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	:
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RESPONDENTS' PETITION FOR REVIEW

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RESPONDENTS' PETITION FOR REVIEW

Pursuant to Rules 410 and 411(b)(2)(ii) of the Commission's Rules of Practice, Respondents Donald L. Koch and Koch Asset Management, LLC ("Respondents) hereby petition the Securities and Exchange Commission (the "Commission") to review the Initial Decision rendered in the above-captioned action on May 24, 2012 (the "Initial Decision").[1]

I. INTRODUCTION

The Commission should review the Initial Decision for three reasons. First, the largely undisputed record here establishes that the securities acquired by Koch Asset Management ("KAM") for its clients were purchased at market prices, not artificial ones, and that each purchase received best execution. The record demonstrates that in the difficult, illiquid markets in which the small bank stocks purchased here trade, KAM took the appropriate steps to ensure that each purchase was made at the most favorable prices available and in accord with the agreements it had with its clients. This is confirmed not just by KAM and its founder Donald Koch, but also by highly respected professionals who examined the transactions and the firm's investment program and a key witness for the Division of Enforcement (the "Division").

Second, the Initial Decision fails to properly articulate key legal standards, make factual findings to support its conclusions or properly consider the context of the transactions on which is findings are premised. In concluding that there was an artificial price, the Initial Decision fails to identify any legal standard or to specify any facts to support its conclusion. Rather, the Initial Decision impermissibly tries to premise findings of violations solely on intent, even in the absence of any demonstrated impact on the market. And, even assuming that intent alone is a

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[1] Both parties filed motions to correct manifest errors of fact; a decision on those motions was rendered on June 15, 2012, such that this petition is timely under Rule 410(b).

proper predicate for such findings, which it is not, the conclusion is wrong because it eschews the context in which statements evincing intent were made.

Finally, the only harm here is to KAM's clients, who lost their trusted investment adviser in the wake of this proceeding. Prior to that, KAM had prudently directed the investment of client funds, held in clients' personal brokerage accounts, for returns of 42% over the last ten years and through the market crisis. Perhaps the most telling statement about each of the security purchases involved here is the fact that, prior to when each KAM client was asked by Mr. Koch to leave the firm because of this proceeding, KAM did not direct the sale of a single share of the securities involved here. Likewise, the Division failed to offer a shred of evidence demonstrating that any of the former KAM clients for whom the shares were purchased later sold the shares involved here. This is for the simple reason that the purchases were a continuation of a highly successful investment program, not the byproduct of manipulation.

II. THE ORDER INSTITUTING PROCEEDINGS

The Order Instituting Proceedings ("OIP") was issued on April 25, 2011. It names as Respondents KAM and its founder, Mr. Koch. The OIP alleges that KAM and Mr. Koch violated Exchange Act Section 10(b), and Rule 10b-5 thereunder, as well as Advisers Act Sections 206(1) and (2), by marking the close in making purchase of High Country Bank Corp. ("High Country") securities on September 30, 2009 (the "September purchase"), October 30, 2009, November 30, 2009, and December 31, 2009. It makes the same allegations with respect to purchases of the Cheviot Financial Corporation ("Cheviot") and Carver Financial Corporation ("Carver") shares made on December 31, 2009 (collectively with December 31, 2009, purchases of High Country, the "December purchases"), all through Huntleigh Securities ("Huntleigh"). Those allegations are based on an e-mail sent by Mr. Koch on September 30, 2009, and certain taped segments of conversation involving Mr. Koch and a Huntleigh trader, Jeff Christanell, on December 31, 2009. The OIP also charges that the Respondents violated each of the antifraud provisions by failing to obtain best execution for the September and December purchases.

In addition, the OIP charges violations of Advisers Act Rule 206(4)-7(a) based on a claim that KAM failed to implement certain procedures and failed to produce certain documents.

III. THE EVIDENCE AT THE HEARING

The evidence at the hearing consisted of four witnesses presented by the Division, six who testified on behalf of the Respondents and approximately 131 exhibits.[2] The evidence established that, in accordance with its longstanding and highly successful investment program, KAM purchased shares of High Country on September 30, 2009, and additional shares of that security, along with stock in Carver and Cheviot, on December 31, 2009.[3] In making those purchases, the record also establishes that:

- Each purchase of Carver, Cheviot and High Country shares received best execution, according to Division witness Mr. Christanell;
- The purchases of Carver did not set the closing price on December 31, 2009, according to Professor Jarrell;
- The purchases of Cheviot did not set the closing price on December 31, 2009, according to Professor Jarrell;

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2 Witnesses for the Division included: Cathy Marshall, KAM account executive and the compliance director at Huntleigh where many KAM clients had accounts; Jeff Christanell, the Huntleigh trader who began handling the KAM accounts in September 2009; Eli Straeter, Huntleigh IT manager; and Stephen Glascoe, a Division senior market surveillance specialist. Respondents called as witnesses: Mr. Koch; Jim Ewoldt and Don Cayce, two long time clients of KAM who had benefited from its investment program; Faith Heidtbrink, KAM's bookkeeper; Professor Gregg Jarrell, University of Rochester and former Commission Chief Economist; and John Schneider, partner at KPMG. Dr. Jarrell was accepted as an expert in market economics and Mr. Schneider as an expert in investment adviser services, systems and procedures.

3 Purchases were also made in October and November. The Initial Decision concluded that there was insufficient evidence to sustain the allegations of the OIP regarding these purchases. Initial Decision at 14. The evidence suggested that these purchases were initiated by Mr. Christanell based on standing orders from KAM to purchase High Country shares at prices under $25, and that KAM later ratified the purchases.

- The purchases of High Country did set the closing prices but the prices were comparable to those paid by other buyers and sellers, according to Professor Jarrell; [4]
- The September and December purchases were consistent with KAM's longstanding investment approach and transactions, according to Mr. Schneider; and
- There is no evidence to support a conclusion that the prices for Carver, Cheviot and High Country on the dates of KAM's purchases were artificial.

KAM was a highly successful registered investment adviser located in St. Louis, Missouri. Its clients enjoyed a 42% return on equity over its last 10 years of operation. Many clients, including those for whom the September and December purchases were made, had significantly higher returns.

KAM's program was limited to making long term investments in shares of select small community banks such as High Country, in Colorado, Carver, in the Bronx, and Cheviot, in Cincinnati. KAM's program required that shares be bought at or below tangible book value ("TBV"), a calculation the adviser made for each bank. Purchasing below TBV protected clients against down-side risk because it approximates FDIC liquidation value. Purchasing in this manner also fostered high returns, since small banks are often takeover targets whose shares are purchased at multiples of TBV.

However, purchasing securities such as High Country, Carver and Cheviot can be difficult because the stock is highly illiquid, as evidenced by the wide bid-ask spreads; the spreads represent, as Professor Jarrell testified, a cost of purchase. Further, the securities did not routinely trade. For example, High Country only traded a few days per year. Availability is thus a key issue.

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[4] Professor Jarrell testified that High Country shares were so illiquid that purchasing the shares was more like a privately negotiated transaction than buying on an exchange. This resulted in conducting an analysis on the transactions which differed from that done on the other shares.

Mr. Koch, the founder and principal of KAM, developed the firm's investment approach based on his years of service in the banking industry and his own personal experience. Mr. Koch's background includes: years as a senior official of Barnett Bank, where he was in charge of making acquisitions; service as the chief economist at the Atlanta Federal Reserve, where he analyzed bank merger proposals; time as a professor at Georgia Tech University; and work for the FDIC on the savings and loan crisis. His approach was tested on his personal portfolio prior to any client investments. Each stock is selected by him based on painstaking investigation, not market reports. Each client, a friend of Mr. Koch, is carefully schooled in the long-term investment approach of the adviser before being accepted as a client. KAM does not market itself, does not advertise and does not have a website.

On September 30, 2009, KAM purchased 2,000 shares of High Country for the account of KAM's longtime client and Mr. Koch's neighbor, Alice Smith. The stock was a favorite of KAM and of the then retired Mrs. Smith. A limit order was placed at $18 at 11:25 a.m. for 400 shares. The spread was an extremely wide $11 to $18. The order was filled with two executions of 200 shares each.

Just before noon the order was revised, increasing the number of shares to 600 but dropping the limit price to $16, despite the fact that the spread had widened to $11.70 to $20. This time KAM only got a partial fill of 180 shares.

KAM then shifted tactics, increasing the order to its more traditional block of 2,000 shares and raising the limit price to $25, the TBV for the stock as calculated by KAM. The spread continued to be an extremely wide $11.71 to $20. An e-mail to trader Jeff Christanell following the revision of the order cautioned the institutional trader who typically bought in large blocks "not to appear to be manipulative." Routing a block order for 2,000 shares to the street for a stock as illiquid as High Country could cause a significant price increase that might exceed KAM's price limit; KAM preferred to fill a large block through smaller executions.

As the market close approached, the order rapidly filled with the small executions KAM favored at prices which only laddered-up slightly from $20 to $23.99. The market closed. KAM had achieved its goal of purchasing 2,000 shares of the difficult-to-acquire security at an average price of $20.3794. The technique of increasing the order size at the end of the day, based on well established academic literature, as Professor Jarrell testified, and purchasing in small blocks proved successful, as did setting the limit price above the bid but below TBV (as KAM had told its clients it would do).

On December 31, 2009, KAM purchased more High Country securities and, in addition, shares of Cheviot and Carver. The December purchases were made to reduce the high cash balances in the accounts of longtime KAM client Tampsco.

KAM alerted trader Christanell several days before year end that it would attempt to acquire a block of High Country shares on the last day of the year, typically a time when the markets are more liquid as shareholders monetize their holdings. On December 31, 2009, Mr. Koch and Mr. Christanell spoke several times. Portions of their conversations were captured on tape.[5] The tapes contain comments about purchasing shares of High Country at prices above $20 and up to $25 in a manner similar to the successful September purchase, with Mr. Koch stating

5 Huntleigh's taping system was supposed to record all conversations between clients and traders. However, when the firm sought to retrieve tapes of KAM's transactions it found only recordings for December 31, 2009, with no recordings before or after that date. While Huntleigh's IT manager theorized that earlier recordings had been overwritten, he had no real explanation for the lack of post-December 31, 2009, recordings beyond speculation that he may have rebooted the system at the end of 2009 and failed to restart it, thereby causing a gap. When searched, the system listed six conversation segments between Mr. Koch and Mr. Christanell. Whether there were other conversations cannot be determined except by relying on a malfunctioning machine. Other questions regarding the tapes' completeness and accuracy remain. For example, one tape is supposed to reflect a conversation at 3:09, in which the two men discuss purchasing only 300 shares of Carver. Yet KAM had entered an order in the Huntleigh system earlier, at 1:01, for 1,000 shares, which was never revised. Later, in a conversation that is supposed to be at 3:48, 12 minutes <u>before</u> market close, they discuss the purchases for the day <u>after</u> the close of the market.

"I need to get it above 20 [inaudible] 25 I'm happy." At 9:06 that morning a limit order was placed by KAM for 5,000 shares of the security with a limit price of $25. Other conversations reference purchasing a block of Cheviot using the same approach of setting the limit price over the bid with Mr. Koch stating "move it up to 8, 8 and a quarter . . ." at a time when the spread was $7.20 to $7.48. At 1:01 KAM placed a limit order for 5,000 shares at $8.25.

In another conversation the two men discussed purchasing 300 shares of Carver at a time when the spread was $8.10 to $9.05. A limit order was entered at 1:01 for 1,000 shares at $9.05. At the time of the order the spread was $8.09 to $9.05.

As in September, Mr. Koch cautioned Christanell to make the purchases in small lots of 100 or 200 shares because large block transactions could drive up the price of these illiquid stocks. While there are discussions about making the acquisitions at the end of the day, the time for executing the orders was delegated to Mr. Christanell by KAM. Thus the orders could be executed at any time after the limit orders were entered in the Huntleigh system, as Mr. Christanell determined.

KAM's trading approach was partially successful. The adviser purchased 6,600 shares of Cheviot below TBV, a stock it had tried unsuccessfully to acquire shortly before Christmas by setting its limit price at just above the bid at Mr. Christanell's suggestion, rather than setting the price above the ask as it had for High Country in September. The firm only obtained a partial fill of 300 shares of Carver at a price below TBV, although Mr. Koch was beginning to have concerns about the bank and KAM would, the next year, liquidate client positions in the security. KAM only obtained a partial fill of its order for High Country. As Mr. Christanell explained, he waited until too late in the day. Although December 31 had been a busy trading day, as expected, and many traders were in the market as the market close approached, acquiring a bulletin board stock like High Country takes time because multiple venues have to be visited to obtain executions. Mr. Christanell's misjudgment as to how long that process would take caused him to run out of time.

The purchases in December, as well as those in September, were consistent with others made by KAM over the years, according to the undisputed testimony of KPMG partner John Schneider, who studied KAM's accounts. As with other KAM purchases, all of the shares were held. None were sold.

After the OIP was issued, Mr. Koch encouraged each KAM client to remove his or her account to another adviser, and all of his clients moved. By the time the accounts were transferred, not a single share from those purchases had been sold. The Division did not offer any evidence that, after the transfer, the shares from the September and December purchases were sold. There is evidence in the record that Alice Smith, who subsequently passed away, left a donation in her will to Mr. Koch's charitable foundation, which promotes education for students.

Mr. Koch is now retired and KAM serves only non-advisory family accounts. The firm is not eligible under The Dodd-Frank Wall Street Reform Act to continue registration with the Commission and has not attempted to register with the state of Missouri.

IV. THE INITIAL DECISION

The Initial Decision[6] concludes that KAM and Mr. Koch violated Exchange Act Section 10(b) and Advisers Act Sections 206(1) and (2) by "marking the close." Initial Decision at 11.

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6 In arriving at the Initial Decision the Administrative Law Judge considered, pursuant to 5, U.S.C. § 557(c), three post-hearing briefs: the Division's Post-Hearing Findings of Fact and Post-Hearing Brief; the Respondents' Proposed Findings of Fact and Conclusions of Law; and the Division's Post-Hearing Reply Brief. Initial Decision at 2. Neither Respondents' Post-Hearing Memorandum of Law, nor Respondents' Surreply Brief, the latter of which was filed in accordance with the Administrative Law Judge's March 7, 2012, order, were considered. No reason was given for not considering these materials.

The determination is based on the conclusion that "[m]arket manipulation is intentional conduct designed to defraud investors by artificially affecting the prices of securities . . . ." *Id.* Marking the close is a form of market manipulation which "is 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." *Id.* at 12 (citations omitted). The Initial Decision concludes that the September and December purchases were made at "artificial prices" (*id.* at 2, 10, 14) and would not have been made but for a manipulative intent (*id.* at 14).

The Initial Decision finds that the three stocks here were extremely illiquid, based on the testimony of Dr. Jarrell and Mr. Schneider, and it finds that a prospective buyer "could not expect to buy at the bid; rather he would have to bid near or at the ask if he wished to obtain stock. Such a bid might draw out stock from a prospective seller. A trader might follow a process of laddering in filling an order . . . ." *Id.* at 10. Since KAM and Mr. Koch made all of the September and December purchases below the TBV for each security, this, along with the testimony of Professor Jarrell and Mr. Schneider, "would provide a reasonable and non-violative explanation for all of the trading at issue if it were not for Koch's email exchange and telephone conversations with Christanell . . . [which] show that Koch's motive . . ." was to mark the close. *Id.* at 10. Indeed, but for that motive, KAM and Mr. Koch would not have made any of the purchases. *Id.*[7]

The findings of fact and conclusions of law in the Decision do not mention the allegation in the OIP that the two cited antifraud provisions were violated by KAM and Mr. Koch by failing

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7 The claimed motive was to enhance the numbers on the monthly account statements of clients. While there was testimony that some KAM clients were understandably concerned about market performance in 2009, there is no evidence establishing that it is the accounts of those clients that were impacted by the purchases here, or how many KAM clients held the three securities in the fall of 2009. The Division's tabulation of the claimed total impact of the purchases is not relevant to the supposed motive because it does not show what a KAM client would see: the impact on his or her particular monthly statement, not the total impact on <u>all</u> KAM client statements. Perhaps the best evidence available on this point is the fact that Tampsco did not sell the purchased securities even after the OIP was issued (Mrs. Smith was already deceased by April 2011).

to get best execution for each of the three securities purchased. The Decision also does not identify the predicate for its conclusions that each security was purchased at an artificial price and that none would have been acquired but for a manipulative intent.

As a result of all of the purchases alleged in the OIP, the Initial Decision concludes that KAM clients paid excess fees in the amount of $4,169.78. *Id.* at 10. The Initial Decision states that the "parties agree" on this amount. *Id.* The number was calculated using the Division's methodology based on the purchases in September, October, November and December, as alleged in the OIP, and assumes that all transactions would have been executed at the opening bid price on the purchase date rather than at the prices paid. Respondents agreed that the math is correct but disagree with the underlying assumptions and method. The number in the Initial Decision does not exclude the transactions for October and November, although the Decision concludes that the Division failed to prove the allegation in the OIP regarding those purchases. *Id.* at 14.

The Decision concludes that Mr. Koch is a primary violator, although KAM is the registered adviser. This conclusion is premised on the conclusion that KAM is the alter ego of Mr. Koch because the advisor has only one employee, not counting its bookkeeper. Based on those conclusions the Initial Decision finds it unnecessary to address the question of aiding and abetting.

Advisers Act Rule 206(4)-7(a), which requires that Commission-registered advisers adopt and implement written policies and procedures reasonably designed to prevent violations of the Act, was violated by KAM and Mr. Koch, according to the Initial Decision. *Id.* at 15. This is based on the Division's contention that "transactions did occur" which violated the securities laws, and the fact that Mr. Koch is the "alter ego" of KAM. *Id.*[8]

Finally, the Initial Decision concludes that a cease-and-desist order is required because the "conduct was egregious and recurrent over a period of three months." The conduct involved at least a reckless degree of scienter. The lack of assurances against future violations and recognition of the wrongful nature of the conduct goes beyond a vigorous defense . . . ." *Id.* at 16. In fact, the Initial Decision found wrongful conduct in only two months. There is no reference to the fact that KAM and Mr. Koch are no longer in the advisory business, or that that Mr. Koch has retired. Likewise, there is no reference to the fact that KAM is no longer eligible to register with the Commission and has not registered with the State.

The Decision also orders disgorgement in the amount calculated by the Division for all of the transactions alleged in the OIP without making any adjustment for those where there was a failure of proof. A second tier penalty was ordered based on a finding of harm to investors in the amount of the excess fees, again without making any adjustment for the failure of proof by the Division. A censure and bar were ordered based on a lack of contrition evidenced by the fact that KAM and Mr. Koch contested the allegations in the OIP and despite the substantial defenses presented.

V. BASIS FOR REVIEW

A. The Issues Presented.

1. Whether the Initial Decision properly identifies a standard for concluding that there was an artificial price and whether the Initial Decision specifies any facts demonstrating an artificial price.

2. Whether intent alone can support a finding of marking the close.

[8] The Initial Decision rejects a claim in the OIP that the Respondents failed to produce documents, finding that the proof offered by the Division was inadequate. *Id.* at 15.

3. Whether, if intent alone can establish marking the close, intent in fact existed under the circumstances in this case.

4. Whether Mr. Koch can be a primary violator.

5. Whether the Initial Decision properly identifies a standard and factual basis for concluding that Respondents necessarily failed to implement KAM's policies and procedures.

6. Whether the sanctions set by the Initial Decision are improper.

B. The Initial Decision Fails To Identify a Standard By Which It Concluded That There Is an Artificial Price or Specify Any Facts to Support Such a Finding.

The OIP charges, and the Initial Decision finds, that Respondents engaged in market manipulation by marking the close in violation of Section 10(b) of the Exchange Act and Section 206 of the Advisers Act. To establish market manipulation the Division was required to prove, and the Initial Decision had to find, deception. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 473 (1977) ("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception."); *See also Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). (Section 206 is based on fiduciary duty.).[9] Here the Initial Decision fails to mention deception but does claim the September and December purchases were made at artificial prices. This conclusion fails. It is not based on an articulated legal standard or factual findings grounded in the record.

First, the Initial Decision fails to identify the legal standard used to determine that the September and December purchases were made at artificial prices. Not only does the Initial Decision fail to mention the requisite element of deception, but it does not identify any standard by which it concluded that the September and December purchases were made at artificial prices.

[9] The Initial Decision defines 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." *Thomas C. Kocherhans*, Exchange Act Release No. 36556 (Dec. 6, 1995), 52 S.E.C. 528, 530; *see also SEC v. Masri*, 523 F. Supp. 2d 361, 369 (S.D.N.Y. 2007) (marking the close is "the practice of repeatedly executing the last transaction of the day in a security in order to affect its closing price").

It simply states that the purchases caused artificial prices. *See, e.g.*, Initial Decision at 2 (Respondents "artificially increase[d] the reported closing price of one or more securities").

Second, the Decision fails to provide any factual analysis to support its artificial price conclusion. The Commission has defined an artificial price to be "the deceptive movement of a security's *price*, accomplished by an intentional interference with the forces of supply and demand." *Setteducati*, SEC-NA 2002 Ref. No. 01580009 (Aug. 9, 2002), *aff'd*, Securities Exchange Act Release No. 48759 (Nov. 7, 2003). Here there is no discussion about "the deceptive movement of a security's price" or "intentional interference with the forces of supply and demand." Yet the Commission has made it clear that "[d]etermining whether a person has engaged in a manipulative scheme depends on inferences from a variety of factual detail, patterns of behavior, and, among other things, trading data." *Elgindy*, Securities Exchange Act Release No. 49389 (Mar. 10, 2004). Here the Initial Decision is devoid of the required analysis. Nevertheless, this unsupported conclusion is the centerpiece of the determination that there were violations of Sections 10(b) and 206.

Third, the Initial Decision's determinations on this critical point are contradictory. On the one hand, it concludes there is an artificial price. On the other, it finds that the defense offered by KAM and Mr. Koch "would provide a reasonable and non-violative explanation for all the trading at issue if it were not for Koch's email exchanges and telephone conversations. . . ." Initial Decision at 10. If the purchases were actually made at artificial prices, any defense offered could not change that fact because either the prices were artificial, and therefore violative, or they were not. These contradictory findings highlight the flawed and confused reasoning on which the Initial Decision is predicated.

The reference in the Initial Decision to illegal profits and the conclusory claim that but for the artificial price Respondents would not have made the September and December purchases does not alter this fact. The claim of illegal profits is a circular argument. It begins and ends with the assumption that there was an artificial price. Circuitous arguments are not a substitute for analysis.

Similarly, the conclusion that but for the artificial prices the September and December purchases would not have been made offers no support for the artificial price determination. Not one fact is offered in the Initial Decision to support this conclusion. Multiple conclusions unsupported by the facts do not constitute a foundation for a factual finding, particularly one made in the absence of a guiding legal standard.

Perhaps the reason the Initial Decision fails to specify the facts supporting its conclusion is that the largely undisputed evidence in the record is to the contrary. Professor Jarrell's uncontradicted testimony established that there was no evidence of manipulation in the purchases of Cheviot and Carver securities and that in any event neither transaction set the closing price. He also testified that the High Country transactions were at prices comparable to other non-KAM transactions. All of this was confirmed by Mr. Schneider's analysis of KAM's purchases in the context of its long term investment program.

This means that, absent proof that every purchase by KAM of High Country, Cheviot and Carver was made at an artificial price, the September and December purchases were not manipulative. And, in any event, those purchases could not have been made at artificial prices since the Division's own witness, Mr. Christanell testified that each represented the best execution despite a claim to the contrary in the OIP testimony. It is telling that the Decision fails to mention either the allegation from the OIP or Mr. Christanell's testimony. *See, e.g.*, *NetCoalition v. SEC*, 615 F.3d 525, 530, n.6 (D.C. Cir. 2010). (The duty of best execution requires a broker-dealer "to exercise reasonable diligence to obtain favorable order execution terms for customers."). In short, the Initial Decision fails to articulate a standard for making its artificial price determination or to specify any facts to support it. Absent an artificial price there can be no violation of Exchange Act Section 10(b), no violation of Advisers Act Sections 206(1), (2) or (4), and no predicate for sanctions. The proceeding should be dismissed.

C. Intent Alone Cannot Establish Marking the Close.

Each of the violations of law found in the Initial Decision is premised on a finding of intent alone. This is clear from its acknowledgment that the evidence of no artificial price as offered by Respondents would be a complete defense to the allegations, *but for* Respondents' intent to mark the close. *See SEC v. Masri*, 523 F. Supp. 2d 361, 372 (S.D.N.Y. 2007). Yet it is clear that intent alone is not sufficient to sustain the conclusion that KAM and Mr. Koch violated the federal securities laws.

Wrongful intent standing alone does not constitute a crime. *Cf. Wooley v. Maynard*, 430 U.S. 705, 714-15 (1977) (the First Amendment protects thought and belief from punishment); *Abood v. Detroit Bd. of Educ.*, 431 U.S. 209, 234-35 (1977) (same). Indeed, the First Amendment "protects against the prosecution of thought crime." *U.S. v. Balsys*, 524 U.S. 666, 714 (1998) (Breyer, J., dissenting). Accordingly, to the extent the Initial Decision attempts to find violations of the federal securities laws based only in wrongful intent, this proceeding must be dismissed.

D. The Record Does Not Establish Wrongful Intent.

Even assuming that wrongful intent alone is sufficient to sustain the claimed violations – and it is not – the conclusions in the Initial Decision cannot be sustained since the evidence does not support a finding of manipulative intent. This is clear since the determinations in the Initial

Decision as to the September and December purchases are premised on nothing more than conclusions unsupported by any specific findings of fact or the record.

1. The September purchases

The wrongful intent conclusion of the Initial Decision as to the September purchases is premised on one e-mail and a rejection of Mr. Koch's testimony about the e-mail. Yet the conclusion is devoid of analysis, is not supported by factual analysis, fails to consider the context of the statement, and ignores the record.

First, the Initial Decision fails to specify any facts to support its conclusion. Relying on what it calls "the plain meaning" of the e-mail, [10] the Initial Decision concludes that it demonstrates a manipulative intent sufficient to sustain violations of Exchange Act Section 10(b) and Advisers Act Sections 206(1) and (2). Initial Decision at 6. No analysis is proffered to explain why a directive not to appear to be manipulative is in fact manipulative. No context is given to support the conclusion. No facts are offered to support the conclusion. While it is possible to read Mr. Koch's directive to mean that he thought the activity was in fact manipulative, this supposition is not supported by any factual analysis and none was offered by the Division.

The only possible support for this conclusion is the Initial Decision's disregard of Mr. Koch's explanation of the email. *Id.* at 6, 13. Yet even if Mr. Koch was unconvincing – which he was not – a rejection of his explanation is not a substitute for proof unless the burden of proof is reversed. That would constitute an impermissible reversal of the burden of proof, essentially meaning that if the Respondents cannot offer a cogent defense, the Division prevails. That is not

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[10] The e-mail from Mr. Koch to Huntleigh trader Christanell states: "[m]ove last trade right before 3pm up to as near to $25 as possible without appearing manipulative. . ." Initial Decision at 13.

the law. *See, e.g., Steadman v. SEC*, 450 U.S. 91, 103 (1981) (Division must prove the allegations by a preponderance of the evidence).

Equally problematic is the Initial Decision's failure to even mention the context of the directive in the e-mail or the other testimony in the record which explains the purchases. When the e-mail was sent, KAM had already been in the market, purchasing shares of High Country beginning with a limit order for 400 shares with a cap price of $18 entered at 11:25 a.m. The order filled by 11:41 a.m. The order was then revised minutes later to 2,000 shares, but with a reduced cap price of $16, although the ask price was $20 and the bid was $11.70. When the order did not fill, KAM again revised its strategy, setting the limit price at $25, over the existing ask of $20, as noted in the e-mail.

In adopting this tactic, Mr. Koch instructed the trader not to appear to be manipulative. Mr. Koch understood that if Mr. Christanell entered a large 1,000 or 2,000 share order, as he might typically do as an institutional trader, that large order could drive up the price of a security as thinly traded and volatile as High Country, thereby precluding a fill of the order. Thus Mr. Koch cautioned Mr. Christanell not to appear manipulative. While the Initial Decision rejects that conclusion as inconsistent with its reading of the e-mail, the executions themselves confirm Mr. Koch's statements: they are all in small lots at prices that laddered up gently. KAM was able to purchase the block of High Country at prices under its $25 TBV. Using lawful trading techniques adapted to the peculiar circumstances of a highly illiquid and volatile security to ensure execution at the best available price clearly is not manipulative. It is best execution, as Mr. Christanell himself testified.

Perhaps as inexplicable as the Initial Decision's lack of analysis is its failure to credit the testimony of Professor Jarrell and Mr. Schneider in evaluating the September purchases. Their testimony confirmed KAM's trading strategy and KAM's consistency with its earlier transactions. Viewed in this context KAM's approach is anything but manipulative.

2. The December purchases

The Initial Decision makes the same error with respect to the December purchases. Here again it substitutes supposition for fact, although the predicate for the determination is anything but clear.

The Initial Decision cites December 23 and 28, 2009, emails from Mr. Koch to Mr. Christanell noting that KAM intended to purchase shares of High Country, if available, on December 31, 2009, and segments of the Huntleigh tapes, which it apparently reads to mean that KAM and Mr. Koch sought to mark the close as with the September email. Yet there is no analysis of the statements. There is no explanation for ignoring the manner in which the transactions were executed or the other evidence in the record.

First, the Division failed to offer any proof to support the reading of the tape segments which was eventually adopted in the Initial Decision. To the contrary, Mr. Christanell testified that the purchases received best execution, which means they clearly were not manipulative.

Second, the purchases were made using a limit order set below the TBV for each particular security and small lots designed to *avoid* price run-ups. For example, the reference to "25" on the tape cited in the Initial Decision is to the TBV for High Country, the price above which KAM would not purchase the security. There is no doubt that KAM and Mr. Koch would be "happy" to purchase the hard-to-acquire stock under that price since KAM had agreed with its investors to purchase stock no higher than TBV.

Third, Professor Jarrell testified that obtaining blocks of thinly traded stock frequently requires setting a limit price, which prevents a price run-up at or above the ask. KAM successfully utilized this approach in September 2009. The approach was used again in December 2009, when the limit price for the High Country purchases was above the ask of $16.80, but at KAM's TBV of $25. Similarly, the limit price for Cheviot was above the ask of $7.62 but at $8.25, below its TBV of $12, and the limit price for Carver was at the ask of $9.05, well below KAM's TBV of $20.

Fourth, if the intent was to mark the close, then Mr. Koch would have directed that the orders be placed at or near the close with large blocks. Yet it did not. Rather, KAM gave Mr. Christanell the orders and limit prices and told him to purchase in small lots. The time of execution was left to Mr. Christanell based on market conditions. Yet the Initial Decision fails to consider this point or much of the other evidence in reaching its conclusions.

Equally baseless is the Decision's finding about Mr. Koch's instruction to "move it up." Not only is the conclusion devoid of facts and analysis, it simply reads the statement out of the context of the tapes. On December 31, 2009, Mr. Koch told Jeff Christanell, "And we may give you some more orders here. Fay's looking into to see what else we want to move up toward the end of the year. I'll find out." As Mr. Christanell testified, this is a reference to KAM's bookkeeper who was trying to identify other accounts that needed to be "push[ed] up," that is, increase their holdings of stock, thereby reducing their cash. Inexplicably, the Initial Decision fails to even mention this undisputed testimony.

The Initial Decision also assumes that Mr. Koch had a motive to mark the close, that he sought to improve the appearance of his clients' portfolios because a few had become focused on short term performance. Initial Decision at 5-6. This supposed motive is undercut by the record. To establish this as a motive the Division would have to prove that the transactions here were for the portfolios of the concerned clients. Although the accounts which purchased the shares here are identified, the Division failed to offer this proof or even establish that after this proceeding was instituted the shares were sold.

Likewise, the Division failed to offer any proof regarding the impact of these transactions on the portfolios of particular KAM clients. Rather, the Division tabulated the gross numbers for all KAM clients, advisory and family. Since no KAM client would ever see such a tabulation and there is no proof that the so-called concerned clients held the three stocks involved here, the claimed motive fails.

Finally, if the motive was to enhance statement appearance, or perhaps to earn more fees, KAM would have been expected to purchase shares in other stocks to "push up" the appearance and fees. Its failure to do so completely undercuts this claimed motive. In short, there was no motive and no intent to manipulate, but only a desire to purchase difficult-to-acquire securities in accord with KAM's obligations to its clients.

E. The Initial Decision Ignores *Janus* and the Directive of the Statute in Concluding that Mr. Koch is a Primary Violator.

The Initial Decision incorrectly determines that KAM and Mr. Koch are both primarily liable for violations of Exchange Act Section 10(b) and Advisers Act Sections 206(1) and (2). This is based on the conclusion that KAM, the adviser, is the "alter ego" of Mr. Koch, an associated person. Initial Decision at 13 ("An associated person may be charged as a primary violator, where, as here, the investment adviser is an alter ego of the associated person.") (citing *John J. Kenny*, Securities Act Release No. 8234 (May 14, 2003), 56 S.E.C. 448, 485 n.54)). As with its other conclusions, the Decision offers no legal analysis beyond a citation and no factual predicate, while ignoring the Supreme Court's teachings in *Janus Capital Group, Inc. v. First Derivative Traders,* -- U.S. --, 131 S. Ct. 2296, 2301-02, 180 L. Ed. 166 (2011), and the directive of Congress in Section 206.

First, in *Janus*, the Supreme Court held that a parent company was not liable for alleged false statements by its subsidiary, because under Section 10(b) the only person who can be primarily liable is the one who has the authority to make the statement, *i.e.*, the one who "make[s] any untrue statement of material fact." 131 S. Ct. at 2301-02. In *Janus* the Court held that the subsidiary "made" the statements, not others in the mutual fund complex, since the subsidiary had the ultimate authority over them. Thus the parent company could not be held primarily liable. To hold otherwise would have nullified aider and abetter liability. *See id.*

In this case, KAM is the registered investment adviser. As such only KAM has the authority to "make" the statements, that is, to execute securities transactions on behalf of its clients. As such, under *Janus*, only KAM, not Mr. Koch, can be primarily liable.

Similarly, the plain language of the Advisers Act indicates that only an investment adviser itself can be held liable under Section 206. *See* Section 206 ("It shall be unlawful for any investment adviser. . ..") (emphasis added). An associated person, such as Mr. Koch, cannot be a primary violator. *See, e.g., Santa Fe* 430 U.S. at 477 (language of the statute was "sufficiently clear" so as to be dispositive).

Finally, even assuming that *Janus* and the plain language of the statute can be ignored, the alter ego analysis of the Initial Decision is clearly insufficient. Again, the Initial Decision offers no analysis to support its "alter ego" finding. While it is clear that Mr. Koch is the only employee of the adviser, setting aside the bookkeeper, that fact alone is insufficient to support an alter ego theory.[11] Accordingly, since the analysis in the Initial Decision is flawed and it fails to make an aiding and abetting analysis, all charges against Mr. Koch must be dismissed.

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[11] Also, just because KAM is a one-man shop does not mean that it is the alter ego of Mr. Koch. *See Definition of "Client" of Investment Advisor for Certain Purposes Relating to Limited Partnerships*, S.E.C. Release No. 956, at *3 (Feb. 25, 1985) (providing one means of assessing whether an investment adviser is the alter ego of a related person for the purposes of applying then-proposed Rule 203(b)(3)).

F. The Initial Decision Does Not Specify the Standard on Which Its Finding of Inadequate Implementation of Procedures Is Based.

The Initial Decision also incorrectly concludes that KAM violated Advisers Act Rule 206(4)-(7)(a), which requires that an adviser adopt and implement written policies and procedures reasonably designed to prevent violations of the Act. The conclusion is incorrect because it is based on the erroneous "alter ego" conclusion, an incorrect standard, and ignores Commission precedent.

First, the finding is based at least in part on the earlier "alter ego" finding. Since that determination is incorrect, it follows that one based on it is also erroneous.

Second, the conclusion is based on an incorrect standard. Setting aside the alter ego conclusion, the Initial Decision acknowledges that KAM adopted the correct procedures but claims it failed to implement them since Mr. Koch was the Chief Compliance officer. In reaching this determination the Initial Decision fails to identify or cite to any legal standard to support its conclusion that this is improper. Indeed, the Advisers Act does not preclude Mr. Koch, as an associated person, from holding such a position, as the Initial Decision concludes.

Finally, the fact that a violation occurred – assuming there was one, which is incorrect – does not necessarily mean that the policies and procedures of the firm are inadequate or not properly implemented. While this was the contention of the Division, as the Initial Decision notes, the reasoning is wrong: the Commission has repeatedly acknowledged that a violation does not necessarily signify a failure to implement policies and procedures. *See, e.g.*, *S.E.C. Charges Former Morgan Stanley Executive with FCPA Violations and Investment Adviser Fraud*, S.E.C. News Digest 2012-80, 2012 WL 1426055, at * 1 (Apr. 25, 2012) (noting that Morgan Stanley itself was not charged in a matter involving a high-level member of its real estate investment advisory and fund advisory business).[12] Accordingly, the Initial Decision's finding of a violation of Rule 206(4)-7(a) is not supported by the law or the facts.

G. The Sanctions Are Improper.

The Initial Decision premises its need for a cease-and-desist order and bar on the recurrent nature of the conduct, its findings that clients were overcharged by $4,169.78, and the prospect of a future recurrence based on Mr. Koch's profession and his apparent failure to recognize his wrongdoing. Again, these findings are not supported by the record and are contrary to law.

First, the finding that the conduct was "recurrent over a period of three months" is simply wrong. Initial Decision at 16. Even assuming that the findings of violation are correct – and they are not – they involved two isolated days in the over two decades KAM has been in business. The finding is factually wrong and fails to consider the context.

Second, the total amount of fees is wrong. As previously demonstrated, not only is the calculation based on unsupported assumptions, but also it includes transactions for which the Initial Decision concluded the Division failed to prove a violation. Thus this number cannot be used to support the conclusion regarding the cease-and-desist order or disgorgement.

Finally, the Initial Decision's conclusion that Mr. Koch is engaged in a profession which will afford opportunities in the future for a recurrence and that the conduct "goes beyond a vigorous defense" ignores the record. It is undisputed that KAM no longer has any advisory clients and that Mr. Koch has retired. It is undisputed that KAM is no longer eligible to register with the Commission as an investment adviser and that the firm has not registered with any state. Accordingly, the record demonstrates that there is no real opportunity for any recurrence.

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12 *See also In re Compliance Programs of Investment Companies and Investment Advisers*, Release No. 2107, at *11 (Feb. 5, 2003) (standards for small advisers is different than those for large advisers); *Custody of Funds or Securities of Clients by Investment Advisers*, Release No. 2968, at *18 (Dec. 30, 2009) (same).

Furthermore, whatever the meaning of the statement about a vigorous defense in the Initial Decision, the mere fact that KAM and Mr. Koch defended this action does not support a finding of a probability of a recurrence. Indeed, it is beyond dispute that when a law enforcement agency brings an action the accused has an unfettered right to defend the action. *See, e.g., SEC v. Perez*, 2011 WL 5597331, at *5 (S.D. Fla. Nov. 17, 2011). This is especially so in this case, where Respondents presented evidence that their trading was legitimate and was done to purchase and hold the stocks at issue.

Finally, while contesting the charges here, Mr. Koch's respect for the rule of law cannot be doubted. As the testimony at the hearing established, he created a foundation dedicated to teaching students about the basic legal principles of this country. He funds this foundation at significant personal expense without any additional revenue source except the bequest of Mrs. Smith. He serves on the board of the Hoover Institute of Stanford University. In sum, although KAM and Mr. Koch did offer a vigorous defense to the charges here based on significant and substantial evidence offered by respected and credible witnesses, there is no need for a cease-and-desist order or a penalty, given Mr. Koch's respect for and dedication to the law, and given the fact that he has retired from the adviser business.

VI. CONCLUSION

The Initial Decision is based on assumptions and conclusions which fail to articulate appropriate legal standards and ignore the undisputed evidence in the record in favor of unsupported suppositions. More importantly, the Initial Decision ignores the undisputed evidence demonstrating that there was no deception relating to the September and December purchases, that there was no artificial price and that for each purchase the client received the best execution. It ignores the fact that the only benefit from these transactions went to KAM's clients, a point well-illustrated by the fact that none of the shares involved here were sold while the clients remained with the firm and there is no evidence of any sale after those clients were notified of the charges in the OIP.

Wherefore, Respondents respectfully submit that the Commission should grant this Petition for Review.

Dated: July 6, 2012

Respectfully submitted,

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