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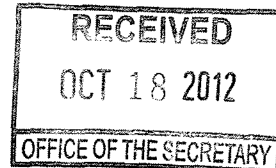
UNITED STATES OF AMERICA
Before The
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-14355



In the Matter of

DONALD L. KOCH and
KOCH ASSET MANAGEMENT LLC,

Respondents.

DIVISION OF ENFORCEMENT'S
MEMORANDUM OF LAW IN OPPOSITION
TO RESPONDENTS' APPEAL OF INITIAL DECISION

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The Division respectfully submits this memorandum of law in opposition to the appeal filed by Respondents Donald L. Koch ("Koch") and Koch Asset Management LLC ("KAM") (collectively, "Respondents").

PRELIMINARY STATEMENT

On April 25, 2011, the Commission instituted proceedings against Respondents Koch Asset Management LLC ("KAM") and Donald L. Koch ("Koch"), KAM's founder, sole owner, principal, and chief compliance officer, pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act").

The Order Instituting Proceedings ("OIP") alleged, *inter alia*, that Respondents marked the close of thinly traded securities held in their clients' advisory accounts on the last trading day of the month for four consecutive months commencing September 30, 2009 and ending December 31, 2009.[1] The stocks at issue were those of regional banks, which was KAM's investment focus: (i) High Country Bancorp Inc. ("HCBC"), (ii) Cheviot Financial Corp. ("CHEV") and (iii) Carver Bancorp, Inc. ("CARV"). The OIP pointed to emails and audio recordings where Respondents directly instructed their broker, Jeffrey Christanell ("Christanell") of Huntleigh Securities Corporation ("Huntleigh"), to place manipulative trades at certain times of the day and at certain elevated prices. For example, the OIP alleged that on December 28, 2009, Koch emailed Christanell instructing him to "[p]lease put on your calendar to buy [High Country Bancorp, Inc. ("HCBC") stock] 30 minutes to an hour before the close of market for the

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[1] The OIP also alleged that Respondents failed to maintain required books and records. The Initial Decision concluded that the Division failed to prove this claim, but the Division is not pursuing it as a cross-appeal.

year. *I would like to get a **closing** price in the 20-25 range*, but certainly above 20." Div. Trial Exh. 187 (emphasis added). Christanell executed the trades consistent with Koch's instructions, thereby defrauding both Respondents' advisory clients (by causing them to overpay for securities and by causing them to pay excessive management fees based on the inflated values of the securities) and the market as a whole (by transmitting false information to the market through manipulative trading).

The hearing in this matter was conducted on six days starting January 10, 2012 and ending January 20, 1012. The Division called four witness:

- Catherine T. Marshall, Huntleigh's Compliance Officer, who testified that (a) she was alerted to the manipulative trades by a letter from NYSE Arca, (b) Respondents were concerned about advisory clients accessing their account information through Huntleigh and raising questions to Respondents, and (c) Respondents could not provide a reasonable explanation for their trading when questioned;

- Jeffrey S. Christanell, a broker at Huntleigh, who testified that Respondents instructed him to trade in order to get a closing price on the last trading day of September, October, November, and December 2009;[2]

- Eli Straeter, Huntleigh's IT Manager, who testified concerning the production of audio recordings from Huntleigh's trade desk recording system; and

- Stephen P. Glascoe, SEC Senior Market Surveillance Specialist, who provided summary testimony concerning Respondents' trading and the effect of that trading on Respondents' clients' accounts.

Respondents called six witnesses:

- Respondent Donald L. Koch, founder, sole owner, president, and chief compliance officer of KAM, who testified about his rationales for his trades, his belief the proceedings against him were a result of the Commission's failure to understand his trading strategy, and his purported retirement from acting as an investment adviser as a result of this action;

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[2] Christanell was the subject of settled proceedings arising out of this conduct. *See Huntleigh Securities Corp. and Jeffrey S. Christanell*, AP File No. 3-14354, 2011 WL 1540324 (Apr. 25, 2011).

- Fay Heidtbrink, KAM's bookkeeper, who testified about Respondents' document retention policies and general office operations;

- Two KAM investors, Don Cayce and James Ewoldt, who testified that they were pleased with the results of their investments with KAM and to Koch's good character;

- John Schneider, a KAM expert witness, whose report established that Respondents' purchases of HCBC on the last trading day of September, October, and November 2009 and of HCBC, CARV, and CHEV on the last trading day of December 2009 were anomalous.

- Professor Gregory Jarrell, a KAM expert witness, who testified that there is academic support for trading theories that seek to acquire thinly traded stocks by executing trades at the end of the day on the last trading day of a period, but, crucially, Jarrell conducted no analysis of whether Respondents had actually employed this trading strategy with the three stocks at issue. Jarrell also testified that he did not review any documents reflecting communications between Respondents and Huntleigh, the very documents wherein Respondents expressly describe the strategy behind their trading.

On May 24, 2012, the Administrative Law Judge ("ALJ") issued an Initial Decision finding that Respondents' violated the antifraud provisions of the Exchange Act and the Advisers Act by "marking the close" of HCBC on September 30 and of HCBC, CHEV and CARV on December 30, 2009 for advisory clients.[3] Initial Decision ("ID") at 1. After considering all of the record evidence, and the parties' arguments, the ALJ found that "Respondents engaged in marking-the-close transactions in the accounts of advisory clients so as to artificially increase the reported closing price of one or more securities at quarter-end on September 30 and December 31, 2009" and that "[t]he closing prices affected the valuation of all Respondents' advisory clients' accounts that held the securities at the end of those quarters." ID at 2. The Administrative Law Judge also determined that it was appropriate to impose a cease-and-desist

[3] The ALJ also concluded that Respondents violated Advisers Act Rule 206(4)-7(a), which requires Commission-registered investment advisers to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act and rules adopted thereunder. ID at 14-15. While Respondents adopted policies preventing marking the close, they did nothing to implement those policies.

order, disgorgement (joint and several) of $4,169.78, a civil money penalty (joint and several) of $75,000, a censure of KAM, and an investment adviser bar against Koch. ID at 16-18. For the reasons stated herein, the Initial Decision should, with minor modification, be affirmed.

ARGUMENT

I. The Standard Of Review

Pursuant to Rule 411(a) of the Commission's Rules of Practice, in reviewing an Initial Decision, the Commission may "affirm, reverse, modify, set aside or remand for further proceedings, in whole or part, an Initial Decision" and it "may make any findings or conclusions that in its judgment are proper and on the basis of the record." 17 C.F.R. § 201.411(a). The scope of the Commission's review is limited by "the issues specified in the petition for review"[4] and "the issues, if any, specified in the briefing schedule order"[5] or "any other matters" that the Commission deems material provided that the parties receive notice from the Commission. 17 C.F.R. § 201.411(d).

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[4] Respondents were required, pursuant to Rule 410(b), to set forth in their petition for review the specific findings and conclusions of the Initial Decision to which they take exception. 17 C.F.R. § 201.410(b). Respondents principally identified legal issues: (i) whether intent alone can support a finding of marking the close, (ii) what is the standard for determining that a price is artificial in a marking-the-close case, and (iii) whether, under *Janus Capital Group, Inc. v. First Derivative Traders*, --- U.S. ---, 131 S.Ct. 2296 (2011), Koch can be a primary violator. Depending on the resolution of these legal issues, Respondents also take exception to the following three conclusions: (i) that Respondents had the requisite intent to support a finding that they marked the close of HCBC, CHEV and CARV on the specified dates, (ii) that the prices were artificial, and (iii) that the disgorgement amount and other sanctions awarded were proper. Respondents did not take any exception to the admission or exclusion of any evidence at trial.

[5] The Commission's Order Granting Petition for Review and Scheduling Briefs dated July 26, 2012, stated that, on its own initiative, the Commission has determined to review what sanctions, if any, are appropriate in this matter.

II. The Initial Decision Applied The Correct Standard And Properly Concluded That Respondents Marked The Close of HCBC, CHEV and CARV And Thereby Willfully Violated Exchange Act § 10(b) and Advisers Act §§ 206(1) and (2)

The Initial Decision concluded that Respondents' instructions to a trader to purchase shares of HCBC on September 30, 2009 and HCBC, CHEV and CARV on December 31, 2009, at a particular time of day and in an effort to obtain a specific high closing price, operated as a manipulative and deceptive scheme to mark-the-close in violation of Exchange Act Section 10(b) and Advisers Act Sections 206(1) and 206(2). ID at 13-15.[6]

On appeal, Respondents argue that the Initial Decision does not adequately identify the legal standards that the ALJ applied in reaching her conclusions and thus the Initial Decision should be dismissed or vacated and remanded. Petition Br. at 11-15, 20-23; Appeal Br. at 8-14. In support of this argument, Respondents rely on *Rapoport v. SEC,* 682 F.3d 98 (D.C. Cir. 2012), where the D.C. Circuit vacated a Commission order denying a motion pursuant to Commission Rule of Practice 155(b) to set aside a default judgment. The court held that, when an agency adopts rules of practice but departs from its own precedent without explaining why, the reviewing court has "no choice" but to remand the case to the agency "for a reasoned explanation." *Id.* at 104. *Rapoport* is inapposite here because Respondents' appeal does not involve an interpretation of a Commission Rule of Practice, it involves the application of federal securities statutes and regulations, and, in any event, the standards applied by the ALJ were plainly stated in the Initial Decision and bolstered by citation to other Commission and federal

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[6] Respondents correctly note that the Initial Decision does not discuss or draw any conclusion as to whether Respondents violated Exchange Act Section 10(b) or Advisers Act Sections 206(1) and 206(2) by failing to *seek* best execution on their trades. Appeal Br. at 11. The Commission can consider the best execution claim on appeal, however, as Respondents have opened the door by contending that the marking-the-close and best execution claims overlap and, in their view, Respondents cannot be liable for market manipulation if they *obtained* best execution. The Division addresses best execution in Point II.A.4.

court decisions in market manipulation cases. ID at 11-15 ("CONCLUSIONS OF LAW" heading) and 15-19 ("SANCTIONS" heading). Even if the Initial Decision was devoid of any discussion of the legal standards applied – which it is not – the Commission can simply articulate the applicable legal standards and make its own findings and conclusions.

A. Exchange Act § 10(b) and Advisers Act § 206(1)

Market manipulation is "[i]ntentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the prices of securities." ID at 11 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)). Market manipulation is prohibited by Exchange Act Section 10(b), which makes it unlawful for any person, directly or indirectly:

> (b) To use or employ, in connection with the purchase or sale of any security…any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b); *see also* 17 C.F.R.§§ 240.10b-5(a), 240.10b-5(c) (making it unlawful, by the use of any means or instrumentality of interstate commerce, the mails, or any facility of a national securities exchange, to "employ any device, scheme or artifice to defraud" or "engage in any act, practice or course of conduct which operates or would operate as a fraud or deceit upon any person"). Market manipulation is also prohibited under the Advisers Act. Section 206(1) prohibits an investment adviser from employing "any device, scheme, or artifice to defraud any client or prospective client." 15 U.S.C. §§ 80b-6(1). Scienter is required to establish violations of Exchange Action Section 10(b) and Advisers Act Section 206(1). ID at 12 (citing *Aaron v. SEC*, 446 U.S. 680, 690-91, 695-97 (1980) and *SEC v. Steadman*, 967 F.2d 636, 641 & n.3 (D.C. Cir. 1992).

Exchange Act Section 10(b) and Advisers Act Section 206(1) encompass an infinite variety of devices and are not limited to the more traditional manipulative devices such as "wash

sales," "matched order" and "rigged prices." *SEC v. First Jersey Secs., Inc.*, 101 F.3d 1450, 1466 (citing *Affiliated Ute Citizens v. U.S.,* 406 U.S. 128, 151 (1972)).[7]

The conduct at issue in this proceeding – "marking the close" -- involves open market trades made without the use of "traditional" manipulative devices but that were specifically designed to obtain a closing price on HCBC, CHEV and CARV shares on the last trading day of September 2009 and December 2009. The Commission has long-held that marking-the-close, defined 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," is manipulative because it conveys false information to the market about a stock's real price level and the demand for it; and, such conduct violates Exchange Act Section 10(b) and Advisers Act Section 206(1) when the alleged manipulator acts with scienter. *See, e.g., Thomas C. Kocherhans*, 160 SEC Docket 2589, 1995 WL 723989, at *2 (Dec. 6, 1995); *see also, e.g., Markowski v. SEC*, 274 F.3d 525, 529 (D.C. Cir. 2001), *cert. denied,* 537 U.S. 819, (2002); *SEC v. Kwak,* 2008 WL 410427, at *1 (D. Conn. Feb. 12, 2008); *SEC v. Masri,* 523 F. Supp. 2d 361, 372 (S.D.N.Y. 2007).[8]

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[7] Section 206 of the Advisers Act establishes a federal statutory fiduciary duty for investment advisers to act for the benefit of their clients, "requiring advisers to exercise the utmost good faith in dealing with clients, to disclose all material facts, and to employ reasonable care to avoid misleading clients." *SEC v. Treadway,* 430 F. Supp. 2d 293, 338 (S.D.N.Y. 2006) (quoting *Transamerica Mortgage Advisers, Inc. v. Lewis,* 44 U.S. 11, 17 (1979)). Section 206 is not limited to misrepresentation or omission cases; rather, on its face, it extends to "any device, scheme or artifice to defraud" and "any transaction or course of business which operates as a fraud" *SEC v. Moran,* 922 F. Supp. 867, 895-96 (S.D.N.Y. 1996) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194, 196 (1963) (discussing the Advisers Act's sweeping reforms and stating that, by passing the Act, Congress empowered federal courts "to enjoin *any* practice intended which operates as a fraud or deceit upon a client")).

[8] Most marking-the-close cases have come before the Commission in settled administrative proceedings. *See, e.g., Eric David Wanger,* 2012 WL 2524953 (July 2, 2012) (Order Making Findings, Imposing Remedial Sanctions and Cease-and-Desist Order); *Schultz Investment Advisors, Inc.*, 2005 WL 3543078 (Dec. 28, 2005) (OIP, Making Findings, Imposing Sanctions and Cease-and-Desist Order); *Texas Vanguard Oil Co.*, 1998 WL 113705 (Mar. 16, 1998) (OIP, Making Findings, Issuing Cease and Desist Order); *Sam Moore*, 1997 WL 598033 (Sept. 30,

Respondents suggest that the Initial Decision has failed to set forth the standards for proving a violation of Exchange Act Section 10(b) and Advisers Act Sections 206(1) and (2) through marking-the-close conduct. Petition Br. at 12-13; Appeal Br. at 9, 15-16. But, the Initial Decision not only sets forth the standards applied, it uses the articulation that Respondents had advocated in their post-hearing briefs. *Compare* ID at 11-15 ("CONCLUSIONS OF LAW" heading) *with* Respondents' Post-Hearing Brief dated Feb. 29, 2012, at 30-33, 43-44 (urging ALJ to require a "plus factor" or to adopt *Masri*). Specifically, the Initial Decision finds that "Koch's manipulative intent altered the timing and prices of his trades and, therefore, Respondents violated Section 10(b) of Exchange Act and Rule 10b-5 thereunder and Sections 206(1), 206(2) and 206(4) of the Advisers Act" and that "Koch ... would not have bought [HCBC, CHEV and CARV] on September 30 and December 31 at the prices at which they were executed but for his purpose of manipulating their closing prices." ID at 14. In their moving papers, however, Respondents appear to abandon the position taken in their post-hearing papers; their position now is that the Division must prove "deception" and/or an "artificial price" and/or that there was no investment purpose for the trades. Petition Br. at 12, Appeal Br. at 15-16. The Division submits that the Initial Decision made clear what standard it applied and it found Respondents' conduct was artificial and manipulative.

1. The Standard For Determining Whether Open Market Conduct Is Manipulative

Unless a manipulation is accomplished via one of the traditional devices described above – such as the devices proscribed by Exchange Act Section 9(a)(1) which are *per se* manipulative – objective evidence that conduct is manipulative is rare. Accordingly, as the Initial Decision

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1997) (OIP, Making Findings, Ordering Cease-and-Desist); *Myron S. Levin,* 1992 WL 213989 (Sept. 1, 1992) (OIP, Making Findings, Imposing Relief); *Andrew Doherty,* 49 SEC Docket 804, 1991 WL 286378 (Aug. 12, 1991).

correctly held, a manipulation is established by proving that the alleged manipulator's intent in engaging in certain conduct was to "interfere[] with the free forces of supply and demand." ID at 11 (citing *Smartwood Hesse Inc.*, 52 SEC Docket 1557, 1992 WL 252184, at *5 (Sept. 22, 1992) ("manipulation is the creation of a deceptive value or market activity for a security accomplished by an intentional interference with the free forces of supply and demand" and "does not hinge on the presence or absence of any particular device"). Proof of the alleged manipulator's intent often depends on inferences gleaned by the fact-finder from a mass of factual data, including patterns of behavior, and apparent irregularities.[9] ID at 11 (citing *Pagel, Inc.*, 33 SEC Docket 1003, 1985 WL 548387, at *3 (Aug. 1, 1985), *aff'd, Pagel, Inc. v. SEC*, 803 F.2d 942, 943-48 (8th Cir. 1986)); *see also Terrance Yoshikawa*, 87 S.E.C. Docket 2580, 2006 WL 1113518, at *4 (Apr. 26, 2006) ("[w]hen all of these are considered together, they can emerge as ingredients in a manipulative scheme designed to tamper with free market forces").

The principal question that Respondents raise is whether these historically accepted methods for proving that conduct is manipulative should apply in a case involving open market transactions such as the trades here.[10] The Commission answered that question years ago, in

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[9] As the Division demonstrated at trial, although the trial record consists of massive amounts of trading data that the Initial Decision appropriately analyzed in arriving at its conclusions, this is the rare case where there is direct written and recorded evidence of the Respondents' intent to interfere with free market forces by placing orders designed specifically to determine the final price reported to the markets for HCBC, CHEV and CARV. *See* Point II.A.3..

[10] Respondents articulate the question is as follows -- "whether intent alone can support a finding of marking the close." Petition Br. at 11, 15; *see also* Koch Post-Hearing Br. at 31 ("whether ... intent to move a stock price in conjunction with purely legal acts is barred"); Appeal Br. at 3, 10, 15-16 ("[i]ntent, standing alone, cannot create an artificial price and deception in the marketplace" and "is not a crime"). This articulation grossly mischaracterizes the caselaw. No Commission decision or federal court decision stands for the proposition that intent, without activity, is manipulative. The OIP did not charge Respondents with and the Initial Decision did not conclude that Respondents were liable for violations of Exchange Act Section 10(b) and Advisers Act Section 206(1) based on "intent alone"; rather, Respondents were found liable because the record, as a whole, revealed that Respondents intended to interfere

Kirlin, 97 SEC Docket 1259, 2009 WL 4731652 (Dec. 10, 2009), when the Commission declined to adopt a new standard applicable only in cases alleging open market manipulations.

In *Kirlin*, the Commission looked to the respondents' trading and other surrounding circumstances to determine whether open market trades (in the stock of a thinly-traded company whose shares the respondent owned 20% of) reflected an effort to interfere with the free forces of supply and demand, and ultimately upheld a FINRA Hearing Panel's determination that the open market trades were manipulative. Among the factors considered by the Commission were that (i) the alleged manipulator accounted for a large percentage of the volume of the trades during the period at issue; (ii) the alleged manipulative trades began after the alleged manipulator received word that his company might be de-listed from NASDAQ if the stock price did not stay above a certain level; (iii) after his initial trades failed to move the stock, the alleged manipulator tweaked his trading strategy; (iv) the strategy involved entering an order above the inside bid, receiving a partial fill, cancelling that order and re-entering it at a higher price; (v) the resulting prices (ranging from $0.68 to $1.15 per share) were unexplained by other legitimate market forces. *Id.* at *10-12. The respondents and other witnesses, including an expert, sought to demonstrate that the purchases were for a legitimate purpose and the trading pattern was consistent with a prudent accumulation strategy, designed to minimize the effect on the

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with the markets for HCBC, CHEV and CARV, which led to instructions to a trader (which are evidenced in emails and audio recordings) to trade at a specific time of day to try to obtain a specific closing price, which resulted in activity to carry out those instructions. The cases Respondents rely on for the proposition that "thoughts are constitutionally protected" are completely inapposite. Petition Br. at 15; Appeal Br. at 10 (citing *Wooley v. Maynard,* 430 U.S. 705, 714-15 (1977), in which the Court held that the First Amendment protects freedom of thought, and thus, New Hampshire residents could not be compelled to display the state motto "Live Free or Die" on their license plates) (also citing the dissenting opinion in *U.S. v. Balsys*, 524 U.S. 666, 714 (1998), which disagreed with the view that a defendant had no right to invoke the Fifth Amendment against self-incrimination in response to an administrative subpoena where he was exposed solely to foreign prosecution).

company's market price, and to acquire large blocks at better prices. The Commission, however, declined to disturb the Hearing Panel's finding that such evidence was not credible. *Id.* at *11.

The *Kirlin* respondents had urged the Commission to adopt the standard applied by the District Court in *SEC v. Masri,* 523 F. Supp. 2d 361 (S.D.N.Y. 2007), requiring the Commission to "prove that but for the manipulative intent, the defendant would not have conducted the transaction." *Kirlin*, 2009 WL 4731652, at *12 & nn.75, 76 (citing *Masri,* 523 F. Supp. 2d at 372-73). The Commission, however, rejected the notion that a different standard should apply in open market cases. The Commission noted that it consistently has held that "an [alleged manipulator's] scienter renders his interference with the market illegal" and it declined to adopt the "but for" standard articulated in *Masri. Id.* at *12 & n.78, 79 (citing *Markowski v. SEC,* 274 F.3d 525 (D.C. Cir. 2001), *cert. denied,* 537 U.S. 819, (2002)); *see also Terrance Yoshikawa*, 2006 WL 1113518, at *4; *Smartwood Hesse*, 1992 WL 252184, at *5; *Pagel*, 1985 WL 548387, at *3.[11]

Accordingly, as the Division has argued throughout this proceeding, the standard historically applied in market manipulation cases brought by the Commission – which focuses on the intent of the alleged manipulator and instructs the fact-finder to draw inferences from the alleged manipulator's conduct – is appropriate in *all* market manipulation cases, regardless of

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[11] Courts have long-rejected the notion that a different standard should apply to cases involving open market manipulations. For example, in *In re Initial Public Offering Securities Litigation*, 241 F. Supp. 2d 281 (S.D.N.Y. 2003), the court explained that, even though "open market manipulation" cases involve "conduct that [on its face] stands near the line between illegal and legal activity because their resolution turns less on conduct and more on the intent of the defendants," there is no legal basis for requiring the plaintiff to prove that the defendant's sole reason for entering into a transaction was to manipulate the stock price. *Id.* at 391. The court correctly recognized that, in *United States v. Mulheren*, 938 F.2d 364 (2d Cir. 1991) – the principal case relied on by the *Masri* court – the Second Circuit never imposed a requirement that a defendant act with the "sole intent" of affecting a stock price and "left open the question of whether a defendant who acts with … the 'primary' intent of affecting a stock price could be criminally liable for securities fraud. *Initial Pub. Offering*, 241 F. Supp. 2d at 391.

whether traditional manipulative devices are used or whether the trades take place in the open market. The Commission has not applied, and does not need to apply, a different standard in open market manipulation cases in order to distinguish between legitimate and manipulative trading strategies.[12]

Respondents' suggestion that the Division must separately establish that the price was "artificial" misses the point and their suggestion that the Division must establish that "investors in the marketplace on September 30 and December 31, 2009 were deceived by Respondents' actions" is misplaced. Appeal Br. at 9 (citing no authority). Conduct that is manipulative injects artificial signals into the marketplace because it interferes with the market's natural forces. As the Commission has previously explained in a case involving non-traditional manipulative devices:

> Whether or not his belief is, in good faith, that the free market has undervalued the securities, the manipulator's design in raising prices is to create the appearance that a free market is supplying demand whereas the demand in fact comes from his planned purpose to stimulate buyers' interest. It is of utmost materiality to a buyer under such circumstances to know that he may not assume that the prices he pays were reached in a free market; and the manipulator cannot make sales not accompanied by disclosure of his activities without committing fraud.

Halsey, Stuart & Co. Inc., 30 S.E.C. 106, 1949 WL 36458, at *4 (1949). With regard to Respondents' assertion that the Division must establish investors were actually deceived, it is well-established that the Division, unlike a private litigant, need not establish reliance, loss

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[12] Cases brought under the Federal Energy Regulatory Commission's ("FERC") anti-manipulation rules, which were modified in 2005 to mirror the language of Exchange Act Section 10(b), are instructive on this point as well. *See, e.g., Brian Hunter*, 2011 WL 1519146, at *10-11 (FERC Apr. 21. 2011) (upholding ALJ's conclusion that open market trades were manipulative under 15 U.S.C. § 717c-1 and 18 C.F.R. § 1c.1, which are identical in language to Section 10(b), adopting the standard the Commission applies in market manipulation cases, and noting that "[t]he difference between legitimate open-market transactions and illegal open-market transactions may be nothing more than a trader's manipulative purpose of executing such transactions") (citing *Markowski v. SEC*, 274 F.3d 525 (D.C. Cir. 2001).

causation, or damages under Exchange Act Section 10(b) or Advisers Act Sections 206(1) or 206(2). *SEC v. Washington Inv. Network,* 475 F.3d 392, 405 (D.C. Cir. 2007) (Advisers Act § 206) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 192-93, 195 (1963)); *GLF Advantage Fund, Ltd. V. Colkitt,* 272 F.3d 189, 206 & n.6 (3rd Cir. 2001) (Exchange Act § 10(b)); *SEC v. Rana Research, Inc.,* 8 F.3d 1358, 1363 & n.4 (9th Cir. 1993) (both).

2. The Administrative Law Judge Applied The Appropriate Standard

Although the ALJ correctly applied the Commission's normal standards for a market manipulation case – by drawing inferences about Respondents' intent to interfere with the markets from the evidence admitted at trial – the Initial Decision twice refers to the standard articulated by a District Court in *SEC v. Masri*, 523 F. Supp. 2d 261 (S.D.N.Y. 2007). The *Masri* Court held that, "in order to impose liability for an open market transaction, the [SEC] must prove that, *but for* the manipulative intent, the defendant would not have conducted the transaction." *Masri*, 523 F. Supp. 2d at 272-73. On page 12, after explaining that conduct which marks the close "conveys false information as to a stock's real price free of manipulative influences," the Initial Decision makes the out-of-place comment that "[*a*] *fortiori*, such a trade is illegal market manipulation if it would not have occurred but for the manipulative intent." ID at 12 (citing *Masri*). Later, on page 14, the Initial Decision concludes that "[a]lthough Koch had previously invested in HCBC, CHEV and CARV, he would not have bought them on September 30 and December 31 at the prices at which they were executed but for his purpose of manipulating their closing prices." ID at 14.

The Initial Decision's reference to *Masri* is confusing, but, the ALJ clearly did not apply *Masri* in analyzing the record or arriving at her conclusions. Notably, the Initial Decision does not conclude that the September 30 and December 31 trades would not have occurred but for

Respondents' intent, it finds that "Koch's manipulative intent altered the timing and prices of his trades.[13] The ALJ acknowledged that Respondents had purchased HCBC, CHEV and CARV for customer accounts and their own accounts in the past and that Respondents' experts had presented "reasonable and non-violative explanations" for Respondents' trading, but ultimately concluded that Respondents' communications with the trader (evidenced in emails and audio recordings) provided direct evidence that Respondents intended to mark the close on September 30 and December 31, 2009, and acted in furtherance of that intent by instructing a trader when to trade and at what price. ID at 6, 8 (citing Div. Trial Exhs. 148-150, 186, 188-193 (emails and audio tapes which explicitly use the term "close" or "closing price" or refer to 3 p.m. CST, which is when the markets close in the Central time zone)).

In light of the Initial Decision's confusing reference to *Masri,* which in turn has confused Respondents, the Division believes that this proceeding and future administrative proceedings would benefit from Commission clarification that *Masri* is not the standard in cases involving non-traditional market manipulations. The Division is not aware of any decision by any ALJ, the Commission, or any United States District Court or Circuit Court of Appeals that has actually adopted the standard set forth in *Masri*, which reflects the opinion of one Judge in one District Court and is not at all binding on these proceedings. *See* Division Post-Hearing Reply Br. at 7-9 (arguing why the *Masri* standard should not be followed).

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[13] It appears, however, that the ALJ may have been influenced by the decision in *SEC v. Kwak*, 2008 WL 410427 (D. Conn. Feb. 12, 2008), a case involving marking-the-close transactions, which criticized and distinguished *Masri*. See ID at 12 (citing *Masri and Kwak*). As discussed at greater length above, the *Kwak* court felt that the *Masri* standard would fail to capture manipulative activity in circumstances where the evidence suggests that the alleged manipulator would have traded that day, but his intent altered the trade in some material respect, such as timing, or price. *Id.* at *4 n.10. The Division agrees.

3. The Commission Should Accept The Initial Decision's Findings And Conclusions That Respondents' Marking-The-Close Conduct Violated Exchange Act § 10(b) and Advisers Act § 206(1)[14]

At trial, the Division presented direct evidence of Respondents' scienter – including Trial Exhibits 148, 186-187, 189-191 – as well as extensive additional evidence from which the ALJ could infer that Respondents had the requisite intent to manipulate the closing price of HCBC on September 30, 2009 and HCBC, CHEV and CARV on December 31, 2009. Based on this evidence, the Commission should affirm the Initial Decision's conclusions that Respondents violated Exchange Act Section 10(b) and Advisers Act Section 206(1) by marking-the-close conduct.

a) The September 30, 2009 HCBC Trade

Koch's intent to mark-the-close of HCBC on September 30, 2009 is evidenced most directly in an email he sent to Christanell, the Huntleigh trader, on the afternoon of September 30, 2009. Earlier in the day, Koch inquired as to how Huntleigh prices stocks on the last day of the month. Christanell did not know the answer to the question and, at 1:19 p.m. Central time, he emailed the person at Huntleigh who handled Huntleigh's pricing systems to get an answer. In Christanell's words:

> Don Koch is asking if stocks are priced at the bid or last trade at the end of the day/month? He's looking at HCBC.

Div. Trial. Exh. 145 (9/30/2009 email). Ten minutes later, at 1:30 p.m. Central time, Christanell emailed Koch with an answer to his question, and told him that:

> [I]f a stock trades on a day, it's priced at the last trade. If it doesn't trade, say no trading volume for a couple of days, it gets priced on

[14] A more robust summary of the trial evidence is contained in the Division's Proposed Findings of Fact, which are contained within the first half of its Post-Hearing Brief dated February 13, 2012.

> the bid. In the case of HCBC today, it will get priced on the last trade.

Div. Trial Exh. 146 (9/30/2009 email) (Div. Trial Exh. 146 is in Eastern time, but, Div. Trial Exhs. 148 and 149 reflect same email in Central time.); Tr. at 460-464 (Christanell). In response to learning that HCBC would be priced at the last trade, at 1:43 p.m. Central time on September 30, 2009, Koch emailed Christanell and told him this was "good" and to "**move last trade right before 3 p.m. up to as near to $25 as possible without appearing manipulative.**"[15] Div. Trial Exh. 148 (9/30/2009 email) (Div. Trial Exh. 148 is in Greenwich Mean time, but, Div. Trial Exh. 149 reflects same email in Central time); Tr. at 472-475, 476-477 (Christanell).

The Initial Decision found that Koch's explanation of his trading instructions to be not credible. ID at 6 & n.9. With respect to Trial Exhibit 148, Koch's explanation was incoherent.

> Q: Okay. What are you telling Mr. Christanell to do right here?
>
> A: Well, you know, I had -- I had not worked with this gentleman that long, so I – and I know he was an institutional trader. He was hired, and most of his activities were large block transactions. The last thing in the world you want is to be the elephant in the room, is to go there and sometime, and get -- say, I'm an institutional player, get 5,000 shares. If he gives that signal to the market, the bid/ask [quotes] – and I'm guessing here -- 30, 35. You destroy the entire market. **So I'm asking him to be as invisible as you can, to be as low key as you can, to do this as small of an increment as you can without jumping up and down in the room, showing who you are, showing that you're an institutional trader.**

Tr. at 879 (Koch) (emphasis supplied). This answer offers no explanation for the words "move [the] last trade right before 3 p.m." and no explanation of why he asked the trader to implement his instructions "without appearing manipulative." Nor could anyone – much less Christanell,

[15] The ALJ took judicial notice that the markets close at 4 p.m. Eastern time, which is 3 p.m. Central time in St. Louis, Missouri, where Respondents and Huntleigh Securities were located. ID at 6 n.10.

who Respondents admit was new to the KAM account – reasonably have understood that the words used in Koch's email meant to trade in "as small of an increment as you can." Koch's instruction contains no information at all about the size of the incremental purchases that Christanell should make; instead, Koch's instructions simply gave Christanell a price target, a time of day (3 p.m. Central time, which is when the markets close) and a specific admonition not to "appear[] manipulative." Koch's instruction not to "appear manipulative" is compelling evidence of his manipulative intent; such an admonition is unnecessary unless the parties understand that their actions are manipulative. The Initial Decision properly found that "[Koch's] interpretation [of his statement in Div. Trial Exh. 148] departs so far from the plain meaning of the words [Koch] used as to be unconvincing." ID at 6. The Initial Decision also properly found that Koch's explanation as to why he was surveying Huntleigh about is pricing practices immediately before changing his order, was "not altogether convincing." ID at 6 n.9. The Commission should not disturb the ALJ's credibility determinations.

The actions that Christanell took in response to Koch's instructions are captured in Div. Trial Exh. 278. The 2,000 shares of HCBC that Christanell purchased at Koch's instruction on September 30, 2009, less than one minute prior to the close, represented 100% of the trading volume reported to the markets that day and established the closing price of $23.50 per share. Div. Trial. Exhs. 258, 263, 277, 305; Tr. at 228-229 (Glascoe). All of the shares were allocated to the account of a 92-year old client, Alice Smith. Div. Trial Exh. 53 (allocation sheet) at SEC-HUNTLEIGH 3336; Div. Trial Exh. 48 (list of client names by account number).[16]

[16] At trial, Koch testified that purchased the shares for Smith's account because she had extra cash. Tr. at 907-908 (Koch). What the record shows is that, on September 8, 2009, Koch sold 12,000 shares of HCBC from the account of one of his clients for an average of $11.71 per share. The majority of those shares (10,000) were crossed into (*i.e.* purchased by) Koch personal and family accounts and 2,000 of the shares were sold on the market. Div. Trial Exh. 53 (allocation

b) The December 31, 2009 HCBC Trade

Koch's intent to mark-the-close of HCBC on December 31, 2009 is evidenced most directly in an series of emails between Koch and Christanell leading up to December 31, and in a series of audio recordings of Christanell's trading desk phone line. On December 23, 2009, at 10:58 a.m. Central time, Koch emailed Christanell and put him on notice that he wanted to purchase HCBC on December 31, 2009, the last trading day of the year. The email stated, with respect to HCBC:

> I also will want to **move up HCBC** the last day of the year before things close down ... so, please be mindful of that if you are there or your backup is around .... Should be a busy day ....

Respondents Trial Exh. R-33; Tr. at 626-627 (Christanell). Five days later, on December 28, 2009, at 10:10 a.m. Central time, Koch emailed Christanell and gave him a specific instruction to get a closing price for HCBC on December 31, in the $20 to $25 per share range. The email stated, in full:

> Dear Jeff,
> Please put on your calendar to buy HCBC 30 minutes to an hour before the close of the market for the year. **I would like to get a closing price in the 20-25 range, but certainly above 20**.
> Thanks. DLK.

Div. Trial Exh. 186 (12/28/2009 email) (Div. Trial Exh. 186 is in Greenwich Mean time, but, Div. Trial Exh. 187 reflects the same email in Central time); Tr. at 499-500, 610-611, 627-628 (Christanell). An audio recording of the trading desk reveals that, at 7:46 a.m. Central time, on December 31, 2009, Koch called Christanell at the office to reiterate his pricing instructions on

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sheet) at SEC-HUNTLEIGH 3327-3328. By contrast, on September 30, Mrs. Smith paid an average price of $20.3794 per share to purchase 2,000 shares of HCBC. Div. Trial Exh. 53 at SEC-HUNTLEIGH 3336. When Mrs. Smith paid an average price of more than $20 per share, Koch thought she got a "terrific deal." ID at 7 (citing Tr. at 883).

HCBC that day and to authorize Christanell to buy up to 5,000 shares if he needed to get that price. Koch stated, among other things:

> My parameters are … if you need 5,000 shares do whatever you have to do … **I need to get it above 20, you know 20 to 25 I'm happy** … you figure out if you want to do it the last half hour … and **just create prints**."

Div. Trial Exh. 189 (12/31/2009 audio recording from 1:46 GMT). At trial, with respect to Trial Exhibit 187, the Division specifically asked Koch what he meant when he instructed Christanell to "get a closing price," and he refused to provide a coherent answer to the question:

> Q: Sir, in that e-mail to Mr. Christanell, why are you referring to a closing price?
>
> A : Well, I'm convinced -- my sense of this is that if we get any kind of notion of stock around those levels, we're going to be able to shake the bushes and have that stock come out. I think I want to see if we can get some stock out. And the only way you can get stock for sale is to walk up the ladder. That's -- That's -- That's how I see it. I mean, I don't -- What I'm trying to do is say, Get your stock to see if you can get it out. If you can -- What you're going to do is you're going to shake the bushes, and you're going to get all those people at the end of the year, and that stock's going to come out in the market, but you have to do it through price.
>
> Q: Well, Sir, why would you want -- why would you want it above $20 [if] you have no idea on December 28th what the spread would be like on the 31st?
>
> A: Well, again, let's go -- I've already said, the spreads are very wide, and usually on a 20 to a 10 spread, you can sell your stock at 10 and you buy it at 20, and then that 20 may be for 100 shares and it may not. That's why you always put limit orders on these things.
>
> Q: Sir, on the 28th, you have no idea what the spread will be on the 31st; is that correct?
>
> A: The spreads don't change.[17] I mean, this is a stock that trades 30 days a year, so you have a very good idea. You have a

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[17] The report of Respondents' expert, Professor Greg Jarrell, conflicts with Koch's testimony in that regard as the report shows that HCBC's spreads do change. Resp. Trial Exh. R39 at 42, 47,

> very good idea from past behavior what you're likely to face. And if I'm trying to get the stock, my best opportunity is the last trading day of the year, to take those people who have positions shares over the years, over the last six months or years, in High Country, that I don't know a thing about, they have positions, and they want to clean them out. They want to get out of that stock and take a dollar or two gain. I don't know what these people are called, but they're basically day traders. I don't know.

Tr. at 927-928 (Koch). Missing from Koch's answer was any explanation for the words "get a closing price." Nor could anyone reasonably have understood the words used by Koch to mean anything but that Koch wanted to mark the close in HCBC on the last day of the year, which is exactly how Christanell understood the instruction. Tr. at 504 (Christanell).

Christanell's actions in response to Koch's December 23, 28 and 31 instructions, are captured in Div. Trial Exh. 278. The 3,200 shares of HCBC that Christanell purchased at Koch's instruction, less than one minute prior to the close, represented 88.9% of the trading volume reported to the markets that day and established the closing price of $19.50 per share. Div. Trial. Exhs. 258, 263, 277, 305; Tr. at 242-245 (Glascoe). All of the shares were allocated to the account of an institutional client, Tampsco, which is related to John McFarland. Div. Trial Exh. 53 (allocation sheet) at SEC-HUNTLEIGH 3379; Div. Trial Exh. 48 (list of client names by account number).

c) ***<u>The December 31, 2009 CHEV and CARV Trades</u>***

Koch's intent to mark-the-close of CHEV and CARV on December 31, 2009 is evidenced most directly in a series of audio recordings taken from Christanell's trading desk phone line.

52, 57 (showing the bid-ask spread for four days). Furthermore, as discussed, Koch was able to purchase HCBC for his personal and family accounts on September 8, 2009 for an average price of $11.71 per share, so, in that context too, Koch's explanation makes no sense.

An audio tape reflects that, on December 31, at 11:41 a.m. Central time, Koch called Christanell at the office to inquire about the trading spread on CHEV. After Christanell told Koch that the bid was $7.20 and the ask $7.48, Koch placed an order to purchase an unspecified number of shares of CHEV and instructed him to get a closing price in the range of $8 to $8.25 per share. The instruction is captured in the following passage on the tape:

> "Let's see if by the end of the day you move it above 8 … 8, 8 and a quarter … and that should be pretty easy (laughter) … so whatever you need to do there … move it up to about 8, 8 and a quarter on the Cheviot, do what you need to do there."

Div. Trial Exh. 191 (12/31/2009 audio recording from 5:41 Greenwich Mean time); Tr. at 500-501, 508-509 (Christanell).

During the same call, Koch inquired about CARV. Koch specifically asked what the price and volume was on CARV. Christanell told him the current bid was $8.10 and the current ask $9.05, that there had been no trades yet that day (meaning there was a risk that CARV would be priced at the bid (of $8.10)), and that at least 2,000 shares were offered at $9.05. Koch responded by placing an order with the following instruction: "What you do at the end of the day … pop that one … to $9.05 … if you have to." Div. Trial Exh. 191 (12/31/2009 audio recording from 5:41 Greenwich Mean time). Later that day, at 2:09 p.m. Central time, Koch called to check on Christanell's progress. Christanell asked if it was okay to purchase just 300 shares of CARV at $9.05 and told him that was fine because the purpose of the order was to "make a print" (*i.e.* get a closing price) not acquire a particular volume of CARV shares. Div. Trial Exh. 190 (12/31/2009 audio recording from 8:09 Greenwich Mean time). The Initial Decision found that Koch's explanation for purchasing CARV on December 31 was "convoluted" and "in fact makes no sense," a determination the Commission should respect. ID at 9; Tr. at 904-906, 923-925 (Koch).

The actions that Christanell took on December 31, 2009, in response to Koch's instructions, are captured in Div. Trial Exh. 278. Within 20 minutes of receiving Koch's instruction, he entered an order into the Huntleigh system to purchase 5,000 shares of CHEV for up to $8.25 per share and 1,000 shares of CARV for up to $9.05 and he routed the trades to the street with less than two minutes left until the close of the markets. Div. Trial Exh. 278 (CHEV 12/31/09 heading) at page 3, Rows 76-77, Columns F, H, I, L, Y.

The 6,667 shares of CHEV that Christanell purchased at Koch's instruction represented approximately 70.7% of the total reported market volume in CHEV that day. Though KAM's trades were executed just seconds before and after the market close, they did not establish the closing price of CHEV, which was $7.39 per share that day. Div. Trial Exhs. 265, 305; Tr. at 250-256 (Glascoe). Another buyer was in the market at exactly the same time as KAM and was able to purchase shares of CHEV at a much lower price than KAM. Tr. at 512-513 (Christanell). Koch expressed disappointment with the fact that Christanell had not established the closing price. Div. Trial Exh. 192 (12/31/2009 audio recording); *see also* Div. Trial Exh. 194 (12/31/2009 email); Tr. at 513-514 (Christanell).

The 200 shares of CARV that Christanell purchased at Koch's instruction represented 100% of the trading volume reported to the markets that day and established the closing price of $9.05 per share. Div. Trial Exhs. 260, 264, 275, 305; Tr. at 248-249 (Glascoe). Koch expressed satisfaction with this result. Div. Trial Exh. 192 (12/31/2009 audio recording).

All of the CHEV and CARV shares purchased by Respondents on December 31 were allocated to a Tampsco account. Div. Trial Exh. 53 (allocation sheet) at SEC-HUNTLEIGH 3379; Div. Trial Exh. 48 (list of client names by account number). Koch testified that Tampsco had idle cash on December 31 that he wanted to invest; but, Tampsco had cash reserves available

throughout the year, Respondents offered no explanation as to why Tampsco's funds needed to be invested on this particular date as opposed to at other times throughout 2009, and the investments still left Tampsco with idle cash. Div. Trial Exh. 260 at SEC-HUNTLEIGH 41600 (12/31/2009 monthly account statement for Tampsco Partnership II account [redacted] at Huntleigh) (binder is in account no. order) and at SEC-KOCH 4310 (12/31/2009 monthly account statement for Tampsco Partnership II account no. [redacted] at UMB Bank) (Tampsco's UMB account is the first non-Huntleigh account in the binder).

d) ***Respondents' HCBC, CHEV And CARV Trades In General***

At trial, Respondents sought to explain their trading patterns through the expert testimony of Prof. Greg Jarrell ("Jarrell") and John Schneider ("Schneider"), who focused on the non-liquid nature of HCBC and the illiquid nature of CHEV and CARV and provided reasons why one might trade late in the day or at the end of a month or quarter in order to acquire shares of HCBC, CHEV and CARV. The Initial Decision suggests that, absent the emails and audio tapes discussed above, Jarrell's and Schneidner's explanations "would provide a reasonable an non-violative explanation for all the trading at issue." ID at 9-10. While the Division agrees with the ALJ's conclusion that these emails and audio recordings – tantamount to smoking gun evidence – outweigh the explanations offered by Jarrell and Schneider, the Division does not agree that Jarrell or Schneider offered reasonable explanations for the HCBC, CHEV and CARV trades that are at issue in this case.

Professor Jarrell explained that most stocks have a U-shaped trading pattern, but he admitted on cross-examination that no such pattern exists for HCBC stock. Resp. Trial Exh. R038 at 17; Tr. at 1154, 1157-1159 (Jarrell) (concluding there is no obvious pattern for HCBC). Moreover, and more importantly, the record shows that Respondents historically have not

purchased HCBC stock near the end of the day much less at the end of a month or quarter. Schneider found that, from January 7, 1998 to December 28, 2010, KAM purchased HCBC on the last trading day of a month only six times, four of which were at issue in this case, two of which occurred in 1998, meaning, in the in the 10 years leading up to this proceeding, Respondents have never traded HCBC like they did on September 30, October 30, November 30, or December 31, 2009. Resp. Trial. Exh. R-36; Tr. at 1226-1227 (Schneider); Tr. at 909-910 (Koch) (agreeing with Schneider). Also, trading records that reflect all trades executed by Huntleigh for KAM from June 1, 2008 to December 31, 2009, show that, when Koch placed orders to purchase HCBC in the past, those trades were made mid-day and he paid close to the bid price, not at or above the ask. Div. Exhs. 321 to 339; *see also, e.g.,* Div. Trial Exh. 336 at 9/8/2009, Rows 176-180 and 182, Columns F, H, K, L, O, S (Huntleigh LAVA Trade Blotter for 9/8/2009).

In summary, as an academic matter, regardless of whether it might be a reasonable trading strategy to attempt to purchase thinly traded stocks late in the day at the end of a month or reporting period, the evidence here is overwhelming that that is not the strategy that Respondents employed. Based on the foregoing evidence, the Commission should affirm the Initial Decision's finding of liability against KAM and Koch.

4. The Commission Should Also Find That Respondents Violated Exchange Act § 10(b) and Advisers Act § 206(1) By Failing To *Seek* Best Execution For Their Clients' Trades

The Division also charged Respondents with violating Exchange Act Section 10(b) and Advisers Act Sections 206(1) by failing to *seek* best execution for their advisory clients' trades by virtue of having strategically placed purchase orders for client accounts on the last trading day of September and December 2009, in order to elevate the closing prices. OIP ¶ 21. The Initial

Decision did not specifically address the Division's best execution claim,[18] which Respondents interpret as a failure of proof by the Division, which, in turn, they argue, suggests it is not appropriate to find for the Division on its marking-the-close claim. Appeal Br. at 8, 11.

"[A]n investment adviser's fiduciary duty includes the requirement to seek the best execution of client securities transactions where the adviser is in a position to direct brokerage transactions." *Fleet Investment Advisors, Inc.*, 70 SEC Docket 1217, 1999 WL 695211, at *7 (Sept. 9, 1999) (investment adviser's failure to "seek" to obtain best execution violates Advisers Act Sections 206(1) and 206(2)); *see also Sage Advisory Services LLC*, 75 S.E.C. Docket 1073, 2001 WL 849405, at *7 (July 27, 2001) (investment adviser's failure to "seek" to obtain best execution violates Section 10(b) of the Exchange Act). The duty requires that a market intermediary "seek" to obtain for its customer's order "the most favorable terms reasonably availability under the circumstances." *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 270 (3d Cir. 1998). Where a trader deliberately seeks to avoid a seller who is seeking to sell at a lower price, that trader fails to seek or obtain best execution. *Kirlin Securities*, 2009 WL 4731652, at *14 (upholding FINRA finding that trader failed to give best execution where trader ignored seller's pending order and sought a price away from the market).

KAM and Koch, as investment advisers, violated Section 10(b) of the Exchange Act and Sections 206(1) and 206(2) of the Advisers Act when they placed trades with the intention of marking the close. It is axiomatic that purchasing securities with the intent of obtaining a particular closing price is a failure to seek best execution. The best terms reasonably available constitute the lowest price for which the stock reasonably can be purchased under the

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[18] The Initial Decision does find, however, that "Koch's seeking to mark the close by purchases for the accounts of others at higher prices than would have resulted from legitimate market forces violated his fiduciary duty as an investment adviser" (ID at 14), which, arguably is a finding for the Division on its best execution claim, though not specifically stated as such.

circumstances.

Here, there are multiple examples in the record of Christanell providing Koch with information about a stock's current bid and ask levels, and then Koch following-up with an instruction to purchase shares at prices well above the then-available ask. For example, on September 30, 2009, Christanell informed Koch that the bid-ask spread on HCBC was $11.71 to $20, yet Koch instructed the trader to "move last trade right before 3 p.m. up to as near to $25 as possible without appearing manipulative," causing Christanell immediately to revise upward his order to a limit of $25. ID at 13 (citing Div. Exhs. 144, 146, 148-150; Div. Trial Exh. 278 (HCBC 9/30/09 heading) at page 5, Row131, Column S (reflecting revised order and bid-ask spread at the time)).[19]

There are also examples of Koch instructing Christanell to purchase shares at a high price days in advance of a trade, when he could not possibly have known where the market would be on the date of the trade. For example, on December 23, 2009, Koch informed Christanell that he "want[s] to move up HCBC the last day of the year before things close down" and, on December 28, 2009, he instructed Christanell "to buy HCBC 30 minutes to an hour before the close of the market for the year" and stating that he "would like to get a closing price in the 20-25 range, but certainly above 20." Resp. Trial Exh. R-33 (12/23/2009 email); Div. Trial Exh. 187 (12/28/2009 email.

The record also shows that Koch instructed Christanell deliberately to avoid sellers who might provide executions at lower prices than what Koch wanted to close at. On December 31,

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[19] *See also, e.g.,* Div. Trial Exh. 191 (12/31/209 audio recording from 5:41 GMT reflecting conversation wherein (i) Christanell tells Koch the bid-ask spread on CHEV is $7.20 to $7.48 and Koch then instructs Christanell to get a closing price in the $8 to $8.25 range and (ii) Christanell tells Koch the bid-ask spread on CARV is $8.10 to $9.05 and Koch then instructs Christanell to "pop" it to $9.05 at the end of the day); Tr. at 500-501, 508-511 (Christanell).

2009, Koch discussed with Christanell the way to execute his order for HCBC that he had placed on December 28. Div. Trial Exh. 187. The exchange between Koch and Christanell went as follows:

KOCH:	If you [Christanell] come in too early, there is a seller.
TRADER:	Yeah. And once he sees it start trading, then he may—
KOCH:	He'll push out the volume.
TRADER:	Yeah. He'll load up.
KOCH:	But, if he doesn't know...if he can't be contacted or no one's around—
TRADER:	Yeah.
KOCH:	The normal market makers will short a few...500 shares...and they'll sorta get scared...
TRADER:	Yeah
KOCH:	[unintelligible]...pick it up.

Div. Trial Exh. 189. At trial, the trader testified that he understood Koch to be to instructing him to avoid this seller if he could so that the executions would not occur at a lower price than Respondents wanted. Tr. at 505-06 (Christanell). Koch's instruction to avoid this seller constitutes a conscious effort not to seek best execution. *See, e.g., Kirlin,* 2009 WL 4731652, at *14 (deliberate avoidance of a seller to artificially increase price constitutes failure to seek or obtain best execution).[20]

Trading in a manner designed to achieve a closing price, at an elevated level, without even seeking to obtain a better price was a clear violation of Respondents' fiduciary duty to *seek* best execution for their clients. The Commission may conclude, just as the Initial Decision appears to have concluded, that Respondents violated Exchange Act Section 10(b) and Advisers Act Section 206(1) on this additional basis.

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[20] Respondents note that, at trial, Christanell testified that Respondents' orders were executed at the best offer available at the times the orders were placed. Appeal Br. at 11 (citing Tr. at 591 (Christanell)). But the snippet of the trader's testimony relied on by Respondents ignores the salient context – that the orders were placed at a time and in a manner they were solely to drive up the stocks' prices before the close. Thus, Respondents were clearly not seeking to purchases the stocks for their clients on the best terms reasonably available at the time.

B. <u>Advisers Act § 206(2)</u>

Market manipulation is also a violation of Advisers Act Section 206(2), which prohibits an investment adviser from employing "engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." 15 U.S.C. § 80b-6(2). An investment adviser violates its fiduciary duty to its clients – and thus violates Advisers Act § 206(2) – when it engages in marking the close transactions in client accounts because such conduct misrepresents to clients the value of their holdings, does not inform clients that the values reported to them are the result of manipulative influences, and causes the accounts to pay excess account advisory fees. *See, e.g., Schultz Investment Advisors, Inc. and Scott Schultz*, Advisers Act Rel. No. 40-2470, 2004 WL 3543078, at *6 (Dec. 28, 2005) (violations of Advisers Act §§ 206(1) and 206(2) where registered investment adviser and associated person breached their fiduciary duties by intentionally placing end-of-quarter trades to artificially inflate the prices of four securities); *Andrew Parlin*, Advisers Act Rel. No. 40-1967, 2001 WL 902328, at *4 (Aug. 10, 2001) (violations of Advisers Act §§ 206(1) and 206(2) where evidence, including trading records and tapes of contemporaneous conversations, reflected that associated person "attempted to mark or marked the close" in the securities at issue).[21]

The elements required for establishing a violation of Advisers Act Section 206(2) are the same as for establishing a violation of Section 206(1), except negligence is sufficient to establish a Section 206(2) violation. ID at 12 (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963); *SEC v. Steadman,* 967 F.2d 636 & n.5 (D.C. Cir. 1992); *Steadman v. SEC*, 603 F.2d 1126, 1132-34 (5th Cir. 1979), *aff'd on other grounds,* 450 U.S. 91 (1981)). Section

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[21] An investment adviser also violates Advisers Act Section 206(2) when it fails to *seek* best execution of its clients' trades. *See, e.g., Fleet Investment Advisors, Inc.*, Adviser Act Rel. No. 1821, 70 SEC Docket 1654, 1663 (Sept. 9, 1999).

206(2) thus focuses on the effect of the investment adviser's actions not on his state of mind. *Capital Gains*, 375 U.S. at 195; *SEC v. Bolla,* 401 F. Supp. 2d 43, 66-75 (D.D.C. 2005) (focusing on misrepresentation and omissions); *SEC v. Moran,* 922 F. Supp. 867 (focusing on deceptive conduct).

Here, the Commission can uphold the Initial Decision's conclusion that Respondents violated Advisers Act Section 206(2) even if it disagrees with the Initial Decision's scienter finding. The indisputable evidence is that the trader, Jeffrey Christanell, understood Koch to be instructing him to obtain high closing prices for HCBC on September 30, 2009 and for HCBC, CHEV and CARV on December 31, 2009, and that he acted in accordance with that understanding, because Koch's instructions used the term "close" and "3 p.m." *See, e.g.,* Div. Trial Exh. 148, 187. At a minimum, since Christanell was new to the trading relationship, it was negligent for Koch to focus on closing prices in his instructions to Christanell. For these reasons, and regardless of whether the Commission upholds the Exchange Act Section 10(b) and Advisers Act Section 206(1) findings, the Commission must affirm the finding of a Section 206(2) violation.

C. The Supreme Court's *Janus* Holding Does Not Extend To Any Of The Claims Asserted Against Koch In This Proceeding

Relying on *Janus Capital Group, Inc. v. First Derivative Traders*, --- U.S. ---, 131 S. Ct. 2296 (2011), Respondent Koch argues that only KAM can be charged as a primary violator of Exchange Act Section 10(b) and Advisers Act Sections 206(1) and (2) because "only KAM has the authority to 'make' the statements, that is, execute securities transactions on behalf of its clients." Petition Br. at 20-21; Appeal Br. at 12 n.5. Although *Janus* was decided well before the trial in case took place, Respondents' pre- and post-hearing briefs were remarkably devoid of

any reference to *Janus*, a case which Koch now argues is controlling on the issue of his exposure to liability as a primary violator.

In *Janus*, the Court analyzed what it means "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 17 C.F. R. § 240.10b-5(b). The Court held that:

> 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. Without control, a person or entity can merely suggest what to say, not "make" a statement in its own right. One who prepares or publishes a statement on behalf of another is not its maker. And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by -- and only by -- the party to whom it is attributed. This rule might best be exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit -- or blame -- for what is ultimately said.

131 S. Ct. at 2302. Respondents here were not charged under Exchange Act Rule 10b-5(b) with making statements; rather, they were charged under Exchange Act Rule 10b-5(a) and (c) with engaging in manipulative and deceptive conduct. Accordingly, the *Janus* holding should not extend to this case.

Efforts to apply *Janus* to conduct-based claims that were properly asserted under Exchange Act Rule 10b-5(a) or (c) have repeatedly been rejected.[22] *See, e.g.*, *SEC v. Sells*, 2012

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[22] *SEC v. Kelly*, 817 F. Supp. 2d 340 (S.D.N.Y. 2011) is not to the contrary. There the SEC's complaint alleged that senior managers of AOL engineered so-called "round-trip transactions" in which (i) AOL declined discounts on good and services purchased from a half-dozen companies in return for which (ii) those companies purchased online advertising from AOL in amounts equal to the declined discounts, thereby enabling AOL to improperly report inflated advertising revenues. *Id.* at 343-44; *see also SEC v. Kelly*, 765 F. Supp. 2d 301, 307 (S.D.N.Y. 2011) (providing factual background). The court dismissed the SEC's claims under Rule 10b-5(a) and (c) because they were "premised on a misrepresentation and neither defendant 'made' a misstatement as *Janus* requires." *SEC v. Kelly*, 817 F. Supp. 2d at 344. The court noted that,

WL 3242551, at *7 (N.D. Cal. Aug. 10, 2012) (*Janus* does not bar claims under Rule 10b-5(a) or (c) because these rules do not concern material misstatements or omissions); *SEC v. Brown*, --- F. Supp. 2d ---, 2012 WL 2927712, at *6 (D.D.C. July 19, 2012) (noting a difference a between 10b-5(b) failure to disclose and a 10b-5(a) and (c) scheme to conceal that failure to disclose and discussing *Janus* only in the context of the 10b-5(b) claim); *SEC v. Pentagon Capital Mgmt. PLC*, 844 F. Supp. 2d 377, 421-22 (S.D.N.Y. 2012) (declining to extend *Janus* to claims that hinge on deceptive conduct); *SEC v. Mercury Interactive, LLC*, 2011 WL 5871020, at *2 (N.D. Cal. Nov. 22, 2011) (same); *SEC v. Geswein*, 2011 WL 4565861, at *2 (N.D. Ohio Sept. 29, 2011) (same), *adopting magistrate's recommendation in pertinent part,* 2011 WL 4541308 (N.D. Ohio Aug. 2, 2011).[23]

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where the "primary purpose and effect of a purported scheme is to make a public misrepresentation or omission, courts have routinely rejected the SEC's attempt to bypass the elements necessary to impose 'statement' liability under [10b-5(b)] by labeling the alleged misconduct a 'scheme' rather than a misstatement.'" *Id.* at 343. The court recognized that claims are appropriately asserted under Rules 10b-5(a) and (c) only where the deceptive act is distinct from the alleged misstatement. *Id.* at 344 (citing *SEC v. U.S. Env't'l., Inc.*, 105 F.3d 107, 112 (2d Cir. 1998)). While the Division believes that *Kelly* wrongly concluded that *Janus* ever applies to claims under Rule 10b-5(a) or (c), the facts of that case are easily distinguishable and its holding is no bar to the Division's claims of fraudulent conduct here. *See also* note 23, *infra* (listing examples of cases that have dismissed, without mentioning *Janus*, misrepresentation claims brought under 10b-5(a) or (c)).

Similarly, in *John P. Flannery & James D. Hopkins*, AP File No. 3-14081, 2011 WL 5130058 (Oct. 28, 2011) (Initial Decision with appeal to Commission pending), an Administrative Law Judge, following *Kelly,* held that *Janus* applied to claims asserted under Sections 17(a)(1) and (3) of the Securities Act of 1933 ("Securities Act") because the "case involve[d] allegations of materially false or misleading statements or omissions." *Id. at *35.* While the Division believes *Flannery* was wrongly decided, the decision is inapplicable in the instant case because it focuses on the standard to be applied in a case involving misstatements, not deceptive conduct separate from a misstatement.

[23] Just as courts have declined to extend *Janus* to claims involving manipulative and deceptive conduct under Exchange Act Rule 10b-5(b), so too have courts readily dismissed misrepresentation claims improperly asserted under Exchange Act Rules 10b-5(a) and (c). *See, e.g., Public Pension Fund Grp. v. KV Pharamaceutical Co.*, 679 F.3d 972, 987 (8th Cir. 2012) (affirming dismissal of claims under 10b-5(a) and (c) where no conduct beyond misrepresentations or omissions was alleged); *WPP Luxembourg Gamma Three Sarl v. Spot*

Here, Respondents' reliance on *Janus* to challenge the Division's contention that Koch violated Exchange Act Rules 10b-5(a) and (c) by trading late in the day to manipulate the closing price of three thinly traded bank stocks at the end of the third and fourth quarters of 2009 is grossly misplaced. The Division's claims are aimed principally at Respondents' conduct – their trading activity – and any related misrepresentations (such as the inflation of clients' month-end portfolio values) is secondary. Further, KAM is a one-man shop, and KAM acted solely through Koch in engaging in the at-issue manipulative trades.[24]

D. Koch Qualifies As An "Investment Advisor" And Can Be Liable As A Primary Violator of Advisers Act §§ 206(1) and (2)

Respondent Koch also asserts that he cannot be liable as a primary violator of Advisers Act Sections 206(1) and 206(2) because, on its face, Section 206 applies only to "investment advisers" and thus an "associated person" such as Koch cannot be liable as a primary violator. Petition Br. at 20-21; Appeal Br. at 12 & n.5.

The Commission previously has considered – and rejected – the argument that Respondent Koch now asserts. For example, in *John J. Kenny and Nicholson/Kenny Capital Management, Inc.*, 80 SEC Docket 473, 2003 WL 21078085 (May 14, 2003), the Commission held that charging an individual as a primary violator under Advisers Act Sections 206(1) and 206(2) was appropriate where the charged individual was Chairman and CEO, and a controlling

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Runner, Inc., 655 F.3d 1039, 1057-58 (9th Cir. 2011) (same); *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161 (2005) (same).

[24] Respondents also assert that *Janus* precludes a finding of primary liability against Koch under Advisers Act Section 206(1) and (2). Petition Br. at 20-21; Appeal Br. at 12 n.5. Unlike Exchange Act Rule 10b-5(b), Sections 206(1) and (2) of the Advisers Act do not address the making of misleading statements or omissions, but, rather, address fraudulent devices, schemes, and practices. The Division is aware of no Commission decision or court case that extends the *Janus* holding to Advisers Act Sections 206(1) and (2).

owner (with his wife), of the investment adviser. *Id.* at *17 & n.54. In explaining this conclusion, the Commission stated:

> An associated person may be charged as a primary violator under Section 206 where the activities of the associated person cause him or her to meet the broad definition of 'investment adviser.' For example, courts have found that an associated person is liable under Section 206 where the investment adviser is an alter ego of the associated person or is controlled by the associated person.

Id. at n.54. Section 202(a)(11) of the Advisers Act defines an investment adviser broadly to include "any person who, for compensation, engages in the business of advising others ... as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." 15 U.S.C. § 80b-2(11).

Commission orders and ALJ Initial Decisions repeatedly have affirmed individual liability under Section 206. *See, e.g., Leaddog Capital Markets, LLC*, AP File No. 3-14623, 2012 WL 4044882, at *12 (Sept. 14, 2012) (majority owner may be charged as primary violator under Advisers Act); *Gualario & Co., LLC and Ronald Gualario*, AP File No. 3-14340, 2012 WL 627198, at *12 (Feb. 14, 2012) (owner, sole principal, president, and CEO can be charged as primary violator); *Zion Capital Mgmt.*, AP File No. 3-10659, 2003 WL 22926822, at *7 (Dec. 11, 2003) (president and sole owner controlled investment adviser and could be charged as primary violator of Advisers Act).

In the instant case, it is undisputed that Koch is the sole owner, founder, president, and chief compliance officer of KAM. Answer at ¶¶ 1-2; Tr. at 760, 786-87, 822 (Koch); Div. Trial Exh. 253-2 (Form ADV dated 8/31/2011) at Item 2, Schedules A and B, and Part IIA, Item 4. Thus, under Commission precedent, Koch can be held primarily liable for violations of the Advisers Act.

III. The Initial Decision Applied The Correct Standard And Properly Concluded That Respondents Willfully Violated Advisers Act § 206(4) And Rule 206(4)-7

The Initial Decision also found that, by manipulating the closing price of three thinly-traded bank stocks on the last trading day of September and December 2009, Respondents also violated Advisers Act Section 206(4) and Rule 206(4)-7. ID at 13-15. Specifically, while KAM's written policies and procedures prohibited illegal marking-the-close activity, Div. Trial Exh. 279 at SEC-KOCH 7148 (KAM Policies and Procedures Manual – 2008 Edition), KAM failed to *implement* those policies, as evidenced by the fact that the Initial Decision finds KAM engaged in manipulative conduct with respect to HCBC, CHEV and CARV. Accordingly KAM violated Rule 206(4)-7(a) by failing to implement procedures reasonably designed to prevent marking-the-close transactions and Koch, its control person and sole employee, willfully aided and abetted those violations. 15 U.S.C. § 80b-206(4). Section 206(4) of the Advisers Act makes it unlawful for any investment adviser, directly or indirectly, to "engage in any act, practice or course of business which is fraudulent, deceptive or manipulative." 15 U.S.C. § 80b-206(4). Advisers Act Rule 206(4)-7(a) makes it unlawful for a registered investment adviser to provide investment advice if they do not "[a]dopt and implement written policies and procedures reasonably designed to prevent the violation, by [the adviser], of the Act and the rules the Commission has adopted under the Act." 17 C.F.R. § 275.206(4)-7(a).

Respondents argue that the Initial Decision's finding of Section 206(4) and Rule 206(4)-7(a) violations is erroneous because it applies a *per se* rule that every time a one-person shop violates the Advisers Act there will be a corresponding failure to implement policies and procedures required under the Advisers Act. Appeal Br. at 11-13. In fact, the Initial Decision

appropriately concluded that a one-man shop that violates the Advisers Act has also failed to implement policies to prevent such violations.[25]

IV. The Initial Decision's Sanctions Award Should Be Affirmed In Part, And Modified In Part, To Grant The Division The Additional Relief It Sought

The Initial Decision properly concluded that Respondents willfully violated the above-referenced Exchange Act and Advisers Act provisions. Applying the factors identified in *Steadman v. SEC*, 603 F.2d 1126 (5th Cir. 1979), *aff'd*, 450 U.S. 91 (1981), the ALJ determined that (i) a cease-and-desist order is appropriate, (ii) Respondents should be ordered jointly to disgorge $4,169.78, plus prejudgment interest, and jointly to pay a second-tier penalty of $75,000.00, (iii) Respondent KAM should be censured, and (iv) Respondent Koch should be permanently barred from association with an investment adviser. ID at 15-18. Respondents challenge the imposition of any sanctions at all.

While the Division generally believes that the sanctions imposed are appropriate, there are two areas where the Division disagrees. For the reasons articulated below, the Commission should find that the Initial Decision improperly denied the Division's request for a third-tier penalty and improperly declined to impose the requested collateral bars, which, contrary to the Initial Decision's findings (ID at 18 & n.29), are not "new sanctions" and do not require a retroactive application of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").

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[25] Elsewhere, the Commission's rules recognize that individuals who opt to organize a registered entity as a sole proprietorship face a greater burden in seeking to reassociate with that registered entity. Preliminary Note to SEC Rule of Practice 193. This greater burden is imposed in recognition that the associated person of a registered entity organized as a sole proprietorship has less supervision than persons associated with registered entities organized differently. Analogously, Respondents should not be able to avoid their obligations under Section 206(4) and Rule 206(4)-7(a) simply by claiming that they cannot implement their policies because they are a sole proprietorship.

A. **Respondents' Violations Were Willful**

At the outset, Respondents argue that the Initial Decision improperly recommended entry of a cease-and-desist order, an investment adviser bar, a censure, and a civil penalty because, in their view, "there is no finding of willfulness other than the finding that Respondents intended to trade as they did." Appeal Br. at 13. Ironically, Respondents' admission that they intended to trade as they did is all that is necessary to establish willfulness.

"Willfulness" may be established by showing that Respondents intended to do the acts which constituted the violation. ID at 13 (citing *Wonsover v. SEC*, 205 F.3d 408, 413-15 (D.C. Cir. 2000); *Steadman*, 603 F.2d at 1135; *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 (2d Cir. 1976); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965)). Willfulness "means no more than that the person charged with the duty knows what he is doing. It does not mean that, in addition, he must suppose that he is breaking the law." *Wonsover,* 205 F.3d at 414 (citing *Hughes v. SEC,* 174 F.2d 969, 977 (D.C. Cir. 1949)); *see also Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965) ("There is no requirement that the actor also be aware that he is violating one of the Rules or Acts.")

Here, not only have Respondents admitted that they intended to trade as they did, but also, Respondents' trading instructions were reflected in emails and audio recordings and thus the finding is well-supported by the evidence. *See, e.g.,* Div. Trial Exh. 148 (9/30/2009 email from Koch instructing Christanell to "move last trade [of HCBC] right before 3pm up to as near to $25 as possible without appearing manipulative"); Div. Trial Exh. 187 (12/28/2009 email from Koch instructing Christanell to "buy HCBC 30 minutes to an hour before market close on the last day of the year," stating that he "would like to get a closing price in the 20-25 range, but certainly above 20"); Div. Trial Exh. 189 (12/31/2009 audio recording of Koch reiterating his pricing instructions to Christanell on HCBC and stating "I need to get it above 20, you know 20

to 25 I'm happy ...you figure out if you want to do it the last half hour ... and just create prints"); Div. Trial Exh. 191 (12/31/2009 audio recording of Koch instructing Christanell to purchase CHEV and CARV at specific price); *see also* Tr. at 879-82, 896-99, 900-07 (Koch) (Koch testimony admitting he instructed Christanell to purchase HCBC on 9/20/2009 and HCBC, CHEV and CARV on 12/31/2009). This record evidence supports the Initial Decision's finding of willfulness.

B. <u>A Cease-And-Desist Order Is Appropriate</u>

Exchange Act Section 21C(a) and Advisers Act Section 203(k) authorize the Commission to impose a cease-and-desist order against any person who "is violating, has violated, or is about to violate any provision of" those Acts or any rule or regulation thereunder. 15 U.S.C. §§ 78u-3 and 80b-3(k). Although the imposition of a cease-and-desist order requires "some" showing of a future risk of violations, "it need not be very great." *KPMG Peat Marwick LLP*, 74 SEC Docket 357, 2001 WL 47245, at *24 (Jan. 19. 2001). Indeed, as the Commission has stated, "[a]bsent evidence to the contrary, a finding of a violation raises a sufficient risk of future violation. To put it another way, evidence showing that a Respondent violated the law once probably shows a risk of repetition that merits our ordering him to cease and desist." *Id.* Here, the Division has shown – and the ALJ appropriately concluded – that there was a violation, and, thus, a cease-and-desist order is necessary to prevent future violations.

The Initial Decision identifies the following facts, among others, which the Court appropriately considered in recommending that Respondents be ordered to cease-and-desist from committing or causing any violations or future violations of Exchange Act Section 10(b) and Rule 10b-5 thereunder and Advisers Act Sections 206(1), 206(2), and 206(4) and Rule 206(4)-7:

> Respondents' 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 of the charges. Koch's chosen occupation in the financial industry will present opportunities for future violations. The violations were recent, having ended about two years ago. The degree of harm to the marketplace is quantified in the $4,169.78 of additional quarterly fees that Respondents received as a result of their misconduct. In light of these considerations, a cease-and-desist order is appropriate.

ID at 16. Respondents assert that, even if liability is found, application of the *Steadman* factors suggests that no cease-and-desist order is warranted because the violations were neither recurrent nor egregious and there is little likelihood of recurrence. Petition Br. at 23-24; Appeal Br. at 28-29. They also argue that the cease-and-desist order is unnecessary because Respondent Koch has "deep respect for the rule of law." Appeal Br. at 29. None of these arguments have merit.

The record evidence demonstrates that Respondents' conduct was both recurrent and egregious. Respondents repeatedly defrauded the market by attempting to (and mostly succeeding in) setting artificial prices for HCBC, CARV, and CHEV on the last trading day of September and December 2009. Div. Trial Exhs. 148, 187, 188-193, 278; Tr. at 475 (Christanell) (testimony that Christanell executed trades consistent with Respondents' instructions). Respondents also repeatedly misled their advisory clients because their manipulative fraudulent purchases caused the reported values of the clients' accounts to be artificially inflated, resulting in the payment of excessive advisory fees to Respondents. Div. Trial Exhs. 306, 309, 310 (demonstrating inflation of client accounts and excessive advisory fees obtained thereby). Moreover, the fraudulent scheme ended only when NYSE Arca questioned Huntleigh about Respondents' suspicious trades, and Huntleigh, in turn, questioned Respondents. Div. Trial Exh. 33 (1/20/2010 NYSE Arca letter to Huntleigh); Div. Trial Exh. 22 (1/29/2010 Huntleigh letter to Respondents); Tr. at 116-19 (Marshall) (discussing Respondents'

"patronizing" response to Huntleigh's inquiry). But for the regulatory inquiry, there is no reason to believe Respondents would have halted their scheme.

The record also amply demonstrates the potential for future violations. To this day, KAM remains registered with the SEC.[26] Moreover, even if KAM terminated its registration, Respondents have conceded that there is nothing preventing KAM from registering with state regulators nor anything preventing Koch from continuing to act as an investment adviser. Tr. at 786-87 (Koch).

Similarly, despite their assertions to the contrary, Respondent have continued to manage money for Koch's personal and family accounts and at least one advisory client. Tr. at 760, 786-787, 806-808, 922-23 (Koch) ("I still manage for John [McFarland], I managed his IRA at a partnership…." and "I still manage his personal account."); *see also* ID at 4. Also, though Koch claims to have retired, his purported withdrawal from the industry was obviously a strategic choice resulting from this proceeding,[27] and, if he wanted to, he could voluntarily return to the industry if not barred by the Commission based on his manipulative trades in HCBC, CHEV and CARV. *See, e.g.*, Div. Trial Exh. 253-4 (IAR Report) at 10 ("It's time to retire when SEC computers do not understand market economics in the niche of thinly traded stocks, and therefore flag good trades – which leads to the filing of a complaint against an advisor with 30 years [sic] experience in creating investment wealth for satisfied clients. Retirement looks

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[26] *See* Koch Asset Management LLC Form ADV *available at* http://www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_landing.aspx?SearchGroup=Firm&FirmKey=106429&BrokerKey=-1 (last visited October 16, 2012) (SEC investment adviser registration form reflecting that KAM remains registered with the SEC).

[27] Koch waited until October 2011 to "retire." Div. Trial Exh. 253-4. His announcement occurred six months after this proceeding was initiated, while this proceeding was stayed. *See* Order Granting Joint Motion to Stay Proceeding Pending Commission Consideration of Offer of Settlement dated 9/13/2011 *and* Prehearing Order dated 11/23/2011 (lifting stay). Given the timing of his "retirement," Koch's move appears more strategic than a genuine, permanent retirement from the industry.

great."). The Commission should not countenance Koch's machinations to avoid accountability for his misconduct.

Moreover, Koch's current status is irrelevant, because the appropriateness of a bar turns on whether the respondent was associated with an investment adviser at the time of the wrongdoing, which Koch was. *See, e.g., John Kilpatrick,* AP File No. 3-6310, 1986 WL 626187, at *5 (May 19, 1986) (stating that Commission has long interpreted Section 203(f) of the Advisers Act to apply to persons who *were* associated with an investment adviser during the relevant period and concluding that a contrary position "would allow persons who violate the law while employed in the securities business to avoid administrative sanctions simply by leaving the business.") (emphasis in original).

Respondents' additional argument that the cease-and-desist order is unnecessary because they have "deep respect for the rule of law," Appeal Br. at 29, is based solely on Koch's self-serving testimony, and inapposite to a determination of whether a bar is warranted. Respondents are subject to sanctions precisely because they did not respect the rule of law – namely the antifraud provisions of the federal securities laws.

In summary, Respondents offer no valid basis for reversing the ALJ's entry of a cease-and-desist order, and, consequently, the Initial Decision should be affirmed.

C. The Initial Decision Appropriately Recommends An Investment Adviser Bar But Inappropriately Declines To Impose Collateral Bars That Pre-Date The Enactment Of Dodd-Frank

Respondents also challenge the imposition of an investment adviser bar against Koch. Appeal Br. at 13; Petition Br. at 23-24. Section 203(f) of the Advisers Act provides authority for the Commission to bar any person from association with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent or nationally recognized statistical

rating organization if that person is found to, among other things, have willfully violated the Exchange Act or the Advisers Act. 15 U.S.C. § 80b-3(f). Relying on this provision and recognizing that Koch's violations involved scienter, that his business provided him future opportunities to commit violations, and Koch's lack of recognition of the wrongful nature of his conduct, the ALJ properly imposed an investment adviser bar. ID at 18.

Respondents' challenge to the investment adviser bar mirrors their challenge to the ALJ's imposition of a cease-and-desist order. For the reasons discussed in Point II.B, these arguments are without merit and the Commission should affirm the Initial Decision's determination that a permanent investment adviser bar is warranted.[28]

The Initial Decision declined, however, to impose the collateral bars sought by the Division based on an incorrect understanding of the law. *See* ID at 18 n.29. Contrary to the Initial Decision's conclusion, the collateral bars sought by the Division (broker, dealer, municipal securities dealer, transfer agent and employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor or principal underwriter)[29] were all available against Koch prior to the effective date of the Dodd Frank Act. *See* 15 U.S.C. §§ 78o(b)(6)(A), 78o-4(c)(4), 78q-1(c)(4)(c), and 80a-9(b); *see also In the Matter of Gregory Bartko, Esq.*, AP File No. 3-17400, 2012 WL 3578907, at *7 (Aug. 21, 2012) (initial decision holding that, because respondent's violations provided factual predicate to bar him from association with broker, dealer, municipal securities dealer, transfer agent, and investment

[28] An investment adviser bar is also appropriate for the additional reason that it deters other potential violators. *See, e.g., In the Matter of Schield Mgmt. Co.*, AP File No. 3-11762, 2006 WL 231642, at * 11 (Jan. 31, 2006).

[29] The Division was not authorized to seek – and does not seek – an order barring Koch from association with a municipal advisor or a nationally recognized statistical rating organization, remedies that were unavailable prior to the effectiveness of the Dodd-Frank Act.

adviser before enactment of Dodd-Frank, such bars were available under Section 203(f) of the Advisers Act as amended by Dodd-Frank); *In the Matter of Roy D. Higgs*, AP File No. 3-14631, 2011 WL 4963360, at *5-6 (Oct. 19, 2011) (same). Koch's willful violations of Section 10(b) and Rule 10b-5(a) and (c) of the Exchange Act and Section 206(1) of the Advisers Act provide the necessary predicate for imposition of these collateral bars. Thus, contrary to the holding in the Initial Decision, the Dodd Frank Act's language making collateral bars available under Section 203(f) of the Advisers Act in no way increases Koch's liability or the range of sanctions available against him. Since the rationale for imposing an investment adviser bar applies equally to the other bars sought by the Division and, since retroactivity is no impediment, those bars should be imposed.

D. The Initial Decision Ordered An Appropriate Disgorgement Amount

The Initial Decision properly ordered Respondents, jointly and severally, to disgorge $4,169.78 in ill-gotten gains. ID at 16-17. Exchange Act Section 21C(e) and Advisers Act Section 203(j) authorize disgorgement, an equitable remedy that requires a violator to give up wrongfully obtained profits causally related to the proven wrongdoing. ID at 16 (citing *SEC v. First City Fin. Corp.,* 890 F.2d 1215, 1230-32 (D.C. Cir. 1989)). The calculated disgorgement "need only be a reasonable approximation of profits causally connected to the violation." *First City Fin.*, 890 F.2d at 1231.

Respondents argue that $4,169.78 is inaccurate because (i) they believe the calculation includes fees for October and November 2009, when the Initial Decision did not find violations during those months, (ii) they contend that the Division should not have based its calculation on prices that would have been reported to KAM clients absent Respondents improper trades, but rather, the calculation should have been based on an alternative methodology that Respondents

did not provide evidence of at trial.. Petition Br. at 10; Appeal Br. at 14. These arguments have no merit.

First, the Division's calculation of Respondents' ill-gotten gains (the incremental increase in advisory fees obtained as a result of levying fees against account balances inflated by the manipulative trading) did not include any fees for October or November 2009 because Respondents charged fees quarterly, not monthly. Div. Trial Exh. 253-2 (Form ADV dated 8/31/2011) at Part IIA, Item 4. Thus, there were no fees charged for October or November and no part of the $4,169.78 in ordered disgorgement is based on trades made in October or November 2009.

Second, the disgorgement calculation reflects a "reasonable approximation" of Respondents' illicit profits. At the hearing, the ALJ took into evidence a chart prepared by the Division reflecting its calculation of $5,819.93 in ill-gotten gains from excessive fees obtained by Respondents through their fraudulent scheme. *See* Div. Tr. Exh. 311. The Division based its calculation on the difference between (i) the month-end closing price that was established by Respondents' manipulative trades and (ii) and estimate of the month-end closing price that would have been reported to Respondents' clients if Respondents had not traded in HCBC on September 30 or December 31 or CARV on December 31.[30] The Division multiplied that

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[30] At trial, the Huntleigh Compliance Director testified to how client holdings were priced on the last date of the month: (i) if a stock traded on the last trading day of the month, the monthly account statements valued the holding at the publicly-reported closing price, which reflected the last trade during market hours; (ii) if a stock did not trade on the last trading day of the month, the monthly account statements valued the holding at the last bid of the day. Tr. at 139-40, 215-16 (Marshall). The Division based its disgorgement calculation on the difference between the prices that were reported to KAM clients in their monthly account statements, and the prices that would have been reported to KAM clients had Respondents not engaged in their manipulative conduct. Specifically, when Respondents' trading constituted 100% of the market, the Division calculated disgorgement based on the last bid before Respondents began trading. When Respondents' trading constituted less than 100% of the market, the Division calculated

number by the number of shares of HCBC held by KAM clients (including Koch personal and family accounts) on September 30 and the number of shares of HCBC and CARV held by KAM clients (including Koch personal and family accounts) on December 31.[31] The result identified the total dollar increase in KAM client holdings caused by Respondents' manipulative trades on September 30 and December 31, 2009. The Division then multiplied the result by KAM's quarterly advisory fee of 0.25% of the aggregate gross value of securities held by the client as a result of Respondents' recommendations. *See* Div. Trial Exh. 253-2 (Form ADV dated 8/31/2011) at Part IIA, Item 4 (reflecting advisory fee of 0.25% per quarter).

At trial, KAM's bookkeeper testified that certain accounts (principally Koch personal and family accounts) were not charged an advisory fee. Tr. at 677-83 (Heidtbrink). This prompted the Division to revise its disgorgement calculation. In its post-hearing brief, the Division calculated excessive fees of $4,288.08, which excluded the accounts identified by KAM's bookkeeper. Div. Post-Hearing Br. at 65-66. Respondents, utilizing the same calculation, calculated excessive fees to be $4,169.78. Resp. Post-Hearing Brief at App'x A, Part III. Recognizing that disgorgement need only reflect a reasonable approximation of the ill-gotten gains, the Division adopted Respondents' lower number for disgorgement, Div. Post-Hearing Reply Br. at 37-38, and the Initial Decision ordered disgorgement of $4,169.78. ID at 10, 16. Thus, the calculated disgorgement reflects a reasonable approximation of Respondents' ill-gotten gains.

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disgorgement based on the last reported non-Koch trade before the close. The Division estimated that HCBC would have closed at $11.70 not $23.50 on September 30 and at $17.50 not $19.50 on December 31 if Respondents had not traded. Div. Trial Exhs. 277 (at Event Date 9/30/2009 and Event Start TM 8:09:53 and Event Date 12/31/2009 and Event Start TM 15:57:33) and 305; Tr. at 229-231, 242-43 (Glascoe).

[31] Respondents did not succeed in their attempt to mark the close of CHEV on December 31, 2009; therefore, for purposes of disgorgement, the Division declined to seek any ill-gotten gains from Respondents related to their CHEV trading.

Finally, Respondents argue that, when a stock did not trade on the last day of the quarter, KAM did not base its quarterly advisory fee calculation on the prices reported to customers on monthly account statements, but rather, it made its own quarter-end fair value estimate and charged fees based on that estimate. Appeal Br. at 14 (citing Tr. at 703-05 (Heidtbrink); Tr. at 869-71 (Koch). KAM thus asserts that the methodology employed by the Division – which was adopted by the ALJ – is improper because it does not use KAM's supposed methodology. But, there is no evidence suggesting how KAM would have arrived at a fair value estimate for HCBC on September 30 or for HCBC and CARV on December 31; thus, making the Division's methodology the only reasonable methodology that was offered at trial. HCBC and CARV clearly were valued on clients' month-end account statements and Huntleigh's Compliance Director provided clear testimony about how the shares would have been priced had there been no manipulative trades by Respondents on September 30 and December 31, 2009. Div. Trial Exhs. 258, 259, and 260; Tr. at 139-40, 215-16 (Marshall).

In sum, Respondents offer no basis for reversing or amending the disgorgement ordered in the Initial Decision.

E. Respondents' Egregious And Repetitive Misconduct Created Substantial Risk of Loss To Their Clients And Others And Warrants Third-Tier Penalties

Section 203(i) of the Advisers Act authorizes the Commission to impose civil money penalties for willful violations of the Exchange or Advisers Acts or rules thereunder. 15 U.S.C. § 80b-3(i). The Initial Decision identified six factors for consideration in determining whether a penalty is in the public interest: "(1) fraud; (2) harm to others; (3) unjust enrichment; (4) previous violations; (5) deterrence; and (6) such other matters as justice may require." ID at 17 (citations omitted). In assessing these factors, the Initial Decision noted that Respondents'

actions involve fraud and harm to others and concluded that "[d]eterrence require[]d penalties against Respondents because of the abuse of the fiduciary duty owed to advisory clients." *Id.* The Initial Decision therefore held that "[p]enalties are in the public interest in this case." *Id.* While the Division sought the maximum third-tier penalty for an entity respondent, i.e., $725,000, the Initial Decision imposed a second-tier penalty of $75,000 (the statutory second-tier penalty amount for individuals), finding that "Respondents' actions...did not result[] in substantial losses or create[] a significant risk of substantial losses to other persons or result[] in substantial pecuniary gain to [Respondents]." *Id.* (internal quotations omitted).

Respondents challenge the imposition of civil penalties at all, arguing that the Initial Decision fails to undertake an analysis of the applicable facts necessary to determine whether penalties are in the public interest. Appeal Br. at 13. Because, as shown above, the Initial Decision includes just such an analysis, Respondents' argument fails, and the imposition of civil penalties is appropriate.

While the Division agrees with the Initial Decision's conclusion that civil penalties are appropriate in this matter, the Division believes that a third-tier civil penalty would better serve the public interest. Respondents engaged in conduct involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, and their conduct led to the risk of substantial losses to other persons sufficient to justify the imposition of third-tier penalties. See 15 U.S.C. § 80b-3(i)(2). For example, Respondents' manipulative trading resulted in the purchase of HCBC for Alice Smith, an elderly advisory client, at prices as high as $23.99 per share. *See* Div. Trial Exh. 278 at 5; Div. Trial Exh. 53 (allocation sheet showing allocation of shares to Alice Smith Revocable Living Trust Account). From September 30, 2009 through at

least December 31, 2011,[32] HCBC never traded as high as the price Respondents purchased it for Mrs. Smith, who was 92 at the time of the trade and passed away in 2010. Div. Trial Exhs. 286 (Smith account opening document reflecting birth date in 1916), 316 (chart showing HCBC subsequent performance), 320 (composite chart containing HCBC data); Tr. at 281-83 (Glascoe). Respondents' manipulative trades on December 31, 2009 caused a different advisory client, Tampsco Partnership II ("Tampsco"), to purchase CARV at $9.05 per share. *See* Div. Trial Exh. 258 (12/31/2009 statement for Tampsco II Acct. No. 2009-4509). CARV shares have not traded as high as $9.05 per share since December 31, 2009; indeed, KAM liquidated CARV from its clients' accounts in 2011 because Koch decided CARV had made bad loans. *See* Div. Trial Exh. 317 (chart of CARV stock price); Tr. at 284-87 (Glascoe); Tr. at 924-25 (Koch). Respondents also caused Tampsco to purchase HCBC on December 31, 2009 at prices as high as $19.50 per share, but from December 31, 2009 through December 31, 2011, HCBC rarely traded above $19.50. Div. Trial Exh. 258 (Tampsco Account Statement), 315 (chart showing HCBC subsequent performance); Tr. at 281 (Glascoe). Based on this evidence, the Commission should conclude that Respondents' trading created a significant risk for loss for these particular clients, who overpaid for their shares, and would have suffered losses if the shares were sold.[33]

The Commission should also consider that Respondents deliberately misled their advisory clients about a fact of fundamental importance to KAM's clients, the value of the securities in their accounts, causing those accounts, in the aggregate, to be overvalued by

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[32] The Division used December 31, 2011 as a hard cut-off for its analysis because the trial of this matter took place starting January 6, 2012.

[33] While Respondents failed in their efforts to establish the closing price for CHEV on December 31, 2009, it was not for lack of trying. Respondents purchased shares of CHEV that were subsequently allocated to Tampsco's account at prices up to $7.99 per share during regular trading hours and $8.19 per share minutes after the close. Tr. at 255 (Glascoe). In between Respondents' purchases, a third party executed trades at $7.39 per share. Tr. at 251 (Glascoe).

millions of dollars. *See* Div. Trial Exhs. 258, 260, 305, 306, 309, 310; Tr. at 235-35, 245, 250, 256-60, 263-65 (Glascoe). This overvaluation created the potential for substantial losses to Respondents' clients because advisory clients purchased shares of HCBC and CARV at prices far above the prices at which those securities typically trade.

Respondents also caused the entire market to be misled concerning the value of the securities that they manipulated through their fraudulent scheme. The prices paid for HCBC on September 30 and for HCBC and CARV on December 31 were far above the prices at which those securities traded thereafter. *See* Div. Trial Exhs. 258, 260, 263, 265, 277, 305, 316, 317, 320; Tr. at 228-29, 234, 250-56, 281-87 (Glascoe). If Respondents had not traded on the days where their trades made up 100% of the markets volume, no new information about the stock price would have been reported to the market, and if Respondents had traded in a non-manipulative way, lower prices would have been reported to the market.

Finally, Respondents' conduct was also ongoing and repetitive. The Initial Decision found that Respondents engaged in violative trading in three stocks over a four month period.[34] The improper trading stopped only when regulators began questioning suspicious trades. These facts warrant imposition of the statutory maximum third-tier civil penalty of $725,000. KAM is an institution; thus, the appropriate civil penalty is the tier-three civil penalty for persons other than natural persons. *See* 15 U.S.C. § 78u(d)(3), 15 U.S.C. 80b-3(i), 17 C.F.R. § 201.1004 & Table IV.

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[34] At trial and in its post-hearing submissions, the Division presented evidence that Respondents marked the close in HCBC on the final trading day of October and November 2009. The Initial Decision concluded that the evidence of Respondents' manipulative intent with respect to those trades was insufficient. ID at 14. The Division disagrees with this conclusion, but accepts the finding; however, for purposes of determining the appropriate penalty, the Commission can consider the evidence, which includes testimony by Christanell that Koch instructed him to obtain a specific closing price for HCBC on the last trading day of October and November 2009. Tr. at 493 (Christanell).

CONCLUSION

For all of the foregoing reasons, the Division respectfully requests that the Commission affirm the Initial Decision's finding of liability and modify the sanctions award as requested herein.

Dated: October 17, 2012

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH RULE 154

I hereby certify that the Division of Enforcement's Memorandum of Law in Opposition to Respondents' Appeal of Initial Decision dated October 17, 2012, complies with the parameters set forth in Rule 450(c) of the Commission's Rules of Practice, which requires opposition briefs to be 14,000 words or less. The Division's opposition brief, including the cover page, but excluding the table of contents and table of authorities, contains 13,834 words. The word count was performed by the Microsoft Office Word word count tool.

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