to writing down the value of the Fund because of the change in the value in the insurance policies, allowing him – but not other investors – to avoid losses associated with the write down. Moreover, the $600,000 figure does not take into consideration gains Jarkesy enjoyed by virtue of his self-dealing, for example, his sale to Fund I of the stock that would later become Radiant Oil, and the business he cultivated for Marathon Advisors (in which he held a 50% interest), when it received money and stock for services he arranged for it to provide to portfolio companies.

Respondents also argue that the penalty sought by the Division is disproportionate to the amount of investor losses.[22] The contention is that the Funds raised about $23 million, not all of which was lost. Yet once again, Respondents have not provided any evidence of the amount of investor loss. The Division established at the hearing that the investors contributed more than $24 million to the Funds. Some money (although Jarkesy could not or would not quantify the amount) was distributed after one of the life insurance policies matured. Beyond that, and a distribution of some restricted Radiant Oil shares, no other Fund-wide distribution has occurred – despite Respondents' claims that they have been winding down Fund I since March 2012.

The evidence is that the Funds' assets are negligible. Two companies that were once the Funds' largest holdings are worthless: Respondents wrote down the value of their holdings in Galaxy to zero in July 2011, and America West declared bankruptcy in February 2013. The Funds lack resources to pay auditors or insurance premiums – there have been no audited financial statements since 2010 and Respondents were forced to let the life settlement policies lapse because the Funds could not afford to pay the premiums. Except for some restricted shares of Radiant Oil (which Jarkesy refuses to sell in violation of the terms of the PPM and Limited

[22] Respondents state that the Division is seeking remedies of more than $90 million against them. That figure appears nowhere in the Division's post-hearing memorandum of law. While the Division seeks maximum monetary sanctions it has not quantified them.

Partnership Agreement), and a single insurance policy, the Funds have no marketable assets.[23] The Respondents have lost nearly all of the $24 million investors deposited in the Funds – easily more than $20 million – and it would be entirely appropriate for this Hearing Officer to fashion a penalty commensurate with such loss.

CONCLUSION

For the reasons set forth in this memorandum and in the Division's post-hearing memorandum and proposed findings of fact, the Division respectfully requests that the Hearing Officer find Respondents liable violating for Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The Division also respectfully requests that the Hearing Officer order all of the requested relief against Respondents.

Respectfully Submitted,

Todd D. Brody
Alix Biel
Division of Enforcement
200 Vesey Street, 4th Floor
New York, NY 10281
(212) 336-0080 (Brody)

Date: May 12, 2014
New York, NY

[23] The statement in Respondents' federal court complaint against the Commission where they allege that the Funds' current value is approximately $15 million (DX 120 at ¶11) is fanciful.

EXHIBIT A

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15255

In the Matter of	:
	:
JOHN THOMAS CAPITAL MANAGEMENT GROUP, LLC, d/b/a PATRIOT28, LLC,	:
	:
GEORGE R. JARKESY JR.,	:
	:
JOHN THOMAS FINANCIAL, INC.,	:
	:
ANASTASIOS "TOMMY' BELESIS,	:
	:
Respondents.	:

DECLARATION OF TODD D. BRODY

I, Todd D. Brody, pursuant to 28 U.S.C. § 1746, declare as follows:

1. I am employed as a Senior Trial Counsel in the Division of Enforcement's ("Division") New York Regional Office and make this declaration based upon my personal knowledge and my review of the relevant files.

2. In Respondents' post-hearing memorandum of law and response to the Division's proposed findings of fact, Respondents argue that the Division has not proven that there were no amendments to the private placement memorandum ("PPM") for Fund I after August 2007. This is not an argument that Respondents made prior to the filing of their post-hearing brief (including during the Wells process).

3. I have personally run searches in the Concordance databases that hold the documents produced by Respondents and other entities and persons in this case. In my diligent search, I have not located any amendments to the PPM after August 2007. Respondents certainly did not produce any such amendments. Nor did Respondents include any such amendment in their exhibit book for the hearing.

4. I have also reviewed the audit files produced by Respondents' auditors Mir Fox Rodriguez, P.C. ("MFR"). The MFR audit files for Fund I through 2010 all contain copies of the same PPM dated June 1, 2007 that was admitted during the hearing as DX-206.

I declare under the penalty of perjury that the foregoing is true and correct.

Dated: May 12, 2014
New York, New York

Todd D. Brody