Initial Decision Release No. 1161
Administrative Proceeding
File No. 3-17387

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

In the Matter of

Donald F. ("Jay") Lathen, Jr.,
Eden Arc Capital Management, LLC, and
Eden Arc Capital Advisers, LLC

Initial Decision
August 16, 2017

Appearances: Nancy A. Brown, Judith Weinstock, Janna I. Berke, and Lindsay S. Moilanen for the Division of Enforcement, Securities and Exchange Commission

Harlan Protass, Protass Law PLLC, and Paul Hugel and Christina Corcoran, Clayman & Rosenberg LLP, for Respondents

Before: Jason S. Patil, Administrative Law Judge

Introduction

This proceeding concerns a novel investment strategy that was disclosed to investors, was profitable to them, and was dependent on a contractual loophole that has run its course.

In 2011, Respondents established a hedge fund to profit from bonds and certificates of deposit (CDs) offered by sophisticated financial institutions. Because the investments could be redeemed early for their full value under survivor's options if a joint owner died, Respondent Donald F. ("Jay") Lathen, Jr., established joint accounts with terminally ill individuals, and upon their deaths, redeemed the investments and assigned the profits to his fund, Eden Arc Capital Partners, LP (the Partnership).

Respondents are charged with defrauding the issuers of the investments because, when redeeming, Lathen did not disclose side agreements that he signed with his fund and with the terminally ill participants. But even assuming that the agreements or any other fund documents would have been material to issuers in assessing Lathen's representations that he was a joint owner of the accounts, Lathen lacked intent to defraud. He acted in good faith, soliciting extensive advice from legal counsel. Based on the advice he received, he believed that his investment strategy was legal, the joint accounts were valid, and that he was not required to make further disclosures to issuers. No precedent establishes that the strategy was illegal, and no standard of care was otherwise established to hold Respondents liable for these arms-length transactions.

Respondent Eden Arc Capital Management, LLC (EACM), the investment adviser to the fund, is also charged with failing to custody the joint accounts in accordance with the Advisers Act custody rule, and Lathen is charged with aiding, abetting, and causing that alleged violation. The custody rule, however, applies only to "client funds and securities." Nothing suggests that the rule was intended to invalidate accounts held in the name of third parties pursuant to private investment contracts in accordance with the client's investment strategy.

Because the Division of Enforcement has failed to sustain its burden, this proceeding is DISMISSED.

Procedural History and Allegations

On August 15, 2016, the Securities and Exchange Commission issued an order instituting administrative and cease-and-desist proceedings (OIP) pursuant to Section 8A of Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934 against Respondents Lathen, EACM, and Eden Arc Capital Advisors, LLC (EACA); Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940 against Lathen and EACM; and Section 9(b) of the Investment Company Act of 1940 against Lathen.

The OIP alleges that since approximately March 2011, Respondents engaged in a fraudulent scheme involving the establishment of a fund that would profit from the use of misrepresentations and omissions of material facts to issuers of bonds and notes. OIP at 2. According to the OIP, Respondents falsely portrayed Lathen and other individuals as owners of those bonds in order to redeem the instruments prior to maturity at par value pursuant to survivor's options. *Id.* The contention is that this strategy was in violation of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit fraudulent conduct in the

offer and sale of securities and in connection with the purchase or sale of securities. *Id.* The OIP further alleges that since approximately October 2012 through approximately February 2016, EACM willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder—known as the custody rule—and that Lathen willfully aided, abetted, and caused EACM's custody rule violations by failing to custody the funds and securities of EACM's client, the Partnership, in an account under the Partnership's name or in an account that contained only the Partnership's funds and securities, under EACM's name as agent or trustee for the Partnership. *Id.* Instead, Lathen and EACM placed the Partnership's funds and securities in brokerage accounts titled in the name of Lathen and various third parties. *Id.*

Respondents denied these allegations of wrongdoing. *See* Answer. They initially asserted eleven affirmative defenses, *id.* at 7-8, and later invoked an advice of counsel defense, which was permitted by the administrative law judge previously assigned to this proceeding. *Donald F. ("Jay") Lathen, Jr.*, Admin. Proc. Rulings Release No. 4272, 2016 SEC LEXIS 3915, at *6-7 (ALJ Oct. 18, 2016).

The hearing was held from January 30, 2017, to February 17, 2017, in New York, NY, and closing arguments were held on March 1, 2017. The admitted exhibits are listed in the revised record index issued by the Commission's Office of the Secretary on August 16, 2017. Post-hearing briefing is now complete.[1]

I will first address Respondents' threshold constitutional objections to this proceeding, after which I will provide background and make findings of fact. I will then address the parties' legal arguments concerning Respondents' alleged antifraud violations and custody rule violations.

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[1] Citations to the hearing transcript are noted as "Tr. __." Citations to the parties' stipulated facts are noted as "SFOF ¶ __." *See Donald F. ("Jay") Lathen, Jr.*, Admin. Proc. Rulings Release No. 4723, 2017 SEC LEXIS 1005 (ALJ Mar. 31, 2017). Citations to the Division's exhibits and Respondents' exhibits are noted as "DX __" and "RX __," respectively. Citations to the Division's briefs are noted as "Div. Prehearing Br.," "Div. Post-hearing Br.," and "Div. Reply." Citations to Respondents' briefs are similarly noted (with the addition of "Resp. Const. Obj. Ltr." for Respondents' letter setting forth constitutional objections to the proceeding), as are citations to the parties' proposed statements of fact, and their responses to proposed statements of fact.

Preliminary Matters

1. Alleged Constitutional Issues

Respondents' constitutional challenges are foreclosed by Commission precedent.

1.1. The appointment of Commission administrative law judges does not violate the Appointments Clause.

Respondents—citing the Tenth Circuit's decision in *Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016), *reh'g and reh'g en banc denied*, No. 15-9586, 2017 WL 1717498 (10th Cir. May 3, 2017)—argue that this proceeding must be dismissed because the undersigned was not properly appointed under the Appointments Clause, U.S. Const. art. II, § 2, cl. 2. *See* Resp. Const. Obj. Ltr. at 3-4. But *Bandimere* is not binding here.

The Commission has held that the Appointments Clause does not apply to Commission administrative law judges because they are not constitutional officers. *See Harding Advisory LLC*, Securities Act Release No. 10277, 2017 WL 66592, at *19 & nn.82, 90 (Jan. 6, 2017); *Raymond J. Lucia Cos.*, Exchange Act Release No. 75837, 2015 WL 5172953, at *20-23 (Sept. 3, 2015), *petition for review denied by an evenly divided court*, No. 15-1345, 2017 WL 2727019, at *1 (D.C. Cir. June 26, 2017) (en banc) (per curiam); *Timbervest, LLC*, Advisers Act Release No. 4197, 2015 WL 5472520, at *23-25 (Sept. 17, 2015), *petition for review filed*, No. 15-1416 (D.C. Cir. Nov. 13, 2015), *modified on limited remand on other grounds*, Advisers Act Release No. 4492, 2016 WL 4426915 (Aug. 22, 2016).

Respondents reside or have their principle places of business in New York and Delaware, which are not in the Tenth Circuit, and they do not indicate how this case could fall under the Tenth Circuit's jurisdiction on appeal. *See, e.g.*, 15 U.S.C. § 80b-13(a). The Commission, exercising its authority under the doctrine of circuit non-acquiescence, has declined to follow *Bandimere* in cases that are not appealable to the Tenth Circuit. *See Lynn Tilton*, Advisers Act Release No. 4735, 2017 WL 3214456, at *2 (July 28, 2017); *Harding Advisory LLC*, 2017 WL 66592, at *19 n.90; *cf. Pending Admin. Proc.*, Securities Act Release No. 10365, 2017 WL 2224348 (May 22, 2017) (staying proceedings that *are* appealable to the Tenth Circuit).

1.2. Commission administrative law judge tenure protections are not in derogation of the Executive Vesting and Take Care Clauses.

Respondents contend that this proceeding violates the Constitution because administrative law judges are constitutional officers yet have two

layers of tenure protection when it comes to their removal. *See* Resp. Const. Obj. Ltr. at 4; *see also* U.S. Const. art. II, § 1, cl. 1; *id.* § 3. However, the Supreme Court's decision in *Free Enterprise Fund v. Public Company Accounting Oversight Board*, 561 U.S. 477, 507 n.10 (2010), on which Respondents rely, specifically declined to address administrative law judges. The Commission has concluded that "*Free Enterprise* left little doubt that civil servants," who are not constitutional officers, "may enjoy multiple layers of protection from presidential removal." *Timbervest*, 2015 WL 5472520, at *27. And—even if administrative law judges were officers—their function, the limitations on their power, and historical practice readily distinguish them from the members of the Board. *Id.* at *27-28.

1.3. The Commission's selection and use of the administrative process do not violate the Fifth Amendment's Due Process Clause.

Respondents assert that they were deprived of due process and equal protection of the laws by the Commission's decision to institute this administrative proceeding and the use of the administrative process itself. *See* Resp. Const. Obj. Ltr. at 5-6; *see also* U.S. Const. amend. V, cl. 4; *Washington v. Davis*, 426 U.S. 229, 239 (1976) ("the Due Process Clause of the Fifth Amendment contains an equal protection component"). Neither the Commission's rules, nor its selection of this forum, however, violate Respondents' constitutional rights.

1.3.1. Commission administrative proceedings provide due process.

Respondents' due process claims fail because "broad attacks on the procedures of the administrative process have been repeatedly rejected by the courts." *Harding Advisory LLC*, Securities Act Release No. 9561, 2014 WL 988532, at *8 (Mar. 14, 2014). "Administrative due process is satisfied where the party against whom the proceeding is brought understands the issues and is afforded a full opportunity to meet the charges during the course of the proceeding." *Application of Jonathan Feins*, Exchange Act Release No. 41943, 1999 WL 770236, at *7 (Sept. 29, 1999). Agency adjudication comports with due process and assures that the hearing officer exercises independent judgment, free from pressures by the parties or other officials within the agency. *See Butz v. Economou*, 438 U.S. 478, 513-14 (1978); *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1104-08 (D.C. Cir. 1988); *The Stuart-James Co.*, Exchange Act Release No. 28810, 1991 WL 291802, at *2 (Jan. 23, 1991).

No authority supports the notion that administrative procedures, including those governing discovery, must be coextensive with those in district court. *See Charles L. Hill*, Exchange Act Release No. 79459, 2016 WL 7032731, at *3 (Dec. 2, 2016); *John J. Aesoph, CPA*, Exchange Act Release

No. 78490, 2016 WL 4176930, at *19 & n.96 (Aug. 5, 2016), *petitions for review filed sub nom. Bennett v. SEC*, Nos. 16-3827 & 16-3830 (8th Cir. Oct. 3, 2016). Respondents have been given ample opportunity to defend the proceeding. Indeed, Respondents could have elected to apply the recently amended Rules of Practice, which allow motions on the pleadings and expanded discovery. *See* Amendments to the Commission's Rules of Practice, 81 Fed. Reg. 50212, 50212, 50228-29 & n.184 (July 29, 2016) (codified at 17 C.F.R. pt. 201). *Compare* 17 C.F.R. §§ 201.221-.234, .250(a), *with* Resp. Const. Obj. Ltr. at 5. But they declined to do so. *Donald F. ("Jay") Lathen, Jr.*, Admin. Proc. Rulings Release No. 4149, 2016 SEC LEXIS 3416, at *1 & n.1 (ALJ Sept. 13, 2016).

1.3.2. Institution of an administrative proceeding does not deprive Respondents of equal protection.

Respondents do not claim to belong to a protected, or unprotected, class; instead, they claim that they were "singl[ed] . . . out for uniquely unfavorable treatment." Resp. Const. Obj. Ltr. at 5. Insofar as Respondents assert a "class-of-one" equal protection claim, it is "not legally cognizable." *Mohammed Riad*, Advisers Act Release No. 4420A, 2016 WL 3627183, at *50 (July 7, 2016), *petition for review filed*, No. 16-1275 (D.C. Cir. Aug. 4, 2016). Although one may state a claim when "intentionally treated differently from others similarly situated" with "no rational basis for the difference in treatment," *Vill. of Willowbrook v. Olech*, 528 U.S. 562, 564 (2000), a class-of-one claim cannot be used to challenge a "subjective, individualized decision." *Engquist v. Or. Dep't of Agric.*, 553 U.S. 591, 604 (2008). Nor have Respondents even made the threshold showing that they were treated differently than others to whom they bear "an extremely high degree of similarity" or established that the Commission lacked a rational basis for its choice of forum. *Timbervest, LLC*, 2015 WL 5472520, at *29 (quoting *Clubside, Inc. v. Valentin*, 468 F.3d 144, 159 (2d Cir. 2006)).

Respondents' contention that this action should have been filed in federal district court based on the factors enumerated the Division's forum selection guidelines does not alter the analysis. By its terms, the document does not create any "substantive or procedural rights," but only provides guidance to the Division in recommending to the Commission where a case should be brought. SEC Div. of Enf't, *Division of Enforcement Approach to*

Forum Selection in Contested Actions, at 1, 4[2]; *see Charles L. Hill*, 2016 WL 7032731, at *3.

Findings of Fact

I base the following findings of fact and conclusions on the entire record and the demeanor of the witnesses who testified at the hearing, applying preponderance of the evidence as the standard of proof. *See Steadman v. SEC*, 450 U.S. 91, 100-04 (1981). All arguments and proposed findings and conclusions that are inconsistent with this decision are rejected.

1. Respondents' Investment Strategy

1.1. Lathen's investment strategy involved purchasing survivor's option investments with terminally ill participants.

At the time of the hearing, Lathen was 49 years old. SFOF ¶ 1. He graduated college in 1989 and received his MBA with distinction in 1993. At one point he held Series 7, 24 and 63 licenses. SFOF ¶ 2. Lathen was a managing director in the investment banking department at Citigroup from July 2007 until September 2008, when he was laid off. SFOF ¶ 3; Tr. 3162. While at Citigroup, he was a managing director and co-head of Citigroup's energy mergers and acquisition business in the United States. Prior to joining Citigroup, Lathen was a managing director at Lehman Brothers where he spent eleven years with its industry-leading global natural resources investment banking group. SFOF ¶ 3. Over the course of his fifteen-year investment banking career, Lathen advised on over $100 billion worth of completed transactions. *Id.*

In 2009, Lathen discovered survivor's option bonds. Tr. 3172-73. The bonds were medium- and long-term bonds, with a life of anywhere from two to thirty years. SFOF ¶ 10. The survivor's option was a right of redemption typically in the form of a par put, which allowed the investment to be sold back to the issuer at par prior to the maturity date in the event of the death of a beneficial owner. DX 369 at 9; *e.g.*, DX 513 at 1. The survivor's option offers individuals flexibility in their finances at the time of the death of a beneficial owner. Tr. 715-16, 1471-72, 1838. While no restrictions exist on who can purchase survivor's option bonds and CDs, *see, e.g.*, Tr. at 729, they are—as Respondents understood—typically marketed to retail investors. SFOF ¶ 9; DX 369 at 16. Lathen wanted to redeem the bonds—which had

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[2] The document is available at: https://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf.

been purchased at a discount—at par (100 cents on the dollar) from the issuer in an abbreviated time frame. Tr. 72-73. To execute the strategy, Lathen needed two people to jointly own the bonds, and one of them had to be likely to die in the near future. *Id.*

Lathen conceived of this investment strategy when members of his own family were struggling with exorbitant healthcare and end-of-life costs. Tr. 3177-78. Lathen researched survivor's option bonds and read many bond and CD prospectuses. Tr. 927, 1675-76, 3172-74. Lathen founded EndCare in July 2009 as a marketing vehicle to solicit terminally ill individuals, or participants. SFOF ¶ 11; DX 369 at 16. Lathen was the president and CEO of EndCare. DX 369 at 16. Lathen sought participants that had six months or less to live. Tr. 55. He located them through hospices and social workers. DX 369 at 16. Participants were "somewhere between modest means and nearly destitute." Tr. 1680-81. Many "were extremely poor." Tr. 1681. In exchange for their participation, participants were provided with an immediate payment of $10,000. Tr. 61; DX 435; *e.g.*, DX 314. Though profit was an obvious motivating factor, EndCare provided a real service to real people in need. Tr. 1526-27, 2355. Lathen strove to ensure that his participants were comfortable with the program and treated them with kindness. Tr. 2346-47, 2349-50.

1.2. Lathen set up investment vehicles in 2011 to further his strategy.

In 2009 and 2010, prior to launching the Partnership and for some time thereafter, Lathen purchased survivor's option bonds with terminally ill individuals using his own money and money from individual investors. Tr. 3198, 3201, 3226-28, 3493-94; *see* DX 2052. Lathen then decided to scale his strategy and create a hedge fund as a financing vehicle. Tr. 3230. He established the Partnership in approximately May 2011. SFOF ¶ 6. Respondent EACA is the general partner of the Partnership. SFOF ¶ 7. Lathen is the managing member of EACA. SFOF ¶¶ 7, 8.

The Partnership provided all financing for the joint accounts, aside from margin loans provided by brokerage firms that worked with Lathen. Tr. 304-05, 420. The Partnership's investment strategy involved purchasing survivor's option instruments on the secondary market at a discount and then putting them back to issuers at par pursuant to the survivor's option provision. DX 369 at 16; Tr. 72. Lathen made himself and not the Partnership a joint account holder on the joint accounts he created to hold the bonds because he understood that an entity cannot be a joint tenant. DX 465 at 2; DX 107 at 5. Initially the Partnership only financed joint-account investments in survivor's option bonds. Later, survivor's option CDs were added to the portfolio, and the CDs predominated by the time of the hearing.

Tr. 159.[3] Although EACA was technically an investor in the Partnership by virtue of being the general partner, neither Lathen nor EACA has ever invested any money in the Partnership. Tr. 50-52.

Lathen is also the CEO, chief compliance officer, chief financial officer, chief investment officer, managing member, and founder of EACM. SFOF ¶ 4. EACM is an investment adviser, and was registered with the Commission between October 2012 and February 2016. EACM acted as the investment manager to the Partnership. SFOF ¶ 5. Lathen was charged with administering and enforcing EACM's code of ethics, which required him to avoid engaging in fraudulent and manipulative practices, to act with honesty, integrity, and professionalism, and to adhere to federal and state securities laws, rules, and regulations. DX 174 at 3-4; Tr. 415. Lathen knew that as an investment adviser, it is important to be accurate. Tr. 496. EACM had one employee, Michael Robinson, who was the vice president of marketing and administration from July 5, 2012, to February 29, 2016. Tr. 120-21, 1667-68. Lathen also relied on a variety of business, legal, and financial professionals to run his business. For example, Mission Critical Services Corp. prepared some Forms ADV for EACM. Tr. 596, 3323. Lathen was honest and forthright with these professionals. Tr. 1756-61. EACM collected management fees from the Partnership, calculated as a percentage of the assets under management. Tr. 120, 155. EACA collected incentive or performance fees from the Partnership, which was based on the Partnership's profits. Tr. 120, 155.

1.3. Participant agreements governed Lathen's relationship with the terminally ill individuals.

Lathen managed his relationships with terminally ill individuals with participant agreements. The purpose of the agreements was to "accomplish a joint tenancy and protect fund investors." Tr. 3634. Lathen continued to update the participant agreement as his investment strategy progressed, and the details of each agreement will be analyzed below. *Infra* Law Section 1.5.2. The basics follow. The agreements disclosed to participants that financing for the accounts was obtained from investors such as the Partnership and told participants that they would not be responsible for funding the accounts. *E.g.*, DX 314 at 1.[4] The agreements provided that the account would be titled

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[3] For the sake of convenience, I will typically refer to the investments as "bonds," even though many of them were CDs.

[4] The Partnership's and EACM's due diligence questionnaire similarly provided: "The Participants who open the accounts in partnership with [the Partnership and EACM] receive compensation, and do not bear any expenses

(continued...)

as a joint tenancy with right of survivorship between Lathen and the participant. *Id.* The agreements all stated that if the participant predeceased Lathen, the account would not pass to the participant's estate, but would become Lathen's through the right of survivorship. *Id.* at 2. The agreements prior to 2013 also contained various restrictions on the participant's access to the account. *Id.* at 2. Each participant signed a limited power of attorney providing Lathen with the right to open and manage the brokerage account, execute agreements in their name, and transfer funds in and out of the account. *Id.* at 4. Participants were encouraged to ask questions about the power of attorney and paperwork before signing the agreement. *Id.* at 1. Each participant received a $10,000 one-time payment, in cash, "within 15 business days of enrollment." DX 435 at 3; Tr. 61; *E.g.* DX 314 at 1. No participant ever received more than the initial $10,000. Tr. 198-99.

A joint tenancy brokerage account was created for each participant after the participant signed the participant agreement. *See* DX 124-29. Lathen signed the account documents on behalf of himself and the participant pursuant to the power of the attorney. Tr. 1690-91. Each joint account was held in the name of Donald Lathen and the participant (and Lathen's father-in-law David Jungbauer for many of the accounts). *See* DX 124-29. The Partnership was not named on any of the joint accounts. *See id.* There were fifty to sixty participants in all. Tr. 104.

Lathen wanted to protect the Partnership's investors, and participants' access to the accounts was limited in certain ways. *See* Tr. 3634-35. They did not typically receive account statements. Tr. 1703. Lathen testified that he believed the brokerage firms required the signatures of both joint owners to allow the withdrawal of funds from the accounts. Tr. 86. Lathen told a prospective investor that as a practical matter, participants are not informed about details of the joint account, including the name of the brokerage firm and the account number. DX 237a at 3.

Lathen also transferred bonds and CDs between participant accounts with some frequency. Tr. 435-36, 441. Robinson testified that sometimes, when Lathen discovered a participant's death was imminent, he would transfer funds into that account. Tr. 1714. On the other hand, when Lathen learned that Joy Davis, a participant who signed up in 2011, was free from cancer, he transferred all the money out of her account and closed it, severing

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or liabilities, including any costs associated with the purchase of securities in their accounts." DX 238 at 11.

the joint tenancy. Tr. 112, 3556; DX 325; DX 510 at 1-2. When another participant, Peter Bankuti, lived longer than six months, Lathen removed some assets from Bankuti's account and used them elsewhere. Tr. 1697, 99.

The Division has admitted that the OIP does not claim that Lathen's disclosures to participants were insufficient or inadequate; that the "limited" powers of attorney executed by participants (or their representatives) were improper or unlawful; or that the participant agreements executed by participants (or their representatives) were improper or unlawful. *See* Div. Amended Response to Resp. Proposed Findings of Fact at 124-25.

1.4. Lathen's relationship with his investment entities was governed by private contracts.

Initially, beginning on May 2, 2011, the relationship between Lathen, EACM, and the Partnership was governed by an investment management agreement (IMA) drafted by counsel. *See* Tr. 165, 168-69; DX 191. The IMA authorized Lathen and Jungbauer to act as nominees on behalf of the Partnership to establish joint tenancies with terminally ill individuals. DX 191 at 1-2. The IMA stated that the Partnership retained a beneficial interest in the investments. *Id.* at 2. Lathen understood the IMA as a profit-sharing agreement between himself and the Partnership in which he assigned his profits from the joint accounts to the Partnership. Tr. 173. Lathen signed the IMA on behalf of the Partnership and EACM. DX 191 at 8. He and Jungbauer also signed as nominees in their individual capacities. *Id.*

On January 24, 2013, Respondents replaced the IMA with a discretionary line agreement (DLA) between the Partnership and Lathen, a promissory note between Lathen and the Partnership, and a profit sharing agreement (PSA) between the Partnership, Lathen, and EACM. DX 72, 190, 193. The DLA was designed to more closely conform the relationship between the parties to that of a lender (the Partnership) and a borrower (Lathen) to match how Respondents "were actually running the business." DX 190 at 2; Tr. 99, 173-75. Lathen signed the DLA on behalf of himself as borrower and the Partnership as lender. DX 190 at 15. The DLA stated that the lender would "provide a discretionary line of credit in order to finance the purchase of certain securities to be owned by Borrower as a joint tenant with rights of survivorship pursuant to agreements between Borrower and certain identified Participants." DX 190 at 2. The joint accounts were pledged as collateral for the loans. *Id.* at 3, 11-12. The stated interest rate for the advances was the prime rate plus three percent. *Id.* at 6. UCC liens in favor of the Partnership were placed on each joint account created after January 2013 under the new structure. SFOF ¶ 12; DX 153-70; Tr. 3516. Lathen and the Partnership also signed a security and account control agreement in

January 2013 pledging the joint accounts as security for the money advanced by the Partnership. DX 945 at 10-11. The payments under the DLA were non-recourse to the borrower, so there was no personal liability for Lathen on the loan. DX 190 at 14; Tr. 206.

Lathen drafted the PSA, which he signed on behalf of himself, the Partnership, and EACM. DX 72 at 2; Tr. 506. It provided that Lathen would transfer all profits and losses he derived from the joint accounts to the Partnership. DX 72 at 2. The income from the accounts would "pass through" the Partnership, which would then allocate it to the partners. *Id.* Under the PSA, the IMA continued to govern accounts created before January 24, 2013. DX 72 at 1; Tr. 419-20, 3569. Respondents continued to redeem investments in the IMA accounts after January 2013. Tr. 3563.

In February 2015, Respondents further modified the DLA by including the participants as borrowers, also on a non-recourse basis. Tr. 206-07, 3336; DX 183-88; DX 183 at 13. Lathen signed the agreements on behalf of himself and the participants pursuant to powers of attorney. *E.g.*, DX 183 at 15; DX 184 at 15. The change to separate DLAs for each participant was made to protect the Partnership's investors. Tr. 3336.

1.5. Lathen disclosed his investment strategy to investors.

Lathen and his counsel also drafted a private placement memorandum for the Partnership in March 2011, which disclosed Lathen's strategy. Tr. 645-47. The memorandum stated: "The key element of the Partnership's investment strategy is to acquire [survivor's option] Investments in joint accounts . . . with Participants." DX 369 at 16. The memorandum laid out risk factors, including the risk of future issuer conflicts over the contractual regime, as follows:

> It is unclear whether any of the issuers of the [survivor's option] investments ever contemplated the partnership's investment strategy when they drafted their prospectuses. While the general partner believes that its strategy conforms with the prospectus guidelines and represents a valid survivor's option redemption, there is a possibility that issuers and trustees may take a contrary view.

Id. at 26. It further noted the regulatory risk:

> In addition, objections to the Partnership's strategy and its implementation, whether or not presently anticipated, could arise by various third persons or

> parties, federal, state or local regulatory or similar bodies or otherwise, which could frustrate or defeat the Partnership's investment strategy.

Id. at 25.[5] The memorandum also noted that because the investments would be held in "joint tenancy accounts with rights of survivorship," there was the possibility that a participant's creditors could seek payment from the joint account, and there was "no assurance" against a participant's creation of obligations "which would cause to defeat or reduce the Partnership's claim with respect to the [joint accounts]." *Id.* at 27-28.

The Division admitted that it produced no evidence of any investor complaints about Lathen's disclosures to investors. *See* Div. Amended Response to Resp. Amended Proposed Findings of Fact at 117. The Division admitted that the OIP does not claim that Lathen's disclosures to investors were insufficient or inadequate. *See id.*; *see also* Mem. of Law in Supp. of the Div. of Enf't Mot. in Lim. to Preclude Certain Evid. & Test. at 2-3 ("This case is about whether Respondents made material misstatements or omissions to bond issuers and whether Respondents violated the Custody Rule; there is no allegation of investor fraud."); Tr. 577 (Division counsel stated, "Mr. Lathen is not charged with anything related to fund investors.").

Lathen solicited a few dozen investors for the Partnership, and ultimately about fifteen invested approximately $5.85 million. Tr. 3252-53. The investors were primarily high-net-worth individuals along with two institutions. Tr. 3253-55. The Partnership's overall profits were between $7.5 and $9.5 million. Tr. 3496-97. Survivor's option CDs generated the vast majority of the profits earned as a result of Lathen's investment strategy. *See* RX 2070.

1.6. Lathen's interactions with issuers.

Lathen directed redemption requests to over seventy issuers. *See* RX 2070. However, the hearing focused mostly on the offering documents and redemptions requested of eight issuers: Citigroup Global Markets Holdings Inc., National Rural Utilities Cooperative Finance Corporation (NRU), Goldman Sachs Group, Inc., Federal Farm Credit Banks Funding Corporation, Prospect Capital Corporation, General Electric Capital

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[5] Lathen also disclosed his strategy, as set forth in his private placement memorandum, to his auditors at Citrin Cooperman and his independent administrator, Integrated Investment Solutions. RX 788; DX 814; Tr. 1756-57, 1760-61, 3235-36, 3606-07.

Corporation, Duke Energy, and Bank of America Corporation. *See* SFOF ¶¶ 20-23, 38, 44-47, 50-52, 54-57, 60-63 (evidence regarding redemptions from six of the issuers); DX 513, 521, 530, 545, 565, 598, 972, 975 (the eight offering documents).[6] The Division called representatives from each of these issuers to testify at the hearing aside from Bank of America, although it called a representative from Bank of America's underwriter, InCapital. Tr. 1262-64, 1270. Redemptions from the issuers called to testify only accounted for a relatively small percentage of Respondents' total profits. *See* RX 2070; Tr. 3360-61. Respondents did not call any issuers to testify.

1.6.1. Lathen provided the issuers with what was required by their offering documents.

The eight issuers' offering documents each provided that a surviving joint tenant may exercise a survivor's option to redeem the bonds and CDs—although the language that the offerings used to describe the specific interest of the deceased joint tenant varied. *See, e.g.*, DX 530 at 62; DX 521 at 21; DX 972 at 176; *see also infra* Law Section 1.4.

The offering documents identified materials that must be submitted to exercise the survivor's options. *See, e.g.*, DX 521 at 22 (detailing the information required by Duke Energy for redemption of their survivor's option instruments); DX 598 at 24 (detailing the information required by Prospect). Some issuers also had specific holding period requirements, and issuers or trustees requested copies of current and past account statements demonstrating that the investment was held for the required period. Tr. 976-77, 1275-78. Issuers' governing documents did not specifically request information regarding sources of funding for the bonds, confirmation of access to brokerage accounts, evidence of future property interests in bond proceeds, or the existence of any side agreements between joint account holders with respect to the bonds. Tr. 1806-08, 1999. On the other hand, some governing documents included broad provisions suggesting that issuers or trustees had an undefined "sole discretion" to make a payment determination. SFOF ¶ 99; Tr. 772-73; *see* SFOF ¶¶ 100-04. The offerings also generally entitled the issuer to request additional information in relation to a redemption request. Tr. 1277-78. None of the offering documents at issue required a specific relationship between the deceased beneficial owners of a survivor's option bond or CD and the surviving owners making a redemption request. Tr. 1999-

[6] The survivor's option provisions in bond prospectuses are longer than those in CD disclosure statements, which tend to have a somewhat sparing discussion of the survivor's option. Tr. 927-31.

2000, 2430-31. Likewise, none of the offerings limited the sale of the instruments or the exercise of the survivor's option feature to retail investors. They could be sold to non-retail investors and institutions. Tr. 760, 815-16.

Each of the survivor's option bonds and CDs purchased by Lathen and participants was held by a broker, and only the broker could submit a redemption request. Tr. 604-05, 1800, 1807; *see*, *e.g.*, DX 124-29 (account applications and redemption requests produced by brokers). Lathen submitted redemption requests to his brokers following the deaths of participants or, if a holding period was required for a particular bond, after the holding period was satisfied. Tr. 668. Lathen would typically provide only a redemption request letter and a certified death certificate to the brokerage firm. Tr. 1800, 1806. Lathen's redemption request letters to his brokerage firm were in his own name and sometimes on EACM's letterhead. SFOF ¶ 91; DX 90 at 1, 2; Tr. 827-28, 830-31, 1903, 1905. Lathen's redemption letters contained three principal representations: (1) the participant was a joint owner, or joint and beneficial owner, of the brokerage account at issue;[7] (2) the participant had died; and (3) Lathen was the surviving joint owner of the brokerage account at issue. SFOF ¶ 92.[8] The broker transmitted Lathen's redemption letter and the death certificate to issuers as part of its redemption package. *E.g.*, DX 824 at 5; RX 1941 at 14691; *see* DX 124-29; Tr. 924-25. Redemption packets submitted by brokers to trustees and issuers also contained broker account statements and an election form, both of which attested to the identity of the account holders. *See, e.g.*, RX 1941 at 14688-90; Tr. 623-27.

Lathen did not space out his redemption requests so as to avoid scrutiny by issuers or trustees. To the contrary, he submitted multiple redemption requests to the same issuer or trustee, with respect to multiple bonds, which Lathen held in multiple joint accounts with participants. Tr. 1808-09, 1903-05, 1911. Indeed, some of the issuers who testified for the Division eventually noticed the redemption packages submitted by Lathen's brokerage firm because of either the amount of money involved, or the repetitive nature of requests in Lathen's name in connection with different people who did not share his last name. Tr. 776-77, 1901-02.

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[7] Sometime in 2014, Lathen changed the language of the redemption letters from "joint owner" to "joint and beneficial owner." SFOF ¶ 13.

[8] In December 2015, Lathen began including enhanced disclosure language in his redemption letters. *See infra* Facts Section 2.7.

Information on Lathen's background, his relationship to EACM, and the nature of the strategy was publicly available online. Tr. 1914-15. Additionally, issuers and their trustees were entitled to and sometimes requested additional information from Respondents' brokers. Tr. 778, 781, 977-78, 1277-78. When an issuer or trustee requested more information from brokers, Lathen often provided what was requested, but sometimes objected to doing so and delayed sending the information. Tr. 783; DX 569; Tr. 1201; DX 556 at 1-4, 557; Tr. 1867; DX 526; DX 592 at 7, 10; Tr. 269-70; DX 626; DX 481 at 14.

1.6.2. A minority of issuers refused to redeem, or did so only after an initial dispute.

Despite the unusual pattern of Lathen's redemption requests, the vast majority of issuers redeemed the bonds and CDs without question. However, some issuers disputed Lathen's right to redeem and did not redeem. Goldman Sachs's treasury department learned of Lathen's redemption requests of three Goldman Sachs CDs in the summer of 2013, and Roger Begelman, the co-chief of compliance for Goldman Sachs Bank USA, requested additional information from Lathen's broker. DX 570 at 1-2; Tr. 776-77. After reviewing the account opening documents, participant agreements, and powers of attorney relating to the joint tenant accounts in which Lathen had purchased or transferred certain Goldman Sachs CDs, Goldman Sachs rejected the redemptions, arguing that "Lathen's status as a joint tenant with rights of survivorship [wa]s not legally recognizable." DX 570 at 3-4; DX 571 at 2; Tr. 782-91. Goldman Sachs decided that further requests should not be immediately honored by its trustee, and should instead be forwarded to Goldman Sachs for review. Tr. 810. Lathen filed complaints against Goldman Sachs with the New York State Department of Financial Services and the Consumer Financial Protection Bureau. SFOF ¶¶ 95-96.

In March 2014, Bank of New York Mellon, acting as trustee for GE Capital, told Lathen's broker that his redemptions of GE Capital notes were rejected. DX 557 at 6. For two months, Lathen insisted that additional information should not be required for GE Capital to honor the redemption requests. DX 556 at 1-4. Lathen eventually sent a participant agreement, power of attorney form, and account opening documents. After review, GE Capital counsel concluded that the documents explicitly negated beneficial ownership in the joint account that Lathen was attempting to redeem. DX 557 at 8-16; Tr. 1206-10. Similarly, Funding Corp. learned of Lathen's attempts to redeem its notes from a letter from U.S. Bank National Association, and ultimately rejected Lathen's redemptions of its notes because it found that EACM was not eligible after reviewing the participant

agreement and power of attorney. Tr. 1867; DX 526. Lathen did not successfully redeem any notes from Funding Corp. Tr. 3357.

Prospect began to ask questions about Lathen's redemption requests in January 2014 because his name was submitted in connection with a number of different requests. Tr. 1485-86; *see* DX 592. Prospect reached out to U.S. Bank, its trustee, who then requested additional information from Lathen's broker for the Prospect redemptions. DX 592 at 7; Tr. 2894. Lathen initially refused to provide U.S. Bank with additional information beyond that required in its bond prospectus. *Id.* at 10-12. Prospect sued Lathen in June 2014 in New York Supreme Court for "fraudulent conduct designed to profit from the deaths of terminally ill individuals." DX 594 at 1; Tr. 264-65. The lawsuit is ongoing. *See Prospect Capital Corp. v. Lathen*, No. 156375/2014 (N.Y. Sup. Ct.). Lathen eventually provided additional information to U.S. Bank, such as a participant agreement, after Prospect sued. Tr. 269-70; *see* DX 626.

Other issuers initially disputed Lathen's redemption right before relenting. BMO Harris Bank N.A. initially refused to redeem, but later paid. Tr. 1676. In communications with BMO Harris, Robinson threatened to sue them and lodge a complaint with a regulator. DX 501 at 1. CIT Group Inc. also refused to redeem, but processed Lathen's survivor's option CD redemption request and paid after receiving a participant agreement—although Respondents likely threatened them with a lawsuit as well. Tr. 2909-11, 3115, 3120-21; RX 1433. Similarly, Barclays Bank PLC initially refused to but ultimately agreed to redeem the survivor's option CDs that Lathen presented for redemption. SFOF ¶ 97; Tr. 1676. To obtain payment, Lathen provided Barclays with participant agreements and made "a few threatening phone calls." DX 481 at 14.

1.7. Brokers were aware of Lathen's investment strategy.

As noted, Respondents' survivor's option investments were held by brokers. The Partnership used five different brokers throughout the time period at issue: Grace Financial Group, SecureVest Financial Group, Inc., C.L. King & Associates, First Southwest Company, and Wedbush Securities. *See* DX 124-29. Sometimes brokerage firms used "clearing agents" to service their accounts. Among other things, the clearing agents would physically hold the accounts and provide statements and confirmations. Tr. 2526-27.

Lathen's brokers were sometimes provided copies of the participant agreement. Tr. 625-26, 1787-90, 2522-23. Robinson, who handled the processing of redemption requests for Lathen, testified as to his close working relationship with brokers and their full awareness of the investment

strategy. Tr. 1787-90. August Celliti, CEO of SecureVest, testified that he understood Lathen's investment strategy. Tr. 2521, 2524-25. Lathen provided SecureVest with documents to further explain his strategy. RX 2028; RX 2032; Tr. 2522-23, 2636. Lathen and SecureVest shared information and documents pertaining to Lathen's investment strategy with compliance professionals and lawyers within SecureVest and SecureVest's clearing agent, J.P. Morgan Securities LLC. Tr. 3286-87; RX 2031; RX 2036; RX 2041-44; RX 2062. Lathen also answered J.P. Morgan's questions regarding an individual named Joseph Caramadre, who was convicted of conspiracy and wire fraud after employing an investment strategy somewhat similar to, but distinguishable from Lathen's. RX 2035; RX 2062; Tr. 2551-53. Lathen encouraged his contacts at SecureVest and J.P. Morgan to review the Caramadre indictment. RX 2035. Around March 2012, J.P. Morgan indicated to SecureVest that it no longer wished to hold Lathen's accounts. Tr. 2530. C.L. King and First Southwest also terminated their relationship with Respondents. Tr. 116; DX 1031. FINRA had been investigating C.L. King and First Southwest related to Lathen's strategy. Tr. 3627; DX 1012.

Issuers' instructions to brokers about how to submit redemption requests specifically informed them that brokers had no obligation to make the redemption request if, for example, they found the "records specified in the Instructions supporting the above representations unsatisfactory." *E.g.*, DX 530 at 66.

2. Respondents' State of Mind and Advice Received from Counsel

From 2009 to the time of the hearing, Lathen retained counsel to ensure Respondents acted lawfully. These engagements included the law firms of Katten Muchin Rosenman LLP, Hinckley Allen & Snyder LLP, Gersten Savage LLP, and Kenneth Galbraith. During the same period, in conjunction with counsel, Lathen attentively followed legal developments on somewhat analogous activities carried out by Caramadre and Benjamin Staples and his son, which further informed his view of the legality of Respondents' activities. Interactions with issuers who initially refused to redeem and with those who changed the language of their offering documents further contributed to Respondents' belief that their strategy was legal. Finally, several witnesses testified to Lathen's good character and trustworthiness, and Lathen's interactions with regulators confirm his law abiding character.

2.1. Katten Muchin's pre-Partnership advice informed Lathen's view of the legality of his overall strategy and joint tenancies.

Lathen retained the legal services of Katten Muchin in 2009, two years prior to the launch of the fund. RX 1052; Tr. 2427. Robert Grundstein, who

had known Lathen for more than thirty years and was a hedge fund lawyer, was the attorney who oversaw the client relationship and served as Lathen's primary contact at the firm. Tr. 2424, 2426-27; *see* RX 1052. Grundstein described Lathen's investment strategy as "a brilliant idea" that allowed Lathen to take advantage of a "loophole" in survivor's option securities. Tr. 2428; *see* Tr. 2444. Grundstein explained that Lathen sought counsel to ensure what he was doing was legal and it was being done in an appropriate manner. Tr. 2428. Though the Katten Muchin attorneys believed that there would be "headline risk" and the potential for regulatory scrutiny of Respondents' strategy due to the strange aspect of "profiting from the death of strangers," Grundstein told Lathen that his investment strategy was "smart" and "perfectly legal." Tr. 2436-37, 2451-52. Grundstein still advised him to "keep it small" to avoid scrutiny, and advised that Lathen should not start a hedge fund. Tr. 2452, 2497. Because of the "regulatory and headline risk," Katten ultimately was not comfortable with representing Lathen in the execution of his fund strategy. Tr. 2436.

The attorneys at Katten Muchin understood that a valid joint tenancy was "a necessary conduit for [Lathen] to implement the strategy." Tr. 2444. Katten Muchin's trusts and estates department evaluated Lathen's pre-Partnership strategy and concluded that it "would form a perfectly good joint tenancy." Tr. 2441-44; DX 735. Among other documents, Grundstein received, reviewed, and edited an early version of the participant agreement, although Grundstein recalled that the attorney who evaluated Lathen's joint tenancies had not seen the participant agreement. Tr. 2429, 2439-40, 2479, 3192-93; DX 691; RX 1036.

2.2. Initial advice from Hinckley Allen distinguished Lathen's model from Caramadre's and further informed Lathen's beliefs about his limited disclosure obligations to issuers.

In 2010, Lathen read articles in the *Wall Street Journal* about Caramadre, who, as noted, was engaged in a similar type of investment strategy. Tr. 572. Statements in the articles from attorneys and financial experts stating that issuers' prospectuses did not prohibit the strategy contributed to Lathen's belief that issuers were aware of the existence of his investment strategy and that it was a contractually valid and legal strategy. RX 1028; RX 1110; Tr. 656-57, 663.

Later in 2010, following the *Wall Street Journal*'s coverage of Caramadre, Lathen retained Hinckley Allen, and in particular Robert Flanders, who represented Caramadre in civil litigation, a criminal investigation, and a Commission investigation regarding his investment program. Tr. 1978-82. Flanders had served on the Rhode Island Supreme

Court for more than eight years. Tr. 1974-75. Beginning in mid-2012, Respondents received advice from another Hinckley Allen attorney, Margaret Farrell. *See* Tr. 2604.

Lathen initially sought and received legal advice from Flanders to keep up with and avoid any regulatory and legal issues affecting Caramadre. Tr. 1983, 1997, 3216-17. Flanders advised Lathen that a problem for Caramadre was misrepresentations to participants, and therefore emphasized that Lathen should make and document disclosures to participants about the investment strategy. Tr. 1986-87, 1997, 2015-16. Caramadre ultimately pleaded guilty in a criminal action pertaining to allegations of fraud against participants. Tr. 2015-16; RX 2026.

Notwithstanding Caramadre's participant disclosure issues, Flanders believed that there was nothing inappropriate about either Caramadre's or Lathen's strategy from the perspective of their contractual rights and obligations. He believed that the strategy was "taking advantage . . . of a loophole in the bond documents." Tr. 1998. Flanders shared a copy of a letter written by the Rhode Island Attorney General's Office to the Bank of New York Mellon regarding Caramadre's strategy which found no lawful reason to deny payment to Caramadre. Tr. 1988-92; RX 1843, 1848. Flanders recalled that after receiving this letter, Bank of New York Mellon honored the redemption requests and paid according to the terms of the contract. Tr. 1992. Lathen viewed this information as helping to confirm that issuers had a contractual obligation to redeem the bonds. Tr. 3218-19.

Flanders testified that because survivor's option bonds were marketed to the elderly population, bond issuers were aware of—and conscientiously took the risk—that a bondholder would die in the short-term and exercise the survivor's option before the bond matured. Tr. 1998-99. Flanders emphasized that the bondholders did not place any limitations on the health of bondholders or relationships between joint account holders, and did not require disclosure of any agreements between the joint account holder limiting or restricting any rights. Tr. 1999-2000.

Flanders advised Lathen to provide issuers or trustees with whatever the brokers or issuers required in their offering documents, but no more. Tr. 2037. He viewed the fact that issuers initially had complete freedom to specify in each offering whatever materials they required in support of a redemption request to mean that anything that they did not require was not material. Tr. 2038. Flanders described bond issuers as "the lord of their offers," and the offering documents as "adhesion contracts"—which he explained meant that the bond issuers could specify whatever they wanted, but once anyone signed the offer, the issuers could not "impose other

conditions" not originally in the document. Tr. 2038-41. Flanders did not believe Lathen was required to disclose side agreements pertaining to the joint accounts to issuers because the issuers themselves did not "deem it to be material when they structured this program." Tr. 2032-33. Flanders could not recall if he had seen Lathen's bond prospectuses, but nonetheless did not believe the bond prospectuses contained any terms that prohibited what Lathen was doing. Tr. 2041-42, 2102.[9]

2.3. Gersten Savage drafted Partnership documents with knowledge of Lathen's investment strategy.

In October 2010, Lathen retained the services of law firm Gersten Savage to help launch the Partnership and put in place the documents necessary to do so. DX 730 at 1; Tr. 2185-86. The counsel was rendered by Eric Roper, head of Gersten Savage's hedge fund practice, with the help of some associates. Tr. 641-42. Roper had expertise in setting up limited partnerships and preparing the appropriate documentation. Tr. 2164.

Gersten Savage drafted the documents based on the Partnership's investment strategy, as well as general prospectus language and requirements. Roper knew that Lathen's investment model was dependent on the creation of valid joint tenancies. Tr. 642-43, 2234-35. Lathen sent Roper an investor presentation, sample prospectuses, the participant agreement, and the memorandum from Katten Muchin's trusts and estates department about the validity of the joint tenancies. RX 782, 1325; DX 982; Tr. 2169, 3230-31. Gersten Savage drafted the Partnership's private placement memorandum, limited partnership agreement, and subscription agreement. Tr. 2186, 2191, 2197; DX 369; RX 783, 786, 787, 788-95, 798, 801-10. Gersten Savage also assisted in drafting the Partnership's initial Form ADV and assisted with some of the updates to it in conjunction with the fund's compliance consultant, Mission Critical. Tr. 591-92, 596, 2237-38. Lathen requested Gersten Savage also review a limited power of attorney form to be used with participants, and asked them to prepare a "term sheet" containing the core of what would be in the Partnership's offering documents. DX 651; RX 846, 847; Tr. 2175-77, 2225.

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[9] Later, when Goldman Sachs refused to honor Lathen's redemption requests, challenging the validity of the joint tenancies, Flanders "flat-out disagreed." Tr. 2033. In a letter to Goldman, which he shared with Lathen, he relayed his view that Goldman was contractually obligated to honor his redemption requests. Tr. 2028-33; DX 754.

Gersten Savage drafted the IMA, which, as noted, included language that referred to Lathen as a “nominee” for the fund. Tr. 168-69, 2207-14; RX 796-97, 799, 800. Roper had “no independent recollection” as to who among them added the nominee language, although he believed that it was the firm’s work product. Tr. 2214. Lathen understood the nominee language to signify the Partnership’s financing and profit-sharing related to the joint accounts, and did not think Roper would have included the language if it undermined the joint tenancies. Tr. 3245-46.

Roper could not recall whether Gersten Savage or another firm reviewed and edited the participant agreement. Tr. 2223-25. Nevertheless, Roper was aware of the terms of the participant agreements, as Lathen sent an early version to him, and showed him a later iteration as well. RX 1325; Tr. 3275.

Lathen reviewed the documents drafted by Gersten Savage and did not see anything that seemed to be inconsistent with or would undermine his investment strategy. Tr. 643. Gersten Savage did not advise Respondents to provide additional disclosures to issuers or trustees, and Lathen believed Roper would have told him to do so if necessary. Tr. 650-52.

2.4. Hinckley Allen revised Partnership documents pertaining to the joint tenancies.

Respondents executed a new retainer agreement with Hinckley Allen in July 2012. RX 2023; Tr. 2000-01. Part of the new retainer agreement requested the preparation of a memorandum summarizing the issues raised by new criminal allegations against Caramadre and setting forth how Lathen’s investment strategy was distinguishable from Caramadre’s. DX 668; RX 2023; Tr. 2001-02. Therefore, the memorandum focused on disclosure obligations to participants and brokers, but not to issuers. DX 668; Tr. 2628-31. According to Farrell, Lathen wanted the memorandum because he was concerned by Caramadre’s indictment, and “he wanted to make sure that he was doing it right.” Tr. 2606-07.

The 2012 retainer agreement also had Hinckley Allen provide legal counsel regarding Respondents’ investment strategy and business model, and this advice was primarily provided by Farrell. Tr. 2001, 2005. Farrell handled the matter because she is a corporate transaction attorney and the firm’s “go-to person” on securities and was “very well-regarded” for that expertise. Tr. 2021-22. Farrell shared Flanders’ view that Lathen only had to provide the issuers what they specified in their offering documents when submitting redemption requests. Tr. 2670, 2777.

Farrell undertook an evaluation of Lathen’s business model and advised of the “risk” that the current structure may not be considered a valid joint

tenancy. Tr. 2620-22. Farrell understood the initial structure of the business to involve Lathen opening joint accounts with participants as "nominee" for the Partnership. Although she "could find no authority that you could not have a joint account with right of survivorship with an entity," after polling her partners in the estate-planning group, they concluded that having a joint account with a right of survivorship with an entity was "questionable" and that "holding as a nominee for an entity may not make a good joint account [with a] right of survivorship." Tr. 2623. Therefore, she recommended that Lathen change the structure to borrow funds from the Partnership and establish the joint accounts in his individual name with the participant. Tr. 2623. Hinckley Allen facilitated the new structure by drafting the DLA to allow Lathen to borrow from the Partnership and to give the Partnership a security interest in the assets through UCC filings that would entitle them to recover their loans out of the joint account assets before any general creditors. Tr. 2622-24. However, Farrell did not remember telling Lathen to stop doing business until she had prepared the new documents for him. Tr. 2624-25.

In addition to preparing the DLA, Hinckley Allen reviewed and revised or prepared numerous documents for Respondents; they revised the participant agreement, possibly the enrollment form, the brochure, and the limited power of attorney. Tr. 2622-23, 2632, 2633. Hinckley Allen discussed with Lathen the terms of the relationship between the parties as set forth by the various agreements. Hinckley Allen advised Lathen that a participant's ability or inability to access the joint accounts during Lathen's lifetime did not change a participant's economic interest in the joint account and did not challenge the validity of the joint tenancies. Tr. 2635-37. Hinckley Allen made changes to the documents, as necessary, every time a question came up, to "make sure that [they] had structured this in the best way possible to create a valid joint account." Tr. 2650.[10]

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[10] At some point, Lathen inquired about the possibility of Hinckley Allen writing a formal legal opinion on the validity of the joint tenancies. The firm decided not to write one based on several factors, including that it was a "heavily fact-intensive question" that had no governing law directly on point, as opposed to a pure legal question. They also wanted to avoid the added liability of having a formal opinion shared with others and possibly getting dragged into litigation or investigations. Hinckley Allen opted, instead, to provide Lathen with informal legal advice on the subject. Tr. 2010-12, 2613-14.

Based on their observations during their representation of Lathen, both Flanders and Farrell formed the opinion that Lathen was genuinely seeking to operate within the bounds of the law and create valid joint accounts. Tr. 2026-27, 2651.

2.5. Galbraith advised Lathen on the validity of the joint tenancies and represented Lathen in disputes with issuers.

Another attorney, Galbraith, who was a solo practitioner, ultimately took on responsibility for handling issuer disputes (other than the one already handled by Flanders) and litigation, including the lawsuit filed by Prospect in the Supreme Court of the State of New York. Tr. 2856. Galbraith had significant experience as an attorney in the investment and financial services practice areas. Tr. 2852-53. Among other things, Galbraith provided detailed advice to Lathen that his joint tenancies were valid under New York Banking Law § 675 and the relevant common law. Tr. 2863-91. That advice was based on extensive research into New York law and many conversations with Lathen about his investment strategy. Tr. 2860, 2863. During the course of Galbraith's representation, he and Lathen also discussed what documents were required to be submitted by the brokerage firm to the trustee (in the case of Prospect) or the issuer to trigger redemption, and what the trustee's obligation was in the event of the issuer's default on payment. Tr. 2894-95. Galbraith and Lathen discussed prospectus language and the fact that both Lathen and the participant had a "present beneficial interest" in the assets in the accounts, although Galbraith did not recall how in-depth the discussion of beneficial ownership was. Tr. 2897-99.

Over the course of his representation, Galbraith formed the "very clear belief" that "[Lathen] believes with certainty that these are valid joint tenancies" and that "[h]e believed and believes wholeheartedly that his investment strategy is entirely lawful." Tr. 2874-75. After working closely with Lathen for several years, Galbraith formed the opinion that Lathen was forthright, transparent, and "meticulous about understanding all the legal issues around his investment strategy." Tr. 2875-76.

2.6. The documents revealed in the Commission's prosecution of the Staples also informed Lathen's belief as to the legality of his strategy.

In September 2013, Lathen learned that the Commission was pursuing a civil case against Benjamin Staples and his son in federal district court in South Carolina relating to the purchase of survivor's option bonds with terminally ill participants. Tr. 704. Lathen believed that the Staples operated their business differently than he was. Tr. 705. Specifically, Lathen understood that the complaint against the Staples alleged that the

participant agreements had "fully stripped the participant of any ownership rights or survivorship in the account." Tr. 705-06. In contrast, Lathen believed, "since [his] agreements preserved survivorship, that they were valid joint tenancies and would be very difficult to challenge on that basis." Tr. 707.

Lathen came into possession of an FBI memorandum regarding the Staples investigation, which concluded that no securities law violations had occurred. RX 1556, 1557; Tr. 707-10. The FBI memorandum recommended that the case be closed based on various government agencies' conclusions that there was nothing illegal about the strategy, including no violation of securities laws or regulations. RX 1557 at 11969. Specifically, according to the memo, the Securities Division of the South Carolina Attorney General's Office "thoroughly examined his operation" and concluded that no state securities regulations were violated. *Id.* at 11968. They also found, "through correspondence with several bond issuers, that Staples merely took advantage of a little known loophole in the rules governing the purchase and redemption of bonds with a survivor's option." *Id.* at 11968-69. The memorandum also highlighted a discussion an Commission trial attorney in Atlanta, who "was not able to pinpoint a regulatory or criminal violation." *Id.* at 11969. The memo also stated that the U.S. Attorney's Office noted that the conduct "may be immoral" but "didn't appear to be illegal." *Id.*

The Staples case was resolved in a settlement, which included a dismissal of all of the scienter based fraud charges with prejudice, and neither admitting nor denying a violation of the negligence based fraud charges. Tr. 871; RX 2000; RX 2001 at 15550.[11]

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[11] I admitted the following Staples-related documents only as evidence of Respondents' mental state when receiving them in August 2016, but not for the truth of the attorneys' statements in them. Tr. 3703-04. Attorneys at Springleaf Financial Services, an issuer of survivor's option bonds, stated that although the Staples's survivor's option investment strategy was not contemplated by Springleaf, it would have redeemed the bonds notwithstanding the existence of side agreements because the strategy was based on a "legal loophole in the terms of the bond offering materials that was permissible under the terms of the bonds." RX 1966 at 15305. An in-house attorney for Ally Financial told Division staff that even with full disclosure regarding side agreements with the terminally ill individuals, Ally Financial still would have redeemed the Staples's bonds in light of the potential cost and litigation risk of not redeeming them. *Id.* at 15304. International Lease Finance Corporation's position was that any harm

(continued…)

2.7. Lathen's interactions with issuers further informed his belief as to the legality of his strategy.

Respondents' interactions with issuers who initially refused to redeem could have further informed his belief as to the legality of his actions. For example, Una Khang, an attorney at CIT—an issuer that initially refused to redeem and later relented—gave a statement to the Division that said, in part, "CIT felt that under the language of their documentation they did not see anything that permitted them to withhold the funds because their language was somewhat permissive compared to other issuers' offering documents." RX 1970. I admitted this document from CIT, "not to prove the truth of the assertions in" it, but as evidence of Respondents' scienter, because it could inform their belief as to the legality of their conduct. Tr. 3703-04. Similarly, Lathen's interactions with Barclays Bank, which initially refused to redeem but paid after being presented with participant agreements, could have informed his belief regarding the legality of his strategy. DX 481 at 14; Tr. 1676.

Beginning in December 2015, after receiving a Wells notice from the Division, Lathen began disclosing in his redemption request letters that he had entered into a separate written agreement with the participant relating to the joint account and that the Partnership had provided the financing for the accounts. Tr. 3407; DX 417 (providing an example of the enhanced disclosure language). According to Lathen, at least thirty issuers honored his redemption requests following the enhanced disclosures put in place in December 2015, and not one of them asked for the agreements themselves. Tr. 3407-08. Wells Fargo & Co. and Bank of America were among those who honored the requests. Tr. 3369.

In response to Lathen's redemptions, several issuers changed the language in their offering documents by adding additional requirements that would foreclose Lathen's investment strategy. For example, GE Capital added language in which it retained the right to reject redemption requests similar to Lathen's where the deceased owner held a minimal interest and a third party stood to profit from the redemption. Tr. 3123-25; RX 1937 at 14518; *see* SFOF ¶ 98. Following its dispute with Lathen, Goldman Sachs changed the language in its offering documents for survivor's option CDs to require a specific familial or legal relationship between joint account owners

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arising from a survivor's option bond strategy involving terminally ill individuals would be related to the time-value of money, and "would likely be immaterial." RX 1971 at 15317.

in order to exercise the survivor's option. Tr. 1921-25; RX 2016 at 15870. Barclays also subsequently changed its survivor's option language to foreclose Lathen's investment strategy. Tr. 564. And CIT and BMO Harris stated they would do so. Tr. 2913-16; RX 1433. Lathen believed these changes to be an acknowledgment by issuers that their pre-existing governing documents did not foreclose his strategy. Tr. 564.

2.8. Several witnesses testified about Lathen's character and trustworthiness.

Throughout his career, Lathen has no history of disciplinary action being taken against him nor, prior to the instant case, was he ever the subject of an investigation into possible misconduct. Tr. 3156. Several witnesses testified about his character and trustworthiness. Robinson worked closely with Lathen in a one-room office during most of the period that the Division alleges Lathen committed misconduct. Tr. 1748, 1752-53. Robinson holds master's degrees in economics and finance and worked in the financial industry for many years. Tr. 1743-44. Robinson testified that he believed the language Lathen used in the redemption letters was true, and that Lathen believed it to be true as well. 1803-05. After working closely with Lathen for several years, and knowing him as a person, Robinson formed a positive opinion of Lathen's character that is inconsistent with the Division's allegations of fraud. The following exchange is illuminating:

> JUDGE PATIL: Mr. Robinson, what frauds do you know of that Mr. Lathen committed?
>
> THE WITNESS: None.
>
> . . .
>
> BY MS. CORCORAN:
>
> Q Can you put some color behind that, in your own words, why?
>
> . . .
>
> A Yeah . . . my close working relationship with Jay over almost four years, sitting in this little room together. You know, we didn't just talk about business. But we talked about our kids, our families. You know, he dealt with contractors and, you know, buying and selling cars and all this sorts of things that you do in daily life. And it was just no sense I had that he was ever engaged in—what you might call shark practices, you know, was

> trying to cheat somebody, trying to hide something, trying to get a little more insurance money for a fender-bender than he was entitled to.
>
> . . .
>
> He just didn't do that stuff. I just came to feel like he was playing straight.

Tr. 1827-29.

On the stand, Robinson was a singularly credible and convincing witness. The Division's intimation that because Robinson was occasionally forceful in his dealings with entities that delayed or refused payments to the detriment of Lathen's investors does not, in my mind, taint his testimony on the stand. *See, e.g.*, DX 501 (Robinson's forceful letter to BMO Harris). He testified in a sincere, forthright, intelligent manner without any indicia of deception. As the one person with direct firsthand knowledge of Lathen's activities and conduct throughout most of the period of alleged misconduct, his testimony was extremely helpful to me in understanding whether Lathen was in fact perpetrating a fraudulent scheme.

Jim Dean has known Lathen for more than thirty years since they attended college together. SFOF ¶ 69. Dean was vice president of strategic planning and analysis at Key Energy Services, LLC, and worked there from 1996 to 2000. SFOF ¶ 70; Tr. 2794-95. During that time, Lathen was a mid-level investment banker at Lehman Brothers and part of the team working for Key Energy. Tr. 2798-99. Dean testified that Lathen was part of team of "consummate professionals" at Lehman, and that he had a perfect record in upholding his fiduciary duties to his clients, including the responsibility of protecting confidential client information. Tr. 2800. Dean testified that Lathen's reputation amongst his peers at Lehman Brothers was excellent. Tr. 2809-10.

Dean was subsequently head of investor relations and corporate development at Penn Virginia Corporation. Tr. 2795, 2801-02. Lathen worked closely with the CEO and CFO of Penn Virginia, as well as the General Counsel, advising them on investment banking matters. Tr. 2803. Dean stated that Lathen's reputation among his colleagues at Penn Virginia was excellent. Tr. 2803-04. Dean testified that Lathen was a person of very high character. Tr. 2816-18. He stated that Lathen was very trustworthy on both a personal and professional level. Tr. 2819.

Robert Grundstein, the Katten attorney who had been Lathen's personal friend for many years, also testified to Lathen's "very high standing

character," and vouched for Lathen's honesty and trustworthiness. Tr. 2426-27.

2.9. Lathen proactively reached out to regulators.

Lathen's law abiding character is further confirmed by his proactive engagement with federal and state regulators. When Dennisse Alamo, the daughter of a now-deceased a participant, reached out to Lathen about being contacted by the Commission, Lathen encouraged her to speak openly with Commission investigators, stating: "I do not know what the [Commission] may be looking into but my guess is that they are looking at my business model because it is unusual. You should speak with him and be fully open and truthful about our arrangement. I have nothing to hide nor should you." RX 869. As noted above, when Goldman Sachs refused to honor redemption requests, Lathen filed a complaint against it with the New York State Department of Financial Services and the Consumer Financial Protection Bureau. Tr. 329-30, 331, 690; DX 236, 574, 577. In 2014, Galbraith and Lathen reached out to, and met with, attorneys at FINRA to explain Lathen's business and investment strategy to the regulators. Galbraith explained that "[Lathen] wanted to be helpful to FINRA so that they could understand what his business actually was, so there was no misperception of misunderstanding on their part." Tr. 2921-25, 3044, 3049.

3. Evidence of Ownership and Custody of the Partnership's Assets

3.1. The Division's expert opined that the joint accounts were the Partnership's funds or securities.

I accepted Martin Lybecker as an expert witness with respect to the applicability of Advisers Act Section 206(4) and the custody rule to the facts in this matter. Tr. 1358-59; *see generally* DX 171. Lybecker opined that the Partnership was the client of Lathen and EACM, and that the joint accounts, as Partnership assets, should have been custodied in an account in the Partnership's name. DX 171 at 12; Tr. 1359. In reaching this opinion, he concluded, among other things, that all the assets held in the joint accounts were funds or securities of the Partnership because of: (1) the terms of the various Partnership agreements; (2) the Partnership's beneficial interest in the proceeds of the accounts; (3) Lathen and the Partnership's descriptions of the joint accounts; (4) and the practical consequences of the investment model. *See* DX 171 at 6-8. However, the majority of Lybecker's opinions amounted to legal conclusions. I do not accept his testimony as proof of those conclusions, but instead reach my own independent legal conclusions. *See infra* Law Section 2.1.

3.2. There is mixed contemporaneous evidence related to whether Respondents considered the joint accounts assets of the Partnership.

3.2.1. EACM's Forms ADV.

EACM filed Forms ADV, amendments to them, and Form ADV Part 2 brochures from September 14, 2012, through January 4, 2016. DX 1, 2, 2a, 3, 4, 4a, 5, 5a, 6, 7, 7a, 8, 8a, 10, 11, 12, 13. Lathen certified under penalty of perjury that the information and statements made in these filings, including exhibits and other information submitted, were true and correct. *E.g.*, DX 1 at 48; *see* Tr. 3506, 3510 (testifying that he reviewed the Forms ADV for accuracy). He further acknowledged his role as the managing member and chief compliance officer of EACM. *E.g.*, DX 1 at 43; DX 5 at 46.

Because he found the Forms ADV "to be incredibly complicated and difficult to understand," Lathen prepared them in collaboration with outside advisers, including lawyers at Gersten Savage and the compliance firm Mission Critical. Tr. 3505-09; *see* Tr. 2237-38; DX 455 (Mission Critical engagement letter). Lathen testified that his goal was to make sure that "they [Gersten Savage and Mission Critical] understood my business, they understood the relevant facts of my business, and that we could correctly fill out the ADV." Tr. 3504-05. As part of the process, Lathen reviewed the Forms ADV before they went out, asking questions about them and making sure they were accurate. Tr. 3504, 3506-07, 3510.

The Forms ADV and amendments stated that EACM was an investment adviser to one private fund, the Partnership, and that the assets under management for EACM generally equaled the assets of the Partnership. *E.g.*, DX 1 at 14, 25; DX 5 at 14, 25; DX 8 at 15, 24; *see* Tr. 348, 355, 358. *But see* DX 3 at 14, 25 (updating the assets under management but not the Partnership assets). Lathen explained that he "was being advised by lawyers" to "include[ ] the gross value of the securities that are in the joint accounts" in assets under management because they were accounts that Lathen held "individually" even though "they weren't owned by the fund." Tr. 348; *see* Tr. 3501-04; DX 491.

In addition, the Forms ADV stated that EACM had custody of client "cash or bank accounts" and "securities." *E.g.*, DX 1 at 35; DX 8 at 35. Initially, the Forms ADV indicated that EACM had custody only over a fraction of the disclosed assets under management. *E.g.*, DX 1 at 14, 35 ($12 million out of $18.5 million); DX 4 at 14, 35 ($13 million out of $31 million). Lathen could not "recall" the basis for the distinction, but believed that the "lower number" was "the equity in the fund" or "the net value in the fund," which did not include the "margin" amounts in the joint accounts. Tr. 349-50,

352. Then, starting in March 2014, the Forms ADV stated that the amount of assets in EACM's custody equaled its assets under management. *E.g.*, DX 5 at 14, 37 (about $44 million for both); DX 8 at 15, 35 (about $32 million for both); *see, e.g.*, Tr. 353-55, 362-63. Lathen acknowledged that, under his understanding of the Form ADV disclosure requirements, as general partner of the Partnership he was deemed to have custody of the assets in the joint accounts, including the margin balances. Tr. 3507.

3.2.2. EACM's compliance manual.

In March 2013, EACM published its compliance policies and procedures, which were signed and acknowledged by Lathen on April 1, 2013. DX 177a at 1, 39; *see* Tr. 3516. The manual admitted that EACM was a registered investment adviser owing a fiduciary duty the Partnership, its client. DX 177a at 4. Among its obligations as an investment adviser, EACM recognized that it had custody of Partnership assets, and that therefore it had to adhere to Advisers Act Rule 206(4)-2 by entrusting any such assets to a qualified custodian and subjecting the Partnership to an annual audit. *Id.* at 12-13. In addition, the manual provided that Lathen, as chief compliance officer and chief financial officer, had "responsibility for all compliance matters" and "for causing [Partnership] assets to be held with qualified custodians." *Id.* at 5, 13.

3.2.3. The Partnership's financial statements.

The Partnership issued audited financial statements for 2011, 2012, 2013, and 2014. DX 194-97. The statements listed the amount "Due" from the investments held in the joint accounts as "assets" of the Partnership. DX 194 at 9-10; DX 195 at 11-12; DX 196 at 10-12; DX 197 at 10-12. The statements calculated the "fair value" of the joint accounts as the price for which they could be sold "in an orderly transaction to an independent buyer." *E.g.*, DX 194 at 8.

In connection with the 2014 audit, Lathen represented to his auditor that as of "December 31, 2014, the Partnership had investments in securities in aggregate amount of $27,811,577." DX 106 at 5. He also listed "bank/brokerage accounts" that were "maintained by the [Partnership] during the period being audited." *Id.*

In a financial record from December 2014, broker and clearance charges related to the joint accounts were recorded as expenses of the Partnership. DX 104 at 4; Tr. 489-90.

3.2.4. Respondents' due diligence questionnaire.

EACM and the Partnership created a due diligence questionnaire dated July 1, 2013. DX 238. Describing its general investment strategy, the questionnaire stated that the Partnership "invests in securities which contain a survivor's option . . . through a series of joint brokerage accounts established with terminally ill individuals." *Id.* at 7. This, Lathen explained, was "sort of shorthand" because it was "obvious that the fund [was] either advancing funds or financing the joint tenancies." Tr. 586. Other parts of the questionnaire largely confirmed this shorthand.

For example, the questionnaire explained that "[a]ssets are held in a series of [joint] accounts . . . established between Mr. Lathen and terminally ill individuals" with money borrowed by Lathen from the Partnership. DX 238 at 7. Lathen would then "assign the profits and losses from the Joint Accounts to the [Partnership]." *Id.* But the questionnaire also stated that its "investor capital was $16 million"—the net value of the joint accounts—in response to the question "[w]hat are the [Partnership's] net assets?" *Id.* at 9; *see* Tr. 542. This description, unlike others in the questionnaire, did not make it explicit that the number represented only the amount due under the loan and profit sharing agreement. Tr. 472-73.

3.2.5. Lathen's tax returns.

Lathen received tax forms indicating the income he received from the joint accounts in capital gains and interest. Tr. 199, 467. Lathen reported that income on his tax return, but then subtracted it, allocating it to the Partnership "pursuant to the profit sharing agreement" and calling it "gains rec'd as nominee." Tr. 199, 467-68; DX 304 at 9; DX 305 at 9; DX 306 at 14.

3.3. Communications regarding custody of the joint accounts with Commission staff and Mission Critical.

3.3.1. Communications with the Commission staff.

The Commission's staff initiated an examination of EACM in late 2014. SFOF ¶ 14. At that point, EACM had not commenced its annual compliance review and had not implemented all of the controls described in EACM's compliance manual. Tr. 380-82; *see* DX 309 at 2-3. When asked by the staff for the "[n]ames of securities held in all client portfolios . . . as of September 30, 2014," Lathen listed all of the bonds and certificates of deposit held in the joint accounts. DX 477 at 4, 7-22; *see* Tr. 377-79.

In a January 15, 2015, letter to Respondents, the staff warned Lathen that EACM may be violating the custody rule's requirement to maintain

client assets "in accounts under the client's name or the Adviser's name as agent to trustee" because EACM had "custody of client assets through the powers described in [the Partnership's] offering materials" and the Partnership's extension of credit to Lathen to invest in joint accounts. DX 309 at 1-3 (faulting EACM, in addition, for failing "to implement adequate policies and procedures . . . regarding [Lathen's] individual access to custody of [the Partnership's] assets").

On February 13, 2015, Lathen responded. SFOF ¶ 19. Lathen advised the staff that the Partnership "does not directly own these [joint] accounts or the securities in them"; rather, it "owns loans to . . . Lathen (secured by the [joint accounts]) and profit sharing rights in the [joint accounts.]" DX 309 at 3; *see* Tr. 3689-90 (explaining that "the joint accounts are collateral," not Partnership assets). Lathen also stated his belief that EACM was "substantively complying" with the custody rule by, among other precautions, keeping them with a qualified custodian and auditing them each year. *Id.*

3.3.2. Communications with Mission Critical.

On January 11, 2015, Mission Critical sent Lathen a draft risk assessment and gap analysis which identified six "High" compliance risks. DX 438 at 13, 31, 33-35. Among other things, the risk assessment determined that because EACM's compliance manual was "not properly customized," it "incorrectly represents the current custodial arrangement" regarding the joint accounts and "should be amended to properly reflect the custodial relationship." *Id.* at 13, 34.

On April 13, 2015, Mission Critical emailed Lathen a compliance review memo noting that the Commission staff had recently expressed doubt about EACM's compliance with the custody rule, but Mission Critical declined to agree with the staff's assessment. DX 446 at 3. Instead, Mission Critical told Lathen that it did not believe that the custody rule applied to the joint accounts because the Partnership did "not own [those] accounts or the securities in them." *Id.*

3.4. Respondents did not custody the January 2013 promissory note.

Respondents did not custody the promissory note between Lathen and the Partnership, which accompanied the DLA, with the Partnership's broker-dealers. Tr. 3517; DX 193.

Conclusions of Law

1. Alleged Antifraud Violations

Respondents are charged with willfully violating the antifraud provisions of the Securities Act and the Exchange Act. OIP at 10-11.

Exchange Act Section 10(b) prohibits the use or employment of any manipulative or deceptive device; specifically, Section 10(b) and Rule 10b-5, which apply "in connection with the purchase or sale of any security," prohibit: (1) employing any device, scheme, or artifice to defraud; (2) making material misstatements of fact or statements that omit material facts; or (3) engaging in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. "[C]onduct that produces a false impression" is deceptive. *Dennis J. Malouf*, Securities Act Release No. 10115, 2016 WL 4035575, at *6 (July 27, 2016), *petition for review filed*, No. 16-9546 (10th Cir. Sept. 8, 2016).

Securities Act Section 17(a), which applies "in the offer or sale of any securities," prohibits: (1) employing any device, scheme, or artifice to defraud; (2) obtaining money or property by means of any material misstatement of fact or statements that omit material facts; or (3) engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. 15 U.S.C. § 77q(a). Unlike Section 10(b), a finding of manipulative or deceptive conduct is not required for a violation of Section 17(a). *Dennis J. Malouf*, 2016 WL 4035575, at *10-11.

Both Section 10(b) and Section 17(a) prohibit "'half-truths'—literally true statements that create a materially misleading impression." *SEC v. Gabelli*, 653 F.3d 49, 57 (2d Cir. 2011), *rev'd on other grounds*, 568 U.S. 442 (2013). Whether a statement is misleading is judged from the point of view of an objective investor. *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

To prove a violation of Securities Act Section 17(a), and Exchange Act Section 10(b) and Rule 10b-5, any misstatements or omissions must be material. A representation or omission is material if there is a substantial likelihood that disclosure of the omitted fact would have been viewed by a reasonable seller or purchaser as having significantly altered the total mix of information available. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-32, 240

(1988); *TSC Indus.*, 426 U.S. at 449; *Azrielli v. Cohen Law Offices*, 21 F.3d 512, 518 (2d Cir. 1994).[12]

Scienter is required to prove violations of Securities Act Section 17(a)(1), and Exchange Act Section 10(b) and Rule 10b-5; a showing of negligence is sufficient to establish violations of Securities Act Sections 17(a)(2) and 17(a)(3). *Aaron v. SEC*, 446 U.S. 680, 701-02 (1980); *see Ira Weiss*, Securities Act Release No. 8641, 2005 WL 3273381, at *12 (Dec. 2, 2005), *petition for review denied*, 468 F.3d 849 (D.C. Cir. 2006). Scienter is defined as a mental state consisting of an intent to deceive, manipulate, or defraud. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Scienter can be established through recklessness. *Bernerd E. Young*, Exchange Act Release No. 10060, 2016 WL 1168564, at *16 (Mar. 24, 2016) (citing *Rockies Fund, Inc. v. SEC*, 428 F.3d 1088, 1093 (D.C. Cir. 2005)), *petition for review filed*, No. 16-1149 (D.C. Cir. May 24, 2016).

1.1. Respondents had a duty to not make material misstatements or materially misleading omissions in their communications with issuers.

I first consider Respondents' duty of disclosure to issuers. "Silence, absent a duty to disclose, is not misleading under Rule 10b-5." *Basic*, 485

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[12] Neither party addresses whether the materiality standard adopted in *TSC Industries* also establishes what is material to *issuers*—the allegedly defrauded persons in this case. *See* Div. Post-hearing Br. at 7 (applying "reasonable investor" standard, without examination, to what was "material[ ] to issuers"). The Supreme Court has framed its analysis in terms of what "a reasonable *investor* would . . . consider significant" or insignificant "in making his *investment* decision." *E.g.*, *Basic*, 485 U.S. at 234 (emphasis added). At least one court has thus expressed doubt about applying the anti-fraud materiality standard to disclosures to an issuer. *See Breakaway Sols., Inc. v. Morgan Stanley & Co. Inc.*, No. CIV.A. 19522, 2004 WL 1949300, at *5 n.31 (Del. Ch. Aug. 27, 2004) ("To define materiality as 'what a reasonable issuer would consider important in determining to issue shares' would be to extend the holding of *TSC Indus.* beyond its intended reach of protecting investors when they chose to purchase or sell shares."), *amended on other grounds*, No. CIV.A. 19522-NC, 2005 WL 3488497 (Del. Ch. Dec. 8, 2005). The Commission has referred to a "reasonable issuer" standard for defining materiality, but only in settled proceedings. *Pryor, McClendon, Counts & Co., Inc.*, Securities Act Release No. 8062, 2002 WL 181580, at *7 (Feb. 6, 2002); *see also First Fid. Sec. Grp.*, Exchange Act Release No. 36694, 1996 WL 20840, at *7 (Jan. 9, 1996). Nevertheless, because the parties have not argued otherwise, I assume that the antifraud materiality standard applies in this unusual context.

U.S. at 239 n.17; *see also Chiarella v. United States*, 445 U.S. 222, 230 (1980) (recognizing that a duty to disclose may arise "from a relationship of trust and confidence between parties to a transaction"). "[A]n omission is actionable under the securities laws only when the [respondent] is subject to a duty to disclose the omitted facts." *Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 101 (2d Cir. 2015) (quoting *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993)). A duty may arise when there is a "statement that would otherwise be 'inaccurate, incomplete, or misleading.'" *Id.* (quoting *Glazer v. Formica Corp.*, 964 F.2d 149, 157 (2d Cir. 1992)). When a party to a securities transaction "discloses material facts . . . [he] assumes a duty to speak fully and truthfully on those subjects." *In re Galectin Therapeutics, Inc.*, 843 F.3d 1257, 1275 (11th Cir. 2016) (quoting *FindWhat Inv'r Grp. v. FindWhat.com*, 658 F.3d 1282, 1305 (11th Cir. 2011)). The antifraud provisions "reach omissions of material fact, including when additional disclosure is necessary to make other 'disclosed statements, whether mandatory or volunteered, not misleading.'" *Mohammed Riad*, Exchange Act Release No. 78049A, 2016 WL 3627183, at *17 (July 7, 2016) (quoting *SEC v. Fehn*, 97 F.3d 1276, 1290 n.12 (9th Cir. 1996)), *petition for review filed*, No. 16-1275 (D.C. Cir. Aug. 4, 2016). "Misleadingly incomplete disclosures or 'half-truths' that are 'literally true' but that 'create a materially misleading impression [ ]' will 'support claims for securities fraud.'" *Id.* (alteration in original) (quoting *Wilson v. Merrill Lynch & Co.*, 671 F.3d 120, 130 (2d Cir. 2011)); *see also John J. Kenny*, Securities Act Release No. 8234, 2003 WL 21078085, at *27 (May 14, 2003) (upon choosing to speak, a respondent is "obligated to do so truthfully and in a way that [is] not misleading"), *petition for review denied*, 87 F. App'x 608 (8th Cir. 2004).

The Division and Respondents propose different theories of Respondents' duty. The Division maintains that Lathen had a broad duty to disclose his side agreements with participants and with the Partnership to issuers, because disclosure "would have notified the issuer of the substantial questions as to the validity of the Respondents' redemption rights." Div. Prehearing Br. at 15. According to the Division, the validity of the joint tenancies is beside the point; rather, the right question is: "did Respondents—by hiding information from the issuers necessary to reach their own conclusion about whether Lathen and the Participants were truly the beneficial owners of the bonds—misrepresent the bonds' ownership?" *Id.* at 25. By submitting redemption requests to issuers, Respondents assumed the duty to speak fully and truthfully, and because they withheld the side agreements, they did not speak the whole truth. Div. Post-hearing Br. at 7.

Respondents contend they did not have to disclose the side agreements. Rather, because they had no fiduciary relationship with the issuers, it was

sufficient that they gave them only the information that they asked for. Resp. Prehearing Br. at 29-30; Resp. Post-hearing Br. at 8-11. Moreover, their failures to disclose the side agreements did not render the redemption letters materially misleading. Resp. Post-hearing Br. at 11. Respondents instead focus on the truthfulness of Lathen's actual statements to issuers. From Respondents' perspective, whether they committed an antifraud violation depends on whether Lathen made truthful statements to issuers in claiming the creation of valid joint tenancies and rights of redemption.

Respondents certainly had no affirmative duty to disclose the side agreements. They had no fiduciary relationship with the issuers; their redemptions were arms-length transactions. Moreover, there was nothing inherently illegal in Respondents' attempt to utilize a loophole in the issuers' offering documents.[13] Flanders, Lathen's attorney at Hinckley Allen, testified persuasively that the issuers were "lord[s] of their offers." Tr. 2000; *see* Tr. 2038-40. Although any offering could have required the disclosure of side agreements, on their face, "[t]hey did not require disclosure of any agreements between the joint accountholders that might restrict or limit [the accountholders'] rights in any way." Tr. 1999. Typical offerings merely requested a written request for repayment, evidence that a joint tenant died, and evidence that the requestor had authority to act for the deceased joint tenant. *See, e.g.*, DX 513 at 23. Although the offerings generally entitled the issuer to request additional information in relation to a redemption request, that does not mean Respondents had to preemptively provide unasked-for information. *See* Tr. 1277-78 (underwriter InCapital's testimony that the language regarding the submission of additional information meant the trustee had "the right to ask for [any] additional information that may impact on determining to pay or not pay").

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[13] In *VanCook v. SEC*, 653 F.3d 130 (2d Cir. 2011)—a case cited by the Division for the theory that Lathen made an implied misrepresentation—the defendant was not merely taking advantage of a loophole in the prospectuses, but was involved in late trading, which is illegal. *See id.* at 133; *see also In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d 845, 856 (D. Md. 2005) ("Late trading is itself illegal, and therefore . . . a scheme, practice, or course of business effectuating late trading is inherently fraudulent." (footnote omitted)). The defendant attempted to cover up his illegal conduct by technically following the terms of the prospectuses, thereby fooling issuers. Here, on the other hand, the redemption of survivor's option bonds impacted by side agreements is not inherently illegal.

Respondents, however, may have had a duty to disclose the side agreements to the extent they undermined or contradicted Lathen's representations to the issuers about the joint tenancies. Once Lathen began to speak to the issuers, he needed to provide "additional disclosure" as "necessary to make 'other disclosed statements . . . not misleading.'" *Mohammed Riad*, 2016 WL 3627183, at *53 (quoting *Fehn*, 97 F.3d at 1290 n.12). If the agreements cast substantial doubt on the validity of the joint tenancies, Respondents' failures to disclose the agreements to issuers may have rendered Lathen's representation in his redemption letters that there were valid joint tenancies materially misleading. The validity of the joint tenancies is central to this proceeding—it is *the* material issue. Because the side agreements bear on the validity of the joint tenancies, they could have been material to an issuers' decisions to redeem the bonds and CDs, refuse to redeem, or sue. *See, e.g.*, Tr. 789-90 (Goldman Sachs refused to redeem once it saw a participant agreement); Tr. 1867 (Funding Corp. refused to redeem after receiving participant agreement); *cf.* Tr. 269-70, 1488-89 (Prospect sued Lathen and received a participant agreement only afterwards). Under this theory, liability could be established even if the joint tenancies' validity was only questionable, because in such a circumstance, Lathen still should have disclosed the side agreements to ensure his statement to issuers was not materially misleading.

Of course, if the joint tenancies were clearly invalid, then Respondents are also liable for making material misstatements. In his redemption letters, Lathen told issuers that a participant was the "joint owner" or the "joint and beneficial owner" of a survivor's option bond and that he, as one of the "surviving joint owners," was entitled to redeem the bond. *E.g.*, DX 372; DX 374. If Lathen's representations to issuers were false, then Lathen made material misstatements of fact. The side agreements are relevant and material to this question, because they shed light on whether Lathen and the participants met the issuers' criteria for redemption. *See* Tr. 3539-40.

Hence, there are two potential theories of liability: (1) Respondents may have made material misstatements to the issuers, and/or (2) their failures to disclose the side agreements to issuers may have been materially misleading omissions.

Whether there was a violation involves two primary questions. (1) Do the offering documents require only the death of a joint tenant for redemption of the bond, or do they, as the Division argues, additionally require the participants to hold a particular kind of beneficial ownership interest? (2) Did Lathen establish valid joint tenancies with the participants? This second question has multiple parts because it could be that the participant agreements, which limited participants' rights to the accounts, prevented the

creation of joint tenancies. Alternatively, or in addition, it may be that the agreements Lathen signed with the Partnership stripped him of beneficial ownership of the accounts and prevented the creation of joint tenancies.[14]

Even if the joint tenancies were invalid—or their legal status was unclear and the side agreements should have been disclosed—Respondents are still not liable for making material misstatements or omissions if they had no intent to defraud. If Respondents did not act with scienter, either because they acted with the advice of counsel, or for some other reason, they are not liable under Section 10(b) of the Exchange Act. Respondents may still be liable under Section 17(a)(2) and 17(a)(3) of the Securities Act for negligent misconduct, but for negligence liability to attach, Respondents must have breached the relevant standard of care, which the Division has the burden to establish.

Yet, before I discuss any of these issues, I will address Respondents' two threshold arguments. (1) Did Lathen actually make statements to the issuers? (2) Is the redemption of a bond a sale under the securities laws? The answer to both is yes.

1.2. Lathen made statements to the issuers.

Respondents argue that they cannot be liable under the securities laws because they did not communicate with the issuers, and therefore could not have made any false or misleading statements to them. Resp. Post-hearing Br. at 4. Rule 10b-5 states it is illegal for anyone "directly or indirectly" to "*make* any untrue statement of a material fact" (emphasis added). "For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011). Respondents maintain that because Lathen only

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[14] The Division also argues that Lathen's redemption letters were fraudulent because they contradicted what he "told investors—namely, that the assets in the [joint] accounts belonged to the [Partnership]." Div. Post-hearing Br. at 5. But that is not exactly what Lathen told his investors; rather, he explained to them in detail how his strategy worked, and significantly, he noted how it was dependent on the creation of valid joint tenancies. *See* DX 488 at 2; *see also* DX 369 at 28 (private placement memorandum for the Partnership noting that because the way the joint accounts are structured, the participant could in theory create obligations that would "defeat or reduce the Partnership's claim with respect to the [joint accounts]"); DX 370 at 28 (same).

sent his redemption letters to brokers, which then prepared their own submission packages and independently sent them to the issuer, Lathen did not have "ultimate authority" over the statements made to the issuers or how the statements were communicated to them. Resp. Post-hearing Br. at 5-6.

However, the statements at issue in this case are Lathen's redemption letters, and Lathen, having drafted and signed them, was their maker. *Cf. S.W. Hatfield, CPA*, Exchange Act Release No. 73763, 2014 WL 6850921, at *6 (Dec. 5, 2014) (holding that CPAs who drafted, dated, and signed audit reports on firm letter head were the makers of a statement). The redemption letters contained the potentially misleading phrase "joint owner" or "joint and beneficial owner"; they were also the documents that failed to mention the side agreements. *E.g.*, DX 372; DX 374. The issuers universally required the letters to evaluate redemption requests. *See, e.g.*, DX 513 at 23 (requiring, for "exercise of the survivor's option," a "written request for repayment signed by the representative" of the deceased owner, along with evidence of the death of that owner and the authority of the representative). Although the letters were addressed to brokers and communicated indirectly to the issuers by the brokers, *see, e.g.*, DX 824 at 5, the Supreme Court in *Janus* explained "it does not matter whether the statement was communicated directly or indirectly to the recipient." *Janus Capital Grp.*, 564 U.S. at 147 n.11; *see also Timothy S. Dembski*, Securities Act Release No. 10326, 2017 WL 1103685, at *7 & n.10 (Mar. 24, 2017) (a person need not be "responsible for the act of communication" to be the maker of a misstatement so long as he or she has "ultimate control" (citing *SEC v. Pentagon Capital Mgmt. PLC*, 725 F.3d 279, 286-87 (2d Cir. 2013))), *petition for review filed*, No. 17-1553 (2d Cir. May 10, 2017).

1.3. Redemption of a bond is a "sale."

Section 10(b) and Rule 10b-5 require that the fraud be "in connection with the purchase or sale of any security." Section 17(a) similarly prohibits fraud "in the offer or sale of any securities." Respondents contend that the redemption of a bond from an issuer is not a purchase, sale, or offer as those terms are commonly defined by the courts. Resp. Post-hearing Br. at 18-19.

Courts, however, have consistently recognized that these terms are to be broadly construed to effectuate the remedial purposes of the securities laws. *See Rubin v. United States*, 449 U.S. 424, 431 (1981); *United States v. Naftalin*, 441 U.S. 768, 773 (1979); *Northland Capital Corp. v. Silver*, 735 F.2d 1421, 1427 (D.C. Cir. 1984). The broad construction of these terms is dictated not only by the purposes of the securities laws, but by the terms' statutory definitions. The definition of "sale" includes "any contract to sell or *otherwise dispose of*." 15 U.S.C. § 78c(a)(14) (emphasis added); *see* 15 U.S.C.

§ 77b(a)(3) ("sale or disposition"). "Disposition" is the "relinquishing of property." *Disposition*, *Black's Law Dictionary* (10th ed. 2014). Sales thus include transactions without "overt resemblance to conventional cash sales" as long as those transactions require some surrender of control or change in the fundamental nature of the investment. *Sacks v. Reynolds Sec., Inc.*, 593 F.2d 1234, 1240 (D.C. Cir. 1978).

When Respondents redeemed the survivor's option bonds, that was the bonds' disposition—Respondents relinquished and extinguished the securities. Whether there were corresponding purchases is irrelevant under the Acts' definitions of "sale." *See* 15 U.S.C. §§ 77b(a)(3); 78c(a)(14).[15] Respondents' actions therefore fit within the framework regulated by the antifraud provisions of the Securities Act and the Exchange Act.

1.4. The Division has not established that there were material misrepresentations regarding beneficial ownership.

1.4.1. The offering documents did not clearly require separate proof of beneficial ownership.

The Division maintains that the issuers' offerings required the death of a "beneficial owner" for one to exercise the survivor's options, and the participants were not beneficial owners because "they held neither the economic privileges nor risks associated with the" bonds. Div. Reply at 19. The Division emphasizes two offerings that defined a "beneficial ownership interest" as the right to receive proceeds from the disposition of the note immediately prior to death and the right to receive payment of the principal of the note. Div. Post-hearing Br. at 3; DX 972 at 176; DX 975 at 44. The participant agreements, according to the Division, limited participants' rights to the proceeds and principal of the notes. If the participants were not beneficial owners under the terms of the offerings, then Lathen's statements to issuers concerning his right to redeem the notes, particularly his

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[15] There is another potential problem with Respondents' argument. At least some of the offering documents allowed the issuers to repurchase the bonds rather than redeem them when Respondents attempted to exercise the survivor's option. *See* DX 521 at 20 ("We may also purchase Notes otherwise tendered for repayment . . . through exercise of the Survivor's Option."); DX 545 at 18 (same); DX 598 at 23 (same). Although it is unclear whether any of the issuers exercised this right, *see, e.g.*, Tr. 457-58 (no mention of optional repurchases in testimony about how transactions were recorded by Respondents), such repurchases would not merely "discharge[ ]" the debt. *SEC v. Sterling Precision Corp.*, 393 F.2d 214, 217 (2d Cir. 1968).

characterization of some participants as "beneficial owners," were materially misleading.

Respondents disagree. They argue issuers never contemplated that the exercise of the survivor's options needed anything more than the death of a joint tenant. The term "beneficial owner" in the offering documents was used to distinguish the owners holding title to the joint accounts from the broker who held the global note in street name. Resp. Post-hearing Br. at 14. According to Respondents, as long as the participants were joint tenants, their deaths entitled Lathen to redeem the bonds. Respondents point in particular to one offering stating that the death of a joint tenant is considered the death of a beneficial owner. *Id.*; DX 530 at 62.

The parties debate the meaning of the offering documents, which are contracts. By the offerings' terms, New York law applies to resolving such a dispute. *See, e.g.*, DX 530 at 11; DX 972 at 179; DX 975 at 11. A contract must be enforced according to its plain language unless it is ambiguous, in which case the court may look to extrinsic evidence of the parties' intent to resolve the ambiguity. *Greenfield v. Philles Records, Inc.*, 780 N.E.2d 166, 170 (N.Y. 2002). If a provision's meaning is still elusive after resort to extrinsic evidence, ambiguity shall be resolved against the drafter, particularly when one party has no power to negotiate the language of the contract. *State v. Home Indem. Co.*, 486 N.E.2d 827, 829 (N.Y. 1985); *151 W. Assocs. v. Printsiples Fabric Corp.*, 460 N.E.2d 1344, 1345 (N.Y. 1984).

As a general matter, Respondents are correct that the term "beneficial owner," when used in the offering documents, merely distinguished the real owner of the underlying interest in the security from the broker holding the note. *See, e.g.*, DX 521 at 45-46 (defining "Beneficial Owner" as the "actual purchaser of the debt security" in contrast to the institutional purchaser who "will receive a credit for the debt securities on DTC's records"); DX 513 at 54 ("[E]ach beneficial owner of a book-entry security will hold that security indirectly through a hierarchy of intermediaries, with DTC at the 'top' and the beneficial owner's own securities intermediary at the 'bottom'"); DX 530 at 27 ("Participants" are entities where the book-entry securities are deposited; a "Participant" is not necessarily the "beneficial owner"). However, this does not end my inquiry, because the term "beneficial ownership interest" sometimes used in the sections of the offering documents discussing the survivor's options may have distinct implications. There are eight offerings at issue in the proceeding, and they can be grouped into three categories.

First, the Funding Corp. offering required only the existence of a joint tenancy. It stated that "[t]he death of a person owning a Retail Bond in joint

tenancy or tenancy by the entirety will be deemed the death of the beneficial owner." DX 530 at 62. No other conditions regarding beneficial ownership were placed on exercising the survivor's option.

The Citigroup, Duke Energy, GE Capital, Goldman Sachs, and Prospect offerings—the second category—each stated that the "death of a person holding a beneficial ownership interest in a note as a joint tenant . . . will be deemed the death of a beneficial owner of that note" for the purposes of the survivor's option. DX 513 at 22; *see* DX 521 at 21; DX 545 at 19; DX 565 at 7; DX 598 at 23. This language is ambiguous. It is not clear if, as the Division maintains, the deceased must not only be a joint tenant, but must also hold an additional "beneficial ownership interest," or if, as Respondents argue, a joint tenant automatically holds a beneficial ownership interest.

Respondents' interpretation is more plausible, however, because these offerings did not require one who redeems based on the death of a joint tenant to provide any additional proof of a beneficial ownership interest. In contrast, they stated that the death of one who is entitled to "substantially all of the beneficial ownership interests" but is not the registered holder of the note, can still trigger the survivor's option, but only as long as those interests are proved to the trustee's and issuer's satisfaction. DX 513 at 22; DX 521 at 21; DX 545 at 19; DX 565 at 7; DX 598 at 23. The juxtaposition of these clauses implies that the death of a joint tenant who holds title to the note is sufficient for the exercise of the survivor's option without additional proof. And in any event, even if the offerings in this category did require a joint tenant to have had a particular kind of "beneficial ownership interest," they never specified what additional features that interest entails. The Division therefore cannot prove that Lathen lied, made a misrepresentation, or misled when he told issuers that participants were "joint and beneficial owners."

The NRU and Bank of America notes, which are the third category, stated that for purposes of the survivor's option, a beneficial owner of a note is a person who has "the right, immediately prior to such person's death, to receive the proceeds from the disposition of" the note, "as well as the right to receive payment of the principal of" the note. DX 972 at 176; DX 975 at 44. Like those in the second category, these notes also said that "[t]he death of a person holding a beneficial ownership interest in" the note "as a joint tenant" triggers the survivor's option. DX 972 at 175; DX 975 at 44.

These requirements are nonetheless somewhat ambiguous. As with the offerings in the second category, those who do not hold title must provide additional evidence of beneficial ownership, DX 972 at 175-76; DX 975 at 45-46, but the notes placed no such requirement on joint tenants. The required contents of the redemption request thus suggest that the issuers may not

have cared about the separate definition of beneficial ownership they provided in their offerings—perhaps it was only there to guide beneficial owners who were not joint tenants. *See* Resp. Response to Div. Statement of Facts at 3.

All of the contracts other than the Funding Corp. offering are somewhat ambiguous. I turn to extrinsic evidence to unravel the puzzle. *See Greenfield*, 780 N.E.2d at 170. No contemporaneous evidence of the intent of the parties when signing the contracts was presented at the hearing. Representatives of several issuers testified at the hearing that they considered beneficial ownership a separate and distinct requirement from joint tenancy. Tr. 769-70 (Goldman Sachs); Tr. 1178 (GE Capital); Tr. 1479 (Prospect). But I find such after-the-fact subjective testimony of little value, as it sheds no light on how either party interpreted the contracts when they were entered into, before any dispute over their terms began. *Accord Hudson-Port Ewen Assocs., L.P. v. Kuo*, 566 N.Y.S.2d 774, 776-77 (App. Div. 1991) (holding that absent evidence that views advanced during litigation "were either discussed or considered by the parties" prior to "the execution of the agreement," the contract terms must be interpreted based on their plain meaning), *aff'd*, 578 N.E.2d 435 (N.Y. 1991).

There is evidence of what some issuers and trustees considered when they refused to honor Lathen's redemption requests, but it too is not dispositive. In its refusal to redeem, Goldman Sachs noted Lathen's failure to create a joint tenancy, but said nothing about any separate requirement to establish beneficial ownership. DX 571 at 2; DX 575 at 3-4. When U.S. Bank, Prospect's trustee, refused to submit a request for redemption, it also noted only an alleged failure to create a joint tenancy. DX 625 at 1; DX 626 at 1. On the other hand, GE Capital's refusal letters argued that participants' lack of beneficial ownership was fatal to Lathen's request regardless of the questions about the joint tenancy. DX 558 at 2; DX 559 at 1-3. Thus, the evidence from issuers at the time of redemption cuts both ways, and simply reflects the position of the issuers after a dispute arose.

Since extrinsic evidence does not resolve the issue, I construe the ambiguous contracts against the issuers who drafted them. *See Home Indem.*, 486 N.E.2d at 829. The offerings were contracts of adhesion; Lathen could not bargain over their terms, and it is not clear that they required anything more than proof of joint tenancy. Thus, the Division has not shown by a preponderance of the evidence that Respondents were obligated by the offerings to demonstrate participants' beneficial ownership in addition to the existence of a valid joint tenancy.

1.4.2. The Division has not established that participants lacked a beneficial ownership interest in the bonds.

In addition, it is not certain that participants lacked the "beneficial ownership interest" possibly required by the notes. As I will discuss in greater detail below, the participant agreement Lathen began to use in 2013—in conjunction with the DLA and PSA—did not restrict the participants' rights to the principal or proceeds of the notes. *See, e.g.*, DX 315 at 1-2 (agreement allowed the participant to receive additional funds if Lathen predeceased the participant, and did not restrict the participant's ability to withdraw funds from the account). And although an earlier iteration of the participant agreement prevented the participant from making withdrawals from the account without Lathen's permission and limited recovery of the funds if Lathen died, it allowed the participant to receive some proceeds and principal of the note. *See, e.g.*, DX 314 at 1-2 (providing participants with up to 5% of the profits during the life of the joint tenancy and 5% of the principal if the joint tenancy is terminated by Lathen's death). Thus, even taking into account that agreement's restrictions, the participants appear to have met the beneficial ownership requirements spelled out in the NRU and Bank of America offerings.[16]

Thus, even if the Division were correct that the offerings contained a beneficial-ownership requirement, I cannot say that Lathen made misrepresentations to issuers when he stated that the participants were beneficial owners.

1.5. The Division has not established that there were material misrepresentations regarding joint tenancy.

1.5.1. The Division has not rebutted the presumption that Respondents intended to establish valid joint tenancies under New York law.

In approaching the validity of the joint tenancies, the parties focus on New York Banking Law § 675, which provides that an account titled as a "joint tenancy with right of survivorship" is entitled to a presumption of

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[16] It may be that the IMA, which was in use at the time, prevented the participants from receiving any beneficial ownership interest, as Lathen may have had no interest himself to grant them. *See infra* Law Section 1.5.3. However, Lathen believed that he was creating joint tenancies with a real ownership interest and therefore did not knowingly make any misrepresentations. *See infra* Law Section 1.6.1.

validity, which can be rebutted if it is shown that the joint form of the account was merely for the convenience of the depositor. *See* N.Y. Banking Law § 675(b). The Division argues that the accounts were for Lathen's convenience and lacked the essential features of true joint accounts. It points to aspects of the participant agreements such as unequal rights of access to the accounts and provisions that undermined participants' right of survivorship if Lathen predeceased them as evidence that Lathen never intended to, and in fact did not, create real joint tenancies. *See* Div. Prehearing Br. at 26-28; Div. Reply at 20-22.

Respondents counter that the Division has not rebutted the presumption and shown the accounts were convenience accounts. *See* Resp. Prehearing Br. at 13-16. Significantly, Respondents argue that the presumption can only be rebutted by evidence that the parties did not intend to create a joint account, and it is clear that Lathen intended to create such accounts, as his investment model depended upon it. *See id.* at 16; Resp. Post-hearing Br. at 13.

New York law governs my evaluation of the effect of the participant agreements on the joint tenancies. *See* DX 314 at 3; DX 315 at 4; DX 323 at 5; DX 325 at 3; DX 346 at 3. And because the offering documents are governed by New York law, *see, e.g.*, DX 530 at 11, it follows that the joint tenancies themselves, which were created to comply with the offerings, should be evaluated under the same law.

In New York, and at common law, a joint tenancy is defined as "an estate held by two or more persons jointly, with equal rights to share in its enjoyment during their lives, and creating in each joint tenant a right of survivorship." *Island Fed. Credit Union v. Smith*, 875 N.Y.S.2d 198, 200 (App. Div. 2009) (quoting 24 N.Y. Jur. 2d Cotenancy & Partition § 16). A joint tenancy can be established in personal property, including investment accounts or securities. *See, e.g.*, *In re McKelway's Estate*, 116 N.E. 348, 348-49 (N.Y. 1917); *In re Estate of Corcoran*, 877 N.Y.S.2d 522, 524-25 (App. Div. 2009); *In re Lorch's Estate*, 33 N.Y.S.2d 157, 166-67 (Sur. Ct. 1941). It does not matter who provides the money for the account. *See Pinasco v. Ara*, 631 N.Y.S.2d 346, 347 (App. Div. 1995) ("[A] joint bank account vests in each named tenant a present unconditional property interest in an undivided one-half of the monies deposited, regardless of the source of the funds."); *Grishaver v. Grishaver*, 225 N.Y.S.2d 924, 931 (Sup. Ct. 1961) (evidence that one tenant "alone furnished the consideration for the acquisition of the property, held in their joint names, . . . is . . . consistent with the creation of such joint ownership"). As under common law, "[t]he continuance of the joint tenancy depends on the maintenance of the unities of title, interest and possession; and the destruction of any of these unities leads to a severance of

the tenancy, and to the creation either of a tenancy in common or of several tenancies." *Goetz v. Slobey*, 908 N.Y.S.2d 237, 239 (App. Div. 2010) (quoting *Loker v. Edmans* 197 N.Y.S. 857, 859 (App. Div. 1923)).

New York Banking Law § 675(a) provides for a statutory joint tenancy in the case of a joint account as follows:

> When a deposit of cash, securities, or other property has been made . . . in or with any banking organization . . . transacting business in this state, . . . in the name of such depositor or shareholder and another person and in form to be paid or delivered to either, or the survivor of them, such deposit or shares and any additions thereto made, by either of such persons, after the making thereof, shall become the property of such persons as joint tenants.

"When an account has been formed in accordance with the statute, and the 'survivorship' language appears on the account's signature card, a presumption arises that the parties *intended* to create a joint tenancy with rights of survivorship." *Corcoran*, 877 N.Y.S.2d at 524 (emphasis added). Courts will also presume that the depositor gifted one half of the deposit to the other joint owner for use during their joint lives. *See Silbert v. Silbert*, 255 N.Y.S.2d 272, 276 (App. Div. 1964), *aff'd*, 208 N.E.2d 783 (N.Y. 1965).

However, the presumption under the Banking Law may be rebutted by clear and convincing evidence of "fraud, undue influence, lack of capacity or, . . . that the accounts were only opened as a matter of convenience and were never *intended* to be joint accounts." *In re Estate of Grancaric*, 936 N.Y.S.2d 723, 726 (App. Div. 2012) (emphasis added). In determining whether an account was intended merely for convenience, courts look to the actions and statements of the parties surrounding the opening and management of the account. *See Corcoran*, 877 N.Y.S.2d at 525. Evidence typically supporting an intent to create a convenience account includes that the depositor supplied all the money for the account, made all investment decisions relating to the account, was the sole possessor of the checkbook for the account, and made all withdrawals from the account. *See Pinasco*, 631 N.Y.S.2d at 347. Other evidence of a convenience account may include that one party did not receive account statements and did not know what would happen to the account when the depositor died. *Corcoran*, 877 N.Y.S.2d at 525.

Convenience accounts usually fall into one of two categories. Perhaps the depositor merely wanted the convenience of having someone else manage the account due to age or illness, and therefore set it up as a joint account even

though he or she never intended to grant a present interest or right of survivorship. *See, e.g.*, *Brezinski v. Brezinski*, 463 N.Y.S.2d 975, 976-77 (App. Div. 1983); *In re Estate of Camarda*, 406 N.Y.S.2d 193, 196 (App. Div. 1978). Or, the depositor may have intended survivorship, but not to confer "a present beneficial interest" on the other party. *In re Friedman*, 478 N.Y.S.2d 695, 696-97 (App. Div.), *aff'd*, 475 N.E.2d 454 (N.Y. 1984); *Wacikowski v. Wacikowski*, 461 N.Y.S.2d 888, 888 (App. Div. 1983); *see Kleinberg v. Heller*, 345 N.E.2d 592, 594 (N.Y. 1976) (parties "do not usually intend" the "crucial fact that, from the moment of the creation of a joint account, a present unconditional property interest in an undivided one half of the moneys deposited devolves upon each tenant" (citing *In re Filfiley*, 313 N.Y.S.2d 793, 796 (Sur. Ct. 1970))). In such a situation, the depositor may have been trying to circumvent probate, and thought that one could make a testamentary disposition by creating a joint account indicating survivorship, which does not work without the intent to create a gift of present interest. *See Gruen v. Gruen*, 496 N.E.2d 869, 872 (N.Y. 1986) ("An inter vivos gift requires that the donor intend to make an irrevocable present transfer of ownership; if the intention is to make a testamentary disposition effective only after death, the gift is invalid unless made by will."); *In re Bobeck*, 531 N.Y.S.2d 340, 343 (App. Div. 1988); *see also Silbert*, 255 N.Y.S.2d at 276.

The "key underlying issue" to determining whether a valid joint tenancy exists is the depositor's "*intent* at the time that the account bearing [the other party's] name was created." *In re Estate of Stalter*, 703 N.Y.S.2d 600, 602 (App. Div. 2000) (emphasis added). The "distinguishing feature" of all the cases finding convenience accounts "is record evidence that the depositor in question did not *intend* to create a joint tenancy." *Id.* (emphasis added). This intent-based regime makes sense because disputes over joint accounts typically arise when it is unclear whether a deceased depositor intended the funds in the account to descend by survivorship or to be part of his or her estate. *See, e.g.*, *Corcoran*, 877 N.Y.S.2d at 523-24. Disputes can also arise when living accountholders disagree about what they intended when they opened the account. *See, e.g.*, *Phillips v. Phillips*, 419 N.Y.S.2d 573, 577-78 (App. Div. 1979). Because the intent of the parties is not readily knowable, a court must rely on circumstantial evidence surrounding the opening and managing of an account.

Lathen needed valid joint tenancies for his investment model to succeed. He certainly intended to create joint tenancies, and for this reason, it is hard

to call them convenience accounts.[17] Lathen's clear intent distinguishes all the cases cited by the Division. For example, in *In re Estate of Zecca*, 544 N.Y.S.2d 40, 41 (App. Div. 1989), the parties disputed whether the decedent intended to create true joint accounts, which would descend by survivorship, or convenience accounts, which would be part of the decedent's estate. The phrase "either to draw and the survivor" was stamped on the accounts in question, which established the presumption under the Banking Law that the accounts were intended as joint tenancies with the right of survivorship. *Id.* (capitalization altered). However, the phrase "2 signatures needed for withdrawal" was also present, which could indicate that neither party intended to give the other one a present gift of one half of the funds in the accounts. *Id.* at 41-42 (capitalization altered). The court held that the "2 signatures" language rebutted the presumption of joint tenancy, and "established that decedent, in placing the money in the bank accounts in his and petitioner's name, did not *intend* to make a present gift of one half of the funds." *Id.* at 42 (emphasis added). The court did not say that the "2 signatures" language is necessarily incompatible with a joint tenancy, only that when intent is disputed, the "2 signatures" language, without any evidence from the petitioner to the contrary, was evidence that no joint tenancy was intended when the account was opened. *See id.* at 41-42.

In fact, all the features distinguishing convenience accounts from true joint accounts in the case law go to intent, not to whether those features are actually inconsistent with the formation of a joint tenancy. *See, e.g.*, *Corcoran*, 877 N.Y.S.2d at 525. Thus, it does not matter that participants did not receive account statements or other account details, or that brokerage firms required signatures of both joint owners to withdraw funds. *See* Tr. 86, 1703; DX 237a at 3. Those "deficiencies" go only to Lathen's intent to set up joint tenancies—and Lathen intended to create them.

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[17] The Division argues that the fact that Lathen transferred money out of his account with Joy Davis when she survived longer than six months demonstrates he never intended to create a real joint tenancy. Div. Reply at 21; DX 510 at 1-2; Tr. 3556. However, I find it more likely that Lathen transferred the money from the account *because* he believed he had created a joint tenancy, and therefore in order to use those funds elsewhere, he had to sever the joint tenancy by emptying the account. *See* Tr. 3556.

1.5.2. Whether the participant agreements prevented the creation of valid joint tenancies is unsettled under New York law.

Although the Division has not rebutted the presumption under New York law that Lathen intended to create joint accounts, one could just as easily argue that this construction of "intent" is a semantic absurdity. To be sure, Lathen "intended" to create joint tenancies, but did he "intend" the participants to get the accounts through survivorship or to use the funds during their lifetimes? His investment model depended on neither of those things occurring. Respondents have not cited any cases where accounts similar to the ones Lathen set up were upheld as valid.

The validity of the joint tenancies here is thus a matter of first impression which should be decided by a New York court. But I must resolve the proceeding before me.

Although the cases surrounding the New York Banking Law focus on the intent of the parties, in the process of determining the parties' intent, New York courts have asked whether an account lacks one or both features of a common law joint tenancy—a right of survivorship and a conveyance of present interest in the funds to the joint account holder. *See Island Fed. Credit Union*, 875 N.Y.S.2d at 200 (a joint tenancy is "an estate held by two or more persons jointly, with equal rights to share in its enjoyment during their lives, and creating in each joint tenant a right of survivorship" (quoting 24 N.Y. Jur. 2d Cotenancy & Partition § 16)); *Zecca*, 544 N.Y.S.2d at 41 ("[A]t the time the account was opened, there must have been a present gift from the original donor to the cotenant of one half of the account which each could withdraw unilaterally while both were alive").

Thus, even if Lathen "intended" to create joint tenancies, a New York court might still consider whether in setting them up, he actually created a right of survivorship and gifted a present interest in the funds. *See Bobeck*, 531 N.Y.S.2d at 343; *Zecca*, 544 N.Y.S.2d at 41-42. If the participant agreements contradicted either of these two aspects, it may be that joint tenancies were not created, or were created and severed. In short, New York courts may hold that statutory joint tenancies created under Banking Law § 675 must retain the features of common law joint tenancies in order to be valid. Lathen used several different iterations of the participant agreement, and I will examine three under the IMA and two under the PSA and DLA. For each, I will consider whether it is more likely than not that Respondents failed to create joint tenancies.

The agreements with James McCord and Patrick McCord in May 2011 were the first agreements signed after the IMA and the creation of the

Partnership. DX 346 at 3; DX 347 at 3; *see* Tr. 3258. The McCord agreements place no restrictions on the right of survivorship. The agreements specifically noted that the funds would pass directly to Lathen upon the McCords' deaths, DX 346 at 1-2, DX 347 at 1-2, and the silence of the agreements and Lathen's testimony establish that the funds would have passed to the McCords if Lathen and any other joint owner (such as Jungbauer) predeceased them. Tr. 3260.

The agreements did contain the following restriction on the McCords' rights: "Participant agrees that he/she is not permitted to pledge, borrow against, withdraw or exercise any right of ownership with respect to the Investments or other assets in the Account(s) without the express written permission of Lathen, which permission may be withheld in Lathen's sole discretion." DX 346 at 1; DX 347 at 1. The Division maintains that this language, particularly the restriction on exercising "any right of ownership" is inconsistent with joint tenancy, because it shows Lathen never intended to give a present gift to the participant. *See* Tr. Closing Arg. 14. I disagree. There is a "well recognized" distinction "in the law of gifts as well as in real property law, between ownership and possession or enjoyment." *Gruen*, 486 N.E.2d at 853. "As long as the evidence establishes an intent to make a present and irrevocable transfer of title or the right of ownership, there is a present transfer of some interest and the gift is effective immediately." *Id.* The transfer is not considered an invalid testamentary disposition, even if "possession or enjoyment of the subject of the gift was postponed to some future time." *Id.*; *see Bobeck*, 531 N.Y.S.2d at 343 ("[A] grantor may make a gift of an ownership interest, while reserving to himself the right to a lifetime possessory interest").[18] Since Lathen intended to set up a joint tenancy, it is

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[18] Non-New York cases apply this distinction even more clearly to the joint tenancy context. In *Miller v. Riegler*, 419 S.W.2d 599, 604-06 (Ark. 1967), the Supreme Court of Arkansas upheld the creation of a joint tenancy in shares of stock even though the parties contracted that the dividends would only be retained by one of them, reasoning as follows:

> Joint tenants may agree between (or among) themselves as to the use to be made of the property. . . . And why should this not be permissible? Why should owners of property, real or personal, be prohibited from doing as they desire with the property, so long as the disposition is not for an immoral purpose, or against public policy?

(continued…)

reasonable to interpret the McCord agreements as granting a present right of ownership, but preventing any exercise of that right during Lathen's lifetime. In other words, Lathen reserved himself a life estate of use and possession, and granted a remainder interest to the participants at the time the agreement was signed, which is a valid *inter vivos* gift. *See Bobeck*, 531 N.Y.S.2d at 343; *see also Shybunko v. Geodesic Homes, Inc.*, 883 N.Y.S.2d 596, 598 (App. Div. 2009) (holding, outside the joint tenancy context, "[t]he mere fact that Daniel retained possession of the stock certificates and control over Geodesic's operation was not inconsistent with his intention to make a present transfer of a remainder interest in the stock, while reserving a life estate for himself").

The next version of the participant agreement, which was used in 2011, also placed no restrictions on survivorship, and it softened the restriction on participants' use of the account by removing the language prohibiting the exercise of "any right of ownership." *See, e.g.*, DX 325 at 2.[19] However, it still prohibited the participant's withdrawal of funds without Lathen's permission, and added the following significant modification: "you hereby authorize Lathen to make transfers of cash and securities into and out of the Account(s) without your prior consent, including to and from other accounts that Lathen and the Investors control." *Id.* at 1. This language is arguably problematic because the transfer of a remainder interest only creates a valid joint account if the gift is irrevocable. *Bobeck*, 531 N.Y.S.2d at 343. In *Bobeck*, the court held that because "the decedent had retained the right to alienate all the assets in the subject bank accounts during her life and this would include the right to transfer ownership of such assets to a third party . . . the money in the several bank accounts at issue, was not irrevocably transferred by the decedent to any person at any time during her life," and "no gift was made." *Id.* Thus, it is possible that Lathen's ability to alienate the funds in the account without participants' consent, coupled with participants' restricted use of the funds, prevented the creation of a joint tenancy.

The third version of the participant agreement, used from November 2011 until January 2013, was the most restrictive. Tr. 3271-72, 3274. Not only did it restrict participants' use of the funds and allow Lathen to transfer

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See also Tindall v. Yeats, 64 N.E.2d 903, 906-07 (Ill. 1946) ("Joint tenants may contract with each other concerning the use of the common property, such as for the exclusive use of the property by one of them.").

[19] There was another version of the participant agreement used earlier in 2011 as well, but the differences between it and the other versions are not significant to the current analysis. *See* Tr. 3262-71.

them in and out without their consent, it also limited participants' right of survivorship. The agreement provided as follows:

> In the event that Lathen and the Designees should pre-decease the Participant, Participant, or if applicable, Participant's estate hereby agree to cooperate with Investors or their designated agent to liquidate the Account(s). Once liquidated, any funds contributed by Investors to the Accounts would be returned to them. The remaining value in the Account(s), if any, would then be divided 95% to Investors and 5% to Participant or their estate.

DX 314 at 2. One could argue that this restriction prevented the creation of a joint tenancy because it essentially eliminated the participant's right of survivorship. At least one out-of-state case supports the idea that a restriction in a side agreement inconsistent with survivorship will sever a joint tenancy. *See McDonald v. Morley*, 101 P.2d 690, 692 (Cal. 1940) ("[B]y their contract the parties specifically provided that if either one of them died, the interest of that one should not go to the survivor but to the daughter. This is entirely inconsistent with an estate in joint tenancy, which was thereby terminated."). *But see Riley v. Turpin*, 301 P.2d 834, 835 (Cal. 1956) (limiting *McDonald* to situations where parties attempt to create a joint tenancy "in the entire estate," and allowing parties to create a joint tenancy "of a life estate only, based upon the life of the survivor of the two parties").

On the other hand, one could interpret the participant agreement as acknowledging survivorship and merely contracting around it. There is support for this view in New York law. In *Ehrlich v. Wolf*, No. 113413/10, 2011 N.Y. Misc. LEXIS 630 (Sup. Ct. Jan. 11, 2011), there was a dispute over an account opened by the decedent and a Mr. Wolf. The estate of the decedent submitted an agreement in which Wolf agreed to transfer the balance of the joint accounts to the estate upon decedent's death. *Id.* at *4. The trial court found that this agreement was not enough to rebut the presumption under the Banking Law that the account was held in joint tenancy with the right of survivorship, but that it raised questions of fact regarding Wolf's obligation to turn over the funds remaining in the account. *Id.* at *6. Thus, it could be that parties to a joint tenancy may separately contract to limit one party's survivorship rights without severing the joint tenancy. According to this approach, one could interpret the participant agreement as acknowledging participants' right of survivorship, but separately requiring them to agree to give up the funds.

Respondents started using a fourth version of the participant agreement in February 2013 after signing the DLA and PSA in January 2013. DX 72, 190, 193, 332; *see* Tr. 3332-33, 3336-37. This agreement removed restrictions on participants' use and withdrawal of the funds, and "removed the 95/5 language" regarding survivorship. Tr. 3333-34. Although it retained restrictions on participants' receipt of income from the securities during the life of the joint tenancy, that is likely a permissible restriction. DX 315 at 1-2; *see Bobeck*, 531 N.Y.S.2d at 343; *Miller*, 419 S.W.2d at 604-06 (joint tenancy not affected by agreement restricting one tenant's right to share in dividends). The participant agreement now stated that the account would "be pledged to secure a loan" provided by the Partnership to finance the purchase of the investments in the account. DX 315 at 2. In the event Lathen predeceased the participant, the Partnership could liquidate the account to satisfy the investment loan. *Id.* But this does not necessarily interfere with the joint tenancy either. Although one New York trial court found that a tenant's placement of a lien on a joint bank account severed the joint tenancy, that was because the tenant acted unilaterally. *See In re Hoffman's Estate*, 25 N.Y.S.2d 339, 342 (Sur. Ct. 1940) ("In securing the debt with the pledged property he indicated an intention to reduce the funds pledged to his separate possession and thus destroy the joint estate with respect thereto. The fact that he did not actually withdraw the funds from the savings account does not make the severance less real."). The situation here is instead akin to the agreement of all tenants to mortgage a property, which jurisdictions outside New York have held does not sever the joint tenancy. *Accord Estate of Kotz*, 406 A.2d 524, 532 (Pa. 1979) ("The mortgage by the joint tenants with right of survivorship does not destroy any of the 'unities' and it contrasts to the unilateral actions of one tenant this Court has deemed sufficient to destroy the necessary unities."); *Ill. Pub. Aid Comm'n v. Stille*, 153 N.E.2d 59, 63-64 (Ill. 1958) ("Where both joint tenants join in the mortgage, however, it has been assumed that there is no severance and that when the mortgage is released, the joint tenancy continues unimpaired."). Thus, the participant's obligation to pay back the investment loan likely did not conflict with the right of survivorship.

The fifth participant agreement was rolled out in February 2015. Tr. 3335-36. It built upon the fourth agreement, and more explicitly maintained all features of a joint tenancy. For example, it stated, "[i]n the event that Lathen predeceases the Participant, the Account(s) will pass to the Participant by operation of law and will not be part of Lathen's estate." DX 323 at 2. It also explicitly referenced the parties' intent to create a valid joint tenancy and not a convenience account, and provided that the account agreement trumps the participant agreement in case of a conflict. *Id.* at 5.

There is nothing in this final version of the participant agreement that appears to be inconsistent with a joint tenancy.[20]

In conclusion, whether Respondents created valid joint tenancies is an unsettled matter of New York law. My inclination is that the two McCord participant agreements and the agreements used during the DLA and PSA period did not interfere with the joint tenancy. The later two agreement templates used during the IMA period may have prevented the successful creation of a joint tenancy. But any conclusion would be speculative in this proceeding, and in any event, as discussed below, I am convinced that Lathen had a sincere good faith belief that each version of the participant agreement created valid joint tenancies. *See infra* Law Section 1.6.

1.5.3. Whether Lathen's agreements with the Partnership prevented the creation of valid statutory joint tenancies is unsettled under New York law.

I turn now to the question of whether the IMA, DLA, and PSA themselves prevented the joint tenancies' creation by interfering with Lathen's ownership of the securities. The Division argues that the IMA invalidated the joint tenancies because it provided that the Partnership owned the accounts, not Lathen, and an entity cannot be a joint tenant. Div. Reply at 19. The Division further argues that in any event, Lathen did not own the joint accounts in any meaningful fashion, as he disclaimed all beneficial interest in them in the IMA. Div. Post-hearing Br. at 5.

An entity or corporation cannot enter into a joint tenancy. *See Island Fed. Credit Union*, 875 N.Y.S.2d at 200 ("As a general principle '[j]oint tenancies are typically confined to natural persons.'" (quoting 24 N.Y. Jur. 2d Cotenancy & Partition § 18) (alteration in original)). Therefore, the first issue

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[20] The Division argues that even after the changes to the participant agreement due to the DLA and PSA, each participant signed a power of attorney which allowed Lathen to, among other things, "transfer funds into and out of such accounts," *see, e.g.*, DX 315 at 7, which effectively prevented participants from having any real access to the accounts. Div. Prehearing Br. at 13, 27 n.12. This argument is unpersuasive because nothing restricts any joint tenant from using a power of attorney to allow someone else to manage their account. The other joint tenant may even be the most likely designee. In his position as having power of attorney, Lathen was not acting for himself, but for the participants, which does not conflict with his grant of survivorship or present interest.

is whether Lathen or the Partnership owned the account; if the latter, no joint tenancy was established.

It is clear that Lathen held title to the accounts. He filed the papers to open them, his name was on them, and he applied to the broker to redeem them. The IMA expressly authorized Lathen to open the accounts and hold right and title to them. DX 191 at 2. The fact that Lathen did so as the Partnership's "nominee" does not mean that the entity rather than Lathen entered into the joint tenancy. Rather, the entity authorized Lathen to enter into the joint tenancies as its agent. *Id.* ("[T]he Nominees . . . shall further be authorized to purchase [survivor's option] Investments . . . and establish joint accounts with Participants"). Reinforcing this understanding of the IMA, Lathen acknowledged in an email to a researcher for potential investors in the Partnership that although he was a nominee of the Partnership, the Partnership did not hold title to the accounts. DX 107 at 5 ("An entity cannot be a tenant on a [joint tenancy]. There is no statutory prohibition against *nominee* ownership of a [joint tenancy], whether as nominee for [ ] an individual owner or an entity owner."); Tr. 889.

The second issue is Lathen's explicit disclaimer of beneficial ownership, which is more complex. The IMA provided that the nominee "has no legal or beneficial interest" in the survivor's option investments. DX 191 at 2. Lathen was to hold the account "and all right, title and interest therein and benefit to be derived therefrom, as nominee for and on behalf of the Partnership only." *Id.* And, "[a]ll other attributes of the beneficial ownership of the [survivor's option] Investments shall be and remain in Partnership." *Id.*[21]

There is no case law addressing a joint account in which the depositor had no beneficial interest. Depositors do not typically open such accounts. A depositor's lack of beneficial ownership might be inconsistent with conferring "a present beneficial interest" on the other joint tenant. *Friedman*, 478 N.Y.S.2d at 696. One cannot give something they lack. If that is the case, then the IMA may not have allowed Lathen to create valid joint tenancies. This is perhaps the most straightforward reading of the IMA and its effect.

However, there is another possible interpretation of the document. Lathen, as nominee and agent for the Partnership, was arguably authorized to confer a beneficial interest on the Partnership's behalf. The Partnership intended to "establish" valid joint tenancies, just as surely as Lathen did, and "authorized" Lathen to do so. DX 191 at 2; *see* DX 366 at 17. That

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[21] This clause appears to be mere surplusage; the prior clauses already reserved beneficial ownership for the Partnership.

authorization would be meaningless if he were unable to convey the necessary interest to participants. Additionally, limitations placed on participants' receipt of the proceeds from the bonds and on their exercise of any "right of ownership" belie their lack of interest in the account. *E.g.*, DX 314 at 1-2; DX 325 at 1-2; DX 346 at 1. Lathen's power to convey a beneficial interest under the IMA is therefore ambiguous.

The DLA and PSA arrangement is not ambiguous, and appears to have preserved Lathen's beneficial interest in the accounts. Under the DLA, the Partnership provided Lathen with loans to finance Lathen's purchase of the securities held in the joint accounts. DX 190 at 2. Lathen was a real owner of the accounts, and therefore he was able to grant a present beneficial interest to the participants as well. The joint accounts were pledged as collateral for the loan, *see id.* at 3, 11-12; DX 72 at 1; DX 945 at 10-11, but, as explained in the prior section, a joint account with a lien on it is likely still a valid joint account, particularly if the lien is agreed to by both tenants. *Accord Kotz*, 406 A.2d at 532; *Stille*, 153 N.E.2d at 63-64. And the fact that Lathen assigned all profits and losses from the accounts to the fund does not appear to interfere with his or participants' ownership of the accounts. DX 72 at 2; *see* Div. Post-hearing Br. at 4-5. Because of the loan, Lathen beneficially owned the money used to create the account and could grant an interest in it to participants, regardless of where the profits went. The DLA and PSA regime likely allowed for the creation of valid joint tenancies.

1.6. The Division has not established that Respondents had a culpable state of mind.

1.6.1. Respondents did not act with scienter.

Thus far I have discussed the central legal issues presented—the offering documents' requirements regarding beneficial ownership and the validity of the joint tenancies. In sum, even if some of the issuers intended to require a type of beneficial ownership that participants lacked, the offering documents are ambiguous. Additionally, it is arguable, although far from clear, that some of the joint tenancies were invalid. But New York law is unsettled on this point. Thus, Lathen's representations of their validity to issuers were not necessarily false at the time he made them. Nonetheless, because the law is unsettled, and the side agreements would have been material to issuers' decisions on how they wished to proceed, Respondents' decision not to disclose the side agreements may have been a materially misleading omission.

However, misrepresentations and omissions are not fraudulent unless Respondents acted with scienter, which is a mental state consisting of an

intent to deceive, manipulate, or defraud. *Ernst & Ernst*, 425 U.S. at 193 n.12. Scienter may also be established by recklessness—"an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the [actor] or is so obvious that the actor must have been aware of it." *David Henry Disraeli*, Securities Act Release No. 8880, 2007 WL 4481515, at *5 (Dec. 21, 2007) (alteration in original) (quoting *SEC v. Rubera*, 350 F.3d 1084, 1094 (9th Cir. 2003)), *petition for rehearing denied*, 334 F. App'x 334 (D.C. Cir. 2009)).

The Division argues that Respondents demonstrated scienter because they knowingly submitted their redemption requests without disclosure of the side agreements, consciously withholding information relevant for the issuers to evaluate their claim. Div. Post-hearing Br. at 10. The Division also argues that Lathen has not established a valid advice of counsel defense because he hid facts from counsel, did not seek advice on his disclosure obligations, and did not fully follow advice he received. Div. Reply at 2-12. Respondents respond that Lathen relied in good faith on the advice of his counsel. Resp. Post-hearing Br. at 20-21. No attorney ever advised Lathen that he would be making a false statement by representing himself as a surviving joint tenant without further disclosures. *Id.* at 22.

Respondents are correct. They were attempting to legally utilize a loophole in the issuers' offerings, and did not knowingly mislead issuers in failing to disclose the side agreements. Lathen believed, based on his attorneys' advice, that he had created valid joint tenancies and did not need to make additional disclosures. As demonstrated above and below, Lathen consulted with his lawyers on nearly every aspect of his investment model, and they drafted many of the documents that the Division argues undermined the joint tenancies. When Lathen made changes to the documents, he likewise consulted with his attorneys. And although Lathen consciously withheld the side agreements from issuers, he was advised by his attorneys that he did not need to disclose them in pursuit of his strategy. I do not need to make a formal finding that Respondents established an advice of counsel defense, because Lathen's interactions with his attorneys demonstrate he did not knowingly or recklessly mislead issuers. *See Howard v. SEC*, 376 F.3d 1136, 1147 (D.C. Cir. 2004) ("[R]eliance on the advice of counsel need not be a formal defense; it is simply evidence of good faith, a relevant consideration in evaluating a defendant's scienter.").

Eric Roper and a colleague from Gersten Savage drafted the IMA. Tr. 168-69, 2207-14. Roper knew that Lathen's investment model was dependent on the creation of valid joint tenancies. *See* Tr. 2234-35. Lathen believed that he had created valid joint tenancies and that, despite the language in the IMA, he had a beneficial interest in the accounts. Tr. 171-72, 175. Lathen did

not think his attorneys would have drafted the IMA in a way that undermined the joint tenancies. Tr. 180.

The same is true for the participant agreements. The lawyers at Katten Muchin, who advised Lathen on his investment model before the creation of the Partnership and had input into the early participant agreements, believed Lathen had established valid joint tenancies. Tr. 2441, 2444; *see* DX 691 (Katten Muchin October 9, 2009, comments on draft agreement); DX 735 (Katten Muchin memo on joint tenancies). Lathen did not recall whether he or Roper drafted the part of the agreement which limited the participants' survivorship rights with the "95/5 split," but Lathen testified that at the very least, he showed it to Roper. Tr. 3275. Roper drafted or was shown earlier versions of the agreement also, which contained language limiting participants' use of the funds and allowed Lathen to move funds in and out of the accounts without participants' permission. *See* RX 1325; Tr. 2223-25, 3261, 3263. Roper knew how central the joint tenancies were to Lathen's investment model, but never pointed out any problems with the agreements he saw. Lathen had little reason to believe that the provisions limiting participants' rights, which had been looked at by Roper and attorneys at Katten, prevented the creation of valid joint tenancies.

The fact that Lathen continued to redeem joint accounts that were created under the IMA after Farrell from Hinckley Allen advised him of its potential problems does not change my analysis. *See* Tr. 3563; Div. Prehearing Br. at 31-33. Although Farrell thought it was "questionable" whether the IMA allowed for the creation of valid joint tenancies, Tr. 2623, she never told Lathen "to stop" using it. Tr. 2625. She had "concerns" about the validity of the joint tenancies under the IMA, thought that "issuers would not like it," and noted that there was regulatory risk—although it "wasn't clear what parts [the regulators] didn't like." Tr. 2621; *see also* DX 744 at 1 (Farrell, in an email to another attorney, notes that with the structure in the IMA, "there will be a lot of uncertainties"). Yet Farrell's concerns are hardly a declaration of illegality. The IMA had been drafted by Roper, who was also an attorney and was aware of Lathen's investment model and the importance of the joint tenancies. And Lathen continued to believe his earlier joint tenancies were valid even after Farrell's advice, and thought Farrell agreed. Tr. 3567-68, 3683. Therefore, it is still hard to say that Lathen's continued redemption of IMA accounts without additional disclosures was knowing or reckless.

Lathen's attorneys also advised him that he did not need to disclose the side agreements to issuers, or at the very least, believed he did not need to. Flanders from Hinckley Allen advised Lathen to provide "whatever the brokers were requiring or the issuers were requiring as a precondition to

honoring the redemption requests. But no more." Tr. 2037. Lathen testified that Roper never told him to provide additional disclosures to the issuers, and that he understood Roper would have told him to do so if necessary. Tr. 651-52.

Nor did pushback from a few issuers alter Respondents' state of mind. Aside from the advice that they were receiving from counsel, Respondents knew that even after learning about the side agreements, some issuers continued to redeem the survivor's option bonds. Tr. 1676; *see* DX 481, RX 1970; *see also* Tr. 3407-08 (over thirty issuers continued to redeem after learning that the agreements were financed by a fund). Lathen also learned that some state and federal regulators and law enforcement officers concluded that there was nothing illegal or fraudulent about the Staples's similar investment scheme. *See* RX 1557 at 11968-69; Tr. 866, 870-71. And Lathen's awareness that suing issuers to compel them to honor his redemptions could "alert other issuers to [his] strategy and cause them to tighten up the loopholes in their docs" did not mean that he knew or was reckless in disregarding the materiality of the other agreements under the terms of the offering documents as he understood them. DX 481 at 1; *see* Tr. 339, 342. Instead, it reinforces that Lathen understood that he was using a *currently* viable contractual loophole that the issuers were fully capable of eliminating from future offerings—which is precisely what happened. *See* SFOF ¶ 98; RX 1433; RX 2016 at 15870; Tr. 564, 1921-25, 2913-16.

In sum, I cannot find scienter if Respondents did not intend to deceive, manipulate, or defraud, and were not reckless. On the facts before me, Respondents knew exactly what they were doing, but honestly believed that they had found a legal loophole. Respondents had no fiduciary duty to the issuers, and there is nothing inherently illegal or deceptive about utilizing such a loophole in an arms-length transaction. Lathen worked with counsel to establish what he believed were valid joint tenancies to take advantage of the loophole. The fact that Lathen knew that some issuers and regulators took issue with his strategy is a far cry from saying he knew or believed that it was an illegal one. It is true that the side agreements may have been material to issuers' decisions to redeem or refuse to redeem the bonds, and Lathen had a duty to speak fully and truthfully when he communicated with issuers. Nonetheless, he believed he was telling the truth about the validity of the joint tenancies, and was advised he did not need to make additional disclosures. Therefore, the Division has not proven that Respondents acted with scienter.

1.6.2. The Division has not identified the appropriate standard of care or otherwise proved that Respondents acted negligently.

Respondents are also charged with violations of Section 17(a)(2) and 17(a)(3), which can be established if a respondent acted with negligence. *See Ira Weiss*, 2005 WL 3273381, at *12. "Negligence is the failure to exercise reasonable care." *Id.* (citing *SEC v. Hughes Capital Corp.*, 124 F.3d 449, 453-54 (3d Cir. 1997)).

The Division has the burden to establish negligence, but its presentation assumed scienter. *See* Resp. Post-hearing Br. at 24-25. The Division mostly argues in its briefs that because Respondents acted with scienter, the requirements for negligent conduct are also met. Div. Prehearing Br. at 19; Div. Post-hearing Br. at 17-18. Likewise, the Division put on no evidence at the hearing defining the standard of care Lathen should have followed when communicating with issuers or what would have constituted its breach. Although "reasonable prudence" and "reasonable care" might be easy enough to measure in a garden-variety securities fraud case, this case is anything but simple. Courts of appeals have held that the Division cannot meet its burden of proof when it fails to provide evidence of the standard of care and its breach. For example, in *SEC v. Ginder*, 752 F.3d 569, 576 (2d Cir. 2014), the Second Circuit found that the Division "ultimately succumb[ed] to its strategic choice." The court reversed the jury verdict and remanded with instructions to dismiss the complaint, explaining,

> as to negligence, the SEC never introduced testimony or any other evidence on the appropriate standard of care against which a jury could measure [the defendant's] conduct. "[T]he SEC's failure to present any evidence that [the defendant] . . . violated an applicable standard of reasonable care was fatal to its case."

Id. (alterations in original) (quoting *SEC v. Shanahan*, 646 F.3d 536, 546 (8th Cir. 2011)). The Division has made a similar choice here.

On reply, the Division argues for the first time that Lathen testified to the applicable industry standards of care—"honesty, integrity and professionalism"—which are found in EACM's code of ethics. Div. Reply at 18. According to the Division, Lathen negligently fell short of these standards by failing to disclose the side agreements, deflecting questions from issuers, and lying to his lawyers. *Id.* Respondents argue, however, that these new arguments about negligence are impermissible on reply, and, in any event, the Division has not established how a reasonably prudent person would have acted differently than Lathen did. Resp. Reply at 14-16.

Without deciding the permissibility of the Division's new arguments, they do little to demonstrate that Lathen acted negligently. Although honesty, integrity, and professionalism should govern nearly all human interaction, there is little evidence in the record to support the Division's assertion that they constitute the relevant standard of care here. Furthermore, I find that Lathen acted with a good faith belief in pursuing a legal strategy; throughout his operation, he continued to honestly believe that he had created valid joint tenancies in consultation with his attorneys and that he did not need to disclose anything more to issuers. For many of the same reasons that the Division has not proven scienter, it also has not proven negligence. Lathen's attorney drafted the IMA, and the participant agreements were also drafted by attorneys or in consultation with them. Lathen's attorneys advised him that he only needed to disclose to issuers what they explicitly specified in the offerings. Given these facts, it would be hard to say that Lathen acted unreasonably in communicating his redemption requests to issuers even if the Division had established the standard of care. Absent evidence of such a standard, I find that Respondents did not act negligently.

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For all of these reasons, the Division has failed to prove that Respondents violated the antifraud provisions of the Securities Act or the Exchange Act. There is nothing necessarily illegal about using, or even exploiting, a contractual loophole. There is also nothing illegal about profiting from the death of the terminally ill, even if some might view it as unsavory. Even if Respondents' actions are within the purview of the securities laws because they failed to disclose material information to issuers, the Division has not demonstrated they had any intent to defraud, and no standard of care was otherwise established. If, in fact, Respondents' joint tenancies were invalid, the issuers' remedy may lie in a lawsuit for breach of contract.

2. Alleged Custody Rule Violation

EACM is also charged with violating the Advisers Act custody provisions in Rule 206(4)-2, and Lathen is charged with aiding, abetting, and causing EACM's violation. OIP at 9-11.

Advisers Act Section 206(4) prohibits an investment adviser from "engag[ing] in any act, practice, or course of business which is fraudulent, deceptive, or manipulative" and authorizes the Commission to promulgate rules to further prevent violative behavior. 15 U.S.C. § 80b-6(4). Rule 206(4)-2, the custody rule, governs the required procedures for investment advisers who have custody of their clients' funds or securities. 17 C.F.R. § 275.206(4)-

2. In relevant part, the rule prohibits an investment adviser "to have custody of client funds or securities unless" they are maintained by a qualified custodian "[i]n a separate account for each client under that client's name" or "[i]n accounts that contain only [the adviser's] clients' funds and securities, under [the adviser's] name as agent or trustee for the clients." 17 C.F.R. § 275.206(4)-2(a)(1)(i)-(ii).

The rule requires that advisers put in place a "robust set of controls over client assets . . . to prevent those assets from being lost, misused, misappropriated or subject to advisers' financial reverses." Custody of Funds or Securities of Clients by Investment Advisers, 75 Fed. Reg. 1456, 1457 (Jan. 11, 2010) (codified at 17 C.F.R. §§ 275.204-2, .206(4)-2). An adviser has custody of client assets if it holds, directly or indirectly, client funds or securities, or if it has the authority to obtain possession of them. 17 C.F.R. § 275.206(4)-2(d)(2). "Lack of intent is no defense" to a custody rule violation. *Abraham & Sons Capital, Inc.*, Exchange Act Release No. 44624, 2001 WL 865448, at *8 n.28 (July 31, 2001).

The OIP alleges, and the Division argues, that the Partnership was EACM's client, EACM had custody of its assets, and the joint accounts were "client funds or securities" because they belonged to the Partnership. The joint accounts were titled to Lathen and the participants, not the Partnership. Therefore, according to the Division, from October 2012 through February 2016—the period that EACM was registered with the Commission—EACM violated the custody rule by failing to hold the joint accounts in the Partnership's name, or in EACM's name as a trustee or agent for the Partnership. OIP at 10-11; Div. Post-hearing Br. at 19-20.

Respondents do not dispute that the Partnership was EACM's client or that EACM had custody of the Partnership's assets. Resp. Post-hearing Br. at 26 n.6. Respondents argue, however, that the joint accounts were not "client funds or securities," and therefore did not need to be held in accordance with the custody rule. *Id.* at 26.

2.1. Respondents did not violate the custody rule because the joint accounts were not client funds.

To determine whether there was a violation of the custody rule, I must consider the language of the side agreements that governed the joint accounts—the IMA until January 2013, and the DLA and PSA thereafter. The agreements do not demonstrate that the joint accounts should be considered client funds for the purposes of the custody rule.

The analysis under the DLA and PSA is straightforward. Lathen borrowed money from the Partnership to establish joint accounts. DX 190 at

2; *see also* DX 183-88. Lathen and the participants owned those accounts in their individual capacities. The Partnership was entitled to profits from the accounts under the PSA, but the accounts themselves were not the property of the Partnership. DX 72 at 2. The Partnership owned only a right to repayment of the loans evidenced by a promissory note, as well as a security interest in the joint accounts as collateral. *See* DX 193 (promissory note); DX 945 at 10-11 (security agreement). It is true that functionally, Lathen, who controlled EACM, also had control over the joint accounts. But to say the accounts then belonged to the Partnership would ignore the contractual structure set up by Respondents.[22]

The analysis under the IMA is more complex. It is true that it provided the Partnership with a beneficial interest in the joint accounts. DX 191 at 2 ("All other attributes of the beneficial ownership of the [survivor's option] Investments shall be and remain in [the] Partnership."). But, as noted earlier, the IMA is an ambiguous document. It is not clear what type of ownership was obtained by Lathen and what precisely was reserved for the Partnership. *See supra* Law Section 1.5.3. It is clear, however, that Respondents intended the IMA to be a profit-sharing agreement—much like the later PSA—and that their investment model was dependent on the Partnership not owning the money or having any direct interest in the joint accounts until their disposition. *See* Tr. 173 (Lathen testified that the IMA reflected the "understanding between the parties where I would be assigning my profits in the accounts to the fund" and that he wanted its language to accomplish "sharing profits with the fund while maintaining the validity of the joint tenancies"). The Partnership did not consider the funds or securities in the joint accounts its money and did not want them to be. Any interpretation of the IMA that would place the joint accounts within the scope of the custody rule would therefore be contrary to the client Partnership's intent.

Functionally, the Partnership had no access to the accounts. They were brokerage accounts titled to Lathen, participants, and sometimes Jungbauer. *E.g.*, DX 124-29 (account applications and account statements); *see* DX 191 at 2 (establishing that Lathen held title to the accounts as a nominee). Because

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[22] The Division argues that, as a matter of policy, an adviser should not be allowed to loan assets to himself or herself in an individual capacity to get around the custody rule. Div. Post-hearing Br. at 22. But one could just as easily contend that the Commission never intended the custody rule to reach an investment model such as this one, which was agreed to by the client, and depended on a person holding the money in their individual capacity.

of this, as Respondents point out, there is no evidence that brokers would have accepted trade requests from the Partnership, and the Partnership had no ability to withdraw money from the accounts. *See* Resp. Post-hearing Br. at 27. The Partnership's inability to access the funds or securities is at odds with it owning them for the purposes of the custody rule. Although a prior version of the custody rule would have reached "any funds or securities in which any client has any beneficial interest," 17 C.F.R. § 275.206(4)-2(a) (2002), that language was removed in 2003. There is no indication that the Commission intended the current version of the rule to be so broad in scope to reach situations where *the client itself* privately contracts to have funds held in the name of third parties in furtherance of its investment model. *See* Custody of Funds or Securities of Clients by Investment Advisers, 67 Fed. Reg. 48,579, 48,590-91 (proposed July 25, 2002) ("proposing comprehensive amendments" to the custody rule because it had not been amended "substantively" in "over forty years" and "portions of the rule have become outdated or inconsistent with modern custodial practices"); *cf. Winter v. Miller*, 676 F.2d 276, 280 n.4 (7th Cir. 1982) (refusing to assume that amendment to regulation "was intended to [simply] clarify rather than change its meaning," where "[t]he regulation [was] silent on this point").

Moreover, the statutory basis of the custody rule does not support a finding of liability. The custody rule is promulgated under Section 206(4) of the Advisers Act, which prohibits fraudulent, deceptive, or manipulative acts. 15 U.S.C. § 80b-6(4). The investment model contemplated by the client Partnership—that the joint accounts be held by Lathen and the participants—seems far from a fraudulent, deceptive, or manipulative act by EACM against the client. *Accord Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945) (recognizing that "[t]he intention of Congress . . . may be relevant in the first instance in choosing between various constructions" of a regulation). The client did not want the accounts to be in its name precisely because the investment model depended on that arrangement. A finding for the Division would subvert the client's contracted-for investment arrangement to an interpretation of the custody rule that usurps client judgment on how assets should be classified. For these reasons, the joint accounts were not "client funds or securities" for the purposes of the custody rule.

2.2. Statements on EACM's Forms ADV and in other documents are not dispositive of the custody rule issue.

The Division also argues that Respondents themselves considered the joint accounts to be assets of the Partnership in EACM's Forms ADV, and that indicates they were client funds. OIP at 10; Div. Post-hearing Br. at 21-22. Each of EACM's Forms ADV stated that EACM had custody of client

funds, and the dollar amount of those funds in custody ran between $12 and $44 million. *See, e.g.*, DX 1 at 35; DX 6 at 33. It is undisputed that at least some of the time that number included the value of the joint accounts. *See* Tr. 354-55, 358.[23]

But this is not dispositive. The fact that EACM's Forms ADV sometimes stated that the company had custody of the funds in the joint accounts does not mean it did. I cannot hold Respondents to their statements in the Forms ADV if they mischaracterized the actual legal arrangement.[24] If the accounts actually belonged to Lathen and participants, and not the Partnership, then EACM did not have "[c]ustody" as defined by Rule 206(4)-2(d)(2), 17 C.F.R. § 275.206(4)-2(d)(2).

For the same reason, Lathen's treatment of the joint accounts in Partnership financials and on his tax returns is irrelevant. *See* Div. Post-hearing Br. at 21-22; Resp. Post-hearing Br. at 29 & n.11. Similarly irrelevant is the Partnership's payment of the brokerage and clearing charges for the joint accounts. *See* Div. Post-hearing Br. at 22. The question is not whether Respondents sometimes claimed the joint accounts were owned by the Partnership, but whether they actually were.

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[23] As noted above, *supra* Facts Section 3.2.1, Lathen testified that in the Forms ADV before 2014 he only included the "equity" in the [Partnership] as client funds in custody, but not the "margin" amounts in the joint accounts. Tr. 349-50. He further explained that he always included the value of the joint accounts as "regulatory assets under management," even though he believed they were not owned by the Partnership, because of advice he received from counsel providing an expansive definition of the term. Tr. 348; *see* DX 491. Lathen admitted, however, that starting in 2014, he included the entire value of the joint accounts as client funds in custody on EACM's Form ADVs. Tr. 352, 354-55, 358.

[24] If EACM did not have custody of the joint accounts, then Lathen and EACM may have made untrue statements in the Forms ADV; however, they are not charged with a violation of Advisers Act Section 207. *See* 15 U.S.C. § 80b-7 (prohibiting the willful making of any untrue statement of a material fact or omission of any material fact in a Form ADV). In any event, it is not clear from the record that Respondents acted dishonestly; their representations were at least in part informed by legal advice that Lathen received at the time. *See* Tr. 348-49.

2.3. The promissory note securing the loans under the DLA was not subject to the custody rule.

The Division argues in the alternative that even if the joint accounts under the DLA and PSA were not client funds, the Partnership owned a right to repayment of the loans it made. Div. Post-hearing Br. at 22-23. Those loans were secured by a promissory note, which the Division contends was a security of the Partnership that should have been held by a qualified custodian because the exemption for uncertificated funds did not apply. *Id.*; *see* 17 C.F.R. § 275.206(4)-2(a)(1), (b)(2)(i). According to the Division, EACM's failure to do so violated the custody rule.

The OIP does not allege that the promissory note was a security of the Partnership that should have been held by a qualified custodian. Rather, the OIP alleges that the EACM's failure to hold the joint accounts in the name of the Partnership or in its own name as trustee or agent for the Partnership violated the custody rule. OIP at 10, 11. Thus, it does not appear the Division's argument is within the scope of the OIP, and it could be rejected on this basis alone. *See Russell W. Stein*, Exchange Act Release No. 47504, 2003 WL 1125746, at *8 n.34 (Mar. 14, 2003), *granting mot. for reconsideration on other grounds*, Exchange Act Release No. 50168, 2004 WL 1778889 (Aug. 9, 2004). Because, however, Respondents do not argue that they lacked notice of the charge, and, indeed, had an opportunity to address the argument at the hearing, I proceed to the merits of the Division's claim. *See* Tr. 3675-77.

Yet the substance of the Division's argument also lacks merit. The Advisers Act defines "security," in part, as "any note" or "evidence of indebtedness." 15 U.S.C. § 80b-2(a)(18). Both terms could apply to the promissory note. However, "the terms mentioned are not to be considered securities if 'the context otherwise requires.'" *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982) (quoting 15 U.S.C. § 78c(a)(10)); *see also Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (in interpreting the term "security," "form should be disregarded for substance and the emphasis should be on economic reality").[25]

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[25] The case law defining security relates to the definitions found in the Securities Act and the Exchange Act. Nonetheless, there is no reason why identical terms in the definitions should not be interpreted in the same fashion. *See Fund of Funds, Ltd. v. Vesco*, No. 74 Civ. 1980, 1976 WL 800, at *7 (S.D.N.Y. July 12, 1976) ("As the statutory definition of a security in the Investment Advisers Act, 15 U.S.C. § 80b-2(a)(18), is identical to that of the Securities Act of 1933, our conclusion that the notes are securities within the

(continued...)

Even assuming that the profit-sharing arrangement under the DLA and PSA constitutes a security, *see* 15 U.S.C. § 80b-2(a)(18) (definition of security under Advisers Act includes "participation in any profit-sharing agreement" or an "investment contract"); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946) (defining investment contract), the promissory note alone is not.

Not every piece of paper associated with a security is itself a security. The note does not evidence or embody the entire investment arrangement. It does not reference the PSA and provides only a right of repayment to the holder. On its face, it merely evidences an arms-length lending transaction.

This is borne out by application of the Supreme Court's four-part test for determining whether a "note" is a security. If, based on the application of four prongs, a particular note bears a "family resemblance" to other instruments that have already been held not to be securities, it is excluded from the purview of the securities laws. *Reves v. Ernst & Young*, 494 U.S. 56, 67 (1990). According to the Court, we first examine whether "the seller's purpose is . . . to finance substantial investments and the buyer is interested primarily *in the profit the note is expected to generate*." *Id.* at 66 (emphasis added). "Second, we examine the 'plan of distribution' of the instrument to determine whether it is an instrument in which there is 'common trading for speculation or investment.'" *Id.* (quoting *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943)). "Third, we examine the reasonable expectations of the investing public," and fourth, "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary." *Id.* at 66-67.

The promissory note fails all four prongs of the test. First, the note itself was not a profit-making mechanism. The Partnership's loans to Lathen were "evidenced by [a] promissory note[ ] and secured by a pledge of securities," but were "payable in fixed amounts at fixed times, and repayment was not conditioned on the success or failure" of Lathen's investments. *United Am. Bank of Nashville v. Gunter*, 620 F.2d 1108, 1115 (5th Cir. 1980). The Partnership "anticipated no gain beyond repayment of the principal it advanced plus interest at a fixed rate." *Id.* The situation here, in which the loans themselves were bona-fide commercial transactions, is different from one where "investment payouts [are] disguised beneath the facade of promissory notes." *SEC v. Better Life Club of Am., Inc.*, 995 F. Supp. 167, 174

1933 and 1934 Acts requires the conclusion that the notes are securities for purposes of the Investment Advisers Act as well.").

(D.D.C. 1998), *aff'd*, 203 F.3d 54 (D.C. Cir. 1999). The promissory note was not a "payout" on the investment—the Partnership's investment payout was the profit-sharing through the PSA. Second, it is self-evident that there was no "plan of distribution" for this lone promissory note. No one was trading in it. Third, no reasonable member of the investing public would assume the note alone is a security. And fourth, since repayment of the note was independent of the performance of Lathen's investments in the bonds and CDs, there was no particular risk associated with the note other than the "risk normally associated with the lending of money for a period of time." *Great W. Bank & Tr. v. Kotz*, 532 F.2d 1252, 1259 (9th Cir. 1976). The loan resembled a standard commercial loan and was regulated by New York law; in fact, Lathen filed UCC financing statements, or liens, with the New York Department of State for each loan. SFOF ¶ 12; DX 153-70; Tr. 3516. In sum, the promissory note resembles a note evidencing a commercial loan in all significant respects. The note, by itself, cannot be a security under the Advisers Act.[26]

In addition, at least some of the purposes of the custody rule do not appear to apply to the promissory note. There was only one such note. *See* Tr. 1439-45. It provided a right to repayment for all loans under the original DLA and possibly later DLAs as well. *See id.* Because the note was not for a fixed, identifiable sum of money, it is not a negotiable instrument. DX 190 at 6 (permitting, but *not requiring*, the Partnership to keep records of amounts advanced and to attach a schedule to the note evidencing such amounts); DX 193 (deeming the Partnership's private records of advances to be part of the note); *see* N.Y. U.C.C. §§ 3-104(1)(b), 3-105(2)(a) & cmt. 8 (a negotiable instrument must be for a "sum certain in money," and "the holder [must be able to] ascertain all of its essential terms from its face"). That means it was not freely transferrable, but could only be transferred by assignment. The Division of Investment Management has recognized that the custody rule is less applicable to non-freely transferable stock certificates, and issued guidance in 2013 specifically stating that it would not object if an adviser does not maintain private stock certificates with a qualified custodian if,

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[26] The Division and Respondents primarily disagree about whether the note was an *uncertificated* security exempted from the custody rule. *See* 17 C.F.R. § 275.206(4)-2(b)(2)(i). However, the term is not defined by the Advisers Act or the custody rule, and the parties do not suggest a definition. *See* Div. Post-hearing Br. at 19-20 (asserting, without further explanation, that the "DLA was in fact certificated by a Promissory Note"). Because I conclude that the promissory note is not a security, I need not discuss whether it was certificated or satisfied the other elements of the exemption.

among other things, transfer of the certificates was restricted. *See* SEC Div. of Inv. Mgmt., Guidance Update No. 2013-04, *Privately Offered Securities under the Investment Advisers Act Custody Rule* 2 (Aug. 2013).[27] Although not all the specifics of the guidance apply here, the limited transferability of the promissory note further indicates that it should not be treated as a security for the purposes of the custody rule.[28]

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For all of these reasons, the Division has failed to prove that Respondents violated the Advisers Act custody rule.

Record Certification

Pursuant to 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the revised record index issued by the Commission's Office of the Secretary on August 16, 2017.

Order

Based on the findings and conclusions set forth above, this administrative proceeding is DISMISSED.

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

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[27] The guidance is available at: https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf.

[28] The Division argues for the first time in its post-hearing brief that EACM also violated the custody rule because it failed to circulate audited financials or get a surprise examination in 2015. Div. Post-hearing Br. at 23 n.19. I will not consider the argument, because the OIP did not allege that EACM violated those provisions of the custody rule. *See* OIP at 9-11; 17 C.F.R. § 275.206(4)-2(a)(4). Moreover, as Respondents allude to in response, they had no notice of the Division's argument, and were afforded no opportunity to adduce any evidence pertaining to this issue at the hearing. *See* Resp. Post-hearing Br. at 31.

days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The initial decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct a manifest error of fact or the Commission determines on its own initiative to review the initial decision as to a party. If any of these events occur, the initial decision shall not become final as to that party.

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Jason S. Patil
Administrative Law Judge