UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15015

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In the Matter of

MICHAEL BRESNER, RALPH CALABRO, JASON KONNER, and DMITRIOS KOUTSOUBOS

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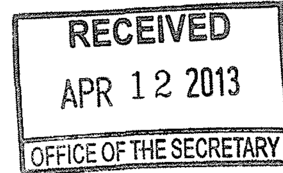

RESPONDENT RALPH CALABRO'S INITIAL POST-HEARING BRIEF

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INTRODUCTION

The unforgiving light of hindsight is 20-20, and the temptation to find fault artificially driven by that light is no different in this case. The evidence revealed that Ralph Calabro ("Calabro") engaged in a strategy based in accepted economic theory which required his considerable effort and generated profits when most investors suffered catastrophic losses. When the market turned against the theory, Harold Moore ("Moore"), Waldo Willhoft ("Willhoft") and Wayne Williams ("Williams") (the "Customers"), as well as Calabro and his family, incurred significant loss. Hindsight proved the loss may have been prevented had Calabro foreseen investing "long" at the "right" time. His failure to predict accurately, however, is not the offense with which he is charged, or a basis for the sanctions the Division now seeks.

Rather, hindsight was relied upon to distort the circumstances under which Moore, Willhoft and Williams made investments, and then was used to reconstruct the facts into a charge of "churning" against Calabro. Indeed, it is uncontested that each Customer signed account documents reflecting a higher risk investment objective during a period of market turmoil, and had the financial wherewithal and experience to incur risk. Each knew Calabro's strategy involved "short" sales and options in an effort to profit from a market decline, and thus involved shorter-term investments. And each either at the time of his accounts, or shortly thereafter, engaged in independent investing that confirmed a broader interest in higher risk investing.

Taking the mountain of documents the Customers signed and their real time actions at face value, and because "short" and options trades are "meant to be short-term investments," as the Division's expert confirmed (Tr. 3244:10-3255:2), Calabro's trade recommendations were consistent with his Customers' objectives. They were certainly not for the purpose of generating outsized commissions without regard for his Customers' interests – the essence of "churning." Indeed, this is the very reason the Division's case depended on reconstructing facts in hindsight.

To counter their real time admissions and actions, and testifying off of virtually identical examination outlines, the Customers asserted they never read the many documents they received, and they signed each document in blank. Each claimed Calabro then hid the inaccurate investment information in the account documents (including their higher risk objectives and outsized wealth) and traded in a manner of which each was unaware. Thus, the Customers declared they were risk averse, "conservative" investors, which the Division then used to claim Calabro had traded their accounts in an excessive manner inconsistent with their interests.

For the reasons set forth below, each Customer's hindsight testimony lacked credibility, their attempt to revise history failed, and the Court should therefore decline the invitation to find Calabro a fraudster. But even more, the Division failed to prove excessive trading because the "typical" churning analysis presented by its expert was an unreliable indicator of excessive trading in a "short" account that experienced a sharp decline in value; expert testimony proved the "typical" analysis *inflated* the traditional turnover and cost/equity ratios in a manner that was "inherently" "not precise" and the expert conceded was never "take[n] into consideration" in his analysis. (Tr. 3255:5-8; 3283:19-24.) And perhaps most importantly, Calabro's real motive was to make his Customers money at a time when the most other investors were experiencing huge losses, using a well-accepted economic theory and trading strategy that was closely reviewed by his superiors; Calabro's intent was not to trade for the principal purpose of generating commissions and thus the evidence was also insufficient to prove he acted with *scienter*.

THE ALLEGATIONS AGAINST CALABRO

The Order Instituting Proceedings (the "OIP") charged Calabro with violating Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, which require a device, scheme, or artifice to defraud. *United States v. Naftalin*, 441 U.S. 768, 773 n.4 (1979). It

accused Calabro of "churning," which is when a broker trades "without regard to the customer's investment interests" "for the purpose of generating commissions." *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1416 (11th Cir. 1983). The charge has three elements: (1) excessive trading in light of "'investment objectives,'" (2) "control," and (3) *scienter*. *Id.* at 1416-17 (quoting *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 (5th Cir. 1981)).

Attempting to address each element, the OIP alleged Calabro engaged "in excessive trading for [his] own gains in disregard of the customers' conservative investment objectives and low or moderate risk tolerances for the purpose of generating commissions." (OIP ¶8.) It further claimed Calabro "exercised *de facto* control over the accounts of the three customers." (*Id.* ¶7.) And it pointed to "turnover ratios" and "annualized break-even rates of return" as "excessive in light of Calabro's customers' investment objectives and experiences, ages and financial needs." (*Id.*) These were the core allegations the Division attempted to prove; its proof failed.

ARGUMENT

I. THE CUSTOMER WITNESSES LACKED CREDIBILITY

A. The Division's Burden

The Division's burden was to prove each churning element by a "preponderance" of evidence. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 329 (2007). That burden incorporates two indispensable factors. The evidence must *first* be *credible* in *quality* because, as the Supreme Court stated in recognizing the preponderance standard in SEC enforcement cases, "Congress was primarily concerned with the elimination of agency decisionmaking premised on evidence which was of poor quality – irrelevant, immaterial, unreliable, and nonprobative . . . ." *Steadman v. SEC*, 450 U.S. 91, 98 (1981). "Poor quality" evidence should be discounted and to meet its burden on each element, the remaining credible evidence must,

second, not be "of insufficient quantity – less than a preponderance." *Id.* Due process demands no less, particularly where, as here, the accused's livelihood and crippling penalties are at stake.

That a witness' credibility is poor does not mean he lied. To be sure, the Court should consider a witness' veracity. But a lack of truth may be attributable to faulty memory, or the witness simply repeated a story he was told. Testimony that is duplicitous, forgetful or prompted is "poor quality" and should be discounted. *See SEC v. Schields*, 2011 WL 3799061, at *1 (D. Colo. Aug. 26, 2011) (court weighs "the witness's means of knowledge, ability to observe, and strength of memory; the manner in which the witness might be affected by the outcome of the litigation; the relationship the witness had to either side in the case; and the extent to which the witness was either supported or contradicted by other witnesses or evidence presented").

B. Moore Lacked Credibility Because His Testimony Was Fabricated

Moore was the Division's first Customer witness, and as it turned out, his testimony lacked *quality* because much of it was fabricated.

i. Moore required notes of the facts he "needed to remember"

Out of the gate, Moore needed notes to ensure he had the "right" story. (Tr. 720:23-25.) Moore explained that the Division told him "how things were going to go," which prompted him to draft notes he brought with him. (Tr. 719:7-18.) The notes were of "things that [he] needed to remember that [he] knew [he] couldn't remember," and to help him "remember what [he] had to say." (Tr. 662:17-22; 719:15-23.) It was "from the notes" that he remembered a trip to visit Calabro and the dates he wired money to his account. (Tr. 672:11-20; 676:2-5.) "Everything else," Moore confirmed, "was from the stuff [the Division] provided." (Tr. 671:21-25.)

While *contemporaneous notes* may sometimes be used to refresh memory, Moore's handwritten notes prepared long after the fact to ensure he got it right, and only after being contacted by and meeting with the Division, is proof positive of a contrived story.

ii. <u>Moore's claim of a rushed signature on a blank form was false</u>

Moore concocted "what [he] had to say" to show, contrary to forms he signed, that he was a conservative investor, had limited funds to invest, and was unaware of Calabro's strategy. Moore's story began with his meeting Calabro and Michael Uckar ("Uckar") at the offices of accountant, Terry Corriher ("Corriher"), in November 2008. Corriher had an account with Calabro and referred him to Moore. (Tr. 618:4-619:4; 619:13-23; 620:4-5; 745:16-18.)

At the heart of Moore's account is that Calabro coaxed him to sign a "blank account opening application" in his rush to "catch a plane." (Tr. 622:1-10; 623:8-18; 630:9-18; 647:24-648:5.) He explained "they were in a hurry and needed to have the stuff signed so I signed it." (Tr. 631:1-16.) Thus, he claimed Calabro never asked his objective or financial information and had he seen the forms he "would have corrected them." (Tr. 639:14-17; 640:1-22.)

Moore's claim that he signed a blank form in haste was false. To be sure, the New Account Form, Margin Agreement, and Options forms show they were prepared on November 21, 2008, the date Moore alleged he was rushed. (Calabro Exs. 23, 25, 26.) But the evidence also proved that Uckar then *mailed the form* along with other "documents" to be "completed." (Calabro Ex. 64.) That Moore received the package was proven by the fact that Uckar's November 21, 2008 cover letter was produced *from Moore's own files* to the SEC Staff.[1] (*Id.*)

The simple physics of time thus proved there could not have been a rushed signature on a blank form the day Calabro met Moore. For after having received the package mailed November

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[1] SEC-Moore-000001 indicates the document's source. (Calabro Ex. 64.)

21, 2008, Moore did not sign the documents until *eleven days later* on December 2, 2008. (Calabro Exs. 23, 25, 26.) Perhaps recognizing his exciting tale of his rushed signature had not panned out, Moore came clean and admitted Calabro had long been gone when he received the forms by mail and he then signed them on December 2, 2008. (Tr. 749:24-25; 776:18-777:5.)[2]

iii. Moore's alleged interest in conservative investing was false

Moore asserted that Calabro never asked his investment objectives, he was "not a risky investor," and he had "no idea we were trading stocks like daily." (Tr. 639:14-17; 640:1-11, 19-22; 696:5-7, 12-21.) Each of the account forms Moore signed reflected the contrary – his interest was in higher risk investing. (Calabro Exs. 23, 24, 26, 27, 37, 41.) Indeed, two letters he received from J.P. Turner prompted him to "review [his] account information" for accuracy, including his objectives of "speculation," "trading profits," and "capital appreciation," and provided an "Investment Objectives Key" to enable him to understand his listed objectives. (Calabro Ex. 28, 65) (Tr. 793:8-11.) Moore never responded.

Moore also knew of his account's shorter term nature from speaking with Calabro "as many as five or six times a day" – an amount consistent with active trading and with Moore's interest given his limited availability and long work hours. (Tr. 650:25-651:23.) Indeed, the calls related to his account activity, for as Moore also explained, Calabro explained "investment opportunities and make recommendations" during the calls. (Tr. 804:12-19.)[3]

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[2] Moore explained "the girl in my office would say, here, you need to sign this and I would and she would fax them to Ralph or whatever." (Tr. 650:25-651:9.) Moore also admitted that the "entire pre-filled application was at least sent to [Moore's] offices for [him] to take a look at and then sign and send back." (Tr. 761:1-5; *see* Tr. 756:10-14.) Thus, although Pam may have filtered what he received, Calabro "had the right to rely on the fact that mail sent to [him] through Pam would ultimately get to [him]." (Tr. 761:19-23; 793:25-794:3.)

[3] Moore's claim that Calabro failed to explain his strategy was implausible. (Tr. 623:8-18; 696:5-21.) The Corriher meeting lasted "an hour" during which Calabro explained "short"

But it was Moore's investments after his J.P. Turner account closed that confirmed his interest in higher risk, shorter term trading. Moore described day-trading as "trad[ing] stocks on a daily basis, every day, get in them make a little bit of money and get out of them," and that it was risky. (Tr. 696:22-697:5; 738:4-12.) In early 2010, Moore withdrew $140,132 from his J.P. Turner account, opened an "on-line" Fidelity account, and directed an employee to trade. (Tr. 697:14-18; 700:2-6; 777:17-19.) The employee then engaged in the very day trading Moore alleged at trial conflicted with his investment objectives. (Tr. 781:22-782:6.)

The trading was massive. In 2010, Moore made $18,225,219 in purchases, $18,363,126 in sales, and incurred a $137,907 loss. (Calabro Ex. 63 at Schedule D-1) (Tr. 736:23-737:15.) Moore claimed to have found out about the day trading at year end and that he was on margin because "that's the only way it could have that much of an exchange in it." (Tr. 782:20-25; 784:6-10.) But consistent with his actual interest in shorter term investing, he failed to stop the employee; Moore instead fired him from his day job and he continued to day trade with impunity. (Tr. 786:13-18.) In 2011, he made in excess of 2,000 transactions of $17,471,718 in purchases and another $16,694,034 in sales for an additional loss of $805,880. (Tr. 733:1-3.)[4]

In short, Moore's assertion that he was uninterested in higher risk, shorter term investing is directly contrary to the documentary evidence and Moore's own actions at the time.

iv. <u>Moore's financial information was accurately reflected</u>

Moore next devised a story concerning his financial wherewithal to incur risk. Moore's J.P. Turner margin application and Options forms reflected a $250,000 annual income, a $3 million net worth, and $1 million in investable assets. (Calabro Ex. 25, 26.) Moore confirmed

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selling, "had a bunch of charts and graphs and things like that and he was showing them," and described his method of "choosing stocks." (Tr. 620:13-621:12; 746:11-747:21.)

[4] Because the trades were so short-term, and thus "wash sales," Moore was permitted a tax loss deduction of only $26,207 on his $805,880 loss. (Calabro Ex. 62 at 89.)

that the $250,000 income was approximately correct. (Tr. 652:10-18.) He claimed, however, that the rest was wrong; his net worth was only $1.5 million (Tr. 654:1-14; 721:21-722:2) and he only had $250,000 in investable assets. (Tr. 654:18-655:3.) Moore's written admissions at the time proved the contrary – his account forms were indeed accurate when signed.

On December 10, 2008 (*two days* after signing J.P. Turner margin and Options forms), Moore declared his net worth was *higher* to a Smith Barney investment group known as McNair. (Calabro Ex. 61)(Tr. 722:18-723:8.) Like the $3 million in his J.P. Turner forms, which he claimed was inaccurate; Moore advised McNair that his net worth was $3.25 million. (Calabro Ex. 61) (Tr. 727:24-728:12.) His fabricated story concerning his lower net worth was exposed.

Indeed, Moore all but admitted the fabrication by changing his story and pointing to the McNair form to explain the reason Calabro had, in fact, recorded his net worth *correctly*. Moore "assume[d] [Calabro] took [the information] off of something else" (Tr.753:16-20), and suggested that "the only thing [he] gave [Calabro]" was the McNair form reflecting his $3.25 million net worth. (Tr. 753:21-754:3.) But even that explanation was contrived, for as with his tale about the rush to sign blank account forms, Moore's claim that Calabro obtained financial information from the McNair form was impossible; he only filled out the McNair form on December 10, 2008 – two weeks *after* his J.P. Turner margin application and Options documents were prepared, and eight days *after* they were signed. (Calabro Exs. 25, 26)(Tr. 753:21-754:3.)

Further evidence – in particular, Moore's tax returns – also proved implausible his claim that Calabro incorrectly listed his investable assets as approximately $1 million. Moore testified that he funded his account with approximately $200,000. On top of that, his tax returns proved annual income and monetary distributions had flowed to him as owner of Protech between 2006 and 2008 ranging from approximately $529,000 to $622,000 per year. (Calabro Exs. 66, 67, 68)

(Tr. 729:2-730:3.) With annual expenses of approximately $240,000 per year (approximately $20,000 per month as he represented to McNair) (Calabro Ex. 61), Moore generated over $1 million in excess cash for the three years leading up to his J.P. Turner account alone.[5]

In sum, Moore's contemporaneous admissions proved that the financial information set forth in his J.P. Turner account forms was accurate.

v. <u>Moore's willingness to game the system to get ahead</u>

Another reason Moore's testimony should be discounted is his lack of compunction about bending the truth when he sees fit. For instance, Moore once "created a sham company to try to get Phillip Morris" to grant his company, Protech, a lucrative contract. (Tr. 740:10-13.)[6] As Moore explained, Philip Morris wanted to award the contract to a "minority-owned company." Because Protech was not minority-owned, Moore set up a sham company in his ex-wife's name "that held the contracts for Phillip Morris," and "didn't really do anything" except subcontract the work to Protech. (Tr. 739:11-740:3.)

This case presents Moore a similar opportunity since he has a pending FINRA arbitration relating to the Division's charge. Indeed, a finding by this Court that Moore was risk averse and lacked financial wherewithal would inure to his benefit in that it could be influential to a FINRA arbitration Panel. Moore, accordingly, has a strong incentive to bend the truth the way he did with Phillip Morris in the hope it will put him in a better position to recover money. *See Marcic*

[5] Moore suggested that instead of using his accumulated cash, he borrowed money from a credit line. Moore's 2009 Tax Returns make no mention of any investment loan interest associated with the line, but instead only refers to margin interest in his J.P. Turner account. (Calabro Ex. 69 at 78 [stm. 22], 79 [stm. 25].)

[6] Philip Morris maintains and enforces a Supplier Diversity Development Program. The program's mission may be found at http://www.altria.com/en/cms/Responsibility/supplier-responsibility/programs/supplier-diversity-development/default.aspx.

v. Reinauer Transp. Cos., 397 F.3d 120, 124 (2d Cir. 2005) ("A claim for money damages does create a financial incentive to be untruthful"); *In the Matter of Public Finance Consultants, Inc.*, Initial Decision Release No. 274, Administrative Proceeding, File No. 3-11465 (February 25, 2005) (credibility questioned where investors were involved in action against respondent and "stand to benefit financially if this proceeding results in an order requiring the payment of substantial civil penalties, disgorgement, and prejudgment interest to an investor fund").

C. Willhoft Lacked Credibility Because Of His Faded Memory

Willhoft's testimony lacked quality because, as it progressed, his memory failed him on many of the core facts the Division now seeks to hold Calabro culpable. He possessed a clear memory in responding mostly to leading questions on direct. On cross-examination concerning the same facts, however, Willhoft professed a lapse, only then to recall conflicting facts. The preponderance standard was designed to address this very circumstance by ensuring decisions are not based upon "irrelevant, immaterial, unreliable, and nonprobative" evidence. *Steadman,* 450 U.S. at 98. Willhoft's testimony was unreliable, and should therefore be discounted.

i. Willhoft's faded memory regarding his trading experience

Willhoft's memory lapse was no more evident than with his claim that he was unsophisticated and inexperienced. (Tr. 1039:11-14.) Willhoft insisted he possessed no background to choose stocks (Tr. 1039:15-19; 1103:23-1104:1), and he *never* "self-executed" a trade in his separate Ameritrade account. (Tr. 1046:2-7.) Willhoft even went so far as to declare conclusively that "[i]n 2007, 2008, and 2009" he did not "*have any experience in [his] life in personally picking* stocks [to] buy or sell." (Tr. 1133:4-7) (emphasis added).

Cross-examination and documents brought about different memories. Willhoft suddenly *could not recall* whether he previously traded on his own. (Tr. 1192:16-21.) By that point in his

testimony, Willhoft could not even recall when his Ameritrade account opened, much less that it was a margin account. (Tr. 1191:15-25; 1218:22-1219:3.) Then his memory changed again.

When confronted, Willhoft admitted he "direct[ed] what happen[ed]" in his Ameritrade account, though he could not "recall any of the specific transactions." (Tr. 1209:23-1210:6; 1227:11-13; 1352:22-1353:4.) His memory then changed again, and though he previously claimed he had no experience in "picking stocks [to] buy or sell" (Tr. 1133:4-7), Willhoft confirmed *he made* investments in Adelphia (Tr. at 1208:7-14), Biosante Pharmaceuticals (Tr. 1219:15-18) and NYSE Euronext – which he may "have heard about on the radio." (Tr. 1227:14-19.) Willhoft even hinted that he recommended stocks to Calabro, including Oceaneering International (Tr. 1217:12-15) and Geo Group. (Tr. 1353:6-10) (Calabro Ex. 70).

His "self-executed" trading experience did not end there. Willhoft traded "the same stocks in his Ameritrade account as [he did] in [his] J.P. Turner account" as early as 2007. (Tr. at 1222:25-1223:4.) For example, he bought Geo Group, Tetra Tech and Maguire Properties in his Ameritrade account on the same day he bought them in his J.P. Turner account. (Calabro Exs. 70, 71.) He also shadow purchased Oceaneering International in his Ameritrade account on January 8, 2008. (Calabro Exs. 72, 73.) And he purchased NYSE Euronext in his Ameritrade account and then a month later did the same in his J.P. Turner account. (Calabro Exs. 71, 74.)

Even more, Willhoft not only traded, but his trading was *short term*. (Calabro Ex. 74 at 3) (Tr. 1224:18-21; 1226:16-20.) For example, Willhoft purchased 1,200 shares of NYSE Euronext in separate transactions that he held for between 15 and 54 days. (Calabro Ex. 74 at 3.) The Ameritrade account statement Willhoft received for the period stated his trades were "ST," which he agreed denoted "short term" trading. (Tr. 1228:4-5.)

Willhoft's memory concerning his scant investing experience, accordingly, was faulty; he in fact had substantial stock trading experience. But his investment experience was not the only substantive area of testimony in which Willhoft's memory failed him.

ii. <u>Willhoft's faded memory concerning his investment objectives</u>

Willhoft could not recall discussing his objectives with Calabro, and like Moore (and Williams) claimed he signed blank account forms. (Tr. 1060:22-1061:1; 1113:5-13; 1147:23-25; 1176:10-12; 1178:17-20.) Founded on that predicate, Willhoft declared incorrect the objectives in his J.P. Turner forms, and claimed he was a "conservative" investor and not a "risk taker." (Tr. 1065:17-19; 1067:16-18; 1087:3-7; 1188:10-15.) His testimony was untrue.

Separate from the four J.P. Turner account forms he signed and two letters he received (and produced to the SEC Staff) which all reflected higher risk objectives (Calabro Exs. 2, 4, 5, 6, 14, 15), every investment form Willhoft signed *independent of* J.P. Turner confirmed he harbored the same objectives. For instance, on December 7, 2007 – ten months *before* Calabro even mentioned options – Willhoft signed a "Margin/Options Account Upgrade Form" to add margin and options privileges to his Ameritrade account. (Calabro Ex. 20) (Tr. 1240:3-13.) The form requested detailed information "[d]ue to the risks involved in options." Willhoft not only represented his investment knowledge was "extensive," but declared his "Investment Objectives" were "Growth" and "Speculation." (*Id.* at SEC-TDA-000769.)

Willhoft also invested in higher risk oil "programs" since the 1970s. (Tr. 1276:6-11.) To qualify for the investments, Willhoft confirmed they involved "a high degree of risk" with "no assurances" he would "recover [his] investment or receive any return on [his] investment at any time in the future." (Calabro Ex. 78 at 3.) Consistent with his higher risk objectives, he then

invested another $300,000 in at least three more oil programs acknowledging in each its "high degree of risk." (Calabro Exs. 75, 76, 77) (Tr. 1289:19-23.)

Willhoft again confirmed his higher risk objective on January 12, 2009, when he opened an account at Prestige Securities. (Calabro Ex. 80.) As with his J.P. Turner and Ameritrade account forms, Willhoft stated in his Prestige Securities account application that his "Investment Objective" was "Speculation."[7] (*Id.*)

Stated simply, Willhoft's claim that he was a conservative investor to bolster the Division's charge was contrary to his repeated, written admissions in real time. Willhoft was far from a "conservative" investor; he was in fact was a "risk taker."

iii. <u>Willhoft's faded memory regarding his financial information</u>

Willhoft's next claim that the financial information in his J.P. Turner forms was wrong, and that he only made $50,000 to $100,000 annually, was also confused. (Tr. 1079:20-22; 1081:11-1082:4.) During the same period, Willhoft advised Ameritrade in his options application that his annual income was "$100,000+" – the highest choice he could select. (Calabro Ex. 20 at SEC-TDA-000777.) Willhoft represented an even higher income in his triple-net real estate subscription documents, stating he had "individual income in excess of $200,000, or joint income with my spouse, in excess of $300,000" (Calabro Exs. 21, 22), which was one definition of an "Accredited Investor." 17 C.F.R. § 230.506(b)(2). Willhoft confirmed he was an "Accredited Investor" when he invested $360,000 in oil wells. (Calabro Exs. 75-78.)

Willhoft's claim that his net worth was $3 million, not the $8 million Calabro believed sounded "about right" based upon Willhoft's known assets, was also mistaken. (Tr. 1081:11-1-82:4; 4044:10-4045:6.) Indeed, Willhoft's accounts with J.P. Turner, on average, exceeded $1

[7] Each Prestige Account Statement reflected Willhoft's objective of "speculation," although he testified that he did not remember the account. (Calabro Ex. 81.)

million and reached $1.4 million in February 2009. (Calabro Exs. 16, 17.) His Ameritrade account averaged approximately $100,000 (*see* Calabro Ex. 70), and he continued to maintain a Smith Barney account that generated income from which he paid his bills. (Tr. 1047:1-1048:9.) Willhoft also had $360,000 in oil investments (Tr. 1289:19-23), and another $400,000 in his triple net real estate investments. (Calabro Exs 21, 22.) In addition, Willhoft owned 30 acres of land in Desert Hot Springs, 53 acres in Hesperia, and 20 acres in Barstow, the value of which he advised Calabro was $4.5 million to $5 million (Tr. 4045:7-4046:7), and had been "growing" during the real estate market climb. (Tr. 1082:5-20; 1263:9-1264:2.) Add the $2 million value of his home (Tr. 4045:7-4046:7) and the $8 million amount was reasonable.

In the end, Willhoft lamented that the events at issue in this case occurred a "while ago" and that, with many facts, he was unable to "remember that far back." (Tr. 1232:20-1231:2.) His contemporaneous written admissions proved that lament true, that in fact his memory had faded with respect to many of the core facts the Division sought to prove.[8]

D. Williams Lacked Credibility Because His Testimony Was Contrived

Williams' mindset is he is relieved of a duty to ensure the truth when *he feels* it "really [does not] matter." (Tr. 1586:6-17; 1611:16-19.) Given his mindset, Williams claimed (1) he signed blank forms because "Ralph asked me to" (Tr. 1492:24-1493:3; 1498:4-19), (2) information of his financial wherewithal and experience was incorrect, (3) he was not a risky

[8] Willhoft's memory flickered throughout. For instance, he claimed he did not "own a computer" to show he had little capability to conduct his own research or follow his account activity, only to recall he had a computer in his garage office used to bid on cars at auction and on which Calabro showed him "how [he] could look at the J.P. Turner accounts." (Tr. 1046:16-17; 1228:9-1230:17.) At another point he testified that his principal business experience was selling cars and building custom homes, only to remember later that he spent ten years owning and managing a Christmas tree farm. (Tr. at 1035:18-1037:21; 1259:19-1260:8.)

investor, and (4) he was unaware of Calabro's strategy. It was that same mindset which proved his testimony was *poor quality* as it, in large measure, turned out to be untrue.

i. **Williams' assertion concerning blank forms was untrue**

Williams claimed he too signed blank account forms, and that the objectives and financial information on them was incorrect. To be sure, Williams signed many forms including a New Account Form, a Margin Agreement, and an Active Account Suitability Questionnaire ("AASQ"). (Tr. 1441:7-15; 1478:9-15; 1517:19-1518:2-5.) But it was his contrived story concerning the Options Suitability Questionnaire he signed on September 24, 2008 (Calabro Ex. 45) that caused the biggest stir, and undermined his hindsight revision of the truth.

The one-page form included *all* the financial, objective and experience information Williams claimed was wrong. As with others, Williams protested it was "absolutely not" filled out when signed. (Tr. 1497:23-25.) Williams asked rhetorically, "my goodness, how could I have filled that out?" He answered because his wife "would have looked at it," it "would have disturbed her," and thus the "information could not have been there." (Tr. 1503:13-1504:9.)

As it turned out, a *pre-filled and signed* Questionnaire was in his possession all along. Williams produced documents to the SEC Staff and on Thursday, December 9, 2010, provided testimony. He returned home and over the weekend "ran across" the Questionnaire signed on September 24, 2008. (DOE Ex. 48.) The document was not a copy of a blank form; it was a copy of the signed and fully-populated Questionnaire attached to a letter J.P. Turner sent to him on October 6, 2008 requesting he "review" for "accuracy" and "notify" it of any change. (*Id.*)

Williams mailed the document to the SEC Staff the next Monday, December 13, 2010. Contrary to his testimony *two years later* in which he declared the Questionnaire had "absolutely not" been filled out (Tr. 1497:23-25), Williams represented in a handwritten cover letter that it

had been "*'pre' filled out* and then mailed for my signature." (DOE Ex. 43) (emphasis added). Williams confirmed he signed the pre-filled Questionnaire, and although he was "aghast," he clarified that he was "not surprised, that [he] signed it." (*Id.*) In short, Williams' testimony that he signed blank forms was unreliable because he stated the contrary two years earlier to the SEC Staff, in writing, and with respect to a crucial form containing all the information of which he, in hindsight, claimed never to have seen and alleged at trial was inaccurate.[9]

ii. The forms Williams signed were accurate

The blank forms claim also lacks credibility because they contained information that was accurate. Calabro obtained the information from someone, and the most reliable, as Williams confirmed, was that Calabro called him for information "to put on the form." (Tr. 1415:18-1416:4.) Williams thus flunked his attempt to paint Calabro as an underhanded broker who "never asked" about, and "never discussed" his objectives and other information. (Tr. 1431:3-4; 1431:11-24; 1443:25-1444:6.) Indeed, when simple logic is considered, it makes no sense for Calabro to have sent blank forms for Williams' signature in an effort to hide information, only then to fill in the accurate information he learned earlier.[10]

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[9] The letter is unique in its layers of mistruth. Williams stated he signed the Questionnaire it because "[w]hen someone you trust asks you to sign a document supposedly for 'your' benefit, it is very difficult to tell them you are being hustled." (DOE Ex. 48.) Thus, Williams inferred he knew the form he sent to J.P. Turner was false, but he signed it nonetheless as part of a Calabro "hustle" he felt powerless to stop. But even that was false because Williams later confirmed that had he "felt Mr. Calabro was doing something wrong in [his] account" or that he "did not want a particular trade or a particular thing to happen in the account," he "felt comfortable" objecting and he "believed based upon [his] relationship" that Calabro "would have followed [his] objection." (Tr. 1632:15-1633:10.)

[10] Calabro "ma[de] sure" a "new customer sees everything and doesn't feel that – you know you're an untrustworthy person." Calabro reasoned that if he hid it, "not only could you lose the referral, you could lose the client that gives you the referral." (Tr. 4065:1-4066:2.)

a. Calabro accurately recorded Williams' income

Williams' hindsight assertion that his J.P. Turner forms should not have reflected annual income exceeding $100,000 was contrary to the documents he signed in real time. (Tr. at 1438:3-20; 1480:16-24; 1494:1-21.) For instance, when Williams opened an account with Newbridge Securities on April 14, 2009, the account application requested his "Annual Income" and provided different ranges from which he could choose. (Calabro Ex. 54.) Rather, than marking "$50,001-$100,000," which Williams testified included his "actual" annual income, or even marking the next higher range of "$100,001 to $200,000," he marked "Over $200,001." (*Id.* at 2.) And that is where his representation to Newbridge remained, even when Williams questioned other account information years later. (DOE Ex. 216.)[11]

Williams' 2009 tax returns confirmed his annual income exceeded $100,000. (Calabro Ex. 82) (Tr. 1438:3-20; 1587:15-17.) Williams and his wife received $78,094 from pensions and $18,864 from social security, as well as interest of $1,498 and dividends of $2,088. (Calabro Ex. 82.) He also received income distributions from oil investments of $11,094, $10,142, $3,696, for a gross income of $125,476. The key to that amount, however, was that Williams "always keep[s] it" (Tr. 1591:23-25); because of the tax shelter nature of his oil investments, Williams paid no tax on any of his income. (*See* Tr. 1591:12-13.)

b. Williams' net and liquid net worth was correct

Williams next testified that his J.P. Turner forms incorrectly reflected his net worth as $3,000,000 ($4,000,000 in the AASQ) and liquid net worth as $2,000,000 ($3,000,000 in the

[11] Williams responded to an inquiry from Newbridge requesting he review his account information and notify it of any changes. When asked the reason he alerted Newbridge that he was not interested in speculation, but left untouched his annual income of "Over 200,001," Williams stated that "it wouldn't have made any difference. " (Tr. 1558:6-10.)

AASQ). (Tr. 1439:2-22; 1440:3-8; 1480:25-1481:16; 1494:1-21.) As with his annual income, however, Williams' testimony is contrary to the contemporaneous documents he signed.

When Williams applied for his Newbridge account, he represented his "Net Worth (excluding residence)" was "$4 MILL+" and he was correct. (Calabro Ex. 54) (Tr. 1559:1-1561:20.) Indeed, by March 2009, the value of his J.P. Turner account was $2,506,984.80, having increased $700,000 in three months. (Calabro Ex. 53 at JPTURNER-SEC-ATL003019) (Tr. 1603:10-1604:5; 1605:9-25.) Williams also owned $300,000 in oil well investments (Tr. 1597:23; 1600:13-25), and a $60,000 investment in HHW Technologies (Tr. 1596:14-25) (Calabro Ex. 82 at Schedule E). These documented amounts do not include Williams' two bank accounts (as reflected in his 2009 tax returns) (Calabro Ex. 82 at Schedule B), the net value of his home, or any other assets he may have accumulated.

c. Calabro accurately recorded Williams' experience

Williams next claimed his J.P. Turner forms misstated his investment experience, but there too the documentary evidence proved the contrary. Williams protested that the "25+" years of experience reflected on the AASQ (DOE Ex. 45) and the "30" years of investing in the Options forms were "untrue." (Tr. 1482:13-25; 1499:3-12.) But he represented the same to Newbridge, when in the form *he prepared and signed* only one month after the AASQ, he confirmed his "Investment Experience" for "Bonds" and "Stocks" was "(yrs. 30+)," for Mutual Funds "(yrs. 30)," and his "Investment Knowledge" was "Excellent." (Calabro Ex. 54.)[12]

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[12] Regarding his experience, Williams declared the $400,000 average trade size in the AASQ (DOE Ex. 45) "absolutely grossly untrue" and "not in my dreams." (Tr. at 1483:11-21.) He also claimed the "450k" "Average size of transaction" in the Options form was "untrue" and "not on [is] life." (Calabro Ex. 45) (Tr. 1499:18-1500:3.) When confronted with his "quick analysis of [his] account" (Calabro Ex. 47) reflecting his knowledge of trades in excess of $800,000 and $1 million, however, he pivoted and confirmed there were "absolutely" trades exceeding of $450,000 "throughout the year." (Tr. 1556:2-25.)

d. Calabro accurately recorded Williams' investment objectives

Williams also proclaimed references to "speculation," "trading profits," "growth" or "short term trading" were "absolutely" false. (Tr. 1442:21-1443:2; 1481:17-1482:5.) He instead repeated his mantra that "I have never been a speculative" or "risky investor," and although he never told Calabro (Tr. at 1436:7-17), he insisted he was "conservative or moderate" and only wanted to protect the money he "currently had and to make a fair return." (Tr. 1430:21-1431:2; 1431:11-24; 1432:2-4; 1432:23-25; 1443:25-1444:6; 1444:19-23; 1481:17-1482:5.) Here too, Williams' testimony lacked credibility based upon the actual trading and volatility in his account of which he was aware, as well as the incontestable documentary evidence.

Indeed, once faced with his own contemporaneous documents, Williams conceded to having known his account was actively traded, and he "wasn't against it, by any means." (Tr. 1534:5-23.) Williams was well-aware of his account's short term nature since he spoke to Calabro two to three times a week to discuss trades, and reviewed each trade confirmation reflecting each trade along with the commissions charged. (Tr. 1449:2-16; 1451:19-1452:10; 1545:16-1546:4.) As Williams made clear, he discussed "shorting stocks quite often" with Calabro and knew he "was doing it on a fairly regular basis." (Tr. 1470:19-26.)

Williams also knew his account was volatile and the trading speculative. He knew by December 1, 2008 his account was up $700,000 – a 100% gain in one year. (Tr. 1547:19-1548:1.) In December 2008 the account added another $90,000, in January 2009 another $250,000, and in February 2009 another $350,000. (Calabro Ex. 53) (Tr. 1603:10-1604:5; 1605:9-22.) And even that volatility was not enough; Williams lamented not having made even more profit from "short" trading given the market was down by a larger percentage than the profit in his account. Having known he was engaged in shorter term trading, and having

experienced rapid and outsized profit, Williams' hindsight claim to have only wanted conservative to moderate investments to obtain a "fair return" is implausible.

Investments independent of J.P. Turner corroborate that Williams harbored a higher risk objective. In his Newbridge account, his "Investment Objective" was "Speculation" and "Risk Tolerance" was "Aggressive." (Calabro Ex. 54.) The form even defined "Speculation" as seeking "[m]aximum total return involving a higher degree of risk through investment in a broad spectrum of securities." (*Id.*) And he was reminded every month that "Speculation" was his objective on the first page of each monthly statement. (Calabro Ex 56) (Tr. 1550:2-7.)

Williams also invested in the same unregistered oil investments as Willhoft. (Calabro Ex. 82 at Schedule C.) Although Williams failed to produce the subscription agreements he signed, Willhoft did, and the agreements disclosed the investments' "high degree of risk." (Calabro Exs. 75-78.) Williams' suggestion that he was a conservative to moderate investor falls short for this separate reason.

iii. <u>Williams was well aware of Calabro's strategy</u>

Williams' claim that there had been no "strategy, per se" until 2009 was also untrue. (Tr. 1426:20-24.) Although his first transactions in 2007 were "long," Williams knew Calabro had concluded the market would turn down. Williams also believed "the economy was going to fall" based on "reading newspapers, looking at the television, things of that nature." (Tr. 1535:12-19.)

Calabro explained his "short" strategy in late 2007. As a result, Williams "understood the basic concept" that "you could sell the stock now and buy it back at a reduced price." (Tr. 1426:13-19; 1428:20-1429:1.) By February 2008, his account was profitable, but held unprofitable open positions which *Williams was able to explain to Calabro.* (Calabro Ex. 47.) In confirming his understanding, Williams' wrote that he hoped that the "'short' gods will turn in

our favor in the not too distant future." (*Id.*) And when Williams was asked whether he "understood [he was] short in the account and [he] wanted the stock market to go down," he hesitated to have empathy for the millions who lost money, and then said "I didn't want it to go down, but that's where we thought it was going to go, down." (Tr. 1614:9-13.) That was the reason he hoped for the "short gods to smile" on him, which they did. (Tr. 1614:14-23.)

E. Each Customer Witness Lacked Credibility Because They Were Led

The sheer inconsistency between the story each Customer told on direct and the facts set forth in documents and further revealed on cross-examination may be explained by the leading questions the Division offered. Objections were made and sustained as to some, but the fact that leading questions appeared to be required to enable the witnesses to tell the "right" story – as opposed to the true story – only confirmed the poor credibility of each. For it is well-recognized that "[t]he evil of leading a friendly witness is that the information may supply a false memory." *United States v. Hansen*, 434 F.3d 92, 105 (1st Cir. 2006); *see* C. Wright & A. Miller, 28 FED. PRAC. & PROC. EVID. § 6168 ("The rationale behind the rule prohibiting the use of leading questions on direct examination is that the leading question may 'induce a false memory in the witness of facts the witness did not perceive.'").

II. CALABRO DID NOT ENGAGE IN EXCESSIVE TRADING

A. Whether Trading Is Excessive Depends On The Circumstances

"The essence of a churning claim is not a particular transaction, it is the aggregation of transactions, allegedly excessive in number, judged *in relation to the plaintiff's investment objectives and the market conditions at that time*." *Baselski v. Paine Webber Jackson & Curtis Inc.*, 514 F. Supp. 535, 541 (N.D. Ill. 1981) (emphasis added); *see Gopez v. Shin*, 736 F. Supp. 51, 58 (D. Del. 1990). Trading in an account with stated objectives of speculation and trading is, therefore, expected to be more frequent than an account with a conservative objective, such as

preserving principal or seeking fixed income. *See Costello v. Oppenheimer & Co., Inc.*, 711 F.2d 1361, 1369 (7th Cir. 1983) (where "the goals of an investor are aggressive or speculative, as opposed to conservative and circumspect, it is easier to conclude that a given course of trading has not been excessive").[13] It is for this very reason the SEC recognizes that an "assessment of the level of trading . . . does not rest on any 'magical per annum percentage,' however calculated." *In re Matter of Gerald E. Donnelly*, Exchange Act Rel. No. 39990 (Jan. 5, 1996); *see* Calabro Ex. 82 at 449 ("Excessive trading 'cannot be and need not be, established by any one precise rule or formula'") (quoting *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 435 (N.D. Cal. 1968), *aff'd.* 430 F.2d 1202 (9th Cir. 1970)).

When Calabro determined in late 2007 that the market was poised to trend down, he recommended Willhoft and Williams (and later Moore) engage in "short" transactions to take advantage of the market decline, which he later supported with options. In a "short" transaction, the investor "borrows" shares and then sells them to the market for the then stated market price in the hope the price declines and the shares can be repurchased for less. (Tr. 3246:10-19) The "short" sale is the "opening transaction," and the later purchase is the "closing transaction." (Tr. 3248:17-23.) Should the price fall in the interim, the investor profits from the difference, but if the price increases, the investor must repurchase shares at the higher price to return them to the lender with the investor taking a loss in the amount of the difference. (Tr. 3251:21-3252:2.)

Unlike owning stock (where the most an investor can lose is its full value), an investor who sells short owns nothing and takes monetary risk potentially exceeding the full value of his entire account because the price could to rise to a level where the assets in the account are

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[13] *See Follansbee v. Davis, Skaggs & Co., Inc.*, 681 F.2d 673, 676 (9th Cir. 1982) ("a trader looking for quick, short-term gains, and taking short-term gains and losses requires frequent trading"); *Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1070 (2d Cir. 1977) ("a greater volume of activity will normally be expected" in a speculation account).

insufficient to repurchase the stock. For this reason, and as the Division's expert confirmed, "[a] short investment is typically a shorter term investment." (Tr. 3244:23-3245:2.) Because they expire, options too "are meant to be short-term investments." (Tr. 3244:10-22.)

In an attempt to show the trading in the Customers' accounts was excessive, the Division offered Louis J. Dempsey, who had never been qualified as a churning expert and based his opinions on a review of "the Division's technical analysis relating to alleged churning." (Tr. 3140:18-21) (DOE Ex. 155 at 2.) The analysis Dempsey verified were calculations of the rate of which each account turned over during the purported "churn period" (the "turnover rate"), as well as the percentage profit each account was required to generate to cover its costs (the "cost/equity ratio"). (DOE Ex. 155 at 2.)

Dempsey's opinions were unreliable because they were based on a faulty methodology combined with an incorrect factual predicate. *See* SEC Rule 320 (irrelevant evidence "shall" be disregarded); *see also Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 589 (1993) (expert testimony must be "not only relevant, but reliable"). Dempsey failed to take into account (much less mention in his report) the "anomaly" of market forces on a "short account," which inflated turnover and cost/equity particularly where, as here, the account values declined rapidly. (Tr. 3253:17-22; 3255:5-8.) Dempsey also failed to account for the fact that the Customers each designated their accounts to engage in higher risk, shorter term investing, where he confirmed "there is no stated theoretical line" (Tr. 3274:18-22), and not the "conservative" objective he presumed. (DOE Ex. 155 at 2, 5.) As such, Dempsey's testimony and opinions were "unreliable" and should not factor into this Court's decision concerning whether the Division met its evidentiary burden. *Steadman*, 450 U.S. at 98.

B. The Division's Calculations Were Unreliable

i. Dempsey failed to consider the "short" nature of each account in calculating turnover

Turnover is the theoretical number of times entire account equity is used in purchase transactions for a given period. Thus, where there is a purchase of stock using the entire account equity (say $100), and the value remains the same throughout the period ($100), the turnover rate is 1: $1 = \frac{\$100\ purchase}{\$100\ average\ equity}$ (Tr. 3250:16-21) (Calabro Demo Ex. 3.) Because equity fluctuates, a change in average equity skews turnover without there being an additional transaction. (Tr. 3251:14-17.) Thus, if the price of the stock goes down to $50 and the average equity value for the period is thus $75, the turnover goes up to 1.33 due simply to the price movement of the stock: $1.33 = \frac{\$100\ purchase}{\$75\ average\ equity}$ (Tr. 3250:22-3251:13) (Calabro Demo Ex. 3.)

The anomaly is magnified (even assuming the same price movement) where the transactions in the account are predominantly "short" sales because *both* the purchase price *and* the average equity fluctuate.[14] For instance, where there is a short sale of stock (for say $100) and the value remains the same throughout the period after which the stock is repurchased (for $100), the turnover rate is 1. But if the price of the stock goes up $50 (to $150), the account equity drops by an equal amount to $50 because $50 in additional equity will be necessary to repurchase the stock (known as "mark to market"). Thus, with the same price movement as in the previous "long" example, the turnover balloons to 2 simply because the transaction was "short": $2 = \frac{\$150\ purchase}{\$75\ average\ equity}$ (Tr. 3252:3-3253:11) (Calabro Demo Ex. 3.) As Dempsey conceded, "it would modify turnover," and have a "really big impact" during "a very large spike

[14] By the same token because the turnover formula relies upon *purchases*, an account could have unlimited short sale transactions (and incur huge commission costs) and maintain a turnover of zero simply because the investor fails to close any with a purchase.

in the marketplace upward" – precisely what happened during the alleged "churn" period in this case. (Tr. 3042:9-11; 3253:12-16; 3256:22-25.)

Dempsey did nothing to account for the anomaly, and its impact became apparent when an "apples to apples" calculation of "opening transactions" divided by average equity was conducted, which he stated "you could" do. (Tr. 3255:9-21.) Accounting for the short nature of Williams' account results in a reduction in turnover from 8 to 6.6: $6.6 = \frac{\$8{,}588{,}124\ short}{\$1{,}299{,}800\ average\ equity}$ (Tr. 3274:23-3275:8) (DOE Ex. 155 at 17.) The same apples to apples calculation results in reduced turnover in Willhoft's '805 account from 9 to 6.9, in his '247 account from 10 to 8.2, and in Moore's from 11 to 8.6. (DOE Ex. 155 at 9, 12, 14.)

But his failure to consider the short nature of the accounts was not the only reason Dempsey's calculations were unreliable.

ii. <u>Dempsey failed to account for the rapid decline in each account</u>

Both turnover and cost/equity are driven by average equity for the given period. Thus, as demonstrated above, a drop in equity impacts turnover without any additional transactions. The same is true with cost/equity. For example, if the commissions on \$100 in purchases was \$10, and the value of the shares remained the same, the cost/equity is 10%: $.1 = \frac{\$10\ cost}{\$100\ average\ equity}$. But should average equity decline to \$50, the cost/equity doubles to 20% without any further transactions occurring or costs incurred in the account: $.2 = \frac{\$10\ cost}{\$50\ average\ equity}$. Thus, Dempsey made it clear that an "account that declines rapidly can also have an impact on the return on equity calculations" (Tr. 3278:21-3279:1); Michael Bresner ("Bresner"), J.P. Turner's Executive Vice President, testified it would cause it to "go up dramatically" (Tr. 3041:12-17); and Michael Issacs, J.P. Turner's compliance chief during the period, confirmed. (Tr. 2635:2-7.)

Accounting for the rapid decline in the Customers' account equity shows the magnitude with which volatile market forces distorted Dempsey's cost/equity calculation. For example, assuming the transaction costs remained the same in Williams' account, but it suffered no decline from its starting value, the cost/equity goes from 22.9% to 18.7% (Tr. 3281:8-3283:3): $18.7\% = \frac{\$296{,}713}{\$1{,}875{,}661 - \$296{,}713}$ (DOE Ex. 155 at 17.)[15] The same calculation results in a reduced cost/equity in Willhoft's '805 account from 29.3% to 21.8%, and in Moore's account from $29.3% to 13.6%. (DOE Ex. 155 at 9, 14.)[16] Dempsey again made no adjustment.

Regarding turnover, the House Committee on Interstate and Foreign Commerce recognized that "if values of portfolio securities change significantly, the [turnover] formula will not accurately reflect the ratio of the amount of purchases to the amount of total capital available for investment" (Calabro Ex. 82 at 452), which is also clear in this case. For example, assuming the value of opening transactions in Williams' suffered no decline from its starting value other than the cost of the trades, the turnover drops from 8 to 5.4: $5.4 = \frac{\$8{,}588{,}124}{\$1{,}875{,}661 - \$296{,}713}$ or $turnover = \frac{total\ opening\ sales}{beginning\ equity - commissions}$. The same calculation results in reduced turnover in Willhoft's '805 account from 9 to 5.2, in his '247 account from 10 to 8.4, and in Moore's account from 11 to 4. (DOE Ex. 155 at 9, 12, and14.) Again, Dempsey made no adjustment to account for the equity value decline.

In short, Dempsey concluded that turnover and cost/equity *under ordinary circumstances* are "inherently" "not precise." (Tr. 3283:19-24.) The Customer accounts here were out of the ordinary in that they combined the distorting anomaly inherent in "short" accounts with an

[15] The formula is $cost/equity = \frac{transaction\ costs}{starting\ equity - transaction\ costs}$ (Tr. 3281:8-3283:3.)

[16] Because most of Moore's deposits were during the alleged "churn" period, the calculation is based on the opening equity plus the additional deposits. The same calculation left the cost to equity ratio in Willhoft's '247 account virtually unchanged.

additional distorting anomaly inherent in rapidly declining accounts. Dempsey made no adjustment to account for them and, as demonstrated above, the results were material. His opinions are unreliable in the first instance given his failure to do so.

C. The Customers' Investment Objectives

Dempsey's opinions suffer from a second major shortcoming: He assumed that Moore, Willhoft and Williams each "had conservative investment objectives and low to moderate risk tolerance." (DOE Ex. 155 at 2.) Dempsey's assumption was wrong.

i. Moore

Moore's testimony that he was, in hindsight, a conservative investor lacked credibility not only because he contradicted himself, but because documents independent of J.P. Turner proved his objective was to incur higher risk in an attempt to maximize gains. But in this case there was much more to prove his true investment objectives.

Moore made his objectives clear to J.P. Turner and Calabro in writing. He signed *two* New Account Forms in December 2008 stating his objectives were "Speculation," "Trading Profits" and "Capital Appreciation," and his risk tolerance was "Aggressive." (Calabro Exs. 23, 37.) Moore confirmed his objectives in an Options Trading Agreement he also signed in December 2008, in which he acknowledged that options trading involves "a high degree of risk" and that "due to the short term nature of options it is likely" he "may be trading such options to a greater degree than with stocks and/or bonds." (Calabro Ex. 26.) The Options Trading Agreement attached a single-page Options Suitability Questionnaire that Moore signed, and confirmed as "correct" that his investment objectives were "speculation" and "growth." (*Id.*)

Moore never changed his investment objectives even when prompted. Each time he submitted an account form, J.P. Turner sent him a written confirmation of his investment

objectives, with a request that he review and correct any inaccuracies. For instance, Moore's investment objectives of "Speculation," "Trading Profits" and "Capital Appreciation" stated in his IRA New Account Form were confirmed in a letter that was stamped received and later produced to the SEC staff by Moore. (Calabro Ex. 28.) The confirmation Moore received included an "Investment Objectives Key" that defined and described speculation and capital appreciation as "high risk," and other objectives with lower risks, to enable him to "review" and "correct" any "incorrect information." (*Id.*) Moore never responded.

A similar confirmation sent regarding an update in Moore's direct account, which he also received and produced to the SEC staff, also reflected "Speculation," "Trading Profits" and "Capital Appreciation" as his investment objectives, and also included "Investment Objective Definitions." (Calabro Ex. 65.) The definitions defined "Speculation" as "seeking a significant increase in principal value of your investments and are willing to accept a corresponding greater degree of risk" and including "options" and "short term or day trading strategies"; they defined "Trading Profits" as seeking "to take advantage of short-term trading" and including "short-term purchases and sales of volatile or low-priced common stocks" and "put or call options," which is a "high-risk strategy"; and they defined "Capital Appreciation" as seeking "to grow the principal value" of "investments over time and are willing to invest in securities that have historically demonstrated a moderate to above average degree of risk." (*Id.*) Moore again never responded.

Thus, separate from his massive day trading at Fidelity described above, Moore's actions and written representations in multiple J.P. Turner account forms confirmed his objective was to engage in higher risk investing.

ii. Willhoft

Willhoft proved that he harbored a higher risk investment objective in his own words separate from his J.P. Turner account – he declared higher risk objectives in forms he signed for Ameritrade and Prestige, and in connection with numerous private real estate and oil investments he made during the same general period. Willhoft's actions separate from J.P. Turner also proved his higher risk objectives, as he engaged in short term and shadow trading in his Ameritrade account. The story of his J.P. Turner accounts only confirmed his objectives.

Willhoft opened two accounts with J.P. Turner in 2006. In both, Willhoft declared that his investment objectives were "Speculation," "Trading Profits," and "Capital Appreciation," which as with Moore, J.P. Turner confirmed in letters Willhoft received and later produced to the SEC Staff. (Calabro Exs. 42, 14, 15.) Unlike Moore, Willhoft was diligent in ensuring his account information was correct as he clarified his name in 2006, but left untouched the investment objectives he chose when he opened the accounts. (Calabro Exs. 14, 15.)

In early 2007, Willhoft decided to open the '247 account and to fund it with money, half of which was to generate income, and the remainder was to be used for more speculative trading. Thus, Calabro prepopulated a New Account Form reflecting Willhoft's objectives by designating "Capital Appreciation," "Trading Profits" and "Income" with a "Moderate" risk tolerance. (Calabro Ex. 1.) Willhoft signed the form on February 5, 2007, but waited until June to fund.

Calabro searched for appropriate investments to fill the income component. Calabro turned the task over to J.P. Turner advisors with more expertise, but they proposed a plan that dissatisfied Willhoft. (Tr. 4027:5-4029:16.) Accordingly, Calabro proposed two private real estate investments intended to generate income, into which Willhoft invested $400,000.

(Calabro Exs. 21, 22.) Willhoft funded the real estate investments with a direct payment to the investment partnership, and thus the $400,000 was never deposited into the '247 account. (*Id.*)

As the remainder of account was to be more speculative, Willhoft signed a one-page update form on April 20, 2007 in which he declared "Speculation," "Trading Profits" and "Capital Appreciation" the objectives for the remaining account with an "Aggressive" risk tolerance. (Calabro Ex. 9.) Willhoft chose not to fund the account until June 8, 2007, when he deposited approximately $371,000, and then further proved his higher risk objective by investing the entire account in four concentrated, higher risk stocks, two of which he *recommended to Calabro*. (Calabro Ex. 71 at 5.) (Tr. 1217:12-15; Tr. 1353:6-10.)

In January 2008, Willhoft decided to transfer his prior two accounts – both marked "Speculation," "Trading Profits" and "Capital Appreciation" (Calabro Exs. 14, 15, 42) – into a trust account. (*See* Calabro Ex. 11.) Willhoft opened the '805 account on January 6, 2008 and signed a New Account Form confirming his objectives remained "Speculation," "Trading Profits" and "Capital Appreciation" with an "Aggressive" risk tolerance. (Calabro Ex. 2)

Willhoft again confirmed his objectives in two Options forms he signed in September 2008 in which acknowledged the "high degree of risk" and "short term nature of options" and reiterated his "speculation" and "growth" objectives. (Calabro Exs. 4, 5.) He also signed an AASQ on March 9, 2009, which like the two options forms he signed five months earlier, contained all of Willhoft's account information on a single page (requiring him simply to look up to know what he was signing).[17] (Calabro Ex. 6.) The AASQ reiterated his investment objectives of "Growth," "Trading Profits," "Speculation" and "Short-Term Trading." (*Id.*)

[17] As trustee of the '247 and '805 accounts, Willhoft was authorized to sign account-related documents including the AASQ and Supplement. (Tr. 1612:13-18.)

Willhoft also signed a single page Supplement to the AASQ containing information about "**What You Should Know About Active Trading**" and imploring him to "*PLEASE READ CAREFULLY.*" (*Id.*) The Supplement reiterated Willhoft's interest in higher risk investing by making it clear in its introduction that "[a]ctive trading can involve a higher degree of risk, increased costs and is suitable only for risk tolerant investors." (*Id.*) The Supplement provided additional detail, stating, among other things, that (1) active trading "should be entered into only by investors who understand the nature of the risk involved and are financially capable to sustain a loss of part or all of their capital," (2) "[d]ue to the higher degree of activity, overall commissions on your account may tend to be greater than a buy and hold strategy," (3) "[y]our portfolio value may tend to be more volatile with shorter-term trading," and (4) "[h]igh-risk tolerance and investment objectives consistent with high-risk investing are appropriate to an active account." (*Id.*) In signing the Supplement, Willhoft acknowledged that "**I have read and understand the Active Account Suitability Supplement Agreement as required.**" (*Id.*)

In short, the overwhelming evidence – most of which contained his signature – proved Willhoft too maintained an interest and objective to engage in higher risk trading.

iii. Williams

Williams met Calabro through Willhoft who, after more than a year of higher risk investing, recommended Calabro. (Tr. 1415:1416:4.) Williams signed a New Account Form for his '982 account and a second New Account Form for an IRA account on October 26, 2007, stating in both that his investment objectives were "Speculation," "Trading Profits" and "Capital Appreciation" and his risk tolerance was "Aggressive." (Calabro Exs. 43, 57.) Williams confirmed his objectives in Options forms he on September 24, 2008, in which he acknowledged that options trading involves "a high degree of risk" and that "due to the short term nature of

options it is likely" he "may be trading such options to a greater degree than with stocks and/or bonds." (Calabro Ex. 45.) Williams also signed the attached Options Suitability Questionnaire, and confirmed as "correct" that his investment objectives were "speculation" and "growth." (*Id.*) And on March 9, 2009, Williams signed an AASQ and related Supplement in which he reiterated his interest in higher risk investing and objectives of "Growth," "Trading Profits," "Speculation" and "Short-Term Trading." (DOE Ex. 6.)

In sum, the Division failed in its burden to prove excessive trading in light of each Customer's investment objectives. Dempsey's calculations were faulty, and their factual predicate – that the Customers each had a "conservative" investment objective – was false. For this reason alone, the Court should find Calabro not culpable of the charges in the OIP.

III. MR. CALABRO DID NOT EXERCISE *DE FACTO* CONTROL

A. The *De Facto* Control Standard

"Control of trading is an essential element of churning." Carras v. Burns, 516 F.2d 251, 258 (4th Cir. 1975). The Division asserted that Calabro exercised "*de facto*" control claiming that Moore, Willhoft, and Williams were each unsophisticated and "relied almost exclusively" on Calabro "to make investment decisions in their accounts." (OIP¶ 13). That is not the test for *de facto* control.

The "touchstone" of *de facto* control is "whether or not the customer has sufficient intelligence and understanding to evaluate the broker's recommendations and to reject one when he thinks it unsuitable." *Follansbee*, 681 F.2d at 677. "As long as the customer has the capacity to exercise the final right to say 'yes' or 'no', the customer controls the account." *Id.*; *see Moran v. Kidder Peabody & Co.*, 609 F. Supp. 661, 666 (S.D.N.Y. 1985) ("Where a customer has the independent capacity to accept or reject his broker's recommendations, he cannot accuse his

broker of having control of his account even if he habitually follows his broker's recommendations."). In this case, it is undisputed that Calabro made the majority of trade recommendations to be sure; but the overwhelming evidence proves Williams, Willhoft and Moore each had the financial acumen and intellectual capacity to understand Calabro's recommendations and reject one he thought unsuitable.

B. **Calabro Did Not Control Williams' Account**

There can be no debate that Williams had the capacity to, and felt comfortable, rejecting a trade recommendation he felt was unsuitable. Williams summed it up best at trial:

> Q. And you felt at any time that you did not want a particular trade or a particular thing to happen in your account, you felt comfortable saying no? You may not have, but you felt comfortable saying it?
>
> A. If I had a reason to say it, I would have said it, yes.
>
> Q. And you believe based upon your relationship with Mr. Calabro, he would have followed your objection, correct?
>
> A. I think he would have, yes. (Tr. 1632:25-1633:10.)

But the evidence is even stronger than his admission; Williams had more than "sufficient intelligence and understanding to evaluate [Calabro's] recommendations and to reject one when he thinks it unsuitable." *Follansbee*, 681 F.2d at 677. By the time he met Calabro, he had a master's degree in business and had been a professor at California Polytechnic University for 30 years where he taught quantitative analysis. (Tr. 1398:10-1400:8.) Williams also had more than 30 years investment experience, as he confirmed both to J.P. Turner and Newbridge, including in the options form he found and sent to the SEC Staff. (Calabro Ex. 54, DOE Exs. 10, 48.)

The evidence that Williams maintained control was even stronger still. In February 2008, shortly after Calabro predicted the market turn and recommended his customers invest "short," Williams did a "quick analysis" of his account in which he calculated gains and losses, the tax

impact of net gains, dividends received, commissions paid, and determined the remaining holdings together with unrealized gains and losses. (Calabro Exs. 47, 48.) Fully understanding his account was invested "short," Williams commented to Calabro that "Hopefully, the 'short' gods will turn in our favor in the not too distant future." (*Id.*) Ultimately, Williams showed his capacity by not only analyzing his account, but doing the same for Willhoft. (Calabro Ex. 49.)

In short, Williams was exponentially more capable than the customer held to have retained control in *Follansbee* – a customer with a degree in economics, a course in accounting, and an investor who read and understood corporate financial reports. 681 F.2d at 677; *see also Norniella v. Kidder Peabodv & Co., Inc.*, 752 F. Supp. 624, 629 (S.D.N.Y. 1990) (investors maintained control over account where they monitored and raised questions about the accounts with stockbroker); *Xaphes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 632 F. Supp. 471, 483 (D. Maine 1986) (a "well-educated, sophisticated investor" who "monitored his account constantly and in great detail, checking confirmation slips as they were sent to him, checking the monthly statements, and making notes about the account for himself and his accountants" had "sufficient financial acumen to determine his own best interests").

C. <u>Calabro Did Not Control Willhoft's Account</u>

As an educated and shrewd businessman with broad investments, Willhoft too had "the independent capacity to accept or reject his broker's recommendations." *Moran*, 609 F. Supp. at 666. Willhoft graduated California Polytechnic University with a business degree in marketing and sales. (Tr. 1033:171034:1.) He had been in the automobile business for years (during which he purchased and sold 12 to 15 monthly) by the time he opened his J.P. Turner accounts, and also served as a contractor and builder of custom homes on "speculation," which he sold at a profit. (Tr. 1035:18-1036:1; 1256:7-9; 1258:9-18.) For ten years, Willhoft also owned and

managed a Christmas tree farm, after which he subdivided it and built the homes he sold for $2 million. (Tr. 1259:19-1260:8.) And he purchased and maintained for investment extensive real estate in Desert Hot Springs, Hesperia, and Barstow, California. (Tr. 1263:9-1264:2.)

Similar to Williams, the documents confirmed Willhoft's acumen and capacity to evaluate investment recommendations. Willhoft represented in account forms relating to his J.P. Turner accounts that he had "30+" years of investment experience. (Calabro Ex. 4, 5, 6.) And although the most experience he could indicate on his Ameritrade "Margin/Options Account Upgrade Form" was "10+" – which Willhoft marked – he made it clear that his "Investment Knowledge" was "Extensive." (Calabro Ex. 20.) Willhoft initiated stock purchases that were his own ideas in his Ameritrade account such as Geo Group and Oceaneering International and engaged in self-directed shadow trades of the stocks he purchased in his J.P. Turner account.

Willhoft further admitted his capacity to evaluate and make investment decisions in connection with his oil exploration and commercial real estate investments. With regard to each oil investment, Willhoft represented that "I have knowledge and experience in financial and business matters and am capable of evaluating the merits and risks of an investment in the Program, and am able to bear the economic risks of my purchase . . . ." (Calabro Exs. 77, 78 79, 80 at 4¶O .) And with regard to each real estate private placement, Willhoft "represent[ed] and warrant[ed]" that he had "the capacity to evaluate the risks of the prospective investment in the Investor Units and that such investment is not disproportionate to my income or available liquid funds and that I further have the capacity to protect my interests in connection with the purchase of the Investor Units." (Calabro Exs. 21, 22.) When asked to describe his "experience in financial and business matters," Willhoft responded: "I have previous stock market experience. I have previous real estate experience." (Calabro Ex. 21.)

In sum, Willhoft also had the intelligence and experience to understand, and then accept or reject Calabro's recommendations in his J.P. Turner accounts, and thus maintained control. *See M & B Contracting Corp. v. Dale*, 795 F.2d 531, 534 (6th Cir. 1986) (it was "clear" that customer's management "maintained control over this account" where one was a "sophisticated businessman and a CPA," and the other was "a tremendously successful builder, graduating, as he said, from the 'school of hard knocks'").

D. <u>Calabro Did Not Control Moore's Account</u>

While Moore did not possess the advanced education of Williams or Willhoft, he spent 20 years building an industrial fabrication business that generated millions in revenue, had over 100 employees, and entered into major service and supply contracts. (Tr. 614:12-24.) In business, Moore was far from a neophyte; he understood business, and had the creativity and independent fortitude to ensure he accomplished his goals – such as creating a sham company to avoid a minority supplier program that would otherwise have prevented his company from obtaining a lucrative supply contract. (Tr. 739:11-740:3.) The "school of hard knocks" ensured that Moore had the intelligence, experience and independent capacity to accept or reject Calabro's investment recommendations. *See M & B Contracting*, 795 F.2d at 534.

But Moore's capacity to control his account was not limited to his business experience. Moore testified that he spoke to Calabro daily and sometimes "as much as five or six times a day." (Tr. 651:10-23.) During those calls, Calabro advised him "about investment opportunities and made recommendations," and told him "how [his] account was doing." (Tr. 804:12-22.) Under these circumstances, in which the customer takes an active interest in his account, the law recognizes that the customer maintains control. *See Leib v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 461 F. Supp. 951, 954-955 (E.D. Mich. 1978), *aff'd,* 647 F.2d 165 (6th Cir. 1981)

("[I]f the customer and the broker speak frequently with each other regarding the status of the account or the prudence of a particular transaction, the courts usually find that the customer, by maintaining such active interest in the account thereby maintained control over it.").

IV. CALABRO DID NOT COMMIT FRAUD

It bears repeating that churning occurs only when a broker buys and sells securities for a customer's account "without regard to the customer's investment interests" and "for the purpose of generating commissions." *Thompson*, 709 F.2d at 1416; *see Craighead v. E.F. Hutton & Co., Inc.*, 899 F.2d 485, 489 (6th Cir. 1990) ("'Churning' is a shorthand expression for a type of fraudulent conduct in a broker-customer relationship where the broker 'overtrades' a relying customer's account to generate inflated sales commissions."). A large number of trades in a customer's account that ultimately results in "losses while [the broker] was receiving substantial commissions," standing alone, is not churning. *Hotmar v. Lowell H Listrom & Co., Inc.*, 808 F.2d 1384, 1386 (10th Cir. 1987). Rather, churning "involves a conflict of interest in which a broker or dealer seeks to maximize his or her remuneration in disregard of the interests of the customer." *In re Donald A. Roche*, Exchange Act Release No. 38742 (SEC June 17, 1997). Calabro made it clear that this was not his purpose.

Calabro's core interest was to "work[] very hard and [do] research and [he] tried to make them money" other investors were suffering catastrophic losses. (Tr. 3946:16-3947:1.) His strategy during the alleged "churn period" involved short sales and associated options trades to take advantage of the anticipated and then actual market collapse. It was a short-term strategy, and thus may ultimately have generated more commissions than a typical buy and hold strategy. The core issue, however, is whether Calabro implemented the strategy for the *principal* purpose of generating commissions. The evidence proved it surely was not.

Moore, Willhoft and Williams each testified that Calabro believed he was able to take advantage of a falling market. (Tr. 620:13-621:6; 746:11-747:21 [Moore]; 1265:8-23 [Willhoft]; 1426:13-19; 1428:20-1429:1 [Williams].) *See Hotmar*, 808 F.2d at 1386 (where broker "freely shared all his knowledge and information," the court was unable "to perceive any real evidence of deception on the party" of the broker, notwithstanding the fact that the customer "suffered substantial losses while [the broker] was receiving substantial commissions"). And they were correct. Calabro studied and relied upon the Standard Business Cycle – or in his words the Parabola Curve – to determine from both a "macro level" and individual level the business sectors that were anticipated to thrive and those that would retreat in a falling market. (Tr. 3948:24; 3953:9-16; 4104:3-7; 4157:21-23.) Using the theory, Calabro foresaw the sectors that he concluded would suffer losses, such as the banking sector in 2008. (Tr. 3048:14-25;4101:3-9; 4104:3-15.) He then chose individual stocks within each relevant sector based upon individual corporate performance charts. (Calabro Demo. Exs. 3, 4) (Tr. 3948:24-3949:2.) A principal purpose to generate commissions did not require this much work.

Calabro's strategy was also closely scrutinized by his superiors. Bresner testified that he conducted an extensive analysis of Calabro's investment strategy. (Tr. 3046:25-3047:4; *see* 4172:9-4173:8.) He also directed Calabro's direct supervisor, James McGrath, to "take a separate look, apart from me" at Calabro's investment strategy. (Tr. 3047:14-24.) McGrath did so and, based upon his study and a review of the "box of stuff" sent to him, he concluded that Calabro did "a lot of work both technically and fundamentally" on the market "using algorithms and different approaches." (Tr. 3048:3-13; *see* 4170:22-4171:17.) Bresner explained:

> Ralph was unique. I mean he was the only one that I knew about throughout our entire system that was making money for clients. And I mean a lot of money, 30 per cent, 50 per cent, 70 per cent on their money, while everybody else, if you just

> had a market neutral account, was down 50 per cent. So it was spectacular performance at that time. (Tr. 3049:1-14.)

Moreover, McGrath spoke to some of Calabro's customers, and determined that they were satisfied with his performance. (Tr. 3050:24-3052:3.)

In short, the evidence proves Calabro's intent was to make his Customers profits during a sharply declining market. His intent was not to trade his customer accounts for the principal purpose of generating commissions.

CONCLUSION

For all the foregoing reasons, the Division's charges against Calabro are without merit, and an Initial Order should be entered in his favor.

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