ADMINISTRATIVE PROCEEDING
FILE NO. 3-14355

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
	:
DONALD L. KOCH AND	:
KOCH ASSET MANAGEMENT, LLC	
	:

RESPONDENTS' PRE-HEARING MEMORANDUM OF LAW

INTRODUCTION

Under Section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act") and Section 206 of the Investment Advisers Act of 1940 (the "Advisers Act"), trading stock for a legitimate economic purpose is not market manipulation. Respondents Donald L. Koch and his firm, Koch Asset Management ("KAM") have long invested in small, community-based banks. All of Mr. Koch and KAM's trades in the stock of these banks have been legitimate trades, made on the open market and within the rules. Mr. Koch seeks long-term investments for his clients; to that end, he directs purchases of the stock of small community banks whose shares are typically very thinly traded and that he has personally researched thoroughly and in which he genuinely values being a shareholder.

All of the trades at issue here the Division of Enforcement ("Division") claims were attempts to manipulate the market, were when viewed in contact in fact consistent with Mr. Koch's overall trading patterns and were made to gain and hold the stock in furtherance of Mr.

Koch's investment strategy. Each was made to enhance the wealth of the client, not Respondents. None of the hallmarks of market manipulation exist in this case: Mr. Koch did not sell the stocks for personal profit. Mr. Koch did not gain financially from the transactions. Investors were not drawn into the market by the transactions. No artificial price was created. In short, there is no deception, no manipulation, just lawful open market transactions in highly illiquid markets undertaken for the benefit of Koch Asset Management ("KAM") clients. Indeed, to hold that the open market transactions here constitute manipulation would not only undercut the plain text requirements of the statutes but also thwart normal market practices, trading and price discovery.

PROCEDURAL BACKGROUND

On April 25, 2011 the Order Instituting Administrative and Cease-and-Desist Proceedings (the "OIP") naming as Respondents Donald L. Koch ("Mr. Koch") and KAM was filed. . Mr. Koch and KAM responded to the OIP on May 20, 2011. In the OIP, the Division levied several allegations against Mr. Koch and KAM, all of which Mr. Koch and KAM deny.

First, the Division alleges that on four days in 2009, Mr. Koch and KAM instructed a trader at Huntleigh Securities Corporation ("Huntleigh") to execute trades at the end of the trading day in an attempt to mark the close in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Sections 206(1) and 206(2) of the Advisers Act. According to the OIP the Huntleigh trader bought 1,400 shares of High Country Bank Corporation ("HCBC") on September 30, 2009, 600 shares of HCBC on October 30, 2009, 2,000 shares of HCBC on November 30, 2009, and 3,200 shares of HCBC on December 31, 2009. The trader also acquired 6,000 shares of Cheviot Financial Corporation ("CHEV") and 200 shares of Carver Bancorp, Incorporated ("CARV") on December 31, 2009. The Division's bare allegations are that Mr. Koch and KAM intended to artificially increase the share price of the three stocks and, to that end, effected end of the day trades in open market transactions. The motive, according to the Division, was to "artificially improve the reported monthly performance for each account holding that security." OIP Par. 6. As a corollary to this claim, the Division alleges that Respondents did not seek best execution on the trades. .

Second, the Division alleges that KAM violated Section 204 of the Advisers Act and Rule 204-2(a)(7) thereunder by failing to adequately maintain certain books and records, and that Mr. Koch aided and abetted that violation. Third, the Division alleges that KAM violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder by failing to implement written policies and procedures reasonably designed to prevent violation of the Advisers Act, and that Mr. Koch aided and abetted such violations.

Mr. Koch and KAM respectfully submit that the evidence that will be adduced at the hearing, when applied to the law as set forth below, will demonstrate that the Commission's allegations are unfounded and should be dismissed as such.

DONALD KOCH AND KAM

Mr. Koch has been an investment adviser for nearly 20 years. Prior to becoming an investment adviser, Mr. Koch had extensive experience valuing banks. For nine and a half years he was Chief Economist for Barnett Bank, during which time Mr. Koch assessed banks that were acquisition prospects for Barnett. After working for Barnett, Mr. Koch was Director of Research and Senior Vice President for the Federal Reserve in Atlanta for four and a half years. At the Federal Reserve, Mr. Koch oversaw bank mergers in the southeastern United States, which caused him to further study the structure of local banks. His background working at and studying community-based banks gave Mr. Koch a firm understanding of the potential investment niche for such bank stocks despite their illiquidity which made trading difficult. Therefore, a few years after he left the Federal Reserve, Mr. Koch began investing in the stock of local banks.

At first, Mr. Koch invested only for himself and his family. But several friends and neighbors approached Mr. Koch and asked if he would manage their money as well. Understanding the responsibility that comes with managing other people's money, Mr. Koch initially declined. Ultimately his friends persuaded him to accept the responsibility which he accepted in an effort to be helpful to them. Mr. Koch began accepting selected clients. As time went on, Mr. Koch acquired a client base via word of mouth. In keeping with the fact that he never solicited clients, Mr. Koch turned down some would-be clients and accepted only those who met certain financial qualifications and who could hold securities for the long term. KAM thus evolved over time as a kind of investment club of friends, associates and close business associates.

KAM's investment approach is an outgrowth of Mr. Koch's banking experience. The firm invests only in selected small cap banking stocks. Evaluation begins with a personal assessment of the balance sheet and financial attributes of the firm by Mr. Koch. He then visits the bank and its branches, talks with and gets to know key officers and carefully evaluates this potential investment in the context of other similar banks and as a potential take-over target in the national market place, a point which at once dictates a long term strategy and mitigate the illiquidity of the stock. Stock purchase price is determined by calculating tangible book value or TBV, essentially the FDIC liquidation value of the bank which helps insure stock acquisitions at a favorable price (takeover value is frequently multiples of TBV) and a safe investment.

KAM's clients reflect the long term view of its investment strategy. Many of its clients have been with the firm for years. Many have held a number of the same small bank stocks for years. KAM typically does not sell securities unless a client needs cash, there is a take over or events at the bank dictate a change in strategy.

Over the years KAM's strategy has been successful. Typical long term clients have very favorable returns despite the impact of the market crisis on bank stocks as well as the overall market. One measure of its success is the long term relationships the firm enjoyed prior to the institution of this proceeding with many clients. Following this action KAM transferred many clients to another adviser.

LEGAL PRINCIPLES

I. Exchange Act Section 10(b) and Advisers Act Section 206

A. Antifraud Measures

The OIP alleges violations of Section 10(b) of the Exchange Act and Sections 206(1) and 206(2) of the Advisers Act centered on manipulation claims of marking the close and failing to get best execution. These statutes are mainly antifraud provisions which sweep in market manipulation. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 473, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977) ("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception."); *Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971). Those cases define market manipulation in terms of causing an artificial price for a stock, drawing investors into the market based on false trading activity or similar deceptive activity *Santa Fe Industries, Inc. v. Green*, 430 U.S. at 476 ("The term ['manipulation'] refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.")

In order to establish market manipulation under Section 10(b) and Section 206(1), the Commission must prove scienter.[1] *Aaron v. SEC*, 446 U.S. 680, 691, 100 S.Ct. 1945, 64 L.Ed.2d 611 (1980). The Second Circuit has held that scienter can be established in the context of securities fraud by demonstrating motive and opportunity or strong circumstantial evidence of conscious misbehavior or recklessness. *In re Centerline Holding Co. Securities Litig.*, 380 Fed. Appx. 91, 92 (2d Cir. 2010).

B. Intent and legitimate market activity

The critical question in market manipulation cases is if intent coupled with purely legal acts is barred by Section 10(b) and Section 206. This is the issue on which the Division's fraud and trading claims center. Three circuit courts have considered the issue.

First, the Third Circuit has held that intent plus a legal act does not constitute market manipulation. *See generally GFL Adv. Fund, Ltd. v. Colkitt*, 272 F.3d 189 (2001). In *GFL*, the court found that the at-issue short sales were not attributable to false information injected into the marketplace or other action which would *artificially* depress share prices. *See id.* at 204. The fact that the short sales may have contributed to a price decline did not matter, because there was no reason to believe that the price had gone down artificially; that is, the decrease was the produce of legitimate trading. *Id.* at 207. The court listed numerous cases in which short selling was problematic because it involved "some other deceptive practice" that did artificially affect the stock price. *Id.* On the other hand, the Third Circuit held, a claim for market manipulation requires deceptive behavior in conjunction with the activity at issue that either injects inaccurate information into the marketplace or creates artificial demands for the securities. *Id.* at 211.

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[1] Section 206(2) carries a negligence standard, *see Aaron*, 446 U.S. at 692, but the Commission must still prove manipulation per the standards set forth herein.

Second, in *U.S. v. Mulheren*, the Second Circuit deliberately avoided directly deciding the issue. *See* 938 F.2d 364, 368 (1991). However, in overturning the defendant's convictions for market manipulation, the court found that there was no evidence of the defendant's subjective intent to move the share price; the government's evidence amounted only to the defendant's potential knowledge of various parties' positions in the stock, including some alleged knowledge gained through ambiguous conversation about the stock. *See id.* at 369-70. The court also pointed out that none of the "traditional badges of manipulation" were evident: there was no profit or personal gain to the alleged manipulator; the alleged manipulator purchased significantly more shares than would have been necessary simply to move the price; there was no evidence that any manipulation had been undertaken in the past; and the shares were purchased "conspicuously on the open market." *See id.* at 370-71. The court therefore, while avoiding the direct issue of whether intent plus legal acts can lead to liability, suggested that manipulation involving a legal act would require some other "traditional badge of manipulation." *Id.* And as the court noted, generally, "[w]hen [a] transaction is effected for an investment purpose . . . there is no manipulation, even if an increase or diminution in price was a foreseeable consequence of the investment." *Id.* at 368.

Third, the D.C. Circuit upheld liability for manipulation where the allegations ostensibly included only intent, but in fact relied on other indicia of manipulation. *Markowski v. SEC*, 274 F.3d 525, 530 (2001). The court pointed not only to the manipulative intent, but also noted that evidence, though not definitive, had been submitted that the defendant had purchased far more stock than could be explained by a genuine investment and in the underlying case there was deceptive conduct. *See id.* Thus the court was able to conclude that the facts of the case supported a manipulation finding.

In sum, although only the Third Circuit has adopted a *per se* rule against liability based only on pure intent and legal acts, the Second Circuit has suggested that indicia of manipulation beyond mere intent is required and the D.C. Circuit has relied on such indicia. In sum, all three recognize the inherent difficulty in distinguishing between wrongful and lawful trading activity in the absence of any actual wrongful act. This difficulty means that, in close cases, courts err on the side of finding that manipulation did not occur. *See Mulheren*, 938 F.2d at 368. And this difficulty means that in order to decide manipulation cases, courts generally look for evidence which would constitute a kind of "plus factor" such as profits, numerous instances of the at-issue trading, or luring investors while selling personally held stock. Basing manipulation on open market transactions in the absence of such "plus factors" raises the grave risk of prohibiting otherwise lawful conduct and risks undercutting the statutory requirement that there be deceptive conduct. Therefore, again, courts generally err on the side of finding against liability in situations involving lawful activity and an alleged intent to manipulate. *Mulheren*, 938 F.2d at 368, 372.

Here, if the Commission is going to prove manipulation based on intent and an open market transaction, It must establish deceptive conduct. It should be required to prove introduce some "plus factor." And, even without a "plus factor," the Commission must <u>at least</u> establish that but for the manipulative intent, the defendant would not have conducted the transaction. *See SEC v. Masri*, 523 F. Supp. 2d 361, 372 (S.D.N.Y. 2007). Stated differently, the transaction must have no legitimate economic purpose. *Id.*

C. Marking the Close

Marking the close is a form of market manipulation. *SEC v. Masri*, 523 F.Supp.2d 361, 367-68 (2007). Thus each element, including scienter, must be established for Section 10(b) and

Section 206(1) violations. The Commission has defined "marking the close" as "the practice of attempting to influence the closing price of a stock by executing purchase or sale orders at or near the close of the market," a type of market manipulation. *In the Matter of Graham*, Release No. 40727, 1997 WL 530040, at *8 n.4 (Nov. 30, 1998).

However, simply trading late in the day does not by itself constitute market manipulation. *Masri*. Likewise simply moving the price, which any trade can do, does not constitute marking the close. Rather, the key is whether there was no legitimate economic reason for the trading, typically demonstrated by profits for the investor, or attempting to keep stock above a certain level for the benefit of the advisor.[2] *Masri*, 523 F. Supp. 2d at 372. Hence, if a legitimate reason for trading exists, there is no manipulation. *See id.* In addition, the Commission must establish scienter, that is, a motive for fraud or particularized facts demonstrating an intent to defraud. .

D. Mr. Koch's and KAM's Activities Were Not Marking the Close

As the evidence will demonstrate, the trades at issue in this matter were made in highly illiquid markets as, effectively, negotiated transactions to acquire property. The transactions are not comparable to trading stock in a liquid market such as the New York Stock Exchange. The trades were executed within the rules and were done so for a legitimate purpose, to acquire and hold the stock. Mr. Koch was simply pursuing his long-standing investment strategy. As such, there is no evidence here of scienter or even negligence. To the contrary, the transactions here benefited each client.

[2] NASD rules require that a broker attempt to get best execution for his clients. Best execution means getting the optimal combination of price, speed and liquidity for a securities trade. *See Kurz v. Fidelity Mgmt. & Rsch. Co.*, 556 F.3d 639, 640 (7th Cir. 2009). Here the Division's claim regarding best execution a derivative of its marking the close allegations hand hinges on the fame factors.

II. Books and Records

Under Rule 204-2(7) of the Advisers Act, an investment adviser must maintain "[o]riginals of all written communications received and copies of all written communications sent by such investment adviser relating to (i) any recommendation made or proposed to be made and any advice given or proposed to be given, (ii) any receipt, disbursement or delivery of funds or securities, or (iii) the placing or execution of any order to purchase or sell any security: *Provided, however, (a)* That the investment adviser shall not be required to keep any unsolicited market letters and other similar communications of general public distribution not prepared by or for the investment adviser, and *(b)* that if the investment adviser sends any notice, circular or other advertisement offering any report, analysis, publication or other investment advisory service to more than 10 persons, the investment adviser shall not be required to keep a record of the names and addresses of the persons to whom it was sent; except that if such notice, circular or advertisement is distributed to persons named on any list, the investment adviser shall retain with the copy of such notice, circular or advertisement a memorandum describing the list and the source thereof." Advisers Act Rule 204-2(a)(7). As the evidence at the hearing will demonstrate, Mr. Koch and KAM kept and maintained well kept systems of records for all client transactions maintained all records required under Rule 204-2(a)(7).

III. Policies and Procedures

Section 206(4) of the Advisers Act states that an adviser may not engage "in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." Advisers Act Section 206(4). Under Rule 206(4)-7 of the Advisers

Act, an investment adviser must (1) adopt and implement written policies and procedures reasonably designed to prevent violation by the adviser or its supervised persons, of the Advisers Act and the rules that the Commission has adopted under the Advisers Act; (2) review, no less frequently than annually, the adequacy of the policies and procedures established pursuant to Section 206(4) and the effectiveness of their implementation; and (3) designate an individual (who is a supervised person within the meaning of the Advisers Act[3]) responsible for administering the policies and procedures that the adviser adopts under Rule 206(4)-7(a). Advisers Act Rule 206(4)-7.

In implementing these compliance and supervision rules in 2003, the Commission noted that they would affect small investment advisers in particular, as approximately half of all small investment advisers did not have the written policies and procedures in place or have a designated compliance officer. However, the Commission also stated that "[b]ecause these small firms typically engage in a limited number and range of transactions and have one or two employees, their internal compliance programs would be markedly less complex than those of their large firm counterparts. In addition, we anticipate that these firms will turn to a variety of industry representatives, commentators, and organizations that have developed outlines and model programs that these firms can tailor to fit their own situations." *In re Compliance Programs of Investment Companies and Investment Advisers*, Release No. 2107, at *11 (Feb. 5, 2003). Thus the Commission expected that small advisers would comply with Rule 206(4)-7 by adopting relatively simple policies and procedures. In fact, the Commission later stated that "[a]s we noted in 2003 when we adopted rule 206(4)-7, we recognize that advisers are too varied

3 A "supervised person" under the Advisers Act is "any partner, officer, director (or any other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser." Section 202(a)(25).

in their operations and size for such an approach to work. Policies and procedures that are appropriate for a 500 employee firm that also operates as a broker-dealer will be unlikely to work (or be necessary) for a five person firm that provides asset allocation advice." *Custody of Funds or Securities of Clients by Investment Advisers*, Release No. 2968, at *18 (Dec. 30, 2009). Here, as will be demonstrated during the hearing, KAM (1) had written policies and procedures to prevent violation of the Advisers Act; (2) it reviewed those policies and procedures periodically reviewed; and (3) Mr. Koch – a supervised person within the meaning of the Advisers Act – was KAM's designated compliance officer, which the Commission itself stated in Paragraph 1 of the Order Instituting Proceedings. Under the circumstances these procedures were reasonable and adequate.

WITNESSES

Mr. Koch and KAM submit that they plan to call the following witnesses:

1. Mr. Koch
2. Faith Heidtbrink
3. James Ewoldt
4. Donald Cayce
5. Gregg Jarrell[4]
6. John Schneider[5]

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4 Pursuant to SEC Rule of Practice 222, Mr. Koch and KAM have submitted a current curriculum vitae along with a list of cases in which Mr. Jarrell has testified will be provided. Respondents have also furnished the Division with list of all materials reviewed b each expert witness and made available a copy of any document not in the Division's files This exceeds the requirements of the Rules of Practice but should facilitate hearing preparation for the Division which is the spirit in which these materials were made available.

5 Pursuant to SEC Rule of Practice 222, Mr. Koch and KAM have submitted a current curriculum vitae along with a list of cases in which Mr. Schneider has testified will be provided.

CONCLUSION

Mr. Koch and KAM respectfully submit that, as will be demonstrated by the evidence put forth during the hearing on this matter, Mr. Koch and KAM did not violate Section 10(b) of the Exchange Act, Sections 206(1) and 206(2) of the Advisers Act, Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, or Section 204 of the Advisers and Rule 204-2(a)(7).

Dated: January 6, 2012

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Respondent's Pre-Hearing Memorandum of Law was filed with the Secretary's office at the Securities & Exchange Commission, served on Judge Carol Fox Foelak and Suzanne J. Romajas at 100 F Street, N.E., Washington, D.C. 20549 by hand on January 6, 2012, and by e-mail at RomajasS@sec.gov on January 6, 2012.

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