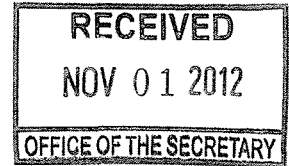


ADMINISTRATIVE PROCEEDING
FILE NO. 3-14355
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



In the Matter of :
 :
DONALD L. KOCH AND :
KOCH ASSET MANAGEMENT, LLC :
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RESPONDENTS' MEMORANDUM IN RESPONSE
TO THE DIVISION'S ANSWER MEMORANDUM

October 31, 2012

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ARGUMENT

I. THE DIVISION'S FACTUAL CLAIMS SHOULD BE REJECTED BECAUSE THEY ARE BASED ON UNSUPPORTED ASSUMPTIONS, IGNORING THE RECORD.

The Division's claim that its case and the Initial Decision ("ID") are built on "direct evidence" and "smoking gun evidence" is incorrect. Fragments of communications between Donald Koch and Huntleigh trader Jeff Christanell read out of context and laced with speculation that ignores the record are not direct, smoking gun evidence. In context, however, the fragments are evidence of proper, effective trading techniques for difficult, illiquid markets.¹

The so-called "smoking gun," and indeed the Division's entire case, is a smattering of conversation fragments - three e-mails and audio tapes from one day out of almost three months of trading - laced with supposition:

- A September 30 e-mail stating in part: "move last trade right before 3 p.m. up to as near to \$25 as possible without appearing manipulative . . ." Exh. 148;
- A December 23 e-mail stating in part: "I will want to move up HCBC the last day of the year . . . so, please be mindful . . ." R. 33.
- A December 28 e-mail stating in part: "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 . . ." Exh. 186.
- A December 31 tape recording that records in part: "My parameters are . . . if you need 5, 000 shares do whatever you have to do . . . I need to get it at 20, you know 20 to 25 I'm happy. . ." Exh. 189.²

¹ Respondents' opening brief dated September 10, 2012 is cited as "Opening Brief --". The Division's answer brief, dated October 17, 2012, is cited as "Division at --."

² There are six audio tapes from the same day which are discussed in Section III *infra*. There were extensive objections to the admission of those tapes which were raised in the Respondents Petition For Review, contrary to the Division's claim. Those objections were based on the fact that all the records before December 31, 2009 and for about two months after are missing and there is no assurance that ones remaining captured all the conversations that day or are complete. Opening Brief at 5 n. 3. *See also* note - *infra*.

These fragments – short hand references from on-going conversations – must be read in the context of the continuing communications between the two men over a two and one half month period that include numerous e-mails, phone calls and the trading records. The ID and the Division, however, eschew this approach in favor of reading the fragments in isolation with a transformative dose of speculation. Thus the simple trading instruction in the September 30 e-mail - Mr. Koch directed the trader to make small purchases to avoid unnecessarily disturbing the market as illustrated by the successful executions that followed - is transformed into “compelling evidence of his manipulative intent; such an admission is unnecessary unless the parties understand that their actions are manipulative.” Division at 17.

Other trading instructions, such as “moving it up,” and “a closing price in the 20-25” – a clipped reference to the market dynamic from a series of small executions at slowly laddering-up prices that attracted sells to the market giving KAM the opportunity to purchase shares below its maximum price - become nefarious evidence that Mr. Koch “wanted to mark the close in HCBC on the last day of the year, which is exactly how Christanell executed the instruction.” Division at 20.

As with any conversation fragments, the ones cited above are subject to misinterpretation when read in isolation - particularly if pejorative speculation is added. When read in the context of the on-going conversations and the securities transactions effected, the picture which emerges is that of a skilful adviser trading in difficult, illiquid and volatile markets to secure best execution. There was no manipulation and no violation of the law.

II. THE ID'S FINDINGS, AND THE DIVISION'S CLAIMS, FAIL TO IDENTIFY THE APPLICABLE STANDARDS AND ARE NOT SUPPORTED BY THE RECORD BECAUSE THERE IS NO EVIDENCE OF DECEPTION, MOTIVE, A FAILURE TO IMPLEMENT ADVISORY PROCEDURES OR THAT THE PUBLIC INTEREST REQUIRES SANCTIONS.

The Division's claim that the ID detailed the applicable standards supported by ample evidence is belied by a reading of the Decision and an analysis of the record.

Standards: For the ID to make findings, and for the Division to prove its case, the starting point is the legal standards alleged to have been violated. Courts have repeatedly rejected Commission determinations where this fundamental requirement was not followed as in *Rappoport v. SEC*, 682 F. 3d 98 (D.C. Cir. 2012) The Division's claim that *Rappoport* is distinguishable is misguided as shown by the uniform determinations on this point over the years. *See, e.g., Marrie v. SEC*, 374 F. 3d 1196 (D.C. Cir 2004); *Checkosky v. SEC*, 139 F. 3d 221 (D.C. Cir. 1998); *Checkosky v. SEC*, 23 F. 3d 452 (D.C. Cir. 1994).

Deception: The central issue in the case is whether the anti-fraud sections of the Exchange and Advisers Act were violated. It is axiomatic that to find a violation of those sections there must be proof of deception, here of artificial prices as charged in the OIP which is a form of deception. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1978); *Santa Fe v. Green*, 430 U.S. 462, 473 (1977). Indeed, the courts have repeatedly reiterated this point in various contexts. *See, e.g., O'Hagan v. U.S.*, 521 U.S. 642, 652 (1997); *Dirks v. SEC*, 463 U.S. 646, 653-54 (1983); *SEC v. Dorozhko*, 574 F. 3d 42 (2nd Cir. 2009); *see also SEC v. Capital Gains*, 375 U.S. 180 (1963). Yet the Initial Decision fails to make this key finding or even mention it.

In attempting to defend the ID, the Division inexplicably claims that the Law Judge and Respondents are confused while calling for the Commission to clarify the standards. Division Brief at 13-14. It is the Division that is confused. At one point it claims to have established that Respondents marked the close in purchasing shares of Carver, but also admits failing to make this showing, undercutting the ID. *Compare* Division Brief at 5 (heading) *with* 44, n. 31.

The standard here is clear and beyond dispute. The Division must prove and the ID must find deception, artificial prices as charged in the OIP. The ID failed to mention deception or to identify any evidence to support such a finding because the Division failed to prove it, offered nothing but conversation fragments and supposition.

The Division's failure is highlighted by the lack of evidence regarding motive. In the manipulation cases it cited (Division Brief at 9) motive was a critical element. For example, in *Kirlin Securities Inc.*, 2009 WL 4731652 (Dec. 10, 2009) the motive was to raise the price to avoid having the company shares delisted. In *In the Matter of Pagel, Inc.* 333 SEC Docket 1003, 1985 WL 548387, at *3 (Aug. 1, 1985), *aff'd*, *Pagel, Inc.*, 803 F. 2d 942 (8th Cir. 1986) it was to create a significant tax loss. In *Terrance Yoshikawa*, 87 SEC Docket 2580, 2006 WL 1113518, at * 4 (April 26, 2006) it was to generate trading profits for the trader.

Here, there is no proof of motive. Despite shifting from one theory to another in violation of a Commission Rule and precedent, claiming first, as alleged in the OIP, that it was to improve client brokerage statements and later that it was to increase advisory fees, the Division failed to prove either.³ The reason is that there was no manipulation.⁴

³ See Rule 200(b)(3); *In the Matter of Philip L. Pascale, CPA*, Adm. Proc. File no. 3-11194 (Initial Decision, May 17, 2004)(matters outside the OIP are only considered for limited purposes such as background).

Implementation: Neither the Initial Decision nor the Division identified any standard to support a finding that KAM violated Advisers Act Section 206-4 by failing to implement its procedures. Claiming that the operator of a sole proprietorship is, by definition, its “alter ego” is not a standard. Claiming that because there is a violation there is a failure to implement procedures is not a standard. Rather, those claims impermissibly attempt to rewrite state law and ignore Commission precedent. Opening Brief at 11. Absent a clearly articulated standard as *Rappoport* and its predecessors make clear, there can be no violation.⁵

Impermissible new issues: The Division should not be permitted to disregard the Commission’s Rules and raise a new issue about the failure of the ID to find in its favor on the OIP charge of failing to obtain best execution. Rule 411(d), Commission’s Rules of Practice, provides in pertinent part that:

Review by the Commission of an Initial Decision shall be limited to the issues specified in the petition for review or the issues, if any, specified in the briefing schedule order issued pursuant to Rule 450(a).

Under this Rule only those issues identified in Respondents’ Petition for Review,⁶ supplemented by the Commission’s order of July 26, 2012 and any issue raised on cross-

⁴ Mr. Koch cannot be a primary violator in view of the plain language of the statute and *Janus Capital Group, Inc. v. First Derivative Traders*, - U.S. -, 131 S. Ct. 2296 (2011). The Division’s claim that this case was brought under subsections (a) and (c) of Rule 10b-5 which were not involved in *Janus* is flatly contradicted by the OIP which only charges a violation of the Rule. And, in any event, as the court made clear in *SEC v. Kelly*, 817 F. Supp 340 (S.D.N.Y. 2001) *Janus* cannot be evaded by repackaging the claim as a violation of those subsections rather than subsection (b).

⁵ KAM implemented its policies the best possible way for a sole-proprietorship, transparency. It maintained meticulous, decades long records of each client transaction. Tr. 707 (Heidtbrink). Each client was fully informed of each transaction, receiving a broker confirmation of each trade, a monthly brokerage statement, [Tr. 139 (Marshall)], a quarterly statement from KAM [Tr. 705 Heidtbrink] and had periodic meetings with Mr. Koch. Tr. 643 (Cayce); Tr. 658 (Ewoldt). Total transparency, the predicate for the federal securities laws, is no doubt the best procedure to prevent manipulation. See, e.g., *Buckley v Valeo*, 424 U.S. 1, 67 (1976)(“Sunlight is said to be the best disinfectant, electric light the most efficient policeman . . .” quoting L. Brandeis, *Other People’s Money* 62 (National Home Library Foundation ed. 1933).

⁶ See Opening Brief at page 3.

appeal are properly considered. Since the Division chose not to raise the best execution question on cross-appeal it should not now be permitted to circumvent the Rule with a baseless claim that the question relates to one raised by Respondents.⁷

Sanctions: Finally, the Division has failed to demonstrate that there is a need for sanctions. There is no evidence demonstrating a likelihood of a reoccurrence of wrongful conduct. As the record shows here, the purchase transactions were made in highly illiquid markets where execution and assembling a block of securities is most difficult. While Respondents believed their approach proper, if the Commission rules otherwise there should be no doubt that they will respect and comply with the ruling.

Equally clear is the fact that the Division failed to prove that the public interest requires sanctions, particularly the third tier penalty it now seeks. As demonstrated in their Opening Brief at 15, the statutes require that before sanctions are imposed there be proof that they would be in the public interest. Yet the ID makes no such finding and the Division fails to even mention it. In view of this failure of proof, the Division's demand for a third tier penalty should only be seen as punitive and rejected.⁸

III. THE TOTALITY OF THE EVIDENCE: FOR A BUSINESS PURPOSE, KAM MADE FOUR LONG TERM INVESTMENTS USING SKILFUL MARKET TECHNIQUES TO OBTAIN BEST EXECUTION.

A. The Program

1. **Long term:** The KAM program, which over the years more than doubled the investment of many clients [Tr. 645 (Cayce); Tr. 654-655 (Ewoldt)], is based

⁷ The Division also tries to resurrect a Section 206(2) claim in violation of the Rule. Again the ID did not find in favor of the Division on this claim and it chose not to cross-appeal. The Division should not be permitted to end run Rule 450(a), ignoring its choice.

⁸ The Division's claim for disgorgement is wholly inappropriate and for a collateral bar is incorrect. Opening Brief at 13.

on purchasing only shares of small community banks for the long term. Each client holds an individualized portfolio. Mr. Koch explained:

I have a basic model in my head, and I design every portfolio in three sectors. I have sectors that are – were fully appreciated . . . I have securities that are basically in the oven cooking . . . And then I have securities that are just coming into the portfolio that are the new ones that will be cooking for some time. So I try to have everyone in three sectors, as long as they have the same characteristics. Tr. 856 – 57.

2. **Origin:** It stems from Mr. Koch’s career as a bank executive making acquisitions, a Federal Reserve economist, a professor of economics, a consultant to the FDIC and his investing experience. Tr. 856 - 857 (Koch). It is grounded in the academic literature. Tr. 1124 - 25 (Jarrell).

3. **Stock selection:** Each stock is carefully selected by Mr. Koch after a rigorous process that includes:

- Evaluating the demographics of the bank’s location;
- Analyzing the financial data;
- Interviewing management;
- Assessing operations in the branches;
- Calculating the enterprise worth and determining the maximum price to pay for a share of stock at FDIC liquidation value to protect against loss and maximize profit potential since takeovers are typically at a multiple of the value – tangible book value or TBV. Tr. 829 – 35. *See also* Tr. 819; 821; 827, 829 (Koch).

B. Purchasing the stocks

1. **Illiquid:** The small bank stocks purchased by KAM are traded in the over-the-counter markets or on the bulletin board. They are highly illiquid, meaning they are difficult to acquire. Former SEC Chief Economist Professor Gregg Jarrell explained:

The 39 stocks . . . that KAM invested in, I'm looking at their average bid-ask spread over 2009 as a percentage. I'm just comparing that to the NASDAQ stock market all 1,000 plus stocks for 2009 to show again – you know, to make sure that we all understand, very important, that while the bid-ask spread is a penny for that liquid stock, .12 percent or .2 percent for that liquid stock, we're talking about here stocks that are much, much less liquid than that. The average bid-ask spread for all of the 39 stocks for KAM over this period of time is over 6 percent. That's many, many times greater than the typical NASDAQ stock of .2, .24 percent . . . the three stocks in question here [High Country, Cheviot and Carver] especially HCBC, you know, they're very high bid-ask spreads . . . That's a very illiquid portfolio of 39 stocks . . . Huge incentives to try to economize on that number. . . [by trading when the market is most liquid]. Tr. 1077 – 1078; *see also* R 39 at 24 – 25 (Jarrell presentation, copy attached)

2. ***Economies:*** Purchasing blocks helped effect economies. KAM tended to acquire blocks of 1,000 to 5,000 shares, according to KPMG partner John Schneider who analyzed KAM's operations. R. 36 at 10; *see also* Tr. 820; 876 -877 (Koch); Tr. 200 (Marshall). Economies are also achieved by trading at the open or the close of the trading day when the markets are most liquid and pricing more efficient according to Professor Jarrell:

But trading volume . . . is highly concentrated in security markets at the open and at the close of trading . . . You have lower costs of transaction . . . It's cheaper. Tr. 1055-56.; *see also* Tr. 1067 (cheapest at end of day)

3. ***Difficult to purchase:*** Illiquidity also meant that the stock might not be available. Shares of High Country, Cheviot and Carver do not trade every day. When they do, the volume is limited as Professor Jarrell testified:

CHEV is - has 10 percent of the days when there's no trading at all. . . CARV now . . . nearly 30 percent have no trading . . . And again HCBC is a totally different animal. There's 85 percent of those 252 trading days, 212 days, there's zero trading for that company . . . It's all most like a privately negotiated transaction . . . Tr. 1082 – 83; *see also* R 39 at 25.

The average NASDAQ stock traded 109,081 shares per day in 2009. Cheviot's average daily volume in that year was 5,414 shares, Carver's 1,857 and High Country's just 212 shares. R. 39 at 25. The difficulties of acquisition may have been compounded in 2009 by the then on-going market crisis.

4. **Purchase day:** Attempting to purchase shares on days when the markets are most liquid increases the chances of acquisition and minimizes cost. While KAM invested over the course of the month, it tended to acquire larger blocks at the end of the month according to Mr. Schneider's analysis. R. 36 at 11-12. It also tended to purchase toward the end of the day. R. 39 at 18. Mr. Koch explained:

[At certain times] everybody wants to monetize paper to cash . . . From a stock certificate to cash, usually around . . . end of the month . . . end of a quarter when there's stock available. There's much more stock available at certain times . . . [The end of the year is] a very good time when people do transactions to convert to cash . . . a very good opportunity to buy. Tr. 861 862.

5. **Pricing:** To acquire a block of an illiquid stock like High Country, Cheviot and Carver, frequently the limit cap had to be set at or above the ask to attract sellers to the market as Professor Jarrell explained for High Country:

If you try to collect 2,000 shares and put down a limit order at the current asking price, you're wasting your time in this type of market. You're not going to get any stock. In fact you're going to have to raise the price quite a bit to scare that stock out of its hiding place. Tr. 1112.

Setting the limit price (which is the highest price that might be paid for the last few shares) in this manner took advantage of market economics, resulting in a continuing series of small executions at prices slowly laddering-up that attracted sellers to the market. Mr. Schneider explained:

. . . when you're buying any volume in these thinly traded securities, it's likely to send a message to those who might be buying at the same time that, you know, there might be an interest out there . . . Tr. 963.

Q. Okay. And so what you're seeing here . . . the same kind of laddering-up effect that you've talked about before in terms of the price? A. That is correct. Q. Okay. And again, that's typical of these kinds of illiquid markets? A. That is correct as well. And you see that throughout . . . It's very conceivable that if you have an open market order [no limit] for a large block . . . it could be at a price that's much higher. Tr. 970.

KAM protected its clients by capping the laddering at TBV as Mr. Koch testified:

. . . I'm consistently comfortable with going up to tangible book value to get the security I want. Tr. 868.

6. *Purchase impact:* Even with a careful, market oriented approach,

there is an inevitable impact. According to Professor Jarrell:

And so if you do a trade at all . . . it's going to represent a majority of that day's trading volume, perhaps 100 percent of it. And that's not your fault. That's just a fact of life . . . the natural economic forces, if you go in and are trying to trade in those types of stocks, it's going to have various effects. *And those effects are going to be present, you know, regardless of your motive.* Tr. 1058 (emphasis added)

Your choices are to accept that circumstance [each transaction moves the price] and live with it and trade at the end of the day and maybe the end of the month to try to minimize the problems – or get out of the stock. Those are your choices. Tr. 1122 - 23.

C. *September 2009: Investing Mrs. Smith's excess cash.*

1. *Investment purpose:* In late September 2009 KAM sought to invest the excess cash of long time client Alice Smith in shares of High Country. Mrs. Smith was a retired business woman who had a successful career in interior design after graduation from Washington University. Tr. 790 – 91 (Koch). As one of KAM's first

clients, and a long time friend of Mr. Koch, she watched her investment more than double over the years and was very familiar with the stock. Tr. 802, 804 - 06 (Koch).⁹

2. **Preparation:** September 30 was the end of the quarter, a time when the markets were expected to be more liquid. Trading opened with the spread at \$11.70 to \$18. R. 39 at 43. KAM tested the market, placing an order for 400 shares with an upper limit price of \$18, below the TBV of \$25, at 11:25:52. *Id.* Tr. 821 (Koch, always used limit orders; Tr. 841(Koch, TBV)).¹⁰ The result:

- 11:29:42, execution for 200 shares at \$18
- 11:41:38, execution for 200 shares at \$16

The spreads remained constant. R. 39 at 43.

3. **Seeking a lower price:** Just before noon the spread widened to \$11.70 to \$20. KAM adjusted its approach, revising the number of shares sought to 600 (or seeking 400 more) but lowered the limit cap price to \$16. R. 39 at 43. The firm got a partial fill of 180 shares at \$16 according to Professor Jarrell:

KAM revising the order, saying, okay, let's go 600 and now the – and the limit order there is 16. And lo and behold, KAM -- even though the ask was 20, KAM – because it was a limited amount, KAM was able to get another 180 shares at 16, inside the spread. So that's – you know, that's impressive. Tr. 1113; *see also* R. 39 at 43.

4. **Seeking economies:** KAM adjusted its order again at 14:15:28, seeking its customary block. Huntleigh recorded a revised order of up to 2,000 (or another 1,420) with an upper limit price or cap of \$25. While the tapes for the day are unavailable because Huntleigh policy required all orders be placed on the phone [T. 170

⁹ The September 9, 2009 KAM transaction in High Country at about \$11 per share questioned by the Division, was largely cross-traded between clients priced, as is typical, at the bid. *See* Tr 998 (Schneider).

¹⁰ The limit does not dictate the purchase price, just the end point. Tr. 581 (Christanell).

(Marshall)] it is reasonable to infer that Mr. Koch telephoned Mr. Christanell. Mr. Koch explained the new limit price as an effort to acquire a block:

Well, all I'm saying here is I know I can't get the stock unless I'm paying 20, if I want to get size [a block]. If I want to get size, I'm going to pay 20, and I can get dribs and drabs, something less than 20, only 580 shares. Tr. 876.

Q. So when you say 25, do you expect to pay 25 for each share you're getting? A. No. On average I would – he [trader] *would be on some kind of ladder*, you know, he may pay 25 the last couple of hundred shares, but he may be very successful if he starts around 22. . . Tr. 882. (emphasis added)

Professor Jarrell, after analyzing the trading, concurred:

Well, KAM had been successful earlier in the day of filling the limited – small orders at prices inside or at the ask. But now when you go to 2,000 in this kind of market, you know, experienced traders are going to know that you're going to now be outside the ask probably. Tr. 1114; *see also* Tr. 1112.

5. ***Execution instructions:*** Mr. Koch sent Huntleigh an e-mail with instructions, directing that the order be broken into pieces for execution. It stated in part: “move the last trade right before 3 p.m. up to as near to \$25 as possible without appearing manipulative.” Exh. 146. Mr. Koch explained this would avoid disturbing the market and unnecessarily running up the price:

he was an institution trader. He [Mr. Christanell] . . . 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 goes -- and I'm guessing here – 30, 35. You destroy the entire market. So I am asking him to be invisible as you can, to be as low keyed as you can, to *do this at 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. 879 (emphasis added).

Both the ID and the Division's Brief rejected the explanation. It is clear Mr. Christanell understood. He broke the order up and obtained smaller executions resulting in laddering price increases that drew more sellers to the market, achieving a fill. As Professor Jarrell stated:

. . . you see (looking at R. 39 at 43) the success of filling that order at prices underneath the 25. They all came under the 25. You have \$20, \$20, \$20, \$22 and \$23.50. Tr. 1114. *See also* Exh. 278 (showing small executions).

D. December 2009: Investing Tampsco's excess cash.

1. Preparation: The busiest trading day of the year.

a. *Paradigm change:* As the second year of the market crisis

drew to a close KAM concluded that the turbulent and depressed markets were about to undergo a significant change:

I [Mr. Koch] was picking up a very unique paradigm shift, and that paradigm shift was non-earning assets of financial companies were falling. So I had very high, long-term visibility and profitability going forward. I could see several quarters going forward. I could see several quarters ahead, that as non-earning assets fell, these companies would be extremely profitable. But the market was still discounting these properties as if they wouldn't be around. So there was a paradigm shift, and I needed to move out of cash. Tr. 894-895.

b. *Preparation:* KAM expected the last day of the year to

present an opportunity to purchase the illiquid securities it coveted:

My sense [Mr. Koch testified] is that I would say supply. Nice supply coming in the market at the end . . . I would have an opportunity to finally buy the blocks I'd like to buy. Tr. 896; *see also* Tr. 1132 (Jarrell, concurring).

c. *New strategy:* On December 23, 2009 KAM tried a trading

strategy crafted by Mr. Christanell to purchase blocks of illiquid securities at cheaper

prices than the approach used in September 2009. The order was for Cheviot, a community bank in Cincinnati, Ohio, a KAM favorite. According to Mr. Christanell:

Q. And that's an email [R. 32] from you back to Don about your strategy . . . A. Right. Q. That's the strategy of conservative price [limit price near the bid], big block, see if we can pull those people into the market? A. Right . . . Q. And it failed? A. Right. Tr. 607 – 611.

No shares were acquired. Tr. 896 (Koch).

d. *Alerting the trader:* KAM alerted trader Christanell that on December 31 it planned to acquire a block of High Country shares in two e-mails. The first, dated December 23, 2009, stated in part: “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 . . .*” R. 33 (emphasis added). The second, dated December 28, 2009, was similar, stating in part: “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.” Exh. 186. KAM was reverting to the proven September strategy, discarding Mr. Christanell's unsuccessful idea.

e. *The client:* Each December 31, 2009 purchase was for long-time client Tampsco, a group of accounts managed by attorney John McFarland for a wealthy family. Tr. 797 (Koch). Tampsco's returns exceeded those of Mrs. Smith. Tr. 808 (Koch) Like Mrs. Smith, the accounts had idle cash earning virtually no return. KAM saw a year-end opportunity to turn non-earning cash into profitable investments. Tr. 907 -08 (Koch).

2. **Purchasing High Country: Christanell's error.**

a. *Pre-open:* Huntleigh entered a 5,000 share order with a limit price capped at \$25 for KAM at 9:06 a.m. Earlier that morning Messrs. Koch and Christanell discussed the order presaged in the December 23 and 28 e-mails:

My parameters are if you need 5,000 shares, do whatever you have to do. I need to get it above 20 . . . 25 I'm happy . . . Okay, you do what you need to do to see what the market is and I think you know just go market share 100s. You know . . . I don't want to tell you your job, but get it up there. Ex. 189

Mr. Koch explained the price references in terms similar to those he used to describe the successful September purchases:

Q. But on the tape, you're saying, I want to move the price up to \$20 to \$25? A. I'm quite convinced if we *walk up that price ladder*, hopefully at the end of the year you're going to see some stock come in, in the market . . . *you'll be able to drive that stock, that volume into the market, by moving up the price ladder.* Tr. 901. (emphasis added).

Executing this strategy would take time, and the precise number of shares that could be acquired as prices laddered-up before reaching the TBV \$25 cap or the close of the market could not be determined in advance. During the conversation the two men agreed to execute the order about one hour before the close, the deepest point of the market on what was anticipated to be a very busy day. Ex. 189. In contrast, if KAM tried to execute the order early in the day it likely would have to pay higher prices. Tr. 1133 (Jarrell).

b. **Timing:** About twenty minutes before the market closed Mr. Koch telephoned the trader. Nothing had been done. Mr. Koch urged the trader to get moving on the order: “Yeah, go ahead, go early.” Ex. 188 ¹¹

c. **Christanell lingered:** The trader ignored the instruction. Finally, about four minutes before the close, he routed the order for execution in small increments as KAM had directed. The spreads were still \$14.05 to \$16.80 as at the open. The executions began and, as Professor Jarrell testified, the prices slowly laddered, drawing sellers to the market, giving KAM the opportunity to purchase as planned:

And then you can see [looking at R. 39 at 58] the broker filling the order in the last five minutes, boom, boom, boom, boom. Second by second, minute by minute, buying 200 shares at 16.80 and that – that’s at the ask. Buying 700 at 16.99. Still very successful prices relative to where that spread is at the beginning of the day. You see that we don’t have – we’re able to pick all of those shares up at 17, 17.50 right at the ask until the spread starts to give way, and then we see 19.50 is the ask; and then the final trade of the day was the last 200 shares at the ask of 19.50 which established the closing price of 19.50. Tr. 1134.

KAM acquired 3,200 shares. R. 39 at 58; Exh. 278.

d. **Disappointment:** While a sizable block was acquired, it was clear more shares could have been purchased if Mr. Christanell had heeded instructions:

It’s Jeff. Okay, now, God, it was tough. The HCBC. I’m sorry, it closed at 17.50. I know you wanted it higher [which would get more shares], and I tried. The main thing with that one is that it’s on the bulletin board and you just can’t put an order out to take it, you know like you could in another market to go buy 5,000 on the market and go boom, boom, boom and you’re done like that . . . Thus you have to go to, you have to hit every venue, bait them for stock, and then they keep coming back with more, and you try to play the game with a

¹¹ The time on this tape is 3:39 p.m. The text suggests it might have been earlier. Tape Exh. 192 lists a time of 3:48 p.m. which is clearly wrong because the text reflects a post close conversation. This is another of the multiple difficulties with the reliability of these tapes. *See also* note 2 *infra*.

little bit here and a little bit there, and then in the process I'm trying to get these other orders plus about five other institutional orders that we're working, dealing today. I got 3,200 and like I said I apologize. Ex. 192.

The trader's description of the laddering price was incorrect. KAM's last execution just before the close was at \$19.50. R. 39 at 58. Had the trades been placed earlier as instructed, prices likely would continued to ladder into the low \$20s as on September 30, permitting the adviser to acquire the entire block at favorable prices.

3. Purchasing Cheviot.

a. *Instructions:* A second stock selected for Tampsco was Cheviot. KAM checked the spreads in a telephone call with Mr. Christanell at about 12:45 p.m. They were at \$7.04 to \$7.62. Mr. Koch directed the trader to use the successful September strategy, bidding above the ask but below TBV of \$12 - \$15 [Tr. 798, 854 (Koch)]:

. . . let's see if by the end of the day you move it around 8, 8 and a quarter . . . Ex. 191.

b. *Entering the order:* Again there is no taped conversation or e-mail mentioning the size of the order. Nevertheless, at 13:01:15 Mr. Christanell entered an order in the Huntleigh system for 5,000 shares at up to a limit price capped at \$8.25. R. 39 at 30. Over an hour later at 14:15:16 KAM got an execution for 200 shares at \$7.25. R. 39 at 30.

c. *More instructions:* Shortly after 3 p.m. Mr. Koch called the trader again, checking on the order. Mr. Christanell had lingered. Mr. Koch instructed:

You know, I'd start the 100, 200 share increment depending on how far it moves. I think it trades little I think you'll . . . pretty fast . . . Exh. 190.

Mr. Koch's explanation echoes his statement about the September e-mail instruction:

Again, I don't – I want him [trader] not to be the elephant in the room. I want him not to be the institutional trader that he is . . . So I'm placing limits on this. I'm trying to *see if you're going to walk up the bid – if you're going to walk up you're going to walk up the ask, walk up the stock, do it in a rationale way so you see at what price on this ladder of prices does the stock come into you, what does it take to get the stock* . . . Tr. 897 (emphasis added).

d. Success: Mr. Christanell did not wait until the last minutes as he did with High Country. KAM began getting executions about 3:40 p.m. The price slowly laddered as expected. Professor Jarrell described the executions:

Now, the first thing I want to point out is . . . all of the trading by all – by the market participants, KAM and other people, tends to come [for Cheviot on Dec. 31] at the end of the day, you see that the period of time from 3:40 to 4:00 p.m. . . . The people that are trading, are trading at that time of day. Tr. 1088.

The strategy was so successful that Mr. Christanell amended the order without asking, raising the number of shares to 7,000 with the same limit cap. R. 39 at 31. Overall 6,700 shares were purchased. R. 39 at 31; Exh. 278. Professor Jarrell described the executions:

you can see [looking at R. 39, at 30-31] KAM is – the broker is filling the order . . . You can see that the prices tend to be either at the ask or inside, in the middle, and of course well underneath the limit price of 8.25. . . Inside the spread or at the ask at the time, absolutely. That's exactly what's going on here . . . 3:45 KAM revises the order and says not 5,000; let's buy 7,000 . . . Keeps the same market limit at 8.25 however, probably because of the success so far . . . KAM's broker is picking up shares whenever and wherever, and the prices again are either at the ask or inside the spread, all the way down until we get to the market close . . . *And that's the trade that set the closing price of 7.39 . . . that trade is not KAM's trade; that's someone else.* Tr. 1092- 1095 (emphasis added).

Later, KAM ratified the broker's action, although the 6,600 shares purchased was larger than its typical order. Exh. 192.

4. Purchasing Carver – a small quantity selected by the trader.

a. *Assessing the market:* Carver, located in Harlem, New York, was another long time KAM favorite. At 1:01 on December 31, 2009 an order was entered for 1,000 shares with a limit price capped at \$ 9.05, well its \$20 TBV. R. 39 at 36; Tr. 798, 854 (Koch). Just before the order was entered Mr. Koch telephoned Jeff Christanell, checking the market:

Mr. Koch: Carver is 9, right? Mr. Christanell: CARV is 8.10 to 9.05.
Mr. Koch: Woo! 8.10 to 9.05. Okay well let's see. . . any trades today? Mr. Christanell: No trades, no volume. So there's at least 2,000 off the 9.05. Mr. Koch: Well, what you do at the end of the day is pop that one . . . Exh. 191.

Again there is no recorded conversation or e-mail indicating the size of the order, suggesting there were other communications in view of Huntleigh's policies.

b. *Reducing the order size:* Twenty minutes before the close Mr. Christanell recommended that KAM limit its purchase to 300 shares, in probability based on the lack of trading:

Mr. Christanell: Yeah. In the Carver, I was thinking of just buying, like, 300 shares at 9.05. Is that alright? Mr. Koch: Okay. Exh. 190.

c. *Partial fill:* KAM obtained only a partial fill of 200 shares. While more stock was available, again the trader waited too long. In the closing seconds of the trading day when Mr. Christanell chose to execute the order, others made the trades as Professor Jarrell's analysis demonstrated:

Well, again, you notice [looking at R. 39 at 36] that most of the activity comes in the last hour of trading . . . And then you see that the broker was able to buy 100 shares later in the day, almost at the end

of the day . . . and got 100 shares at 9.05 and then got another 100 at 9.05 and then that was it. *Then the last trade of the day somebody either bought or sold three shares at whatever that number is, \$8.68. Then the last trade of the day is 100 shares by someone else at 9.05, again the ask.* That's probably a purchase. And then that set the market closing price at 9.05, which had been the asking price at the beginning of the period. Tr. 1098 – 1102 (emphasis added).

E. The totality of the evidence: KAM and Mr. Koch did not mark the close but did make purchases at competitive prices for long term investments.

1. No manipulation

a. *Cheviot and Carver:* There is no evidence that KAM and Mr. Koch marked the close or engaged in manipulative conduct in violation of the antifraud provisions of the federal securities laws in purchasing shares of Cheviot and Carver on December 31, 2009. As Professor Jarrell concluded after an extensive analysis of the trading and markets:

In my opinion with respect to CHEV and CARV, I saw no evidence consistent with marking the close. No economic evidence that I examined was consistent with marking the close. There's no price impact that's significant, and they're not even the last trade of the day. And I think that's inconsistent with marking the close. Tr. 1137.

Mr. Schneider's analysis confirmed this point, finding that each purchase was fully consistent with KAM's long standing program and prior purchase transactions. Tr. 944, 1003 – 04.

b. *High Country:* Professor Jarrell's analysis confirmed that KAM's purchases of High Country shares in September and December 2009 were at prices that are wholly consistent with those paid by other traders on other dates: ¹²

¹² Professor Jarrell testified that High Country is so illiquid that the type of analysis done on Cheviot and Carver could not be performed. Shares of High Country are subject to a well documented phenomenon known as the "bid-ask bounce" in which virtually every transaction causes the price to bounce between the bid and ask price. Tr. 1103 - 08; R 39 at 39 – 40. Accordingly, he adopted a different mode of analysis to analyze the High Country trades. R 39 at 44 – 45, 59 – 60.

It's my opinion based on all of my work that KAM's trading in HCBC's stock would have impacted the price in a similar manner because of HCBC's status as an extremely illiquid high bid-ask stock. Tr. 1137

Stated differently, the purchases were at competitive prices, not artificial ones. Again, Mr. Schneider's analysis confirmed this point, finding that each purchase was fully consistent with KAM's long standing program and prior purchase transactions. R. 36 at 9.

2. Best execution

Mr. Christanell's undisputed testimony established that each purchase made by KAM in September and December 2009 received best execution:

Q. When you piecemealed it [the order] out, each little piece of that piecemeal got the best execution that you could get, right? A. Got the best offer out there that we could get, yes. Tr. 591).

This conclusion is fully consistent with the findings of Professor Jarrell and Mr. Schneider.

3. Investment purpose

Each purchase here was made for a valid business purpose as demonstrated by the undisputed testimony. The High Country shares purchased on September 30, 2009 were for the account of Mrs. Smith who continued to hold them until she passed away. There is no evidence they were sold. All of the shares purchased on December 31, 2009 were for the accounts of Tampsco. There is no evidence those shares were sold. The trustee of those accounts, John McFarland, continues to share an IRA account with Mr. Koch. Tr. 806-07 (Koch).

4. No contrary evidence

The Division failed to offer any evidence of deceptive conduct by KAM or Mr. Koch. It offered no evidence of an artificial price, of manipulative trading or of a motive to manipulate. The Division has attempted to draw inferences from bits and pieces of evidence, simply piling inference on inference, supplemented with its speculation. Those inferences are insufficient to overcome the extensive analysis of Professor Jarrell and Mr. Schneider, the testimony of Mr. Koch, the unchallenged evidence of valid investment purpose and the uncontested evidence of best execution which, collectively, demonstrates that there was no manipulation and no violation of the statutes. As the Commission held under similar circumstances: “Although the existence of manipulation may be gathered from circumstantial evidence, simply piling inference upon inference is not enough . . .” in view of expert testimony and other evidence to the contrary. *In the Matter of H.J. Meyers & Co.*, Adm. Proc File No. 3-10140 (Aug. 9, 2002).

CONCLUSION

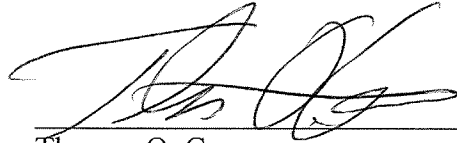
The Commission’s statutory mandate is investor protection. Critical to that mission is its enforcement program which polices the markets to ensure fairness and integrity for investors. Its hallmark has always been fundamental fairness, conducting investigations where there is cause, pursuing actions and sanctions where supported by the evidence and dismissing them when the evidence warrants. This has earned it a reputation for fairness that is critical to the program’s success.

Here the totality of the evidence demonstrates that the investments made by KAM for its clients were for a valid business purpose and in accord with a long term and very successful investment program. Fairness dictates under these circumstances that the charges be dismissed.

WHEREFORE, Respondents respectfully request that this proceeding be dismissed.

Dated: October 31, 2012

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'T. Gorman', written over a horizontal line.

Thomas O. Gorman
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CERTIFICATE OF COMPLIANCE WITH RULE 154

I hereby certify that the foregoing Reply Brief complies with the parameters set forth in Rule 450(c) of the Commission's Rules of Practice, which requires reply briefs to be 7,000 words or less. The foregoing reply brief, including the cover page, but excluding the table of contents and table of authorities, contains 6,981 words. The word count was performed by the Microsoft office Word word count tool.



Thomas O. Gorman

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Respondent's Memorandum in Response to the Division's Answer Memorandum was filed with the Secretary's office at the Securities & Exchange Commission on October 31, 2012, and served on Suzanne J. Romajas at 100 F Street, N.E., Washington, D.C. 20549 by hand on October 31, 2012, and by e-mail at RomajasS@sec.gov on October 31, 2012.



Thomas O. Gorman

Demonstrative Exhibits

Gregg A. Jarrell

Professor of Economics and Finance



*Where Thinkers
Become Leaders*

Qualifications

- Education
 - Ph.D., University of Chicago
Business Economics, 1978
Major Concentration: Industrial Organization and Finance
 - M.B.A., University of Chicago
Economics, 1976
Major Concentration: Economics and Finance
 - B.S., University of Delaware
Business Administration, 1974

Qualifications (cont'd): Employment

Academia

- **University of Rochester**
Simon Business School
Professor of Economics and Finance
July 1988 – Present

Director of Bradley Policy Research Center
1990 – 1994

Director of the Managerial Economics Research Center
1988 – 1990

AT&T Foundation Resident Management Fellow
January 1987 – June 1987

Assistant Professor of Economics
July 1977 – August 1981
- **Georgetown University**
Law School
Adjunct Professor
July 1985 – July 1986
- **University of Chicago**
Post-Doctoral Research Fellow
August 1981 – April 1983

Private Sector

- **The Alcar Group, Inc.**
Senior Vice President
July 1987 – July 1990
- **Lexecon, Inc.**
Senior Economist
April 1983 – March 1984

Government Sector

- **U.S. Securities and Exchange
Commission**
Chief Economist
April 1984 – January 1987
- **U.S. SEC Advisory Committee on
Tender Offer Policy**
Member
February 1983 – July 1983
- **Federal Trade Commission**
Consultant
December 1981 – January 1983

Qualifications (cont'd): SEC Office of the Chief Economist

- Chief Economist for the SEC in Washington, D.C.
 - Supervised numerous economic studies:
 - Effects of mergers, takeovers, LBOs and MBOs on the value of the companies' stocks
 - The effects of regulation on the market for mergers and acquisitions
 - The economic effect of insider trading on stock prices and volume

Qualifications (cont'd)

- Academic Honors and Fellowships
 - Superior Teaching Award, University of Rochester
 - Received 12 times (1980 – 2011)
 - Beta Gamma Sigma
 - University of Chicago Fellowship
 - 1976-1977
 - Earhart Fellowship in Industrial Organization
 - 1975-1976

Qualifications (cont'd)

- Publications
 - Authored or co-authored over 30 articles and studies in scholarly journals on topics such as:
 - Mergers and acquisitions
 - Regulation of financial markets
 - Response of stock prices to release of information

Selected Publications

- “Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation,” with Annette Poulsen, *The Journal of Law, Economics, and Organization*, 5 (2), 225-248, Fall 1989.
- “Hostile Takeovers and the Regulatory Dilemma: Twenty-Five Years of Debate,” with John Pound, *The Midland Corporate Finance Journal*, 5 (2), Summer 1987.
- “Shark Repellents and Poison Pills: Stockholders Protection – from the Good Guys or the Bad Guys?,” with Annette Poulsen, *The Midland Corporate Finance Journal*, 4 (2), Summer 1986.
- “Do Targets Gain from Defeating Tender Offers?” with Frank Easterbrook, *New York University Law Review*, 59, 277-300, May 1984.

Expert Witness: Selected Testimonial Experience

On behalf of the U.S. Government

- Estate of Douglas L. Manship, et al. v. United States of America
- H.J. Heinz Company, et al. v. United States of America
- GWI PCS1, Inc., et al. v. Federal Communications Commission
- The Boeing Company v. United States of America
- Pension Benefit Guaranty Corp. v. White Consolidated Industries, Inc., et al.
- Wrangler Apparel Corporation v. United States of America
- Smith Corona Corporations, et al. v. Pension Benefit Guaranty Corporation
- CSC Industries, Inc., et al. v. Pension Benefit Guaranty Corporation
- Nestle Holdings, Inc. v. Commissioner of the IRS
- U.S. Securities and Exchange Commission v. Carter Hawley Hale Stores, Inc.

Opposing the U.S. Government

- United States of America v. Raj Rajaratnam
- United States of America v. Roger D. Blackwell, et al.
- U.S. Securities and Exchange Commission v. Scott K. Ginsburg, et al.
- U.S. Securities and Exchange Commission v. First Jersey Securities, Inc., et al.
- Edward Seykota, et al. v. Commissioner of the IRS

Materials Reviewed

Trading Data – KAM ¹

- Koch Asset Management data
 - Money Market Manager Plus System
 - 1998 – 2009
 - 4,334 transactions
- Huntleigh Securities Corp. data
 - NYFIX OATS Activity Report
 - Dec. 2005 – Jan. 2008
 - 13,641 transactions
(includes non-KAM trades)
 - Lava Trade Blotter
 - June 2008 – Dec. 2009
 - 9,142 transactions

Market Data

- Bloomberg
- FT Interactive
- FactSet
- University of Chicago's Center for Research in Security Prices ("CRSP") database
- New York Stock Exchange Trade and Quote ("TAQ") database
- OTC Market Groups ("Pink Sheets")

¹ Difference in number of transactions from different sources partially attributable to broker-dealer breaking trades into smaller blocks.

Summary of Opinions

- Trading volume in the overall market is concentrated at the open and close of the trading day when liquidity is greatest
- KAM invested heavily in shares of highly illiquid stocks, therefore it is economically rational to trade such illiquid stocks at the end of the trading day
- Any trade in an infrequently traded, illiquid stock will likely represent the majority (if not all) of that day's trading volume
 - Such trading is not a red flag for “marking the close”

Summary of Opinions (cont'd)

- KAM's trading in Cheviot Financial ("CHEV") and Carver Bancorp ("CARV") had minimal price impacts on these stocks on December 31, 2009
 - CHEV closed down \$0.07 per share or -0.9%
 - CARV closed up \$0.03 per share or +0.3%
- KAM was not the last trade of the day for CHEV and CARV on December 31, 2009
- In my opinion, this evidence is inconsistent with the SEC's contention that KAM's trading in CHEV and CARV reflected "marking the close"

Summary of Opinions (cont'd)

- KAM's trading in High Country Bancorp ("HCBC") resulted in stock price increases of between 16.6% and 48.9%
 - HCBC's stock price is exceptionally volatile
 - HCBC's bid-ask spread is more than 135x greater than the average bid-ask spread on NASDAQ
- In my opinion, KAM's trading in HCBC's stock would have impacted the price because HCBC is extremely illiquid

Overview of Testimony

- **The “U-Shaped” Trading Pattern**

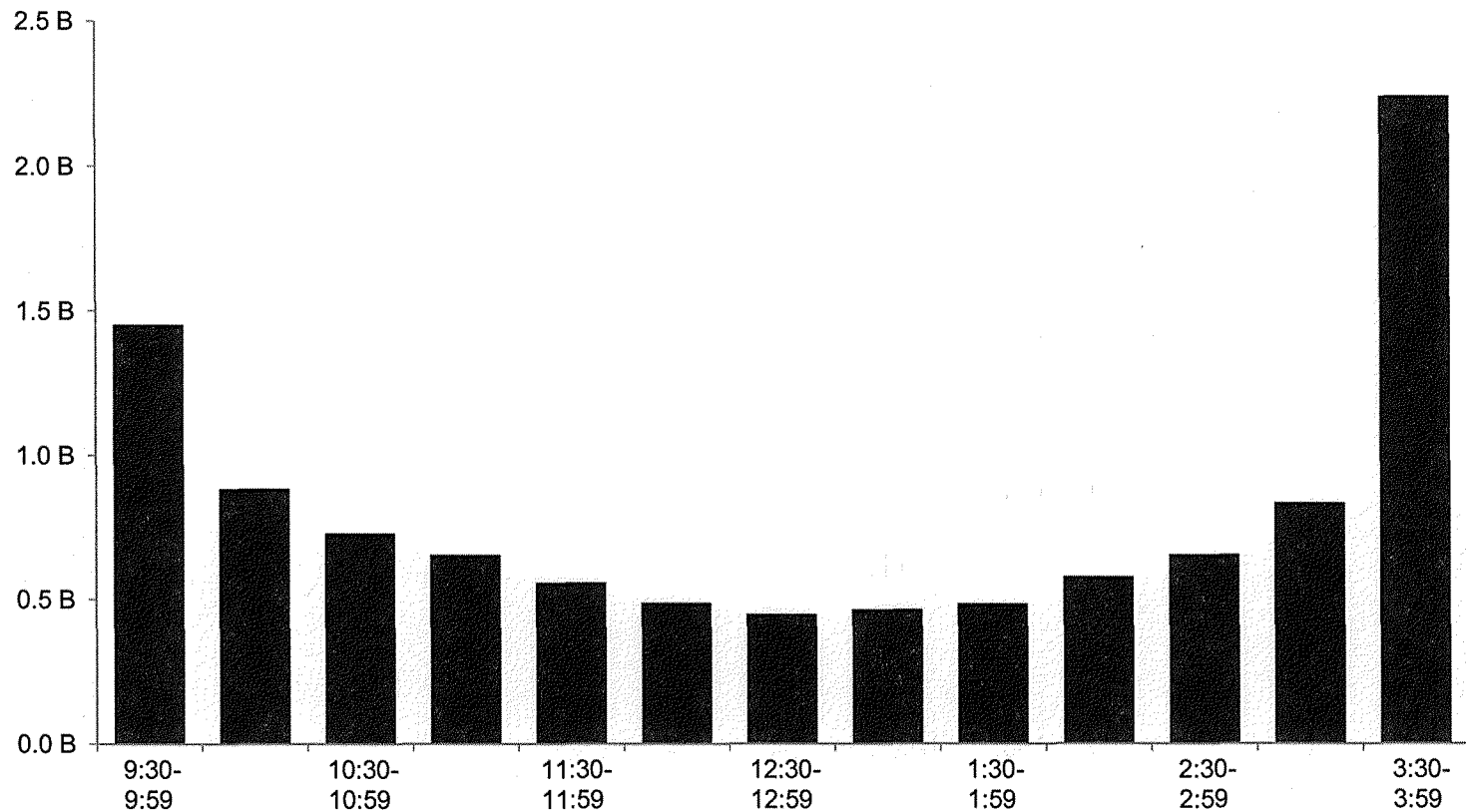
- Liquidity and Bid-Ask Spreads
- KAM’s Trading in CHEV
- KAM’s Trading in CARV
- KAM’s Trading in HCBC

The “U-Shaped” Trading Pattern: Intraday Volume

- In the 1980s, academic researchers found a regularly occurring intraday trading pattern
- Trading is concentrated at the open and close of the trading day
- Attributed to traders seeking liquidity
- Well documented research on the “U-Shaped” trading pattern
 - “A Theory of Intraday Patterns: Volume and Price Variability,” A. Admati, P. Pfleiderer, *The Review of Financial Studies*, Vol. 1, No. 1, 3-40, Spring 1988
 - “Are Intraday Volume and Volatility U-Shaped After Accounting for Public Information?” J. Eaves, J. Williams, *American Journal of Agricultural Economics*, 92(1), 212-227, January 2010

The “U-Shaped” Trading Pattern in Overall Market: High Volume at Both Open and Close of Trading

NYSE/NASDAQ Daily Average 30-Minute Interval Trading Volume (March 2010 – Dec. 2010)

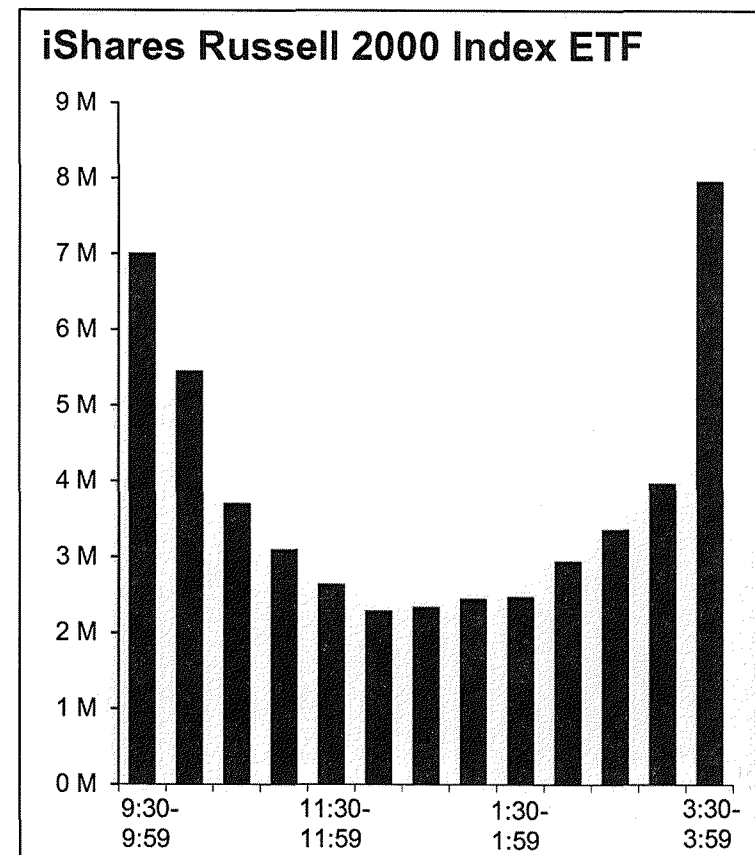
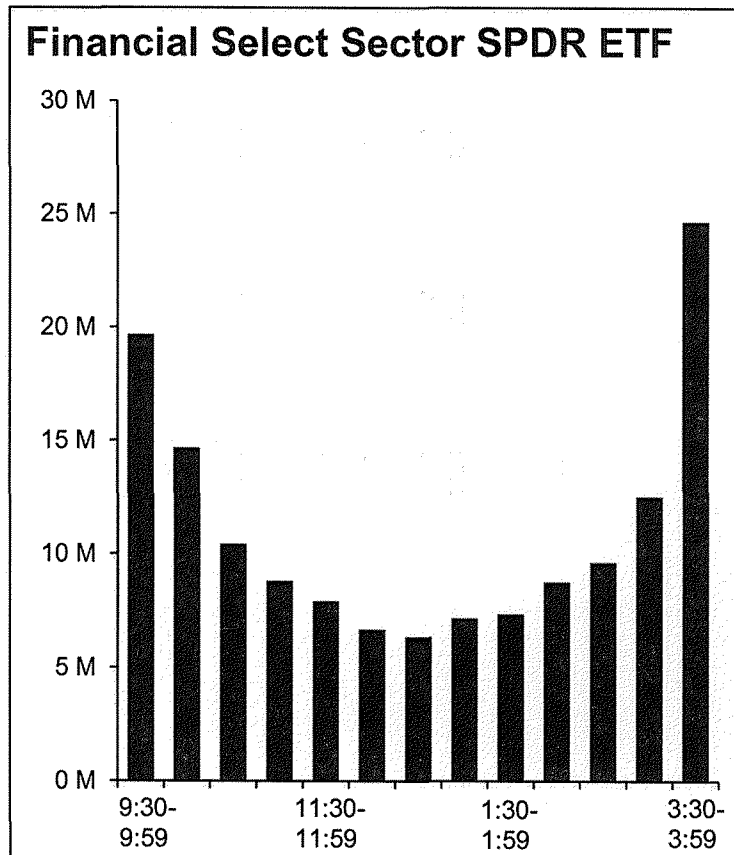


Note: Daily average volume for each security equals total volume over the time interval divided by the number of U.S. market trading days (including holiday half-trading days).

Source: Bloomberg (VOLNE for NYSE and VOLQE for NASDAQ). Data before March 2010 was not available from Bloomberg.

The “U-Shaped” Trading Pattern in Financial and Small-Cap Stocks

Daily Average 30-Minute Interval Trading Volume During 2009

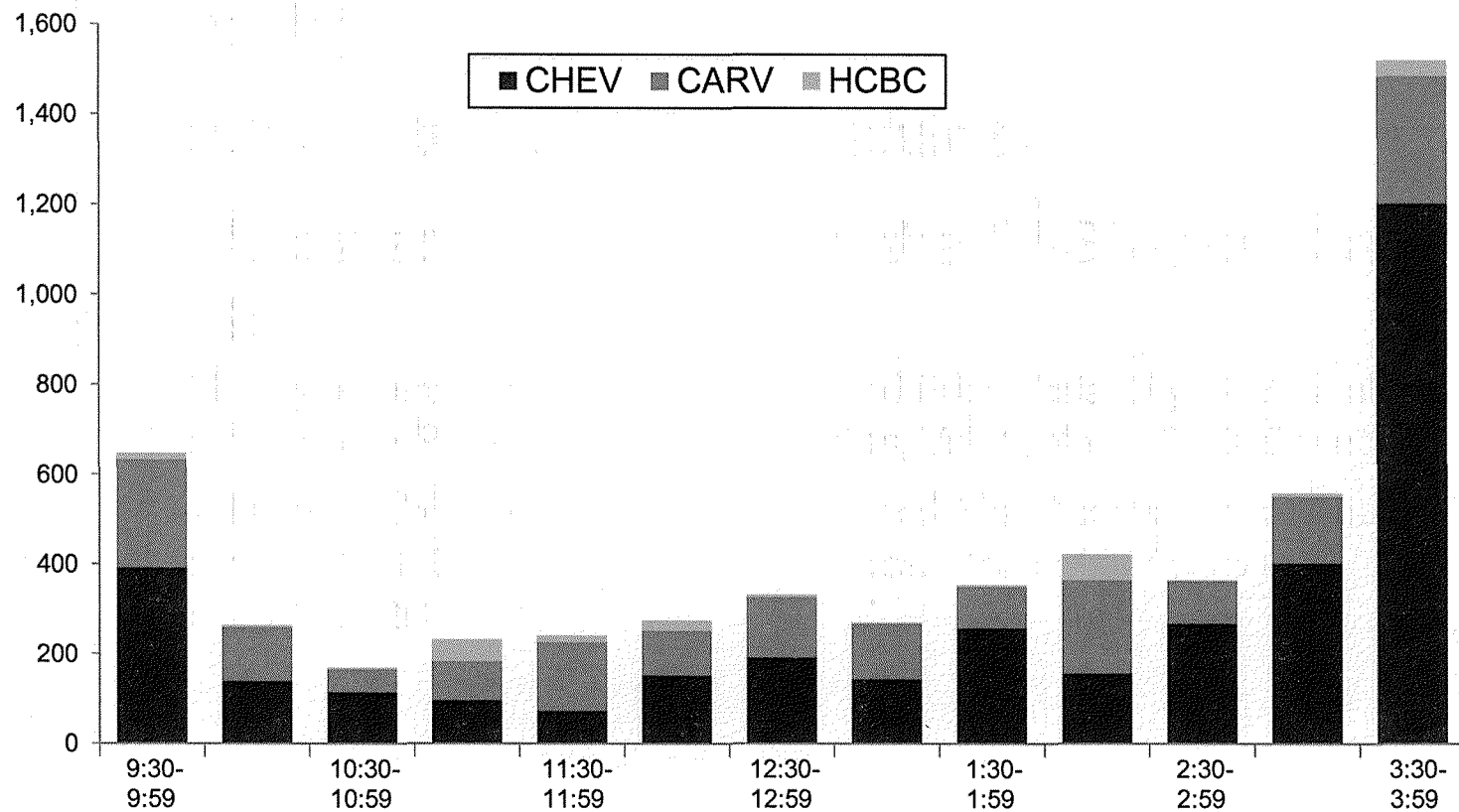


Note: Daily average volume for each security equals total volume over the time interval divided by the number of U.S. market trading days (including holiday half-trading days).

Source: Bloomberg (XLF for Financial Select Sector SPDR ETF and IWM for iShares Russell 2000 Index ETF).

The Market's "U-Shaped" Trading Pattern in CHEV, CARV and HCBC

Daily Average 30-Minute Interval Trading Volume During 2009

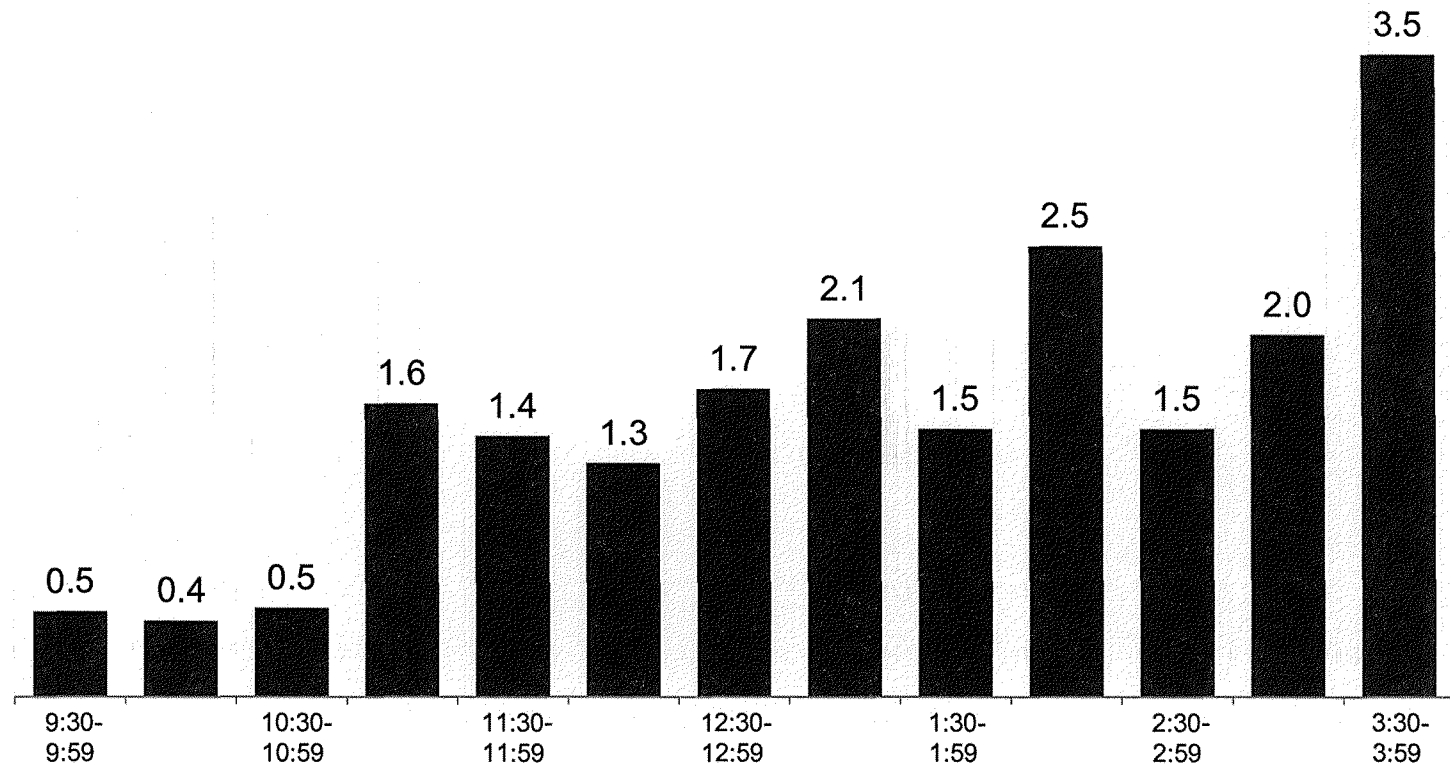


Note: Daily average volume for each security equals total volume over the time interval divided by the number of U.S. market trading days (including holiday half-trading days).

Source: Bloomberg (CHEV, CARV and HCBC).

KAM's Frequency of Trading Peaks at the End of the Trading Day

Daily Average 30-Minute Interval Number of Trades During 2009

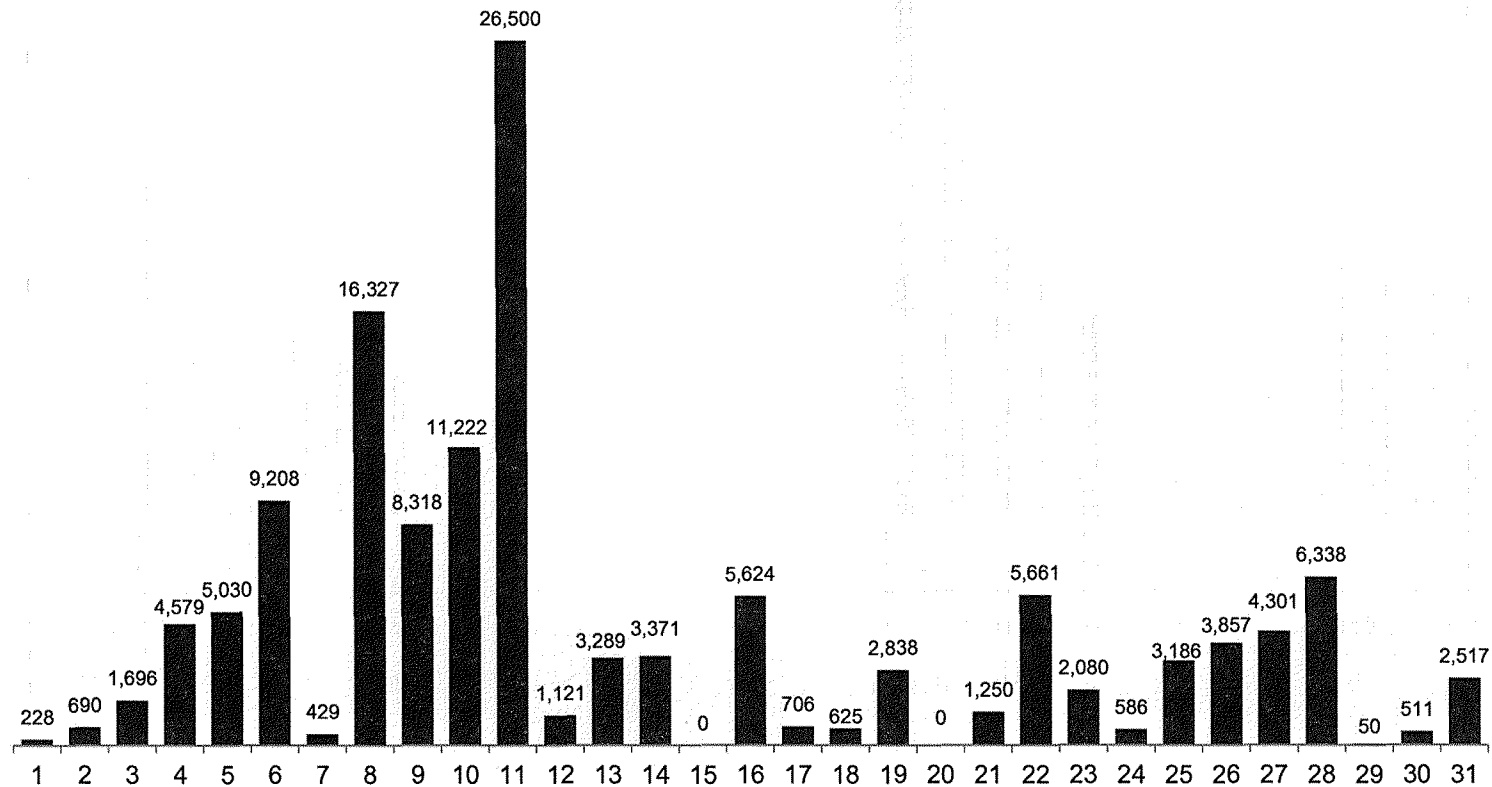


Note: Daily average number of trades equals total number of trades over the time interval divided by the number of U.S. market trading days (including holiday half-trading days).

Source: Huntleigh Database (only includes stocks traded in the KAM Database during 2009 for KAM clients).

KAM's Average Trading Throughout the Month

Daily Average Number of Shares Traded During 2009



Note: Daily average number of shares traded equals sum of shares traded on a specific day (*i.e.*, 1 through 31) of each month during 2009 divided by the number of months where the market was open for that specific day.

Source: KAM Database (KAM clients only).

Overview of Testimony

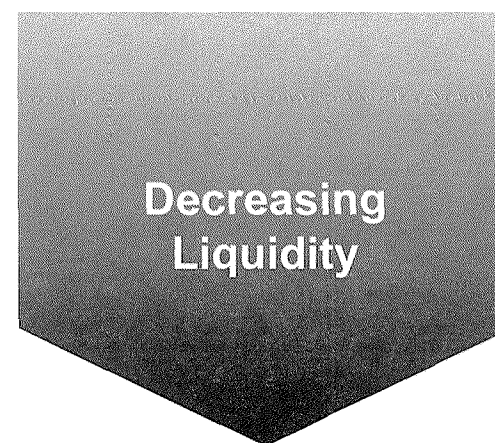
- The “U-Shaped” Trading Pattern

- **Liquidity and Bid-Ask Spreads**

- KAM’s Trading in CHEV
- KAM’s Trading in CARV
- KAM’s Trading in HCBC

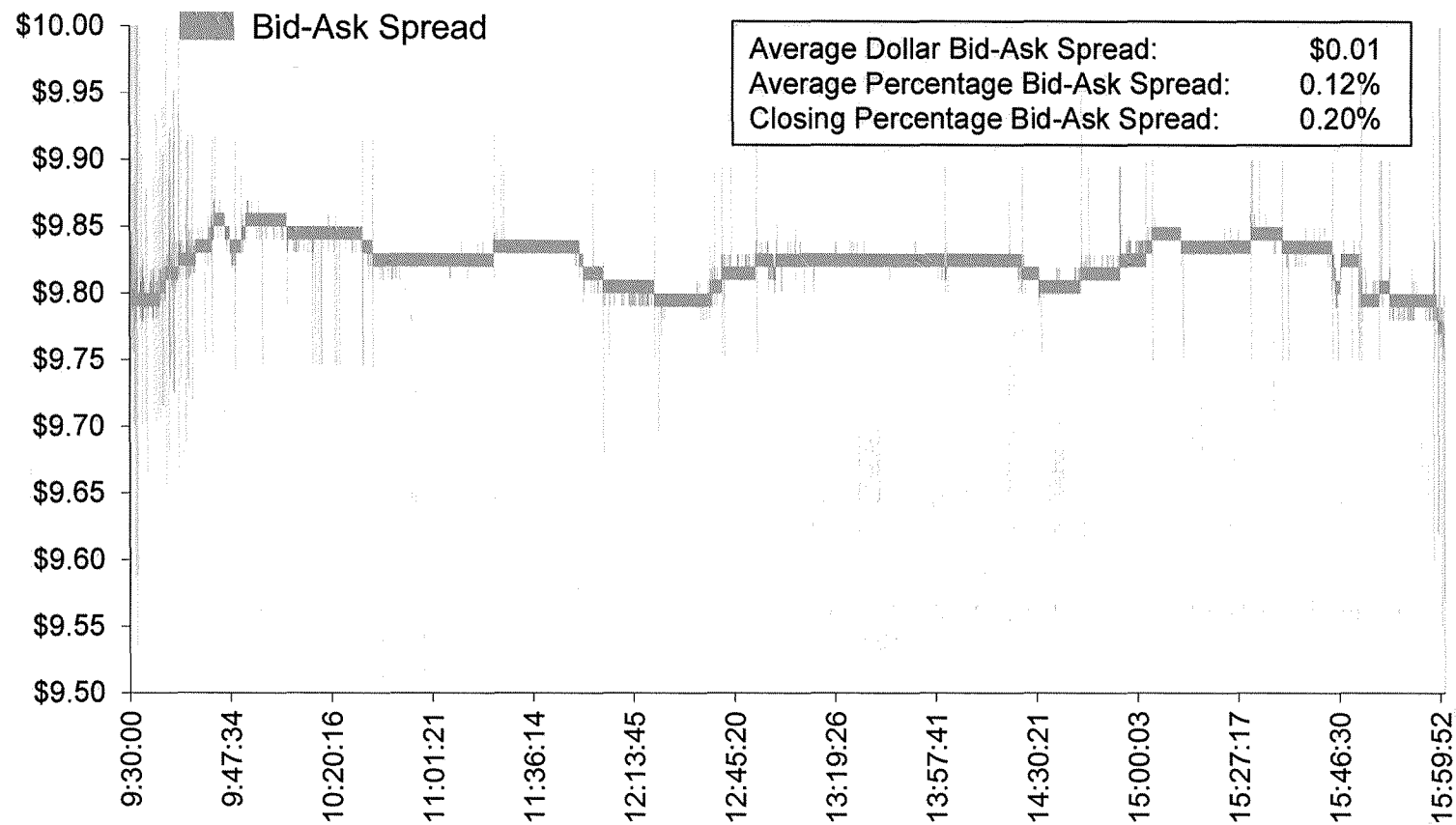
Liquidity and the Bid-Ask Spread

- A primary measure of liquidity is the size of the bid-ask spread
 - Bid price: price at which dealer is willing to buy
 - Ask price: price at which dealer is willing to sell
 - Bid-ask spread = $\frac{\text{ask price} - \text{bid price}}{\text{average of bid and ask prices}}$
- The larger the bid-ask spread, the less liquidity in the stock



Typical Bid-Ask Spread for a Liquid Stock Traded on NASDAQ

Fifth Third Bancorp (NASDAQ: FITB): December 31, 2009
Market capitalization: \$7.8 billion

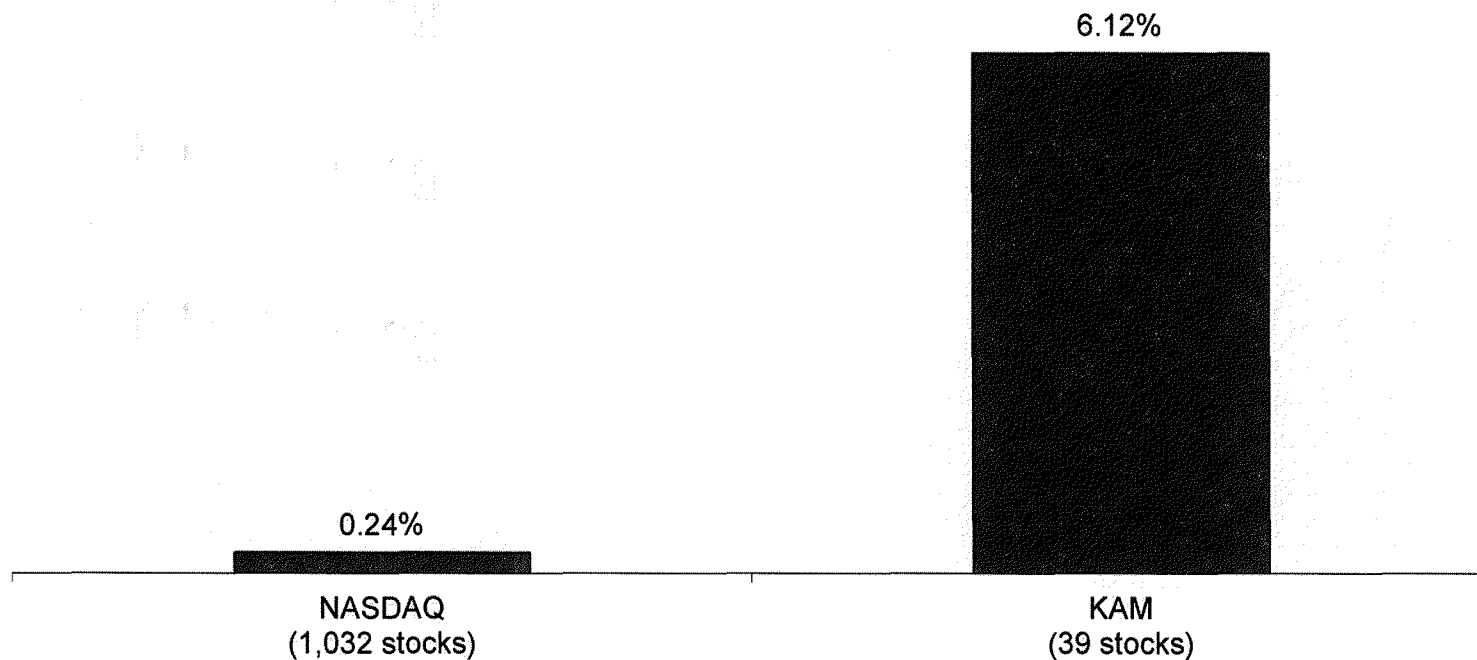


Notes: Data includes all intraday bid-ask quotes, except observations where the ask or the bid was withdrawn. KAM purchased shares of FITB during December 2009.

Sources: New York Stock Exchange Trade and Quote ("TAQ") database; Bloomberg.

KAM Invested in Illiquid Stocks

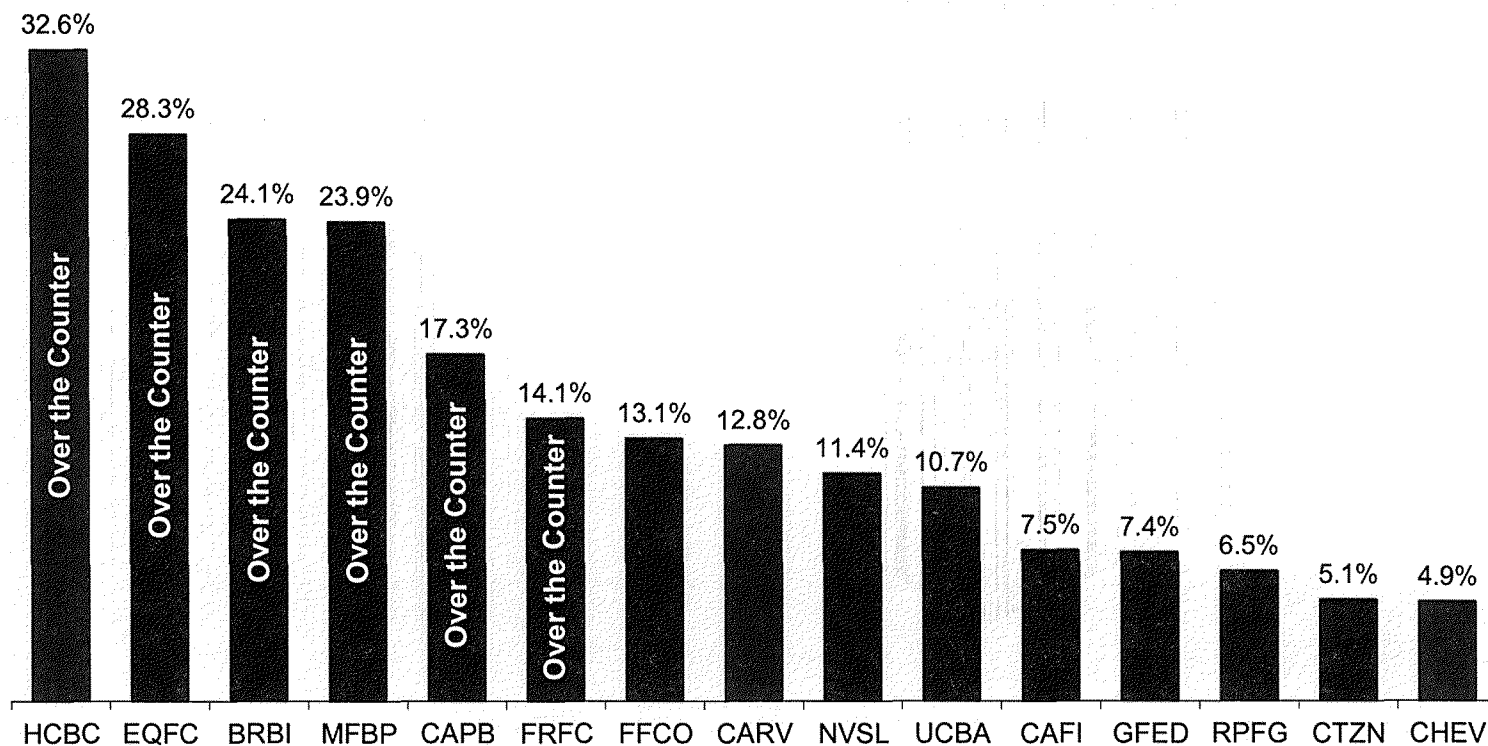
Average Bid-Ask Spreads in 2009



Note: Average bid-ask spread represents the average across all securities of each security's average daily bid-ask spread during 2009. NASDAQ average excludes CHEV and CARV and is based on closing bid and ask prices obtained from the University of Chicago's Center for Research in Security Prices ("CRSP") database. NASDAQ securities identified as exchange code 3. Average for each security calculated by CUSIP for securities having at least 50 valid daily observations and average market capitalization of at least \$250 million. Daily observations excluded if: non-active (trade status not equal to A); ask price less than or equal to bid price; ask price more than \$15 greater than bid price; missing bid price, ask price, closing price (or bid-ask average) or shares outstanding. KAM average based on closing bid and ask prices obtained from Bloomberg, except FT Interactive used for HCBC and CNB.

KAM's Top 15 Illiquid Investments in 2009

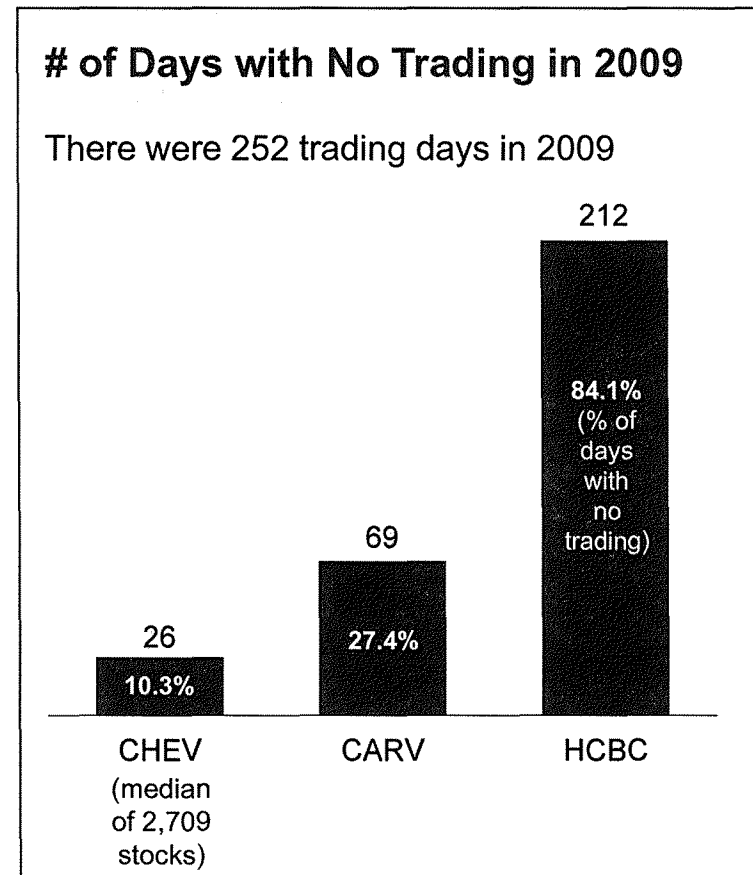
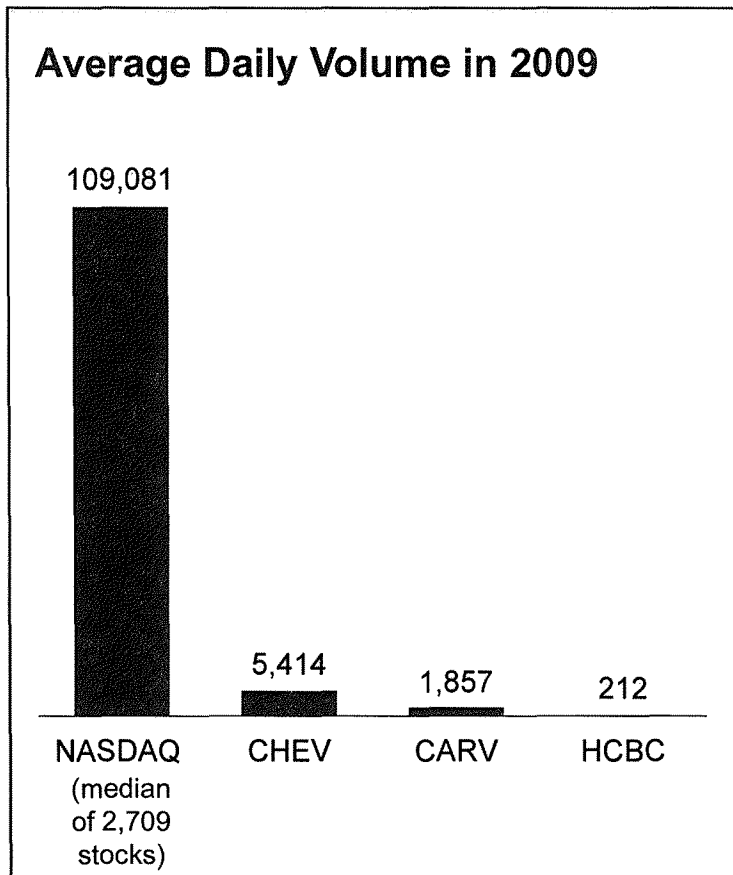
Average Bid-Ask Spreads in 2009



Note: "Over the Counter" includes Bulletin Board and Pink Sheet stocks. All other stocks trade on NASDAQ. Average of closing bid and ask prices calculated for securities having at least 50 valid daily observations. Daily observations excluded if: ask price less than or equal to bid price; or ask price more than \$15 greater than bid price.

Source: Bloomberg; FT Interactive (HCBC only).

Stock Market Activity in 2009



Note: NASDAQ's median daily volume represents the median across all securities of each security's average daily volume during 2009, excluding CHEV and CARV. NASDAQ data obtained from the University of Chicago's Center for Research in Security Prices ("CRSP") database. NASDAQ securities identified as exchange code 3. Average daily volume and number of days with no trading for each security calculated by CUSIP for securities having 252 valid daily observations. Daily observations excluded if: non-active (trade status not equal to A); missing volume, closing price (or bid-ask average) or shares outstanding. Average daily volume across all included NASDAQ securities is 791,876 and median is 109,081. CHEV, CARV and HCBC average daily volume based on 252 trading days with data obtained from Bloomberg.

Economically Rational to Trade Illiquid Stocks at the End of the Trading Day

- CHEV, CARV and HCBC were illiquid stocks in 2009
 - Large bid-ask spreads
 - Low average daily volume
 - Days with no trading
- Pursuit of “best price”
 - Concentration of traders at end of trading day
 - Greater number of quote updates/revisions from broker-dealers at end of trading day
 - “Making a Market with Spreads and Depths,” K. Chung, X. Zhao, *Journal of Business Finance & Accounting*, 31(7) & (8), September/October 2004
 - Narrower bid-ask spreads at end of trading day
 - “Market Structure and Intraday Pattern of Bid-Ask Spreads for NASDAQ Securities,” K. Chan, W. Christie, P. Schultz, *Journal of Business*, Vol. 68, No. 1, 1995

Overview of Testimony

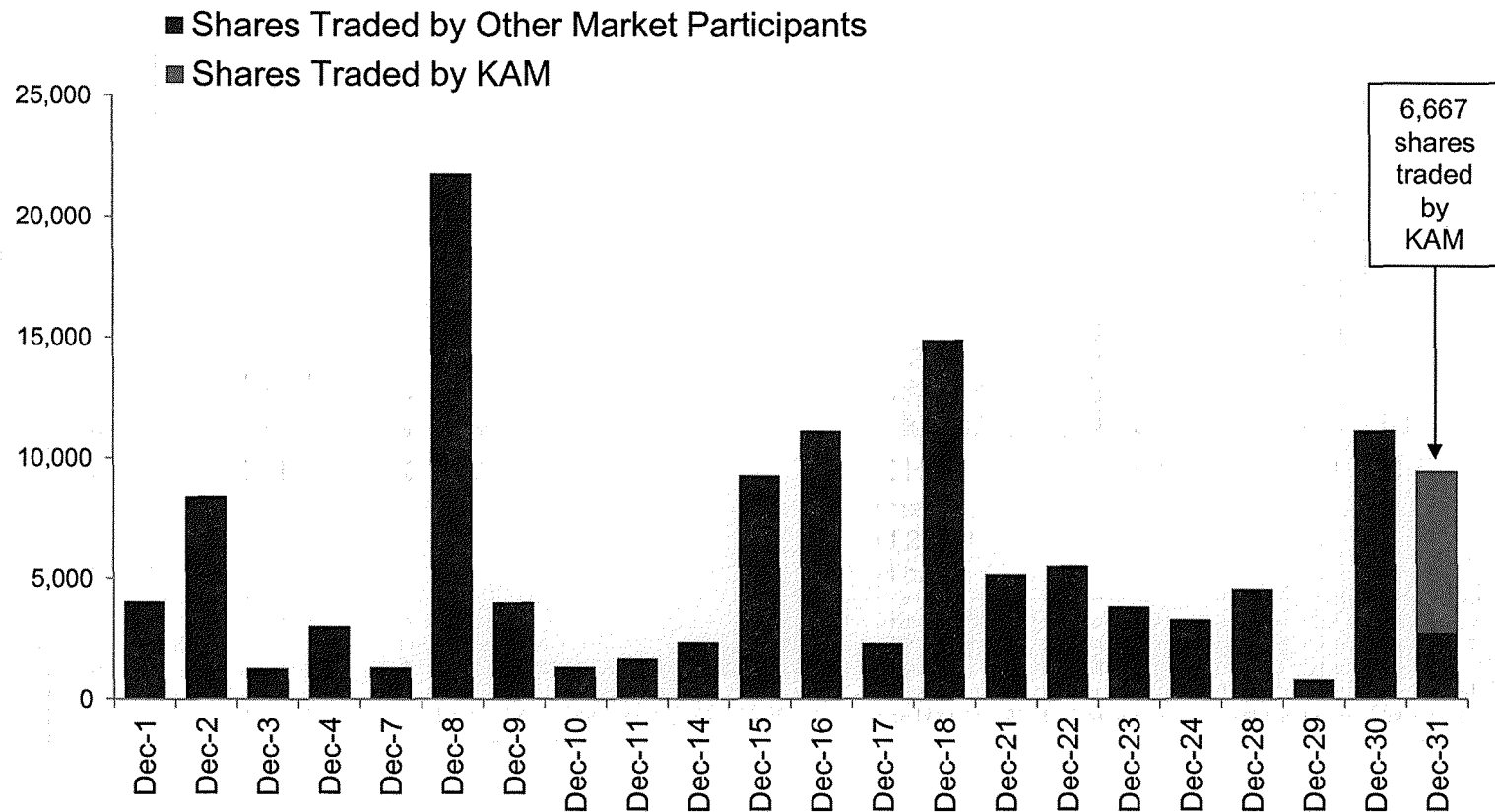
- The “U-Shaped” Trading Pattern
- Liquidity and Bid-Ask Spreads

- **KAM’s Trading in CHEV**

- KAM’s Trading in CARV
- KAM’s Trading in HCBC

KAM's Trading in CHEV during December 2009 Represented 5.1% of Total Volume

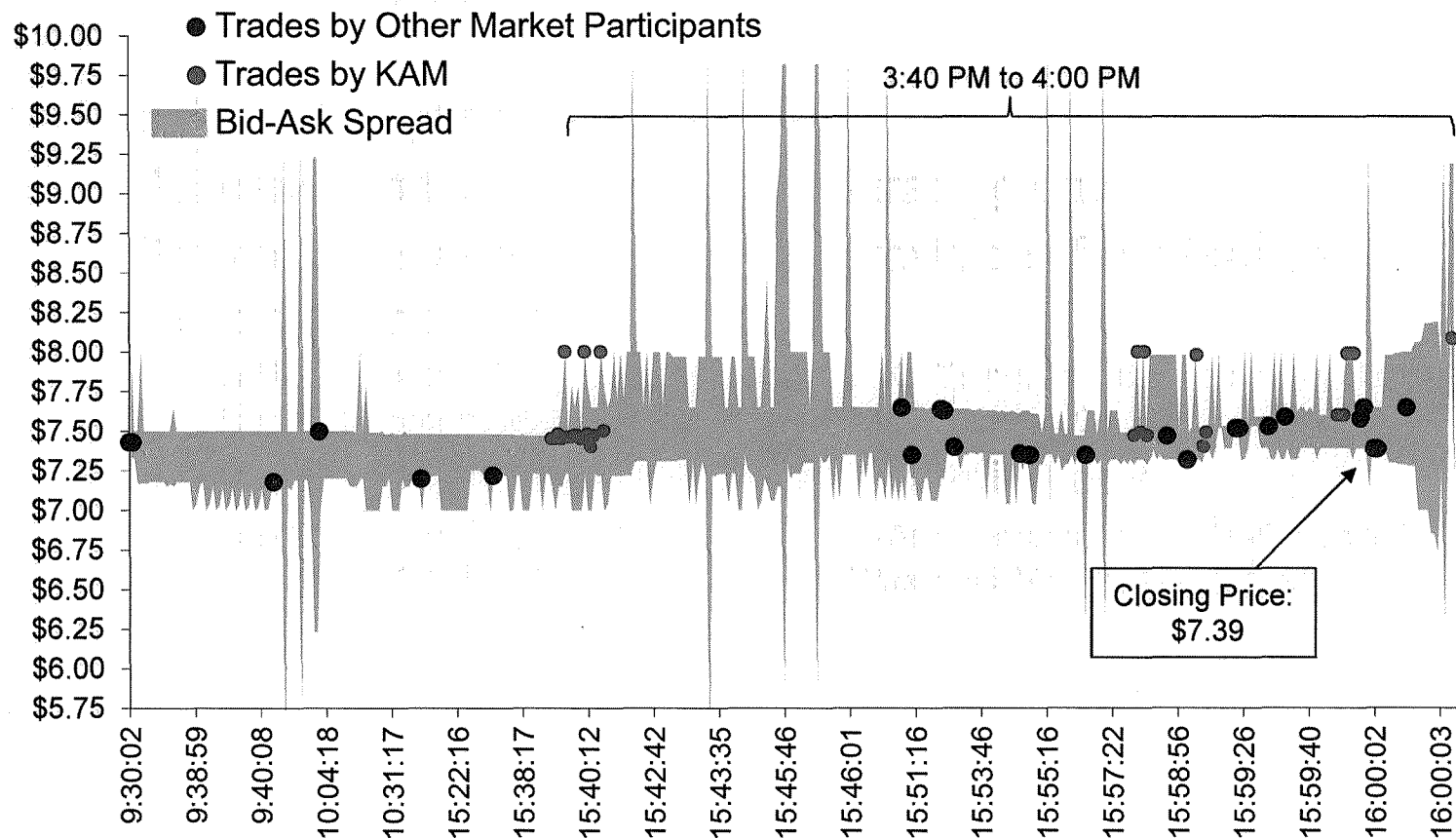
CHEV's Daily Volume



Sources: Bloomberg; KAM Database.

CHEV: Intraday Trading on December 31, 2009

All trades were within the bid-ask spread



Notes: Data includes all intraday bid-ask quotes, except observations where the ask or the bid was withdrawn; or ask price was more than \$15 greater than the bid price. CHEV closing price of \$7.39 per share obtained from Bloomberg, FactSet, CRSP and Huntleigh brokerage statement (see Bates No. SEC-KOCH_PROD-E-0014957). Sources: New York Stock Exchange Trade and Quote ("TAQ") database; KAM's transactions based on Huntleigh Database.

CHEV:

Intraday Trading on December 31, 2009 (detail)

Date	Time	Trader	Shares Traded	Price	Bid/Ask Quote per TAQ
12/31/2009	9:30:02		113	\$7.43	\$7.33 - \$8.00
12/31/2009	9:30:02		113	\$7.43	\$7.33 - \$7.50
12/31/2009	9:41:00		2	\$7.18	\$7.18 - \$7.50
12/31/2009	10:01:54		168	\$7.50	
12/31/2009	13:01:15	KAM			\$7.20 - \$7.48
12/31/2009	14:15:16		200	\$7.20	\$7.00 - \$7.48
12/31/2009	15:35:27		100	\$7.22	\$7.22 - \$7.48
12/31/2009	15:40:12	KAM	4	\$7.45	\$7.15 - \$7.48
12/31/2009	15:40:12	KAM	4	\$7.45	\$7.00 - \$7.47
12/31/2009	15:40:12	KAM	100	\$7.48	\$7.15 - \$7.50
12/31/2009	15:40:12	KAM	4	\$7.45	\$7.15 - \$7.65
12/31/2009	15:40:12	KAM	100	\$8.00	\$7.23 - \$8.00
12/31/2009	15:40:12	KAM	4	\$7.46	\$7.23 - \$7.47
12/31/2009	15:40:12	KAM	74	\$7.46	\$7.00 - \$7.78
12/31/2009	15:40:12	KAM	9	\$7.47	\$7.00 - \$7.65
12/31/2009	15:40:12	KAM	196	\$7.47	\$7.00 - \$7.78
12/31/2009	15:40:12	KAM	4	\$7.45	\$7.00 - \$7.47
12/31/2009	15:40:12	KAM	300	\$8.00	\$7.23 - \$8.00
12/31/2009	15:40:12	KAM	100	\$7.48	\$7.00 - \$7.78
12/31/2009	15:40:12	KAM	104	\$7.40	\$7.00 - \$7.65
12/31/2009	15:40:12	KAM	100	\$7.47	\$7.23 - \$7.65
12/31/2009	15:40:12	KAM	533	\$8.00	\$7.22 - \$8.00
12/31/2009	15:40:13	KAM	364	\$7.50	
12/31/2009	15:50:59		100	\$7.65	\$7.20 - \$8.00
12/31/2009	15:51:16		100	\$7.35	\$7.20 - \$8.00
12/31/2009	15:52:58		100	\$7.64	\$7.20 - \$7.65
12/31/2009	15:52:58		100	\$7.63	\$7.20 - \$7.64
12/31/2009	15:53:17		100	\$7.40	\$7.35 - \$7.64

Order Placed by KAM (5,000 at \$8.25)

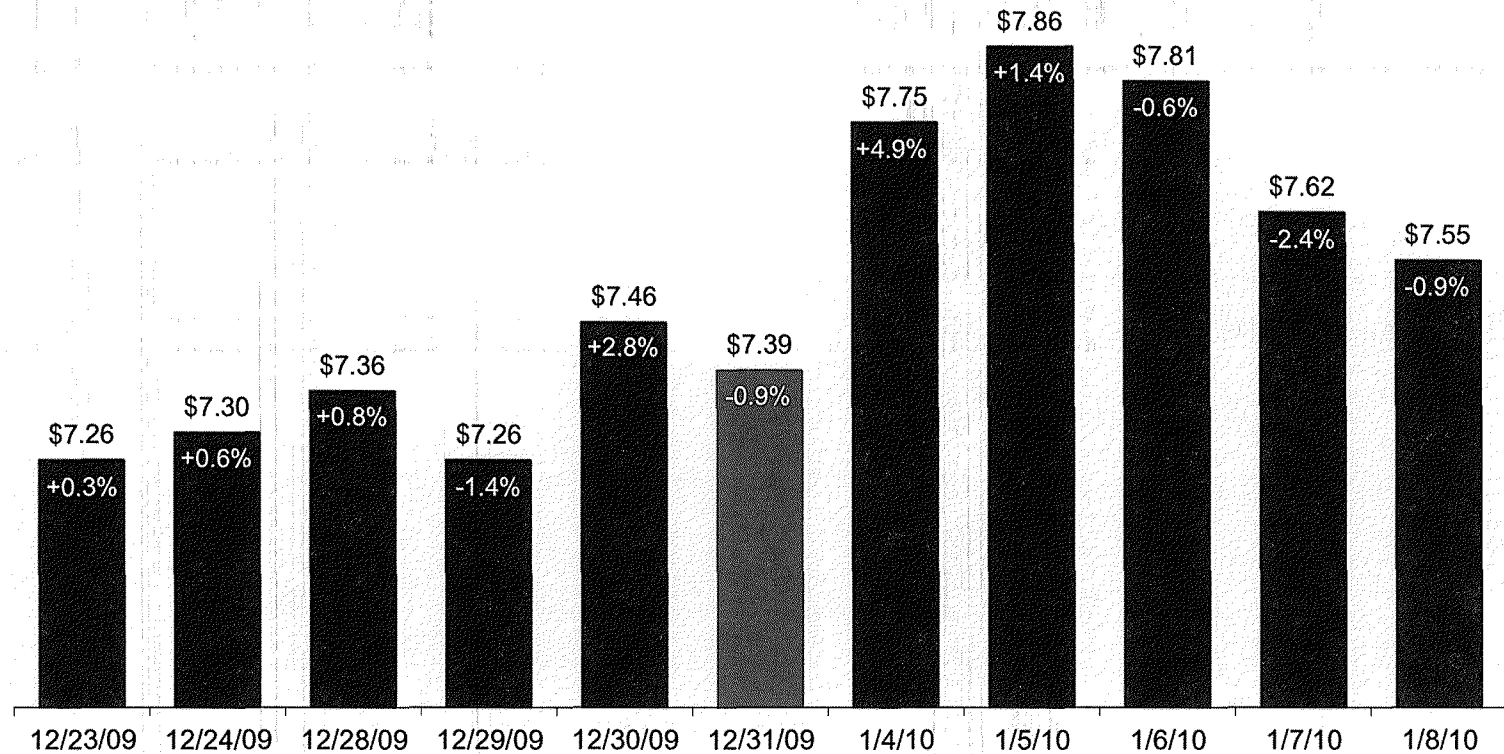
CHEV:

Intraday Trading on December 31, 2009 (detail, cont'd)

Date	Time	Trader	Shares Traded	Price	Bid/Ask Quote per TAQ	
12/31/2009	15:54:05	KAM			\$7.04 - \$7.62	Order Revised by KAM (7,000 at \$8.25)
12/31/2009	15:55:02		100	\$7.36	\$7.35 - \$7.61	
12/31/2009	15:55:02		100	\$7.35	\$7.25 - \$7.63	
12/31/2009	15:56:42		200	\$7.35	\$6.34 - \$7.47	
12/31/2009	15:57:56	KAM	112	\$7.47	\$7.29 - \$7.49	
12/31/2009	15:57:56	KAM	1,400	\$8.00	\$7.32 - \$8.00	
12/31/2009	15:57:56	KAM	220	\$7.49	\$7.32 - \$7.49	
12/31/2009	15:57:56	KAM	100	\$8.00	\$7.32 - \$8.00	
12/31/2009	15:57:56	KAM	168	\$7.47	\$7.29 - \$7.49	
12/31/2009	15:58:39		100	\$7.47		
12/31/2009	15:59:09		100	\$7.32		
12/31/2009	15:59:20	KAM	86	\$7.40	\$7.30 - \$7.52	
12/31/2009	15:59:20	KAM	100	\$7.49	\$7.39 - \$7.52	
12/31/2009	15:59:20	KAM	814	\$7.98	\$7.32 - \$7.98	
12/31/2009	15:59:25		100	\$7.52	\$7.52 - \$7.53	
12/31/2009	15:59:25		100	\$7.52	\$7.52 - \$7.53	
12/31/2009	15:59:28		100	\$7.53		
12/31/2009	15:59:39		200	\$7.59	\$7.32 - \$7.65	
12/31/2009	15:59:53	KAM	100	\$7.60	\$7.39 - \$7.60	
12/31/2009	15:59:53	KAM	200	\$7.60	\$7.39 - \$7.60	
12/31/2009	15:59:53	KAM	200	\$7.60	\$7.39 - \$7.65	
12/31/2009	15:59:53	KAM	100	\$7.99	\$7.39 - \$7.99	
12/31/2009	15:59:53	KAM	200	\$7.99	\$7.39 - \$7.99	
12/31/2009	15:59:53	KAM	200	\$7.99	\$7.32 - \$7.99	
12/31/2009	15:59:56		186	\$7.58	\$7.39 - \$7.65	
12/31/2009	15:59:58		314	\$7.65	\$7.39 - \$7.65	
12/31/2009	16:00:02		186	\$7.39	\$7.39 - \$7.65	
12/31/2009	16:00:02		186	\$7.39	\$7.39 - \$7.65	Market Closed
12/31/2009	16:00:03		314	\$7.65	\$7.29 - \$8.00	
12/31/2009	16:00:09	KAM	667	\$8.09		

CHEV's Stock Prices Around December 31, 2009

Stock price and percentage change in price



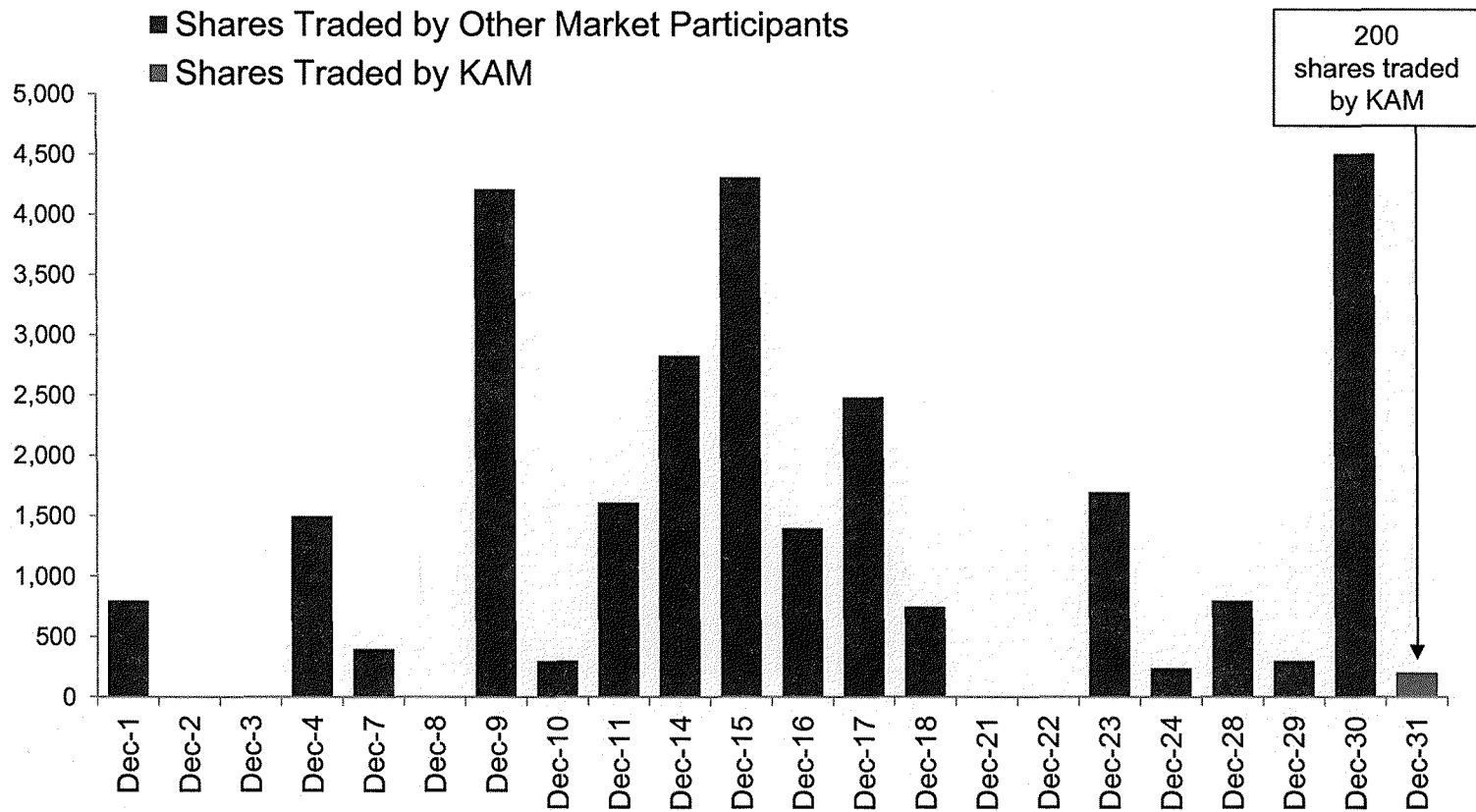
Source: Bloomberg.

Overview of Testimony

- The “U-Shaped” Trading Pattern
- Liquidity and Bid-Ask Spreads
- KAM’s Trading in CHEV
- **KAM’s Trading in CARV**
- KAM’s Trading in HCBC

KAM's Trading in CARV during December 2009 Represented 0.7% of Total Volume

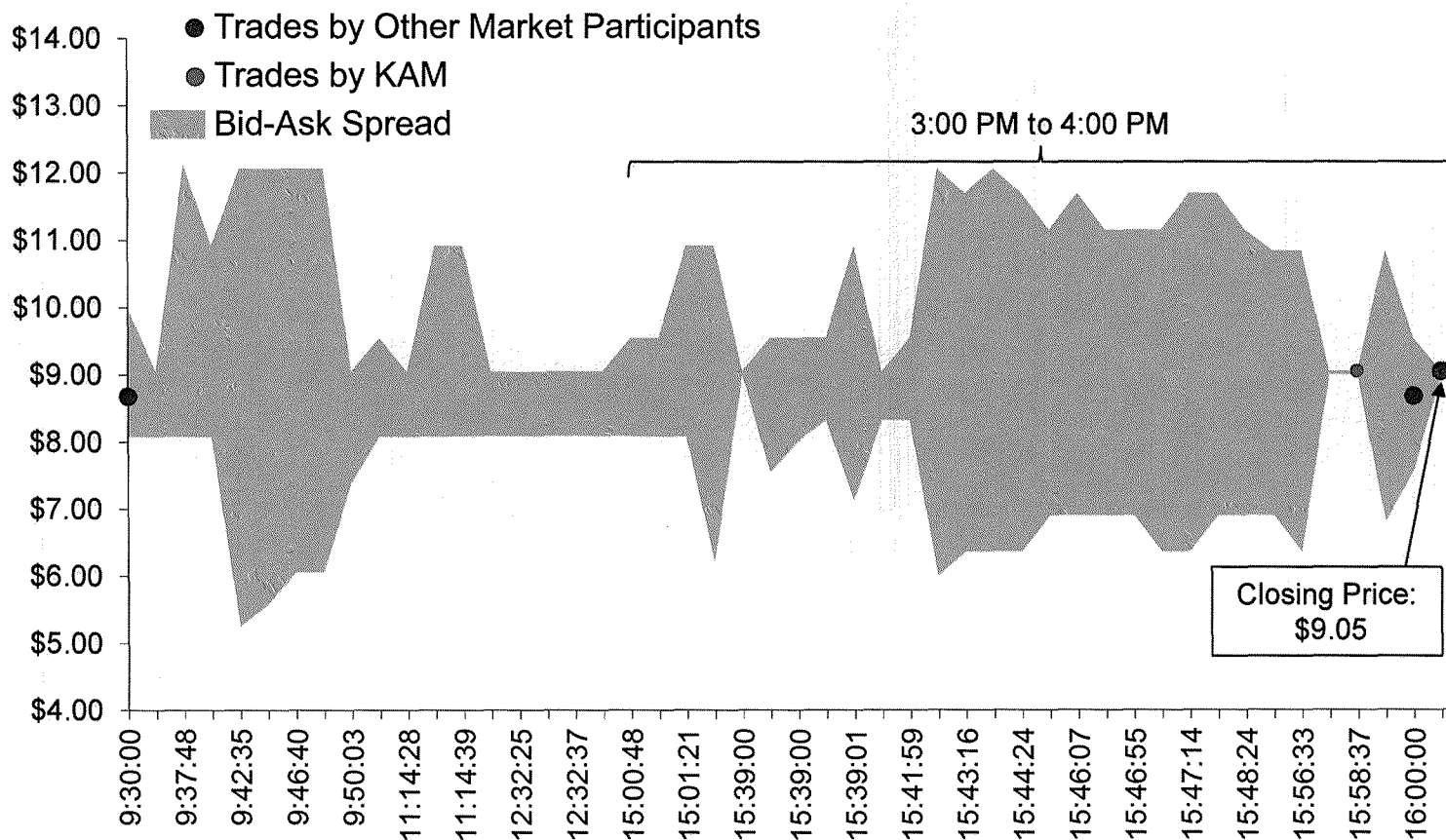
CARV's Daily Volume



Sources: Bloomberg; KAM Database.

CARV: Intraday Trading on December 31, 2009

All trades were within the bid-ask spread



Notes: Data includes all intraday bid-ask quotes, except observations where the ask or the bid was withdrawn; or ask price was more than \$15 greater than the bid price. CARV closing price of \$9.05 per share obtained from Bloomberg, FactSet, CRSP and Huntleigh brokerage statement (see Bates No. SEC-KOCH_PROD-E-0014957). Sources: New York Stock Exchange Trade and Quote ("TAQ") database; KAM's transactions based on Huntleigh Database.

CARV: Intraday Trading on December 31, 2009 (detail)

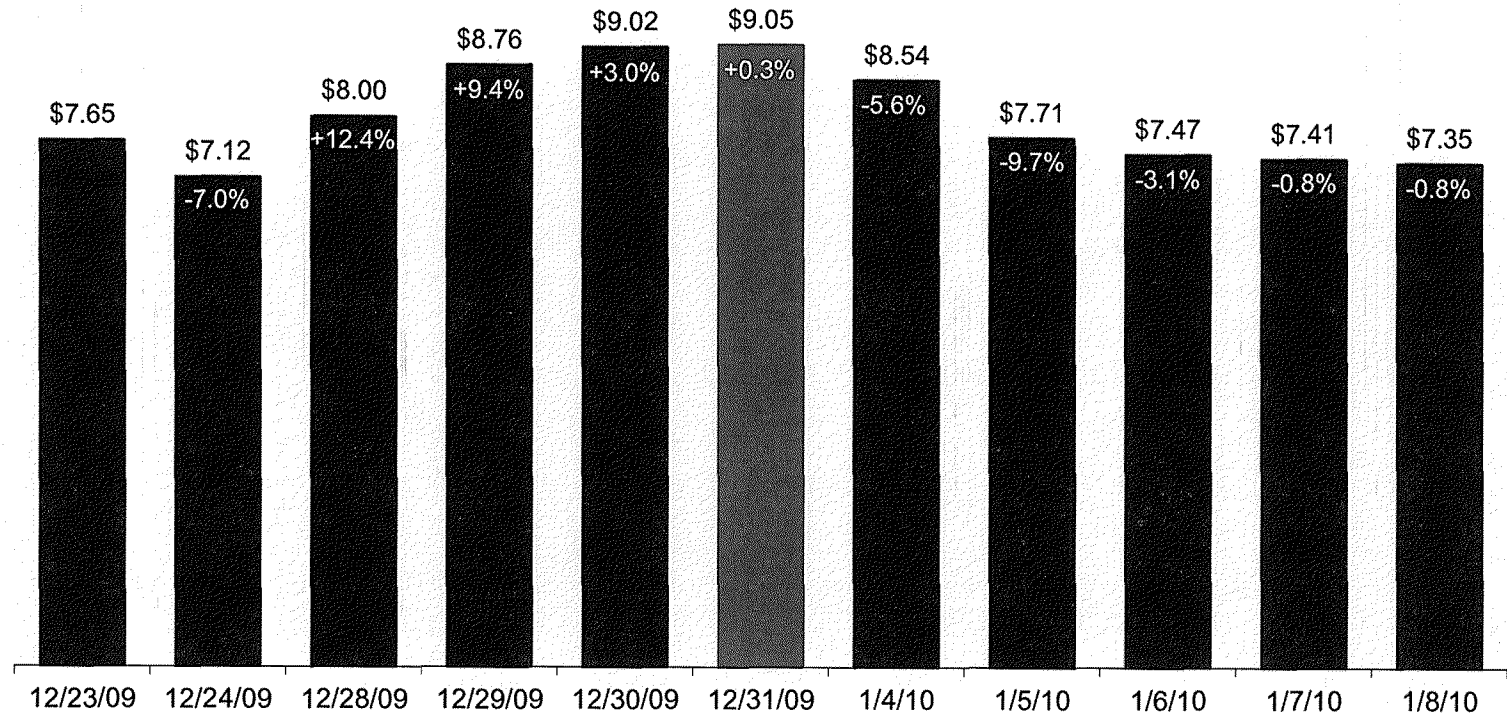
Date	Time	Trader	Shares Traded	Price	Bid/Ask Quote per TAQ	
12/31/2009	9:30:00		3	\$8.68	\$8.08 - \$10.00	
12/31/2009	13:01:32	KAM			\$8.09 - \$9.05	Order Placed by KAM (1,000 at \$9.05)
12/31/2009	15:58:37	KAM	100	\$9.05	\$9.00 - \$9.05	
12/31/2009	15:58:37	KAM	100	\$9.05	\$9.00 - \$9.05	
12/31/2009	16:00:00		3	\$8.68	\$7.55 - \$9.55	
12/31/2009	16:00:03		100	\$9.05	\$9.00 - \$9.05	Market Closed

Notes: Bid-ask quotes not associated with a specific trade are not shown. CARV closing price of \$9.05 per share obtained from Bloomberg, FactSet, CRSP and Huntleigh brokerage statement (see Bates No. SEC-KOCH_PROD-E-0014957).

Sources: New York Stock Exchange Trade and Quote ("TAQ") database; KAM's transactions based on Huntleigh Database.

CARV's Stock Prices Around December 31, 2009

Stock price and percentage change in price



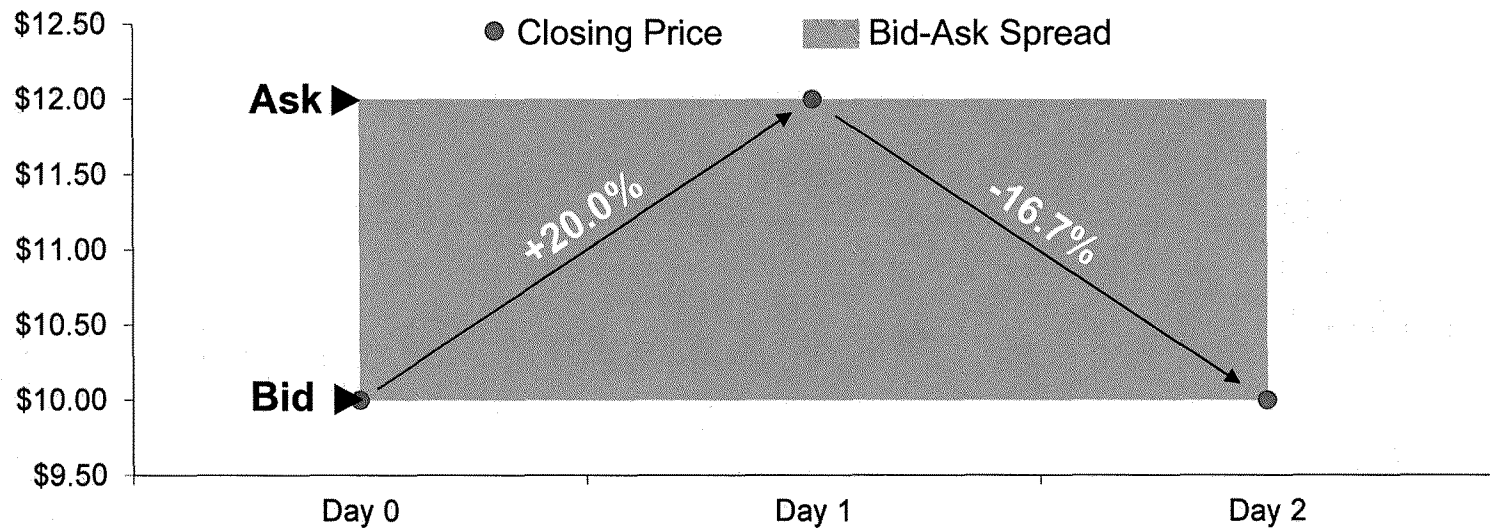
Source: Bloomberg.

Overview of Testimony

- The “U-Shaped” Trading Pattern
- Liquidity and Bid-Ask Spreads
- KAM’s Trading in CHEV
- KAM’s Trading in CARV
- **KAM’s Trading in HCBC**

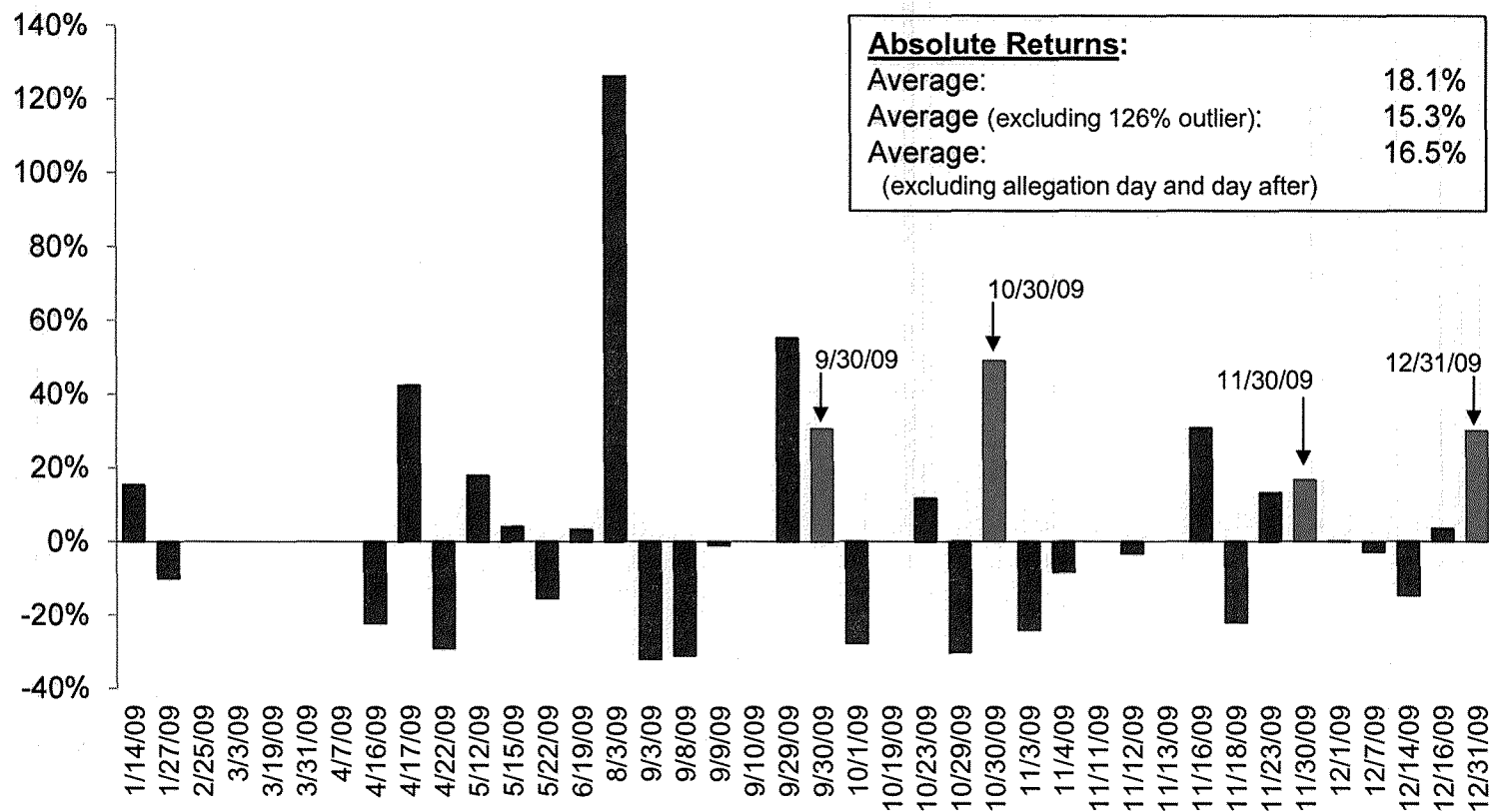
Bid-Ask Bounce

- Closing stock price is generally bound by the bid and ask prices
- Stock returns for companies with large bid-ask spreads can be distorted by “bouncing” between the bid and ask prices



HCBC's Stock Price is Exceptionally Volatile

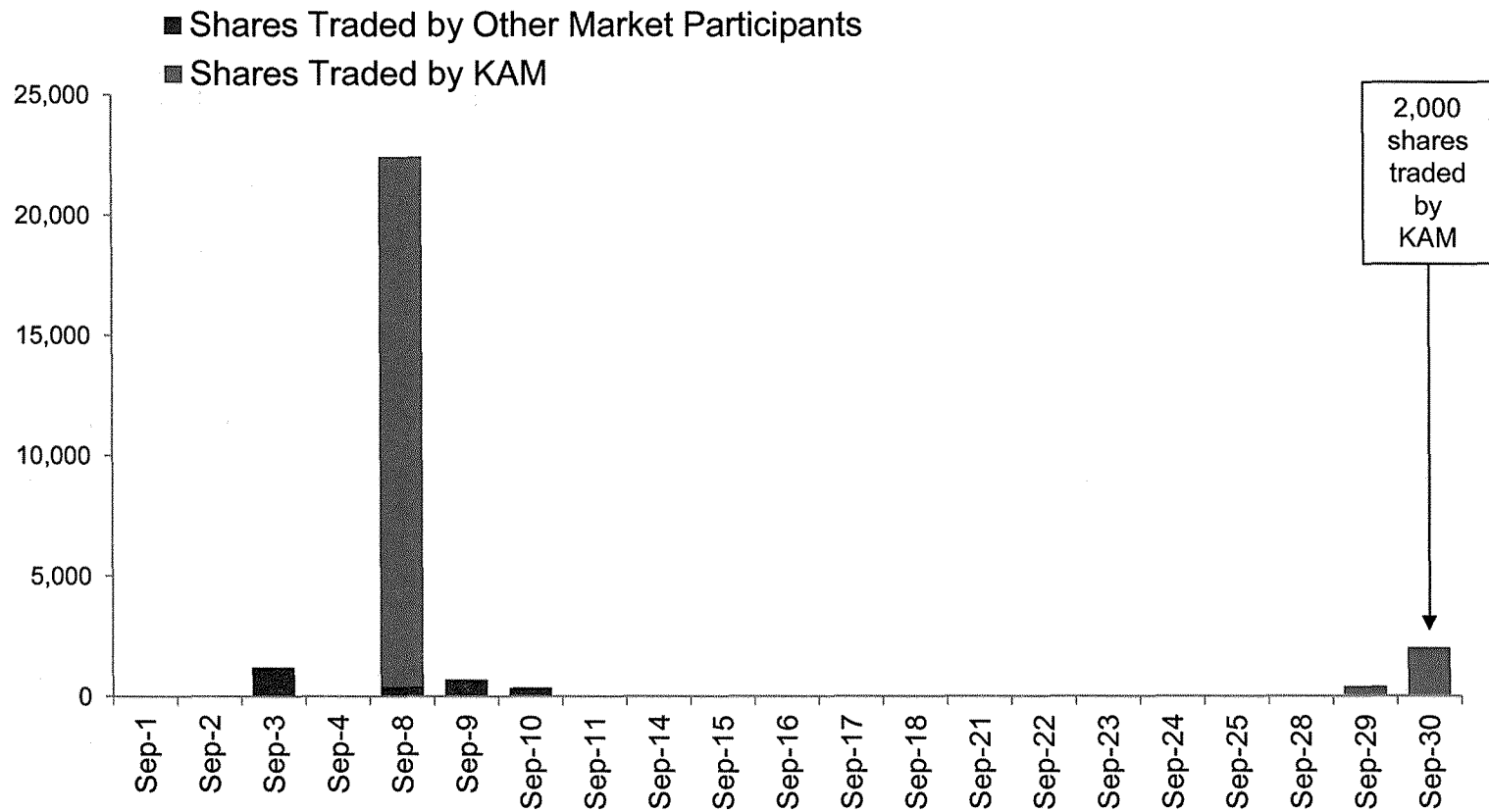
Percentage change in HCBC's stock prices (2009)



Note: Percentage change in HCBC's stock prices frequently reflects a multi-day return due to lack of trading in HCBC's stock.
Source: Bloomberg (total returns including dividends).

KAM's Trading in HCBC during September 2009 Represented 90.1% of Total Volume

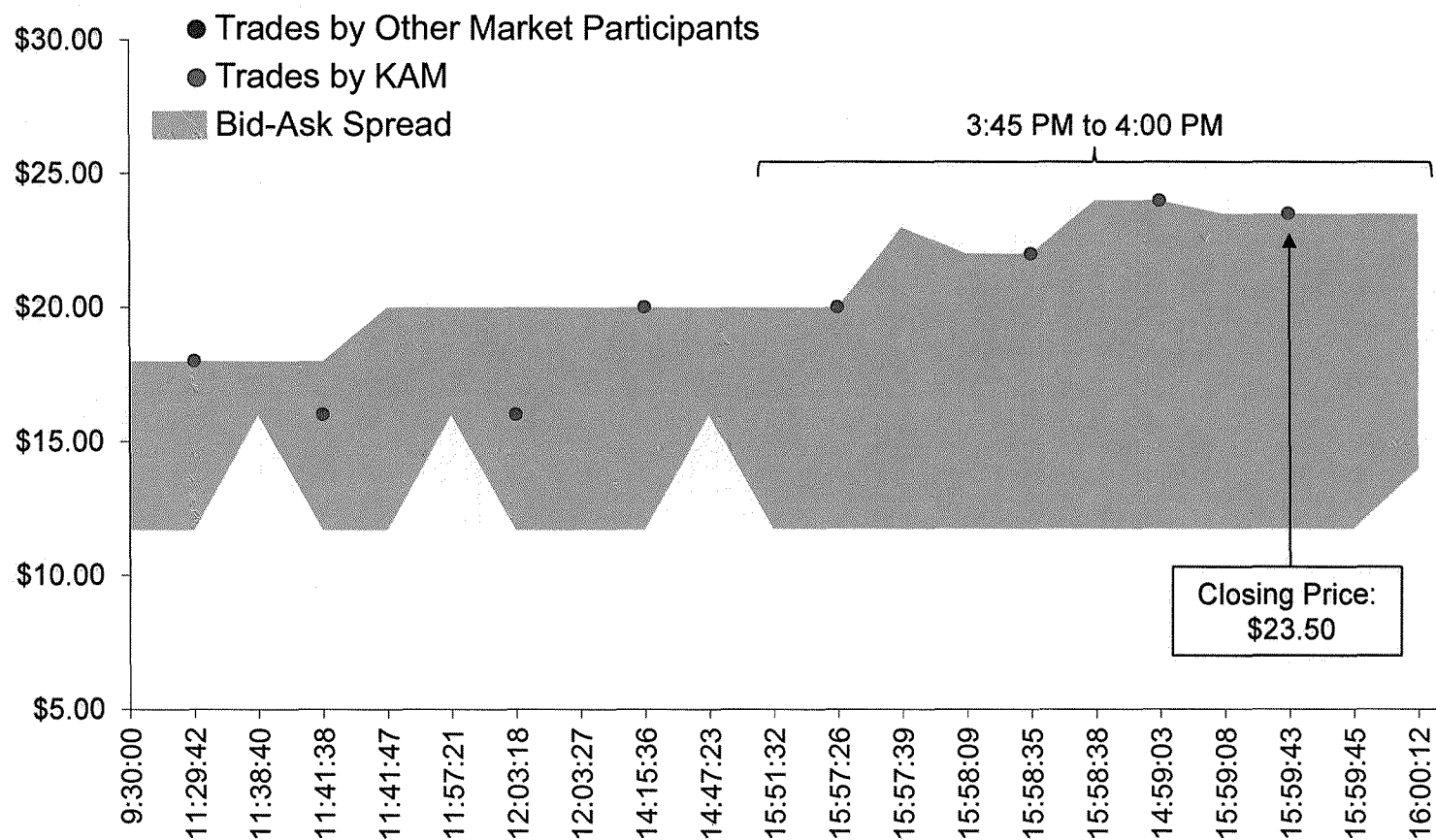
HCBC's Daily Volume



Sources: Bloomberg; KAM Database.

HCBC: Intraday Trading on September 30, 2009

All trades were within the bid-ask spread



Notes: Data based on intraday inside bid-ask quotes, except observations where the ask price was more than \$15 greater than the bid price. HCBC closing price of \$23.50 per share obtained from Bloomberg, FactSet and Huntleigh brokerage statement (see Bates No. SEC-KOCH_PROD-E-0018557).

Sources: OTC Market Groups ("Pink Sheets") data; KAM's transactions based on Huntleigh Database.

HCBC: Intraday Trading on September 30, 2009 (detail)

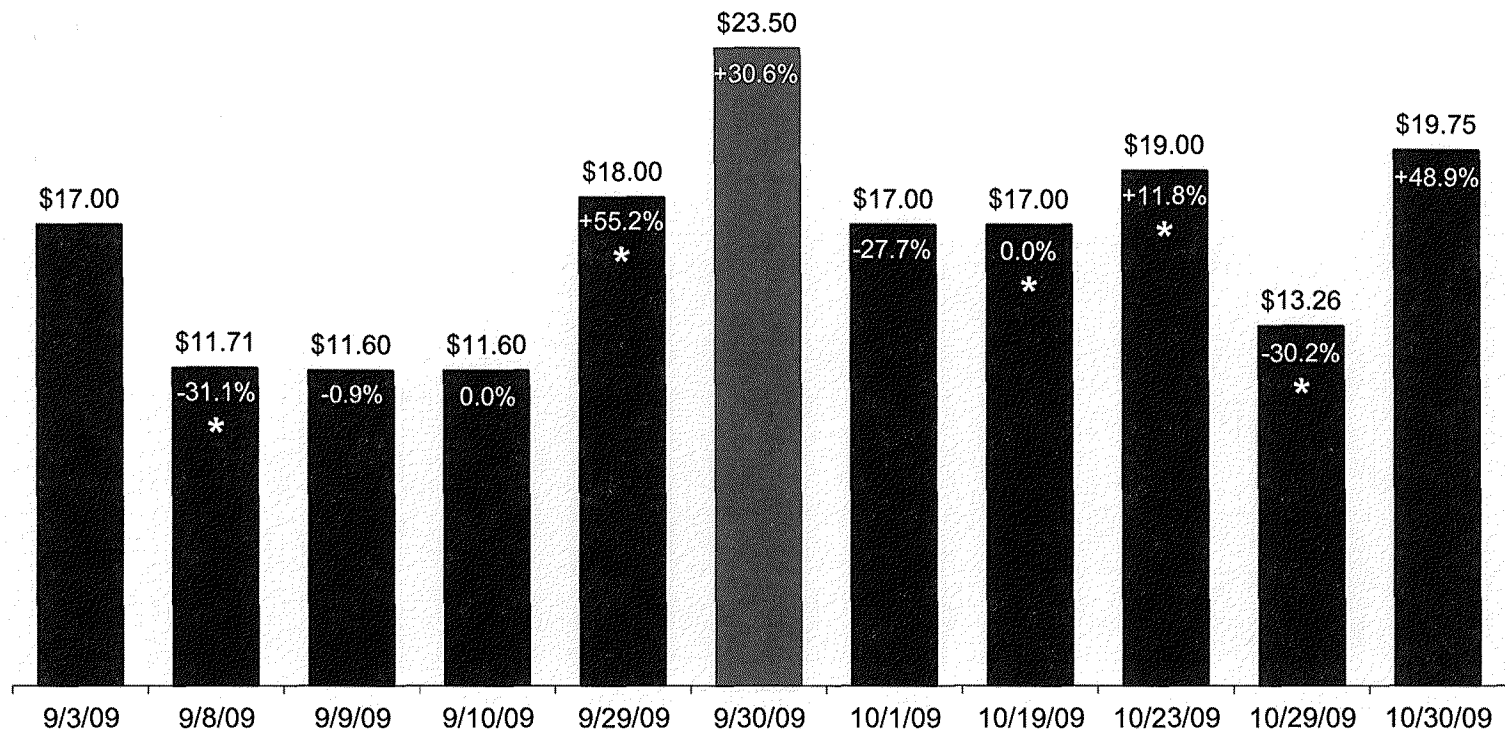
Date	Time	Trader	Shares Traded	Price	Bid/Ask Quote per OTC	
9/30/2009	11:25:52	KAM			\$11.70 - \$18.00	Order Placed by KAM (400 at \$18.00)
9/30/2009	11:29:42	KAM	200	\$18.00	\$11.70 - \$18.00	
9/30/2009	11:41:38	KAM	200	\$16.00	\$11.70 - \$18.00	
9/30/2009	11:56:59	KAM			\$11.70 - \$20.00	Order Revised by KAM (600 at \$16.00)
9/30/2009	12:03:18	KAM	180	\$16.00	\$11.70 - \$20.00	
9/30/2009	14:15:28	KAM			\$11.71 - \$20.00	Order Revised by KAM (2,000 at \$25.00)
9/30/2009	14:15:36	KAM	20	\$20.00	\$11.71 - \$20.00	
9/30/2009	15:57:26	KAM	480	\$20.00	\$11.75 - \$20.00	
9/30/2009	15:58:35	KAM	400	\$22.00	\$11.75 - \$22.00	
9/30/2009	14:59:03	KAM	120	\$23.99	\$11.75 - \$24.00	
9/30/2009	15:59:43	KAM	400	\$23.50	\$11.75 - \$23.50	Market Closed

Notes: Bid-ask quotes not associated with a specific trade are not shown. HCBC closing price of \$23.50 per share obtained from Bloomberg, FactSet and Huntleigh brokerage statement (see Bates No. SEC-KOCH_PROD-E-0018557).

Sources: OTC Market Groups ("Pink Sheets") data; KAM's transactions based on Huntleigh Database.

HCBC's Stock Prices Around September 30, 2009

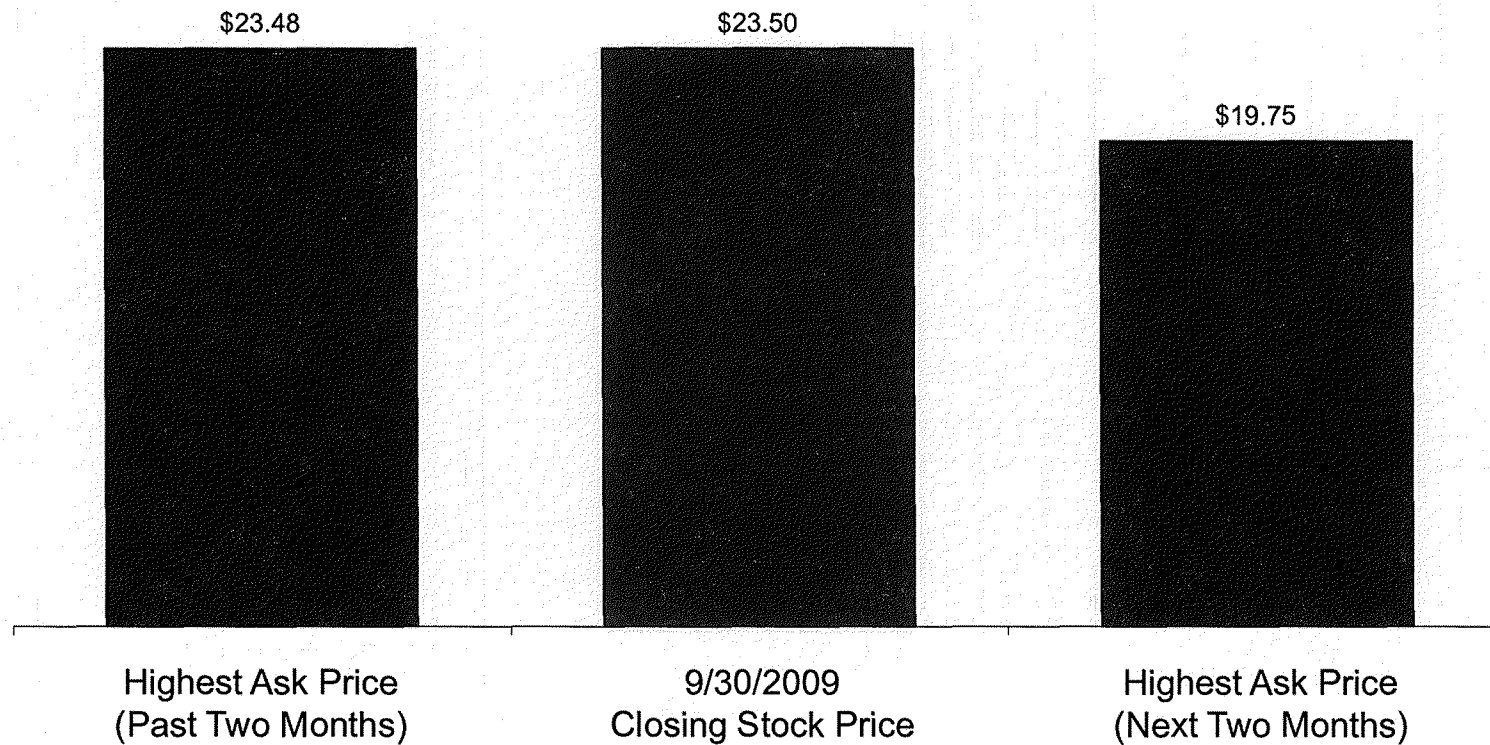
Stock price and percentage change in price



Source: Bloomberg.

* Stock did not trade on previous trading day; percentage change in stock price reflects a multi-day return.

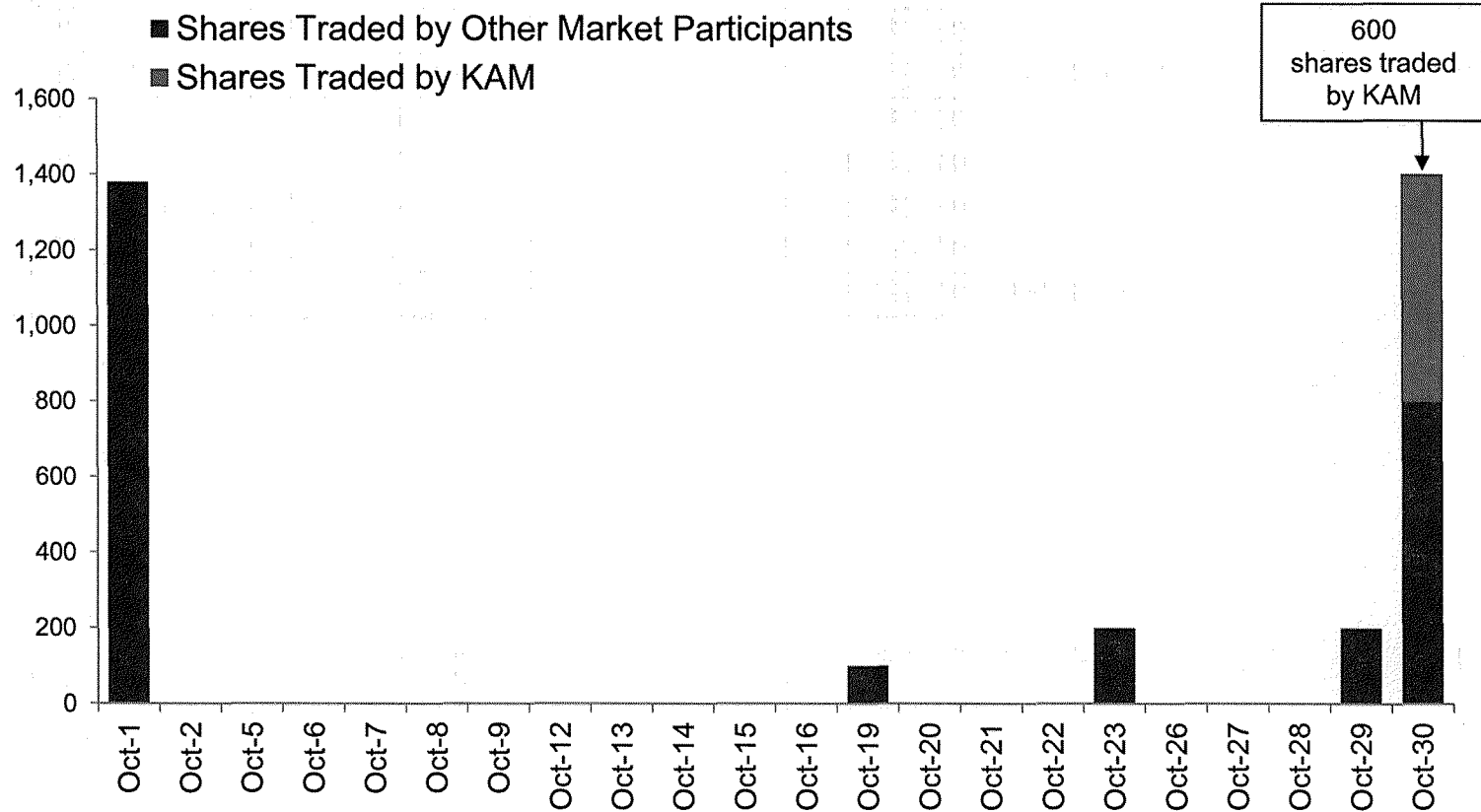
HCBC's Prices Two Months Before and After September 30, 2009



Sources: FT Interactive for closing ask prices (excludes prices on allegation dates); Bloomberg for closing stock price.

KAM's Trading in HCBC during October 2009 Represented 18.3% of Total Volume

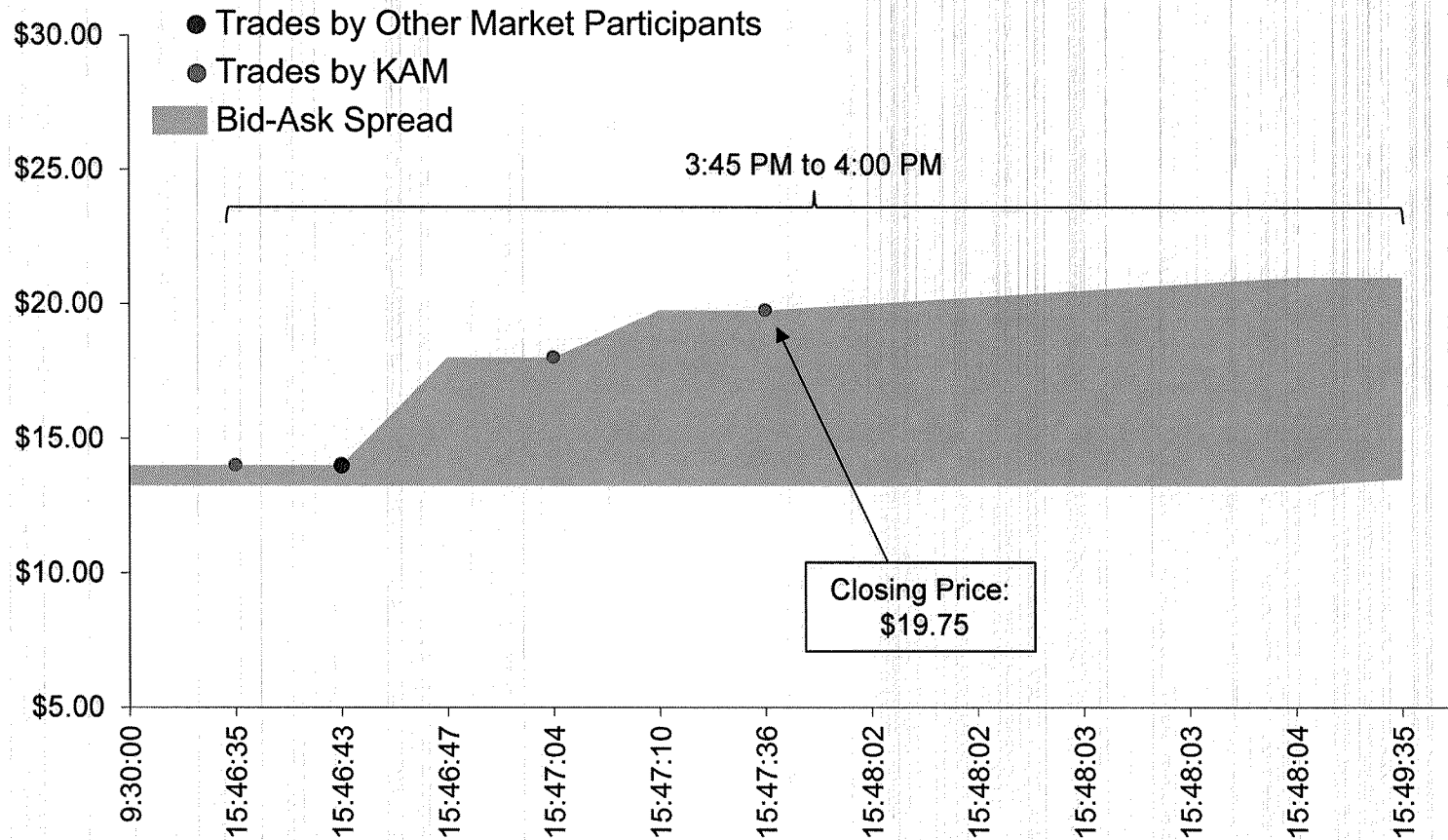
HCBC's Daily Volume



Sources: Bloomberg; KAM Database.

HCBC: Intraday Trading on October 30, 2009

All trades were within the bid-ask spread



Notes: Data based on intraday inside bid-ask quotes, except observations where the ask price was more than \$15 greater than the bid price. HCBC closing price of \$19.75 per share obtained from Bloomberg, FactSet and Huntleigh brokerage statement (see Bates No. SEC-KOCH_PROD-E-0018541). Sources: OTC Market Groups ("Pink Sheets") data; KAM's transactions based on Huntleigh Database.

HCBC: Intraday Trading on October 30, 2009 (detail)

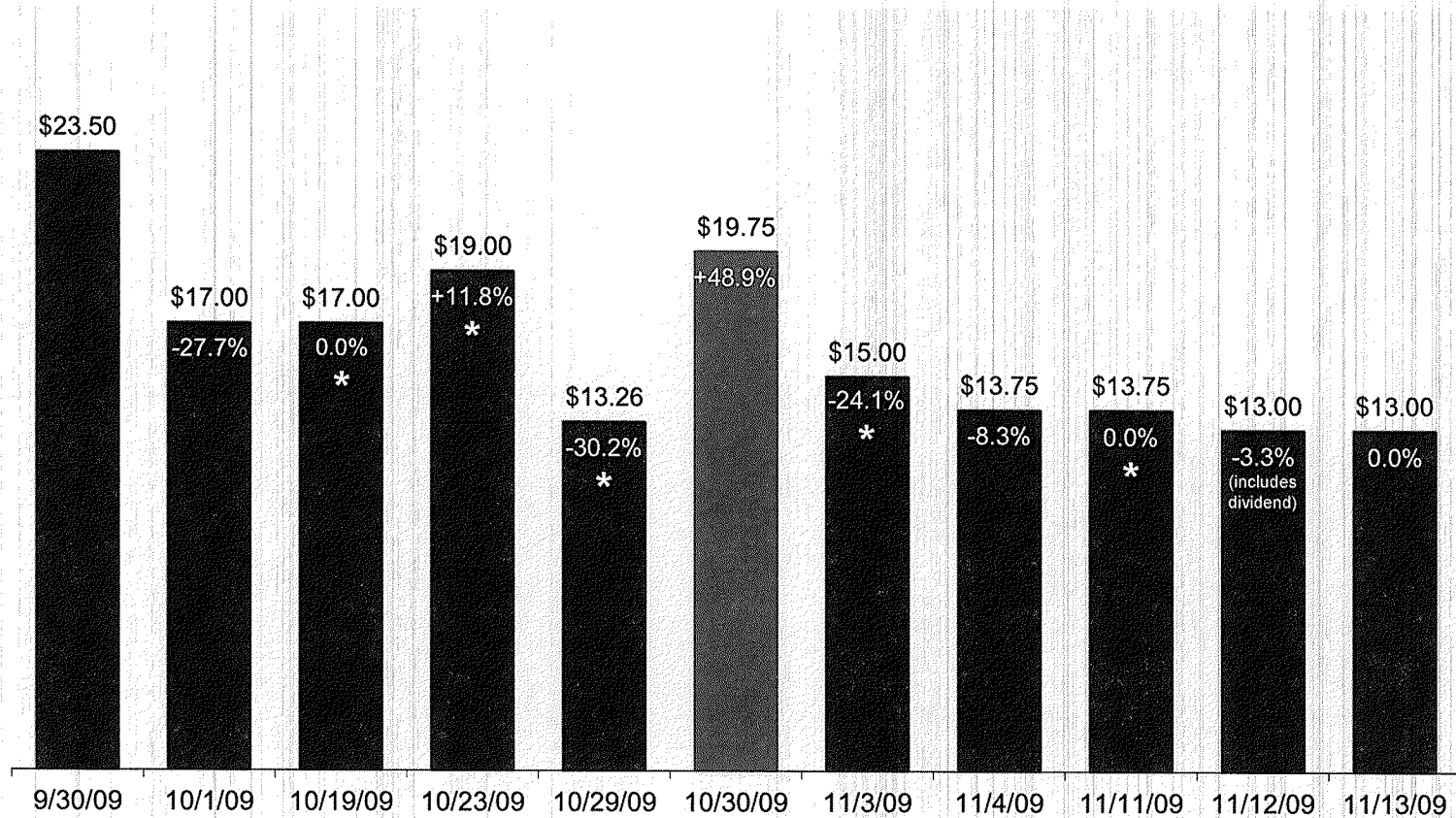
Date	Time	Trader	Shares Traded	Price	Bid/Ask Quote per OTC	
10/30/2009	10:55:33	KAM			\$13.25 - \$14.00	Order Placed by KAM (1,000 at \$24.00)
10/30/2009	15:45:48	KAM			\$13.25 - \$14.00	Order Revised by KAM (1,000 at Market)
10/30/2009	15:46:35	KAM	200	\$14.00	\$13.25 - \$14.00	
10/30/2009	15:46:43		800	\$14.00	\$13.25 - \$14.00	
10/30/2009	15:47:04	KAM	200	\$18.00	\$13.25 - \$18.00	
10/30/2009	15:47:36	KAM	200	\$19.75	\$13.25 - \$19.75	Market Closed

Notes: Bid-ask quotes not associated with a specific trade are not shown. HCBC closing price of \$19.75 per share obtained from Bloomberg, FactSet and Huntleigh brokerage statement (see Bates No. SEC-KOCH_PROD-E-0018541).

Sources: OTC Market Groups ("Pink Sheets") data; KAM's transactions based on Huntleigh Database.

HCBC's Stock Prices Around October 30, 2009

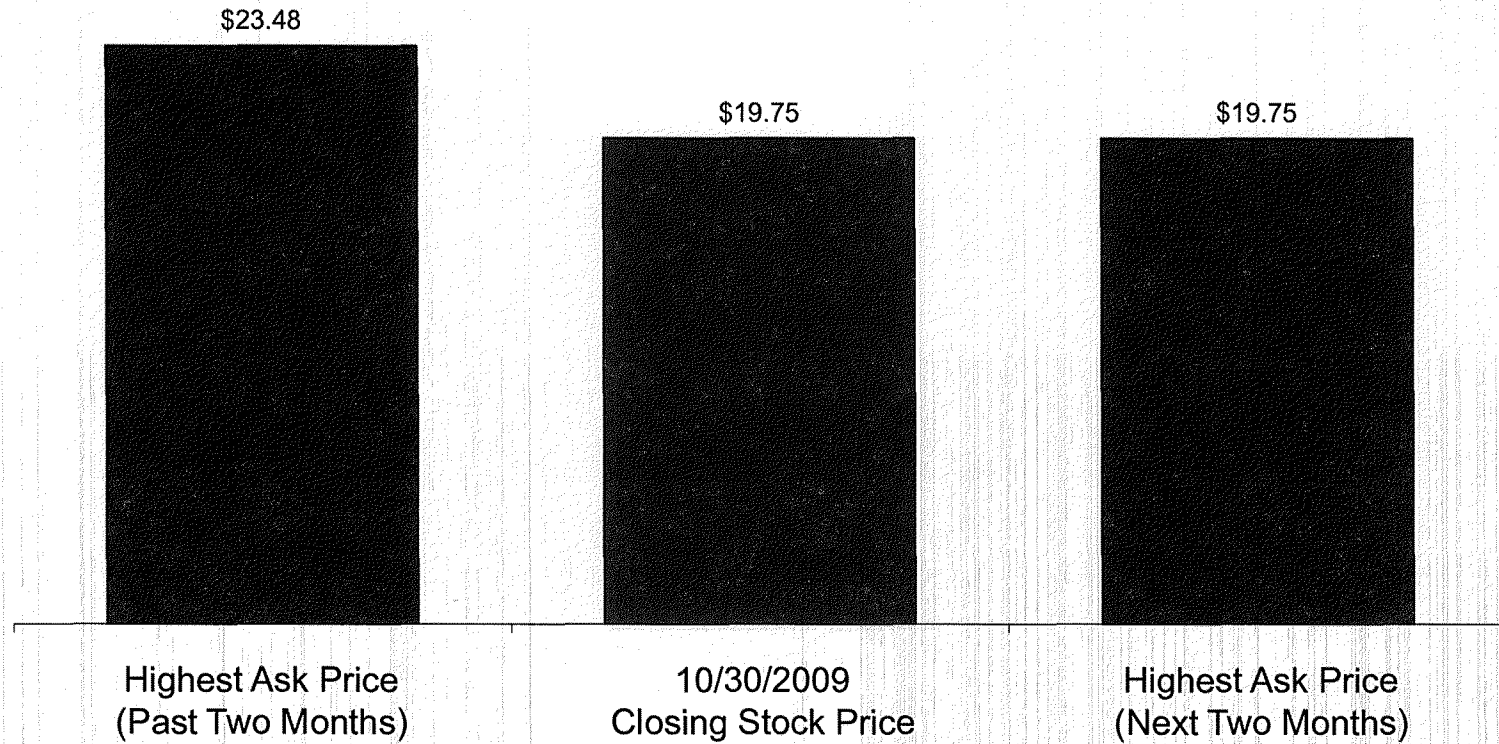
Stock price and percentage change in price



Source: Bloomberg.

* Stock did not trade on previous trading day; percentage change in stock price reflects a multi-day return.

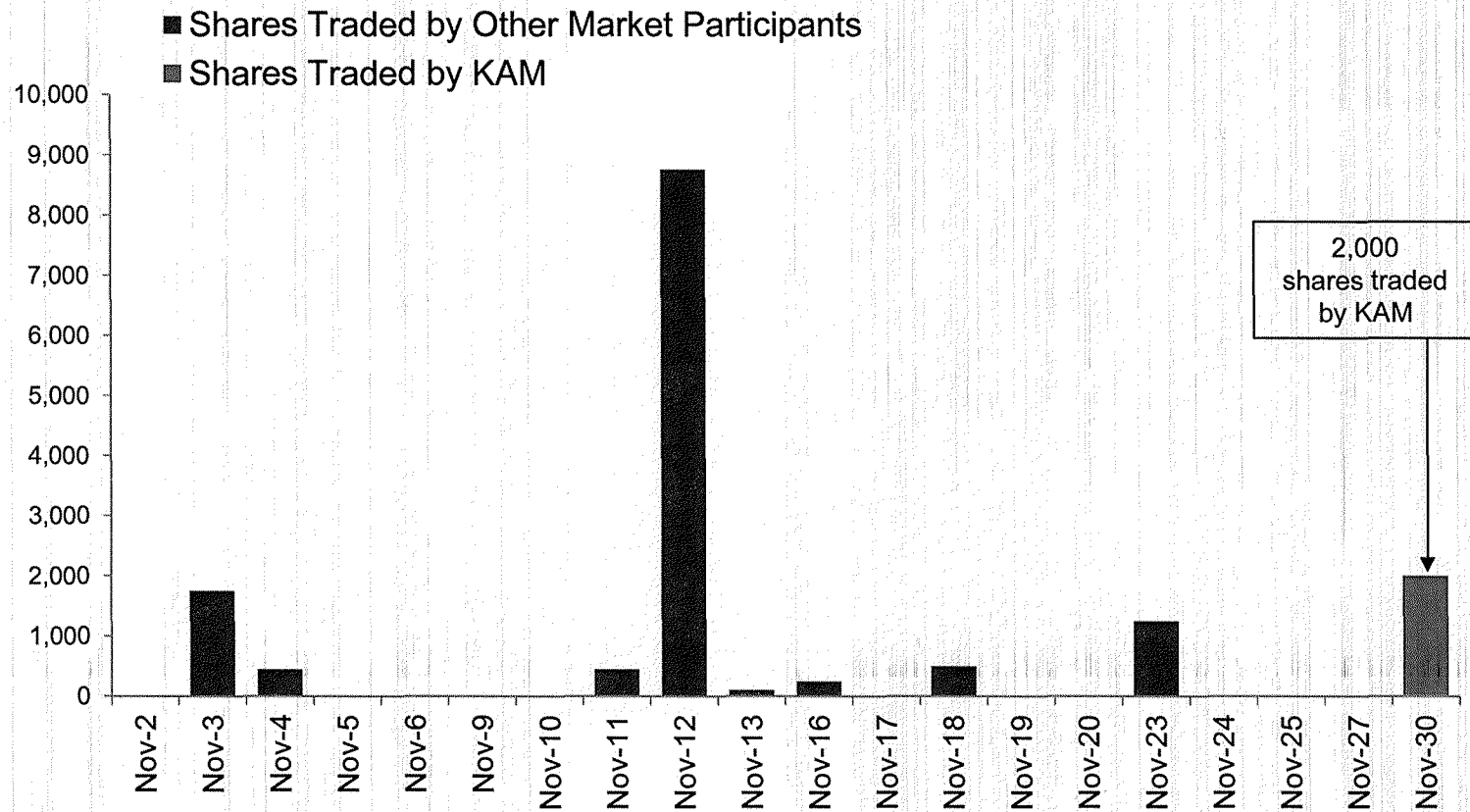
HCBC's Prices Two Months Before and After October 30, 2009



Sources: FT Interactive for closing ask prices (excludes prices on allegation dates); Bloomberg for closing stock price.

KAM's Trading in HCBC during November 2009 Represented 12.9% of Total Volume

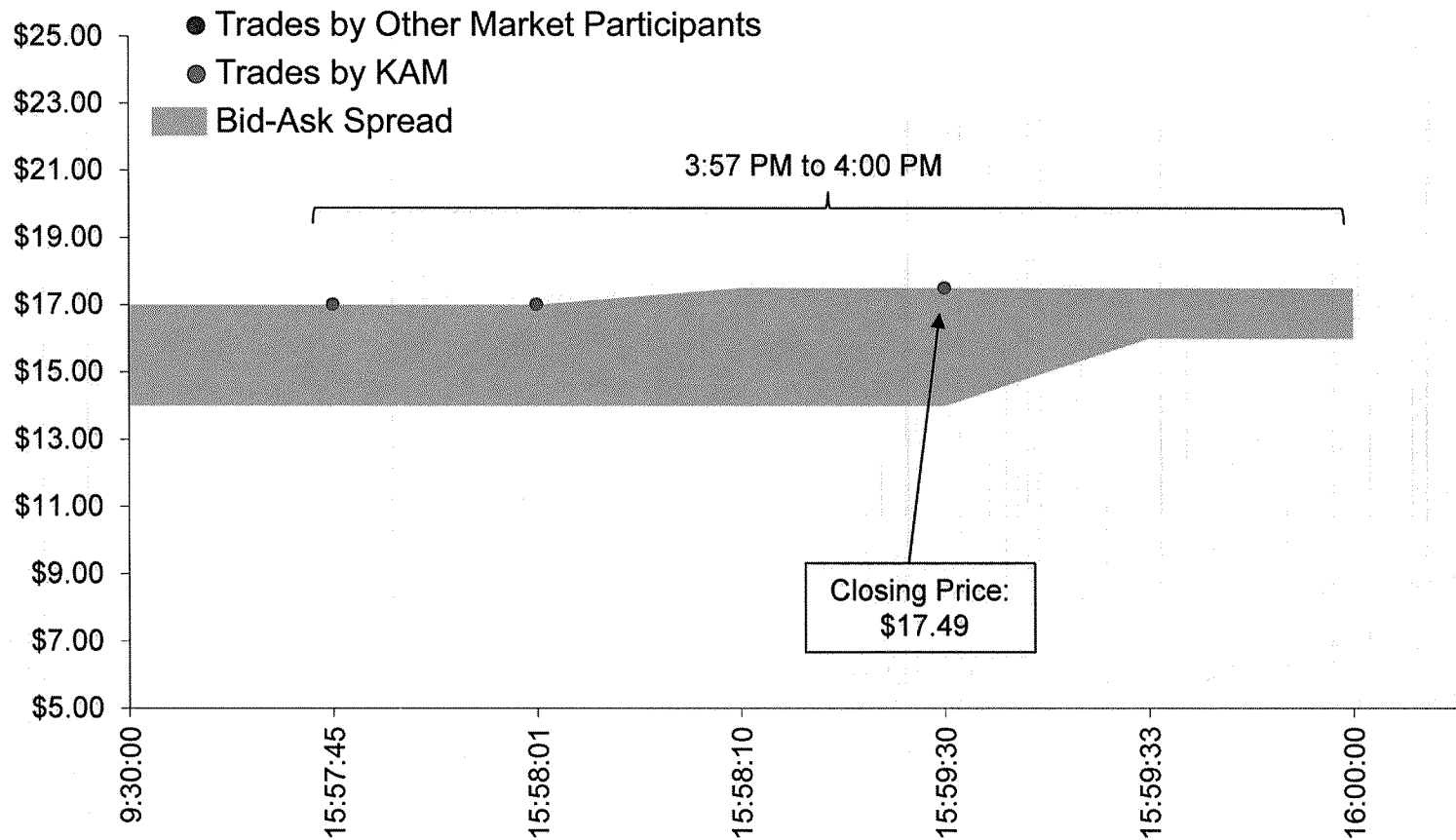
HCBC's Daily Volume



Sources: Bloomberg; KAM Database.

HCBC: Intraday Trading on November 30, 2009

All trades were within the bid-ask spread



Notes: Data based on intraday inside bid-ask quotes, except observations where the ask price was more than \$15 greater than the bid price. HCBC closing price of \$17.49 per share obtained from Bloomberg, FactSet and Huntleigh brokerage statement (see Bates No. SEC-KOCH_PROD-E-0018565).
Sources: OTC Market Groups ("Pink Sheets") data; KAM's transactions based on Huntleigh Database.

HCBC: Intraday Trading on November 30, 2009 (detail)

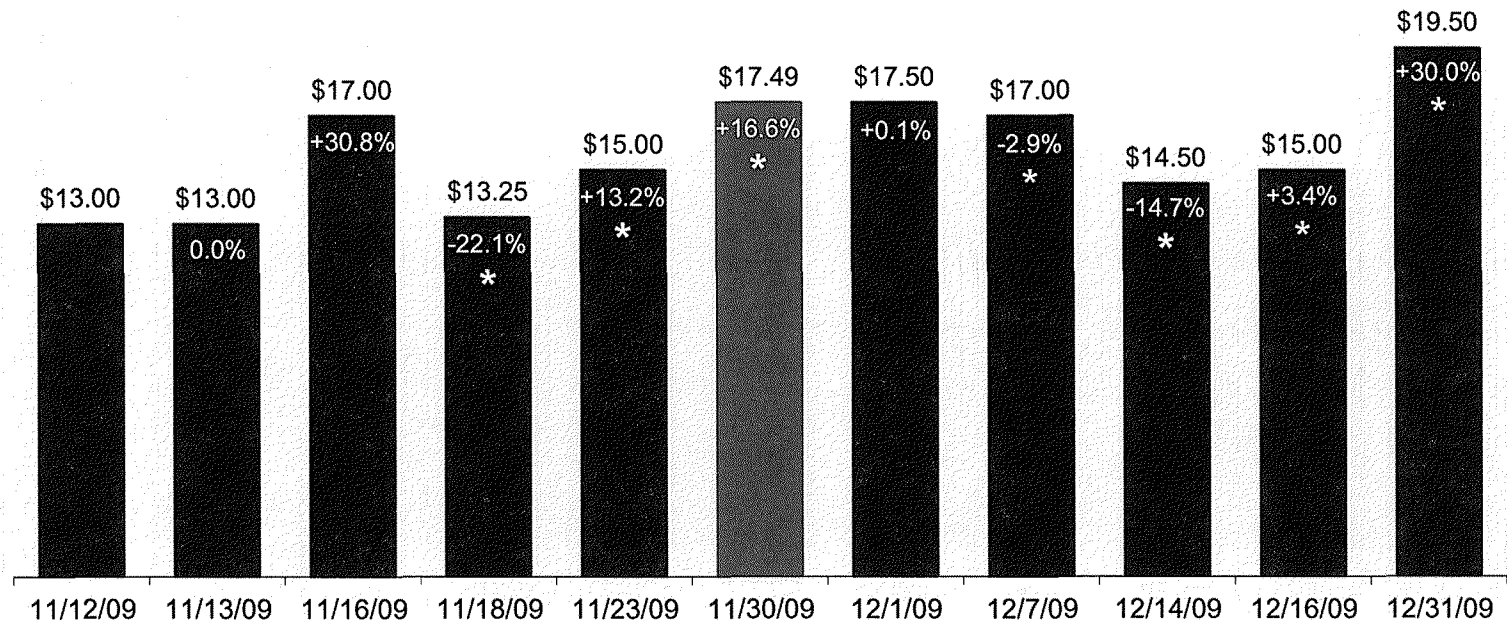
Date	Time	Trader	Shares Traded	Price	Bid/Ask Quote per OTC	
11/30/2009	11:14:20	KAM			\$14.00 - \$17.00	Order Placed by KAM (2,000 at \$20.00)
11/30/2009	15:52:05	KAM			\$14.00 - \$17.00	Order Revised by KAM (2,000 at \$21.00)
11/30/2009	15:57:45	KAM	200	\$17.00	\$14.00 - \$17.00	
11/30/2009	15:58:01	KAM	800	\$17.00	\$14.00 - \$17.00	
11/30/2009	15:59:30	KAM	1,000	\$17.49	\$14.00 - \$17.50	Market Closed

Notes: Bid-ask quotes not associated with a specific trade are not shown. HCBC closing price of \$17.49 per share obtained from Bloomberg, FactSet and Huntleigh brokerage statement (see Bates No. SEC-KOCH_PROD-E-0018565).

Sources: OTC Market Groups ("Pink Sheets") data; KAM's transactions based on Huntleigh Database.

HCBC's Stock Prices Around November 30, 2009

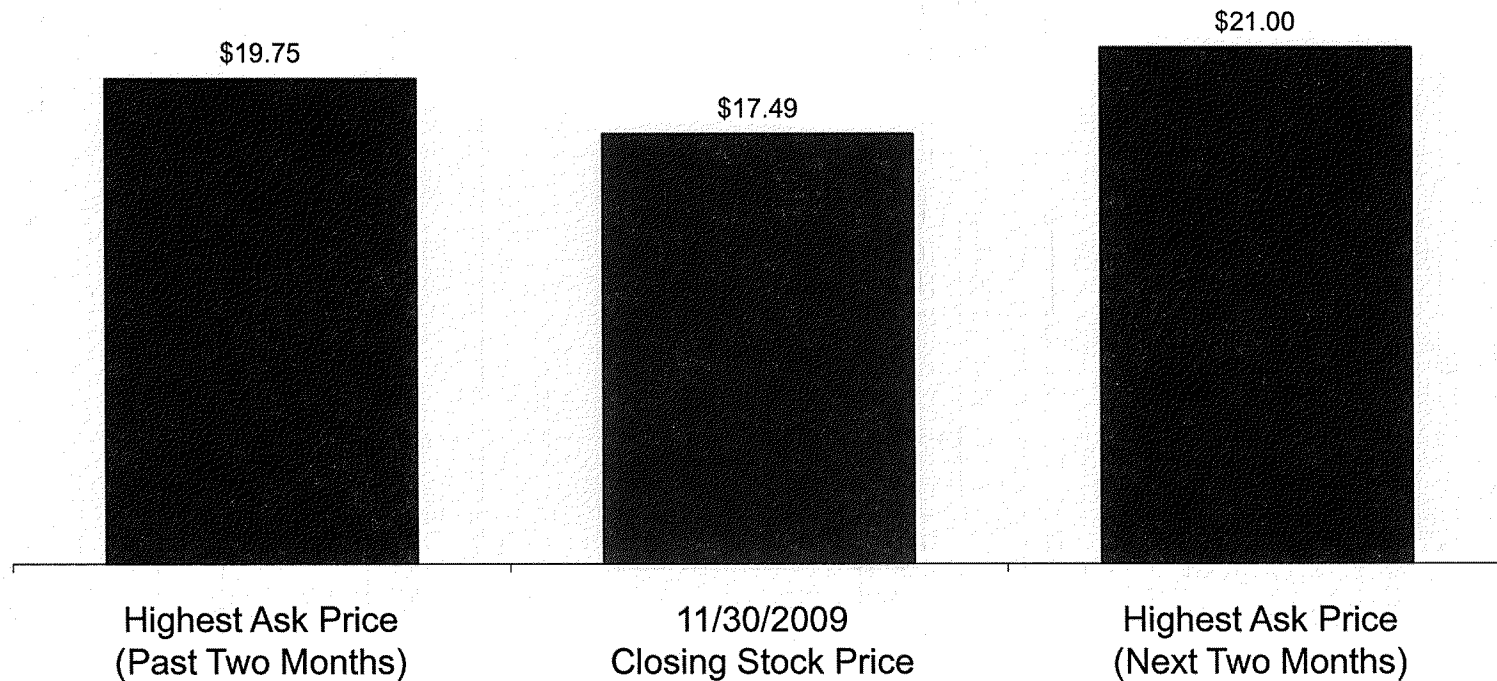
Stock price and percentage change in price



Source: Bloomberg.

* Stock did not trade on previous trading day; percentage change in stock price reflects a multi-day return.

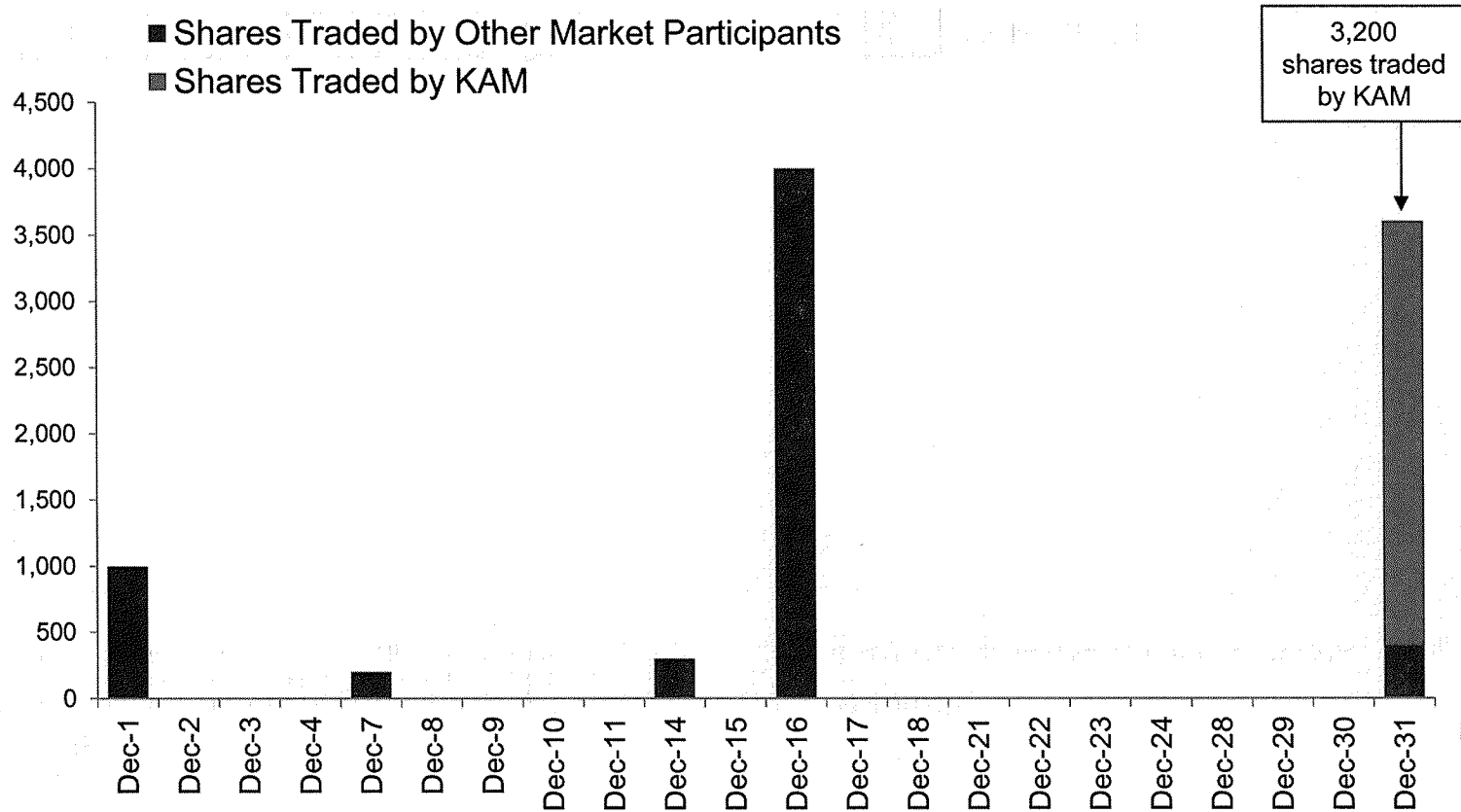
HCBC's Prices Two Months Before and After November 30, 2009



Sources: FT Interactive for closing ask prices (excludes prices on allegation dates); Bloomberg for closing stock price.

KAM's Trading in HCBC during December 2009 Represented 35.2% of Total Volume

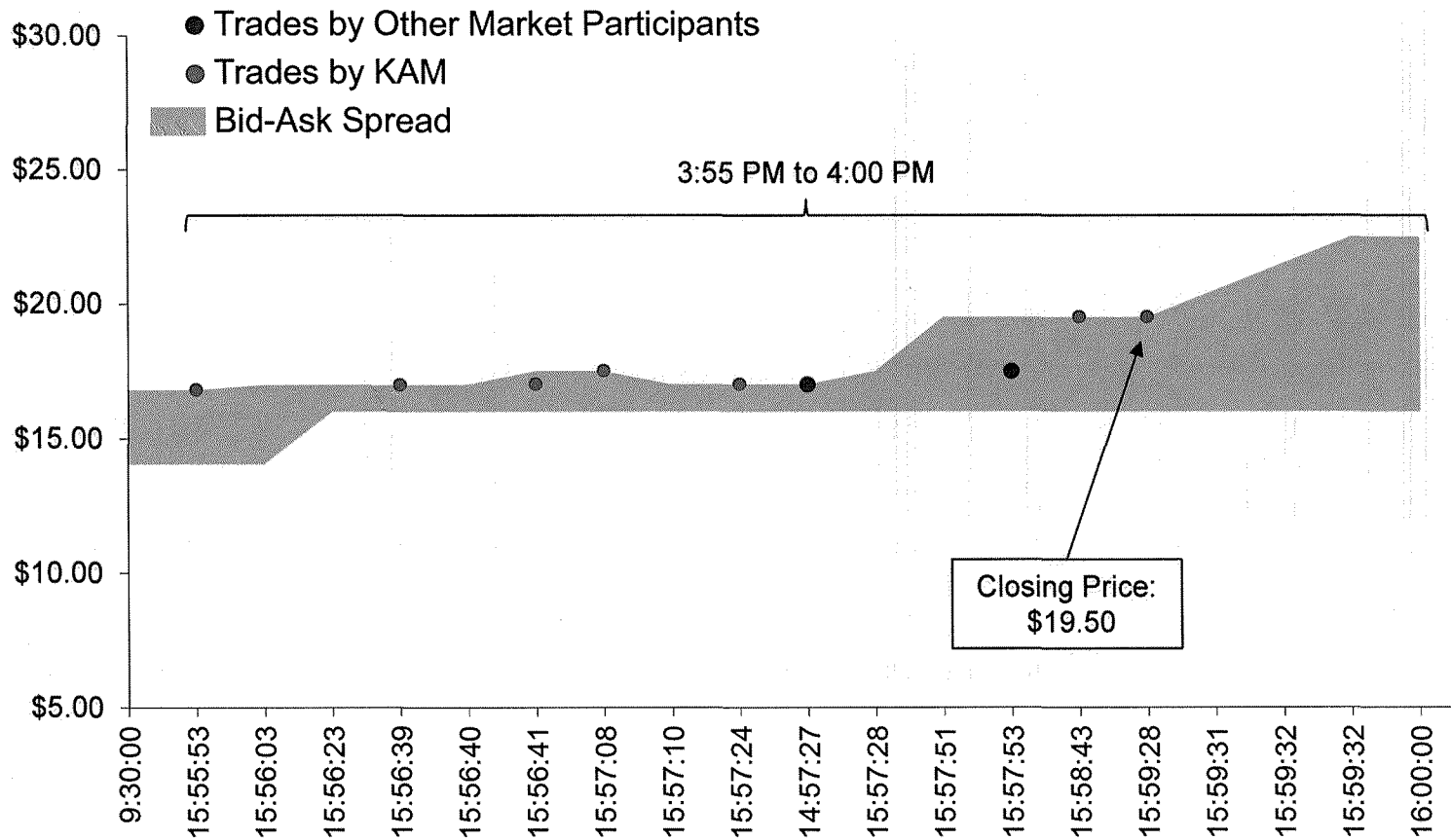
HCBC's Daily Volume



Sources: Bloomberg; KAM Database.

HCBC: Intraday Trading on December 31, 2009

All trades were within the bid-ask spread



Notes: Data based on intraday inside bid-ask quotes, except observations where the ask price was more than \$15 greater than the bid price. HCBC closing price of \$19.50 per share obtained from Bloomberg, FactSet and Huntleigh brokerage statement (see Bates No. SEC-KOCH_PROD-E-0014957).
Sources: OTC Market Groups ("Pink Sheets") data; KAM's transactions based on Huntleigh Database.

HCBC: Intraday Trading on December 31, 2009 (detail)

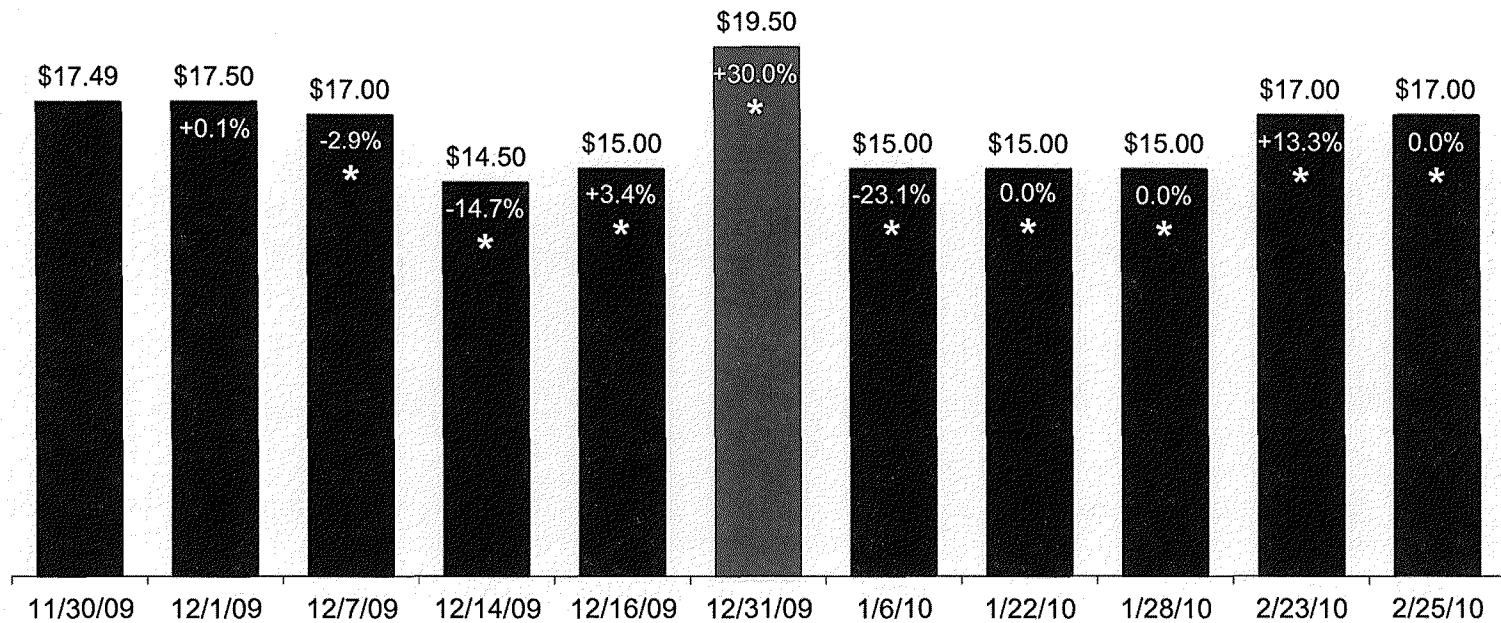
Date	Time	Trader	Shares Traded	Price	Bid/Ask Quote per OTC	
12/31/2009	9:06:00	KAM			\$14.05 - \$16.80	Order Placed by KAM (5,000 at \$25.00)
12/31/2009	15:55:53	KAM	200	\$16.80	\$14.05 - \$16.80	
12/31/2009	15:56:39	KAM	700	\$16.99	\$16.00 - \$16.99	
12/31/2009	15:56:41	KAM	800	\$17.00	\$16.00 - \$17.50	
12/31/2009	15:57:08	KAM	200	\$17.50	\$16.00 - \$17.50	
12/31/2009	15:57:24	KAM	900	\$17.00	\$16.00 - \$17.00	
12/31/2009	14:57:27		100	\$17.00	\$16.00 - \$17.00	
12/31/2009	15:57:53		300	\$17.50	\$16.00 - \$19.50	
12/31/2009	15:58:43	KAM	200	\$19.50	\$16.00 - \$19.50	
12/31/2009	15:59:28	KAM	200	\$19.50	\$16.00 - \$19.50	Market Closed

Notes: Bid-ask quotes not associated with a specific trade are not shown. HCBC closing price of \$19.50 per share obtained from Bloomberg, FactSet and Huntleigh brokerage statement (see Bates No. SEC-KOCH_PROD-E-0014957).

Sources: OTC Market Groups ("Pink Sheets") data; KAM's transactions based on Huntleigh Database.

HCBC's Stock Prices Around December 31, 2009

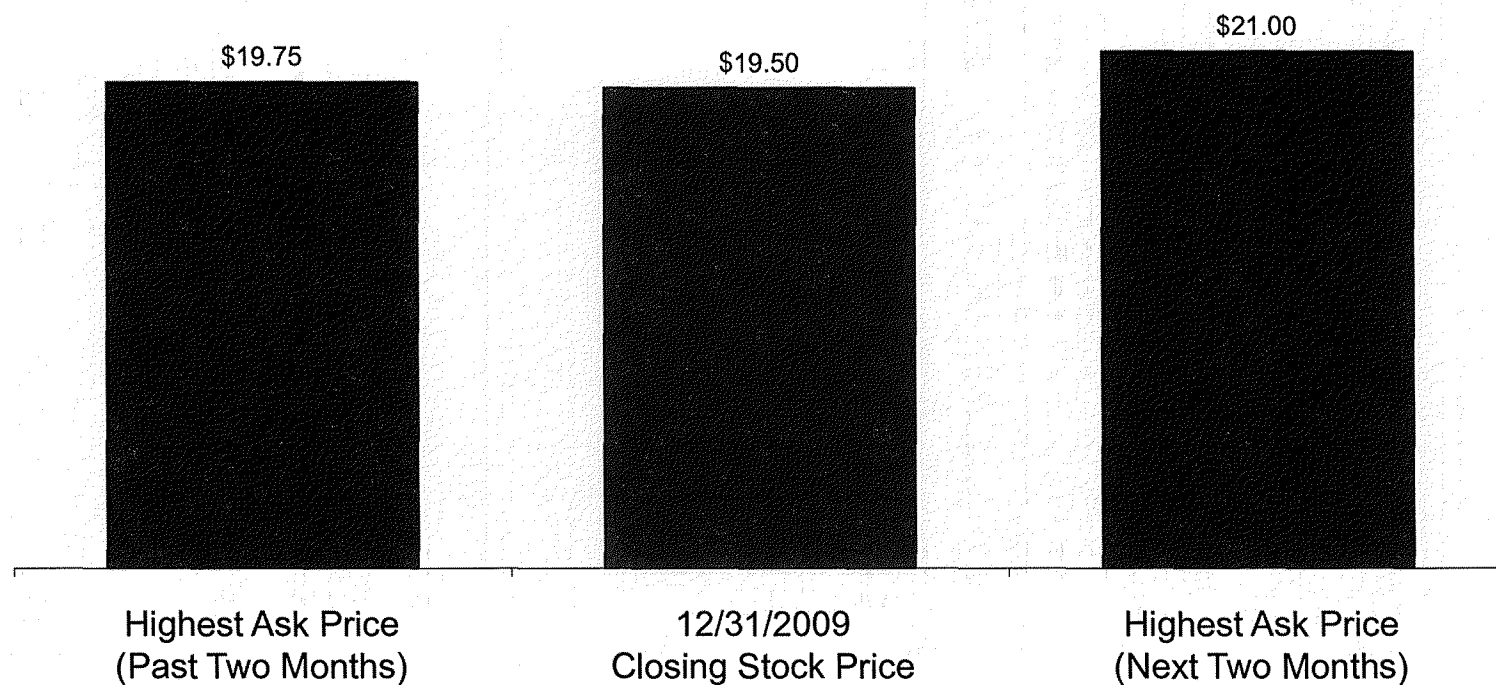
Stock price and percentage change in price



Source: Bloomberg.

* Stock did not trade on previous trading day; percentage change in stock price reflects a multi-day return.

HCBC's Prices Two Months Before and After December 31, 2009



Sources: FT Interactive for closing ask prices (excludes prices on allegation dates); Bloomberg for closing stock price.

Conclusion

- In my opinion, it is economically rational to trade illiquid stocks at the end of the trading day
- In my opinion, KAM's trading in HCBC's stock would have impacted the price because HCBC is extremely illiquid
- In my opinion, the lack of a stock price reaction in the shares of CHEV and CARV is inconsistent with the SEC's contention that KAM's trading in CHEV and CARV reflected "marking the close"