INITIAL DECISION RELEASE NO. 888
ADMINISTRATIVE PROCEEDING
File No. 3-16312

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

In the Matter of SCOTT M. STEPHAN	INITIAL DECISION September 25, 2015

APPEARANCES: Tony M. Frouge and Michael D. Birnbaum, for the Division of Enforcement, Securities and Exchange Commission

Andrew J. Pace, Pace & Pace Law, LLC, for Respondent Scott M. Stephan

BEFORE: Jason S. Patil, Administrative Law Judge

Summary

In this Initial Decision, I conclude that the appropriate remedial action against Scott M. Stephan is disgorgement of $60,000, with prejudgment interest. I do not order any civil penalties.

Procedural History

On December 10, 2014, the Securities and Exchange Commission entered an Order Instituting Administrative and Cease-and-Desist Proceedings, in which it accepted Respondent Scott M. Stephan's offer of settlement, made findings and conclusions, imposed certain sanctions, and directed for further proceedings to be held (Consent Order). Specifically, the Commission found by consent that Stephan willfully violated and aided and abetted and caused violations of Securities Act of 1933 Section 17(a), Securities Exchange Act of 1934 Section 10(b) and Rule 10b-5 thereunder, Investment Advisers Act of 1940 Section 206(4) and Rule 206(4)-8 thereunder. Consent Order at 8. The Commission ordered Stephan to cease and desist from committing or causing any violations and any future violations of these provisions; and imposed full associational, investment company, and penny stock bars. *Id*. at 9. The Commission further ordered, and Stephan agreed to, additional proceedings to determine what, if any, disgorgement and civil penalties are appropriate under the Securities Act, Exchange Act, Advisers Act, and Investment Company Act. *Id*. at 8-9.

On January 9, 2015, I ordered that this proceeding be consolidated with related Administrative Proceeding File No. 3-16311, for purposes of the hearing, pursuant to Commission Rule of Practice 201, 17 C.F.R. § 201.201. *Reliance Fin. Advisors, LLC*, Admin. Proc. Rulings Release No. 2205, 2015 SEC LEXIS 96. On May 11-14 and 18, 2015, a consolidated hearing was

held as to Stephan and Timothy S. Dembski,[1] with Stephan and his counsel appearing on May 11, and thereafter being excused.[2]

Facts

For purposes of this proceeding, the Consent Order's allegations "shall be accepted as and deemed true by the hearing officer," and Stephan is "precluded from arguing that he did not violate the federal securities laws described in [the Consent Order]." Consent Order at 8. Accordingly, in his Answer, Stephan admitted all of the allegations contained in the Consent Order.[3] Answer at 1; *see* Tr. 52. I do not recite all of the factual contentions contained in the Consent Order, but incorporate them by reference. For the benefit of the reader, however, I provide a brief summary of the facts for context.

Stephan, age 40, is a resident of Hamburg, New York, and co-founded Prestige Wealth Management Fund, LP (Prestige Fund), a hedge fund, and Prestige Wealth Management, LLC (Prestige), the general partner and an unregistered investment adviser to the Prestige Fund, in or around late 2010 or early 2011. Consent Order at 2-4, 6. He and Dembski were the sole members of Prestige, each owning fifty percent. *Id.* at 4. Stephan served as the Prestige Fund's chief investment officer and sole portfolio manager. *Id.* at 3. Stephan had no prior experience in managing a hedge fund and virtually no investing experience at all. *Id.* The Prestige Fund's trading strategy was described to prospective investors as being fully-automated with all trades being made according to, and by, a computer algorithm created by Stephan. *Id.* Stephan knew or recklessly disregarded that the Prestige Fund was a highly speculative, risky investment. *Id.* Despite this, he assisted in marketing it to potential investors and knowingly or recklessly made false and misleading statements to clients in order to create the false appearance that an investment in the Prestige Fund was less risky than it was. *Id.* Specifically, Stephan drafted a biography for the Prestige Fund's private placement memorandum (PPM) that misrepresented his experience in the securities industry. *Id.* Then, in September 2011, only a few months after the Prestige Fund had begun trading in April 2011, Stephan deceptively failed to inform investors that he had turned off the algorithm in the Prestige Fund and had begun to make investment decisions himself, manually placing trades in contravention to representations made about the Prestige Fund's automatic trading strategy. *Id.* at 3, 7. In December 2012, the Prestige Fund collapsed and lost

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[1] The Division's claims against Dembski will be the subject of a separate initial decision issued under Administrative Proceeding File No. 3-16311.

[2] Citations to exhibits offered by the Division and Stephan are noted as "Div. Ex. __" and "Resp. Ex. __," respectively. Citations to the parties' stipulated facts, admitted as Div. Ex. 139, are noted as "Stip. ___." The Division and Stephan's post-hearing briefs are noted as "Div. Br. ___" and "Resp. Br. ___," respectively. The Division's post-hearing reply brief is noted as "Div. Reply __." Citations to the hearing transcript are noted as "Tr. ___."

[3] In its post-hearing brief, the Division noted that in his Answer, Stephan admitted all of the allegations "but for paragraph six, which focused on [other Respondents'] conduct and which he did not deny." Div. Br. at 3. However, the Answer on file with the Office of the Secretary shows Stephan admitting *all* allegations in the Consent Order.

approximately eighty percent of its value, as a direct result of Stephan placing manual trades in contravention to the automated trading strategy sold to investors. *Id.* at 3.

I may determine the issues raised in this proceeding on the basis of affidavits, declarations, excerpts of sworn deposition or investigative testimony, and documentary evidence. Consent Order at 8. I have considered all evidence, and where I have found a fact supported by the preponderance of evidence, and relevant to any remaining remedies issues, I have noted both my finding and evidentiary support in my analysis. *See Steadman v. SEC*, 450 U.S. 91, 100-04 (1981).

Remedial Actions

Pursuant to the Consent Order, I have determined that $60,000 in disgorgement, and prejudgment interest on that amount, is appropriate under the Securities Act, Exchange Act, Advisers Act, and Investment Company Act.

Disgorgement, Civil Penalties, and Inability to Pay

Securities Act Section 8A(e), Exchange Act Sections 21B(e) and 21C(e), Investment Company Act Section 9(e), and Advisers Act Sections 203(j) and (k)(5) authorize me to order disgorgement in this proceeding, including reasonable interest. 15 U.S.C. §§ 77h-1(e), 78u-2(e), 78u-3(e), 80a-9(e), 80b-3(j) and 80b-3(k)(5); *see* Consent Order at 8-9. Disgorgement of ill-gotten gains "is an equitable remedy designed to deprive a wrongdoer of his unjust enrichment and to deter others from violating the securities laws." *Montford & Co.*, Advisers Act Release No. 3829, 2014 SEC LEXIS 1529, at *94 (May 2, 2014) (quoting *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989)), *pet. denied*, 793 F.3d 76 (D.C. Cir. 2015). Disgorgement "is imposed not to punish, but to ensure illegal actions do not yield unwarranted enrichment." *Jay T. Comeaux*, Advisers Act Release No. 3902, 2014 WL 4160054, at *5 n.36 (Aug. 21, 2014) (quotation marks and citation omitted). "When calculating disgorgement, 'separating legal from illegal profits exactly may at times be a near-impossible task.'" *Montford & Co.*, 2014 SEC LEXIS 1529, at *94 (quoting *First City*, 890 F.2d at 1231). "As a result, disgorgement 'need only be a reasonable approximation of profits causally connected to the violation.'" *Id.* (quoting *SEC v. Patel*, 61 F.3d 137, 139 (2d Cir. 1995)). "Once the Division shows that the disgorgement is a reasonable approximation, the burden shifts to the respondent to show that the amount of disgorgement is not a reasonable approximation." *Id.* (citing *SEC v. Happ*, 392 F.3d 12, 32 (1st Cir. 2004)). "The risk of uncertainty in calculating disgorgement should fall on the wrongdoer whose illegal conduct created that uncertainty." *Id.* (quoting *Happ*, 392 F.3d at 31); *accord SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1096 (9th Cir. 2010).

Securities Act Section 8A(g), Exchange Act Section 21B(a), Investment Company Act Section 9(d), and Advisers Act Section 203(i) authorize me to impose civil penalties in this proceeding if in the public interest, with some of these provisions also requiring the violations at issue to have been willful, as was the case here. 15 U.S.C. §§ 77h-1(g), 78u-2(a), 80a-9(d), 80b-3(i); Consent Order at 8.

Inability to Pay

Stephan maintains that he is unable to pay disgorgement or civil penalties. *See* Resp. Br. at 4-5. The Commission may consider a respondent's ability to pay in determining civil penalties under the Securities Act, Exchange Act, Investment Company Act, and Advisers Act. *See* 15 U.S.C. §§ 77h-1(g)(3), 78u-2(d), 80a-9(d)(4), 80b-3(i)(4). However, even when a respondent demonstrates an inability to pay, the Commission has discretion not to waive the penalty, disgorgement, or prejudgment interest, "particularly when the misconduct is sufficiently egregious." *Robert L. Burns*, Advisers Act Release No. 3260, 2011 SEC LEXIS 2722, at *39 (Aug. 5, 2011) (quotation marks and citation omitted).

While ability to pay may also be considered in determining disgorgement, *see* 17 C.F.R. § 201.630, it should be given less weight than when determining civil penalties because disgorgement is designed to reverse unjust enrichment, and giving ability to pay significant weight in the disgorgement context would create a perverse incentive for securities law violators to spend ill-gotten gains quickly and without restraint. *See SEC v. First Jersey Secs., Inc.*, 101 F.3d 1450, 1474 (2d Cir. 1996) ("The effective enforcement of the federal securities laws requires that the SEC be able to make violations unprofitable. The deterrent effect of an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illicit profits." (citations omitted)).

In accordance with Rule 630, 17 C.F.R. § 201.630, in support of his inability to pay defense, Stephan submitted: (1) his Form D-A (17 C.F.R. § 209.1); (2) proposed[4] Form 1040 federal income tax returns for the years 2011-2013[5]; (3) Form W-2 tax forms for the years 2011-2013 and a Form 1099 for 2013; (4) Bank of America joint checking account statements from February 14, 2015, to April 17, 2015; and (5) a voluntary petition for Chapter 7 Bankruptcy in the names of Stephan and his wife, filed on December 6, 2013, in the United States Bankruptcy Court for the Western District of New York.[6] Resp. Ex. 1. The record reflects that Stephan has a negative net worth, with liabilities outweighing his total assets. *Id.* at 3. Stephan testified that he spent the $123,505.91 he received in fees from the Prestige Fund to cover personal expenses, including "bills, after school [care] for [his] kids, [and] a house." Tr. 130. Stephan has made a convincing showing that he would be unable to pay substantial disgorgement or civil penalties. Stephan does not have a college degree and has now been barred from the securities industry. Stip. ¶ 1; Consent Order at 9. Although Stephan is currently employed, his job is low-paying, and as the father of three children, he is struggling to make ends meet. Tr. 133; Resp. Br. at 4-5; Resp. Ex. 1 at 6, 12. Given his limited employment prospects, Stephan's pessimism regarding his future finances seems warranted.

The Division does not attempt to rebut Stephan's showing that he lacks the ability to pay substantial disgorgement, prejudgment interest, or civil penalties. Rather, the Division argues that

[4] Stephan has not filed taxes for the years 2011-2014. Resp. Ex. 1 at 1 (of 111 PDF pages).

[5] Although Stephan's cover letter attaching these documents notes that proposed federal income tax returns for 2011-2014 were included, no proposed returns for 2014 were.

[6] This proceeding appears to be pending. *See In re Scott M. Stephan & Melissa A. Stephan*, No. 1:13-bk-13236 (Bankr. W.D.N.Y. 2013).

"the egregious nature of Stephan's fraud . . . demands a penalty," and that with regard to disgorgement, simply relieving Stephan of having to pay disgorgement would allow him "to keep profits taken from defrauded investors and suggest an incentive for securities law violators to burn through their profits before they can be held accountable for their misconduct." Div. Br. at 8. I am unpersuaded by the Division's objections to Stephan's inability to pay defense. There is no indication that Stephan engaged in extravagant spending, or attempted to conceal the money he received. I will therefore consider Stephan's inability to pay with respect to civil penalties and disgorgement.

Disgorgement

The Division seeks disgorgement of $123,505.91 and prejudgment interest of $9,565.60. *See* Div. Br. at 4-5. It is undisputed that Stephan received $123,505.91 in management and performance fees from investments in the Prestige Fund from July 7, 2011, to December 3, 2012. Stip. ¶ 24; Tr. 106-07, 129. Because of the difficulty in many cases to separate "legal from illegal profit . . . , it is proper to assume that all profits gained while defendants were in violation of the law constituted ill-gotten gains." *SEC v Bilzerian*, 814 F. Supp. 116, 121 (D.D.C. 1993) (internal citations omitted), *aff'd*, 29 F.3d 689 (D.C. Cir. 1994); *see also SEC v. Drexel Burnham Lambert Inc.*, 837 F. Supp. 587, 611-12 (S.D.N.Y. 1993), *aff'd sub nom, SEC v. Posner*, 16 F.3d 520 (2d Cir. 1994). I find that $123,505.91 is a "reasonable approximation of profits causally connected to the violation." *First Jersey Secs., Inc.*, 101 F.3d at 1475 (internal quotation marks omitted).

Stephan admitted that the Prestige Fund investments were obtained through the use of a "highly misleading" PPM he assisted in creating. Tr. 92, 95-98, 100, 146-147; Consent Order at 6-7; Div. Ex. 14; Div. Ex. 90 at 55; Stip. ¶ 16. In addition to his misconduct regarding the content of the PPM, Stephan also "knew, or recklessly disregarded, that Prestige Fund investors had been told that the Fund's trading strategy would be fully automated and . . . that his manual trading was entirely inconsistent with this stated strategy." Consent Order at 7-8. Stephan then "[d]eceptively failed to inform investors that he . . . began to make investment decisions himself [by] manually placing trades in contravention to representations made about the Prestige Fund's automated trading strategy." *Id.* at 3.

Disgorging Stephan's management and performance fees would prevent him from realizing ill-gotten gains from his fraudulent conduct and will deter others from committing comparable frauds in the future. *First Jersey Secs., Inc.*, 101 F.3d at 1474. Given Stephan's showing of an inability to pay, however, I do not order the full measure of disgorgement requested by the Division. Stephan is faring poorly financially and has considerable expenses in raising three children. Rather than excuse Stephan completely based on his inability to pay, however, I elect to discount the amount of disgorgement by roughly fifty percent, and will order disgorgement in the amount of $60,000, with prejudgment interest calculated from January 1, 2013, the first day of the month following the date on which Stephan last received a share of the management and performance fees (i.e., December 3, 2012),[7] to the last day of the month preceding the month in which disgorgement is

[7] Commission Rule of Practice 600(a) states that "[p]rejudgment interest shall be due from the first day of the month following each such violation through the last day of the month preceding the month in which payment of disgorgement is made." 17 C.F.R. § 201.600(a). The precise date of each of Stephan's violations is unclear. However, given that Stephan received his last share of

made, consistent with 17 C.F.R. § 201.600.[8] While it appears unlikely that Stephan will obtain a positive net worth in the near future, given his young age, he "may subsequently acquire the means to satisfy the judgment." *SEC v. Robinson & Cellular Video Car Alarms, Inc.*, No. 00 Civ. 7452, 2002 WL 1552049, at *8-9 (S.D.N.Y. July 16, 2002) (internal quotation marks and citation omitted).

Civil Penalties

The Division seeks "substantial third-tier penalties" against Stephan but does not specify a precise amount, instead requesting that I "order Stephan to pay a total civil penalty that is a multiple of the $150,000 third-tier amount" for each violation. Div. Br. at 5-6. The factors relevant to the determination of whether civil penalties are in the public interest are: (1) whether the violation involved fraud; (2) whether the violation resulted in harm to others; (3) the extent to which there was unjust enrichment; (4) whether the individual has committed previous violations; (5) the need to deter the individual and others; and (6) such other matters as justice may require. 15 U.S.C. §§ 78u-2(c), 80a-9(d)(3), 80b-3(i)(3); *John P. Flannery*, Advisers Act Release No. 3981, 2014 WL 7145625, at *40 (Dec. 15, 2014).

While the first three factors weigh in favor of civil penalties, the last three factors weigh against imposing them. First, Stephan's conduct involved scienter-based fraud. *See* Consent Order at 8; *Fundamental Portfolio Advisors, Inc.*, Securities Act Release No. 8251, 2003 SEC LEXIS 1654, at *29 (July 15, 2003). Stephan participated in the creation of a highly misleading PPM for use with prospective investors, and completely deviated from the Fund's trading strategy without disclosing that change, or the problems that ensued, to investors. Tr. 92, 100, 114; Consent Order at 7-8. Second, his actions resulted in the loss of more than $3 million of investor funds, which represents a substantial harm to others. Tr. 116-17; *see also* Consent Order at 6, 8. Third, Stephan was unjustly enriched by a pecuniary gain of $123,505.91. Stip. ¶ 24; Tr. 106-107.

As to the fourth factor, there is no evidence that Stephan has committed any prior violations. I give significant weight to deterrence, the fifth factor, which militates against imposition of civil penalties. The interest of deterrence is sufficiently addressed by the Consent Order subjecting Stephan to full associational, investment company, and penny stock bars, along with a cease-and-desist order. Consent Order at 9. Further, because the disgorgement amount dramatically exceeds Stephan's negative net worth, it will have a strong deterrent effect. Finally, with respect to other matters that justice requires, I have found that Stephan has established that he is unable to pay a substantial civil penalty. *See* Resp. Ex. 1. I also find that Stephan, who settled the issue of liability and most remedies, exhibited genuine remorse for his actions. *See* Tr. 133-134. Balancing the foregoing factors, I have determined that a civil penalty is not appropriate in this proceeding.

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management and performance fees on December 3, 2012, I use January 1, 2013, as the starting date for purposes of calculating prejudgment interest. Stip. ¶ 24; Tr. 106-07, 129.

[8] *See Terence Michael Coxon*, Securities Act Release No. 8271, 2003 SEC LEXIS 3162, at *65 (Aug. 21, 2003) ("[E]xcept in the most unique and compelling circumstances, prejudgment interest should be awarded on disgorgement, among other things, in order to deny a wrongdoer the equivalent of an interest free loan from the wrongdoer's victims."), *aff'd*, 137 F. App'x 975 (9th Cir. 2005).

Record Certification

Pursuant to 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the record index issued by the Commission's Office of the Secretary on September 4, 2015.

Order

It is ORDERED that, pursuant to the Securities Act of 1933 Section 8A(e), Securities Exchange Act of 1934 Sections 21B(e) and 21C(e), Investment Company Act of 1940 Section 9(e), and Investment Advisers Act of 1940 Sections 203(j) and (k)(5), Respondent Scott M. Stephan shall PAY DISGORGEMENT in the amount of $60,000, plus prejudgment interest on that amount, calculated from January 1, 2013, to the last day of the month preceding the month in which disgorgement is made, consistent with 17 C.F.R. § 201.600. Prejudgment interest shall be calculated at the underpayment rate of interest established under Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), and shall be compounded quarterly. 17 C.F.R. § 201.600. Interest shall continue to accrue on all funds owed until they are paid.

Payment of disgorgement and prejudgment interest shall be made no later than twenty-one days following the day this Initial Decision becomes final, unless the Commission directs otherwise. Payment shall be made in one of the following ways: (1) transmitted electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) direct payments from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or (3) by certified check, bank cashier's check, or United States postal money order made payable to the Securities and Exchange Commission and hand-delivered or mailed to the following address alongside a cover letter identifying the Respondent and Administrative Proceeding No. 3-16312: Enterprises Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Bld., Oklahoma City, Oklahoma 73169. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

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

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Jason S. Patil
Administrative Law Judge