UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15255

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In the Matter of	:
	:
JOHN THOMAS CAPITAL MANAGEMENT	:
GROUP, LLC, d/b/a PATRIOT28, LLC,	:
	:
GEORGE R. JARKESY JR.,	:
	:
JOHN THOMAS FINANCIAL, INC. and	:
	:
ANASTASIOS "TOMMY' BELESIS,	:
	:
Respondents.	:
	:

Division of Enforcement's Post-Hearing Memorandum of Law Pursuant to Rule of Practice 340

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Pursuant to Rule of Practice 340, the Division of Enforcement ("Division") submits the following post-hearing memorandum of law, which outlines its case against John Thomas Capital Management Group LLC, d/b/a Patriot28, LLC ("JTCM") and George R. Jarkesy, Jr. ("Jarkesy") (collectively "Respondents") and the legal theories upon which the Division relies. The facts upon which this memorandum of law is based are described in the Division's proposed findings of fact and conclusions of law, filed herewith.[1]

I. <u>The Credibility of the Witnesses Who Testified at the Hearing.</u>

Twelve witnesses testified in this case, eleven of them credibly and believably. Only Jarkesy's testimony lacked credibility. During the Division's examination, Jarkesy repeatedly answered that he did not remember essentially anything that occurred while he managed the two John Thomas Bridge and Opportunity Funds (the "Funds"). Jarkesy even claimed he could not recall the assets that are currently in the two Funds or their values, notwithstanding his testimony that those Funds are still operating. And Jarkesy repeatedly suggested that documents he was shown were inauthentic, even though the documents were his own records that had been produced by his own counsel during the investigation. During examination by his own attorneys, however, Jarkesy's memory suddenly improved and he was able to answer questions substantively. Just as suddenly, when the Division followed up on these answers during cross-examination, Jarkesy's memory again failed him. Jarkesy's self-serving and seemingly coached testimony should not be given any credence by the Hearing Officer. *See, e.g., In the Matter of*

[1] As described in the proposed findings of fact and conclusions of law, the Division offered DX 231 and DX 503-506 into evidence but those documents were not admitted. DX-231 is a document that was produced by Respondents and carries the JTBOF bates stamp. DX-503-506 are documents that were produced pursuant to subpoena and are the subject of business record declarations by John Thomas Financial, Inc. ("JTF") It would be inconsistent with the other evidentiary rulings in this case to exclude such exhibits and the Division renews its request that they be admitted. The Division notes that DX 503-506 are discussed and explained in the pages from the investigative testimony of Anastasios "Tommy" Belesis ("Belesis") that were counter-designated by the Division as per the order of the Hearing Officer.

Next Financial Group, Inc., 2008 SEC LEXIS 1393 *54 (Initial Decision June 18, 2008) (fact that witnesses "developed poor memories when the inquiry turned to their personal involvement" leads Hearing Officer to discount their testimony"); *In the Matter of Gregory M. Dearlove, CPA*, 2006 SEC LEXIS 1684 *159 (Initial Decision July 27, 2006) (witnesses "inordinate number of 'I don't recall' answers" leads Hearing Officer to conclude that his testimony was not credible"); *In the Matter of Steven E. Muth*, 2004 SEC LEXIS 2320 *58 (Initial Decision Oct. 8, 2004) (hearing officer finds Respondent not credible where his "testimony was littered with references about being unable to remember certain events, yet he recalled specific facts and details when it served his interests to do so").

II. The Claims Asserted by the Division against Respondents

The Division asserts claims against Respondents based on Section 10(b) of the Exchange Act of 1934 ("Exchange Act") and Rules 10b-5(a)-(c) thereunder; Section 17(a)(1)-(3) of the Securities Act of 1933 ("Securities Act"); and Section 206 of the Investment Advisers Act of 1940 ("Advisers Act") and Rule 206(4)-8 thereunder.

Section 10(b) of the Exchange Act prohibits fraud in connection with the purchase or sale of securities. Specifically, Section 10(b) and Rule 10b-5(b) thereunder prohibit the making of material misstatements or omissions in connection with the sale or purchase of securities. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (U.S. 1988); *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833 (2d Cir. 1968), *cert. den.*, 394 U.S. 976 (U.S. 1969). Rules 10b-5(a) and (c) prohibit any "scheme … to defraud" or "course of business which operates … as a fraud or deceit upon any person."

To prove a § 10(b) violation or Rule 10b-5 violation, the SEC must show (1) material misrepresentations or materially misleading omissions, (2) in connection with the purchase or sale of securities, (3) made with scienter. *See, e.g., SEC v. Curshen*, No. 09-1196, 2010 U.S. App. LEXIS 7555 (10th Cir. 2010); *SEC v. Merch. Capital, LLC*, 483 F.3d 747, 766 (11th Cir. 2007). In actions brought by the Division, reliance, damages, and loss causation are not required elements. *See, e.g., SEC v. Morgan Keegan & Co.*, 678 F.3d 1233, 1244 (11th Cir. May 2, 2012).

Section 17(a) of the Securities Act prohibits any person in the offer or sale of securities from (1) employing any device, scheme or artifice to defraud, (2) obtaining money or property by means of material misstatements and omissions, and (3) engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon a purchaser. Section 17(a) of the Securities Act prohibits fraud in the offer or sale of securities, using the mails or instruments of interstate commerce. Section 17(a)(1) forbids the direct or indirect use of any device, scheme, or artifice to defraud; Section 17(a)(2) makes it unlawful to obtain money or property through misstatements or omissions about material facts; and Section 17(a)(3) proscribes any transaction or course of business that operates as a fraud or deceit upon a securities buyer. *SEC v. Softpoint, Inc.*, 958 F.Supp. 846, 861 (S.D.N.Y. 1997), *aff'd*, 159 F.3d 1348 (2d Cir. 1998). Claims under Section 17(a) of the Securities Act have essentially the same elements as 10(b), although subsections (a)(2) and (a)(3) require only a finding of negligence not scienter. *Aaron v. SEC*, 446 U.S. 680, 697 (U.S. 1980); *.SEC v. Pentagon Capital Mgmt.*, 725 F.3d 279, 285 (2d Cir. 2013). Subsection 17(a)(2) also requires that the person "obtained money or property" through the misstatements. The statute does not require that the person obtained "some kind of additional 'fraud bonus.'" *Sec v. Tourre*, 10 Civ. 3229, 2014 U.S. Dist. LEXIS 1570 *11-12 (S.D.N.Y. Jan. 7, 2014).[2]

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[2] A Respondent may be liable under Section 17(a)(2) even if he did not personally obtain money or property. *See SEC v. Stoker*, 865 F. Supp.2d457, 463 (S.D.N.Y. 2012); *see also SEC v. Mudd*, 885 F. Supp.2d654, 669-70 (S.D.N.Y. 2012). In *Stoker*, the court rejected the argument that Section 17(a)(2) requires personal gain by the defendant, reasoning that the statute, "on its face, does not state that a defendant must obtain the funds personally or

Section 206 of the Advisers Act makes it unlawful for any investment adviser, among other things, "(1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client ...; [and] (4) to engage in any act, practice or course of business which is fraudulent, deceptive or manipulative." Rule 206(4)-8 specifically prohibits advisers of pooled investment vehicles from making material misrepresentations and omissions or otherwise engaging in any fraud, deception or manipulation. Proof under Section 206 of the Advisers Act has been deemed less stringent than under Section 10(b) of the Exchange Act because there is no requirement under Section 206 that the fraudulent activity be in the offer or sale of a security or in connection with the purchase of a security. *SEC v. Lauer*, No. 03-80612, 2008 U.S. Dist. LEXIS 73026 *90-91 (S.D. Fla. Sept. 24, 2008) (*citing* Advisers Act Rel. No. 1092, 1987 SEC LEXIS 3487 (Oct. 8, 1987)). "Section 206 imposes a fiduciary duty on investment advisers to act at all times in the best interest of the fund and its investors, and includes an obligation to provide 'full and fair disclosure of all material facts' to investors and independent trustees of the fund. *SEC v. Tambone*, 550 F.3d 106, 146 (1st Cir. 2008) (*quoting SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963)); *see also SEC v. Batterman*, 00 Civ. 4835, 2002 U.S. Dist. LEXIS 18556, *23 (S.D.N.Y. Sept. 30, 2002) ("An investment adviser has a fiduciary duty to exercise good faith, full and fair disclosure of all

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directly," and that it would defeat the statute's remedial purpose "to allow a corporate employee who facilitated a fraud that netted his company millions of dollars to escape liability for the fraud by reading into the statute a narrowing requirement not found in the statutory language itself." 865 F. Supp.2dat 463. *Stoker* further observed that to narrow the statute would be to ignore the Supreme Court's instruction that "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purpose.'" *Id.* (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (U.S. 1972)). Thus, even if Jarkesy did not personally obtain money or property but JTCM received money or property, Jarkesy can still be held liable.

material facts, and an affirmative obligation 'to employ reasonable care to avoid misleading' his clients.") (*internal citation omitted*).

A. Respondents Made Numerous Misrepresentations to Investors

Respondents made numerous misrepresentations to investors. In the Private Placement Memoranda ("PPM") and Limited Partnership Agreements, Respondents represented that (1) the Funds would purchase insurance policies with face value of 117% of the investor capital; (2) half of all investor capital would be used to purchase the insurance policies or would be set aside and segregated to pay premiums; (3) Respondents would mitigate life expectancy risk; (4) the insurance policies would be transferred to the Master Trust; (5) the total investment of the partnership in any one company at any one time would not exceed 5% of the aggregate capital commitments; (6) the general partner, JTCM, would utilize good faith; (6) fair value would be used to value securities where no market quotation was readily available; (7) the Funds' financial statements would be prepared according to generally accepted accounting principles ("GAAP"); and (8) that the management of the partnership would be vested exclusively in the General Partner. Many of these misrepresentations were repeated in marketing materials, in periodic investor updates (including a podcast following the release of the 2008 audited financial statements), and in the Funds' audited financial statements.

Respondents' marketing materials and investor updates made additional misrepresentations, including that: (1) KPMG was the auditor for the Funds; (2) Deutsche Bank was the prime broker for the Funds; (3) insurance policies would be purchased from AA rated insurance companies; (4) Fund I had purchased fourteen policies from fourteen separate insurance companies; (5) the bridge loans were be "collateralized"; and (6) valuations of the

Funds' assets would be conservative. Respondents' website made the additional misrepresentation that JTF did not manage, direct, or make any decisions for the Funds.

In addition to the misrepresentations, Respondents fraudulently valued many of the positions in the portfolio including (1) the life insurance policies, which Respondents valued using a 12% discount rate instead of the 15% discount rate that valuation consultants had used; (2) the restricted stock, which Respondents valued at the same price as free-trading stock; (3) the notes of America West Resources ("America West") and Galaxy Media & Marketing Corp. ("Galaxy"), which Respondents valued at par notwithstanding that the notes were in default; (4) the shares of Radiant Oil & Gas, Inc. ("Radiant") and America West, which Respondents valued based upon promotional activities they paid for with money from the Funds; (5) the Radiant warrants, which Respondents valued at a non-existent stock price; and (7) the shares of portfolio companies like Galaxy, which Respondents overvalued, given the poor financial condition of those companies. These valuations, which Respondents knew lacked any reasonable basis, are fraudulent. *See, e.g. IKB Int'l S.A. v. Bank of America*, 12 Civ. 4036, 2014 U.S. Dist. LEXIS 45813 *2 (S.D.N.Y. March 31, 2014) (implicit representation that there is a reasonable basis for valuation); *Weiss v. SEC*, 468 F.3d 849, 855 (D.C. Cir. 2006) ("[a]n opinion must have a reasonable basis"); *In re Connetics Corp. Sec. Litig.*, 542 F. Supp.2d996, 1010 (N.D. Cal. 2008) (opinions are actionable where there is no reasonable basis for the belief or the speaker is aware of undisclosed facts tending to seriously undermine the accuracy of the statement); *SEC v. Gane*, No. 03-61553, 2005 U.S. Dist. LEXIS 607 *30-31 (S.D. Fla. Jan. 4, 2005).

Respondents may argue that under the U.S. Supreme Court's holding in *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (U.S. 2011), they cannot be held liable for the misrepresentations in the PPM because those misrepresentations are attributable only to the Funds and not to themselves. This argument fails for numerous reasons. First, because Respondents had "ultimate authority" over the PPM and its contents, they are liable for the misrepresentations contained therein. *See, e.g.*, *Janus,* 131 S. Ct. at 2302 (attribution can be implicit from surrounding circumstances); *SEC v. Levin*, No. 12-21917-CIV, 2013 U.S. Dist. LEXIS 146702 *43 (S.D. Fla. Oct. 10, 2013) (managing member and owner of company had sufficient control over the statements); *In re Stillwater Capital Partners Inc. Litig.*, 858 F. Supp.2d277, 288 (S.D.N.Y. 2012) (reasonable fact finder could conclude that in company with few employees, statements made by its officers); *In re Merck & Co., Deriv. & ERISA Litig.*, MDL No. 1658, 2011 U.S. Dist. LEXIS 87578 *25 (D.N.J. Aug. 8, 2011) (senior executive liable as maker of company's financial statements). As demonstrated at the hearing, Respondents had the "ultimate authority" for the statements in the PPM.

Second, the misstatements in the PPM were repeated numerous times in documents that were directly attributable to Respondents, including the power point presentations, the investor updates, the marketing materials, the audited financial statements, the monthly account statements, and the website. Consequently, even if Respondents were not liable for the misstatements in the PPM, they would be liable for the misstatements in the other documents that they provided or caused to be provided to Fund investors.

Third, *Janus* applies only to cases brought under Rule 10b-5(b). It does not apply to scheme liability claims under Section 10(b) of the Exchange Act and it does not apply to any claims under Section 17 of the Securities Act. *See, e.g., SEC v. Garber,* 959 F.Supp.2d 374, 380 (S.D.N.Y. 2013) ("The textual basis for *Janus* does not extend to claims based on schemes to defraud under Rule 10b–5(a) and (c), which do not focus on the 'making' of an untrue statement"); *SEC v. Pentagon Capital Mgmt. PLC,* 844 F.Supp.2d 377, 421 (S.D.N.Y. 2012);

SEC v. Boock, 2011 U.S. Dist. LEXIS 129673, at *2-5 (S.D.N.Y. Nov. 9, 2011) (liability under Rule 10b-5(a) and (c) was not affected by *Janus*); *SEC v. Monerosso*, 2014 U.S. App. LEXIS 3891, *16 (11th Cir. Mar. 3, 2014) (Janus does not apply to Section 17 or scheme liability provisions); *SEC v. Geswein*, 2014 U.S. Dist. LEXIS 28057 (N.D. Ohio Mar. 5, 2014) ("the Court will not presume to extend Janus to violations of the Securities Act Section 17(a)").[3]

B. Respondents Misrepresentations Were Material

A statement is material if a substantial likelihood exists that a reasonable investor would consider the information important in making an investment decision. *Basic*, 485 U.S. at 231-32; *SEC v. Mayhew*, 121 F.3d 44, 51-52 (2d Cir. 1997). The information need not be of a type that necessarily would cause an investor to change his investment decision. Rather, a statement is material so long as the investor would have viewed it as significantly altering the total mix of information available. *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162 (2d Cir. 2000); *Folger Adam Co. v. PMI Indus., Inc.*, 938 F.2d 1529, 1533 (2d Cir.), *cert. den.,* 502 U.S. 983 (1991).

Misstatements that are quantitatively off by more than five percent are presumptively material. *ECA & Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co.*, 553 F.3d 187, 204 (2d Cir. 2009). Misstatements may be material, however, even if they fall beneath a numerical threshold; qualitative factors may cause even small misstatements to be material. Staff Accounting Bulletin No. 99, provides a non-exhaustive list of qualitative factors that may make small misstatements material. *Ganino* 228 F.3d at 162; *SEC v. Penthouse Int'l, Inc.*, 390 F. Supp.2d344, 353 (S.D.N.Y. 2005).

Misrepresentations concerning the value of the investments are considered qualitatively material as a matter of law. *See Evergreen Investment Mgmnt. Co., LLC*, 2009 SEC LEXIS 1853

[3] To date, there have been no decisions addressing whether *Janus* applies to Rule 206(4)-8 under the Advisers Act,

*31-32 (June 8, 2009); *SEC v. Lauer*, No. 03-80612, 2008 U.S. Dist. LEXIS 73026 *77-78 (S.D. Fla. Sept. 24, 2008); *SEC v. Seghers*, No. 3:04-CV-1320, 2006 U.S. Dist. LEXIS 69293 *3-5 (N.D. Tex., Sept. 14, 2006), *aff'd in part and vacated in part on other grounds* 2008 U.S. App. LEXIS 23507 (5^{th} Cir. 2008). This includes misrepresentations about the actual value of the securities as well as misrepresentations about the way in which the securities would be valued. Therefore, all of Respondents' fraudulent valuations were qualitatively material.

From a quantitative standpoint, however, the fraudulent valuations were also material. As demonstrated at the hearing, the Funds' auditors determined that for the year ended December 31, 2008, any misstatement (or combination of misstatements) of more than $150,000 was material. (DX-340). For the year ended December 31, 2009, any misstatement (or combination of misstatements) of more than $180,000 was material. (DX-341). And for the year ended December 31, 2010, any misstatement (or combination of misstatements) of more than $210,000 was material. (DX-342). The fraudulent valuations well-exceeded this amount. For example, had Jarkesy used Steve Boger's December 31, 2008 valuation of the eight insurance policies based on 15% NPV, the policies would have been valued at negative $176,452. Instead, Jarkesy valued the policies at $555,149, which represented the value of only five of the eight policies at 12% NPV. The difference in the two valuations is $731,601, well above the $150,000 materiality threshold. Similarly, Respondents failed to write-down hundreds of thousands of dollars of America West notes that were in default. Furthermore, Jarkesy valued the Galaxy stock position in 2010 at millions of dollars. Had he used an appropriate valuation for the shares, the value of the position would have been negligible.

In a similar vein, misrepresentations concerning the risks of the investment are material as a matter of law. See, e.g. *Krasner v. Rahfco Funds, L.P.*, 11 CV 4092, 2012 U.S. Dist. LEXIS

134353 *14 (S.D.N.Y. Aug. 9, 2012) (misrepresenting the risk entailed in the investments is a material misrepresentation).[4] The representations concerning the five percent limitation on investment in a single company, the 117% insurance coverage requirement, and the identity of the prime broker and auditor all relate to risk. Accordingly, the investors testified at the hearing that these representations were important to them. The insurance feature was a primary reason why they invested; they thought that the policies would ensure a return of their principal. As Robert Fulhardt testified, "it was like a backstop investment that would protect against downside losses." The five percent limitation was important factor in their investment because they believed that diversification would reduce the risk. As Mr. Fulhardt testified, "if the Fund limited its investment in any one company it could withstand a number of bad investments without devastating the Fund." Having Deutsche Bank and KPMG associated with the Fund was also important to investors. As Steven Benkovsky testified, knowing that Deutsche Bank was the prime broker gave him comfort in his investment in the Fund. The investor testimony establishes that Respondents' misrepresentations were material. *See, e.g., SEC v. Koester*, No. 1:12-cv-01364, 2014 U.S. Dist. LEXIS 45863 *11 (S.D. Ind. April 2, 2014);

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[4] *See also Pennsylvania. Pub. Sch. Emplys. Ret. Sys.v. Bank of Am. Corp.*, 874 F. Supp.2d 341 (S.D.N.Y. 2012) (representations that defendant held particular loan assets were material because of a failure to disclose clouded ownership); *SEC v. Fife*, 311 F.3d 1 (1st Cir.), *cert. den.*, 538 U.S. 1031 (U.S. 2002) ("a reasonable investor would want to know the risks involved"); *SEC v. Novus Techs., LLC*, No. 2:07-CV-235, 2010 U.S .Dist. LEXIS 111851 *33 (D. Utah Oct. 20, 2010), *aff'd*, 783 F.3d 1151 (10th Cir. 2013) ("[m]isrepresentations regarding ... the risk associated with the investment are material"); *In re Sadia, S.A. Sec. Litig.*, 269 F.R.D. 298, 315 (S.D.N.Y. 2010) ("common sense ... suggest[s] that risk taking is material to investors").

1. The PPM Disclosures did not Make the Representations Immaterial

Respondents may argue that the warnings in the PPMs made some of the misrepresentations immaterial. As described below, this argument would be unsupported by the law or the specific facts of this case.

First, the "bespeaks caution" doctrine does not apply to <u>facts</u>. "Fraud is still fraud, and all of the cautionary language in the world will not replace a true material omission or misstatement of a fact which would matter to a reasonable investor." *In re Integrated Resources Real Estate Ltd. Part. Sec. Litig.*, 815 F. Supp. 620, 674 (S.D.N.Y. 1993). Consequently, no warning in the PPMs would eliminate liability for Respondents' representations that they had actually purchased 117% face value of life insurance policies (or more) or had set aside the money to pay the premiums on the policies when, in fact, they did neither. Second, general boilerplate warnings that the investment was risky or speculative, or that the investor could lose all of its investment, do not qualify under the "bespeaks caution" doctrine. *See, e.g. In the Matter of Leaddog Capital Markets LLC,* 2012 SEC LEXIS 2918 *44-45 (Initial Decision, Sept. 14, 2012) ("boilerplate language in the offering materials warning against the possibility of almost any eventuality ... does not excuse misrepresentations"); *In re S1 Corp. Secs. Litig.*, 173 F. Supp.2d 1334, 1351 (N.D. Ga. 2001) ("boilerplate warnings merely reminding an investor that the investment holds risk are not sufficient"); *Underland v. Alter*, No. 10-3621, 2011 U.S. Dist. LEXIS 102896 *25 (E.D. Pa. Sept. 9, 2011) ("a blanket warning that an investment is risky is likely to be insufficient to ward off a securities fraud claim"); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371 (3d Cir. 1993), *cert. den.,* 510 U.S. 1178 (U.S. 1994) ("blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation").

Respondents might argue that because the PPMs gave them some discretion over the valuation of portfolio positions, the valuations – even if inflated – cannot form the basis of a fraud claim. This argument was rejected in *In re: Rochester Funds Group Sec. Litig.*, 838 F. Supp.2d 1148, 1171-72 (D. Colo. 2012), where the court stated:

> [i]f a security's designation of liquidity is purely subjective and solely within the business judgment of Defendants to determine, then the statement [that the fund would monitor liquidity and maintain less than a certain amount of illiquid securities] conveyed no meaningful information and certainly no meaningful assurances to prospective investors. Yet the statements clearly suggest that something real is being warranted.

Moreover, such an argument by Respondents would ignore the specific provisions in the PPMs and the limited partnership agreements stating that GAAP and fair value would be utilized and that valuations would be reasonable and in good faith. Similarly, the Fund's audited financial statements specifically stated that the statements had been prepared using GAAP and fair value. Thus, Respondents' discretion was limited. A valuation without basis and/or contrary to the valuations purportedly provided by outside consultants is neither reasonable nor in good faith.

Respondents similarly might argue that because the PPMs stated that some of the positions would be hard to value, the valuations – even if inflated – cannot be deemed material. This exact argument was rejected in *SEC v. Mannion*, 789 F. Supp.2d 1321, 1333 (N.D. Ga. 2011). In that case, the defendants argued that statements about the value of an investment in a "side pocket" were not material because they had represented to investors that valuing these assets would be a challenge and the existence of the "side pocket" sent a "powerful signal" that the assets were illiquid, impaired, or hard to value. The court disagreed.

> Under Defendant's theory, creating the Side Pocket and calling it hard to value would give fund advisors free reign to assign any value they wish to the Side Pocket. This argument is illogical and contradicts the remedial purpose of the

securities laws. The SEC does not allege that Defendants simply had difficulty valuing the Side Pocket, but that they deliberately inflated the Side Pocket's value. A reasonable investor would know that the valuation of the Side Pocket was less reliable than typical market-traded securities and that the value of World Health assets would be unstable, but **they were entitled to expect Defendants to attempt in good faith** to determine the best, most accurate value possible for the Side Pocket. Defendants' estimate of the Side Pocket is especially relevant where **investors rely on Defendants' investing expertise and specific familiarity** with World Health. *Id.* at 1333-34 (emphasis added).

Finally, even the more specific warnings in the PPMs about the risks of the corporate investments or the risks associated with the insurance policy portfolio (including life-expectancy risk) were insufficient because the PPMs were used during the entire existence of the Funds and did not disclose that some of the contingencies actually had taken place. Thus, even if some of the risk warnings in the Fund I PPM originally were sufficient in 2007, they became insufficient upon the occurrence of the contingencies. *SEC v. Merchant Capital*, 483 F.3d 747, 759 (11th Cir. 2007) ("what may once have been a good faith projection became, with experience, a materially misleading omission of material fact"). The PPM used to sell Fund I interests in 2009 did not disclose that Respondents had decided to allow the largest of the life settlement policies (Paul Evert) to lapse because the costs associated with that policy were greater than the benefits due to the change in life expectancies. The PPM for Fund I that was used to sell interests in 2010 did not disclose that America West and Amber Ready/Galaxy were in default on loan obligations. The PPM did not disclose that the Funds, in fact, had been unable to sell much of the stock that was received in connection with the bridge loans because there was no market for that stock. In *SEC v. Meltzer*, 440 F. Supp.2d 179, 191 (E.D.N.Y. 2006) the court explained that the "bespeaks caution" doctrine is not applicable in such a case:

> It must be remembered that the "cautionary language associated with the 'bespeaks caution' doctrine is aimed at warning investors that bad things may come to pass in dealing with the contingent or unforeseen future." Thus, the doctrine does not apply to "historical or present fact-knowledge within the grasp

> of the offeror." "Such facts exist and are known; they are not unforeseen or contingent. It would be perverse indeed if an offeror could knowingly misrepresent historical facts but at the same time disclaim those misrepresented facts with cautionary language." In sum, the "bespeaks caution" doctrine does not apply "where a defendant knew that its statement was false when made."

Consequently, any argument Respondents raise based on warnings should fail.

C. Respondents Had the Requisite Scienter

Scienter is a "mental state embracing intent to deceive, manipulate or defraud" and is also considered present when one acts with a reckless disregard for the truth. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976). "[K]nowledge . . . is sufficient to satisfy [the scienter] requirement." *Graham v. SEC*, 222 F.3d 994, 1004 (D.C. Cir. 2000); *see also SEC v. U.S. Env'tl., Inc.*, 155 F.3d 107, 111 (2d Cir. 1998) ("It is well-settled that knowledge of the proscribed activity is sufficient scienter under § 10(b)"), *cert. den.*, 526 U.S. 1111 (U.S. 2000). The Division, however, does not have to demonstrate that Respondents intended "to do something fraudulent." *SEC v. Stanard*, 06 Civ. 7736, 2009 U.S. Dist. LEXIS 6068 *79 (S.D.N.Y. Jan. 27, 2009). Reckless conduct also suffices to violate the antifraud provisions. *Id.*

Reckless conduct is conduct that is highly unreasonable and represents an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it. Recklessness may be established through Respondents' knowledge of or access to contradictory information. Recklessness may also be established where Respondents failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud. *See Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d Cir.), *cert. den.*, 439 U.S. 1039 (U.S. 1978); *U.S. Envt'l, Inc.*, 155 F.3d at 111; *SEC v. McNulty*, 137 F.3d 732, 741 (2d Cir.), *cert. den.*, 525 U.S. 931 (U.S. 1996); *SEC v. Biovail Corp.*, No. 08 Civ. 2979, 2009 U.S. Dist. LEXIS 15546 (S.D.N.Y. Feb. 10, 2009). Representations and opinions given without basis and in reckless disregard of their truth or falsity establish scienter. *SEC v. Bremont*, 954 F. Supp. 726 (S.D.N.Y. 1997); *Rolf* 570 F.2d at 47.

Jarkesy had the requisite scienter. He knew that KPMG did not audit either Fund. He knew that Deutsche Bank was not the prime broker for the Funds, but he continued to represent that Deutsche Bank was the prime broker even after Deutsche Bank demanded that its name be removed from Fund II's PPM. The fact that Respondents may have engaged KPMG and Deutsche Bank for the International Master Fund and/or the International Feeder Fund did not give them license to tell investors and prospective investors that these well-known, respected, and trusted entities were engaged by Fund I or Fund II, particularly when KPMG never performed any audit and no Deutsche Bank account was ever funded. In sum, Respondents used the good names of KPMG and Deutsche Bank to lend legitimacy to their fraudulent operations.

Jarkesy controlled all operations of JTCM and made all investment decisions for the Funds. He either knew that he was concentrating more than five percent of investor capital into several of the portfolio companies or he was reckless in doing so. Indeed, the total investment in America West in Fund I was well in excess of $2 million when Fund I investor capital was approximately $20 million. In *Leaddog Capital Markets*, 2012 SEC LEXIS 2918 at *43-44, this Hearing Officer held that such representations were fraudulent:

> The representation that Leaddog would "try to limit investments to 5% per issuer maximum" was manifestly false, given that the Fund's portfolio was concentrated in four issuers, with United EcoEnergy at 26.64%. Messalas's answers show at least a reckless degree of scienter – highly unreasonable and an extreme departure from the standards of ordinary care – and a clear violation of the fiduciary duty owed by an investment adviser. These representations were so far from the truth that LaRocco also, even absent special knowledge of trading the type of securities that Leaddog held, had to have known that they were misrepresentations.

Notably, in Leaddog, the representation was that the hedge fund would "**try** to limit its investment to 5% per issuer ...." *Id.* (emphasis added). In the instant case, the PPM for Fund I stated that "[t]he total investment of the Partnership in any one company at any one time **will not exceed** 5% of the aggregate Capital Commitments." (emphasis added).

Jarkesy purchased the insurance policies for the Fund. He either knew or recklessly disregarded that he was not purchasing policies with 117% face value of investor capital. He also knew or recklessly disregarded that he was not putting aside the money that he represented would be set aside and segregated to pay the insurance premiums. Furthermore, Jarkesy negotiated the terms of the loans that the Funds provided to the portfolio companies. He either knew or recklessly disregarded that many of the bridge loans were not "collateralized," creating great risk to the Funds in the event of default.

With respect to the valuations, Jarkesy knew that the appropriate discount rate for the life insurance policies was not 12%. He told the brokers who were looking for policies that he was seeking policies with yields of 15%. He told investors that the Fund had purchased policies with average yields of 15%. Jarkesy knew that his representations concerning the independent relationship between the Funds and JTF were misleading because, even as he made them, he was directly negotiating investment banking agreements that often were in conflict with the interests of the Funds. Jarkesy's intent is best expressed by his email to Belesis that "we will always try to get you as much as possible. Every time without exception." Jarkesy negotiated the investment banking agreement between America West and JTF but did not attempt to reduce JTF's fees – even though it was in the interest of the Funds to have JTF's fees be as low as possible.

[5] The Division does not claim that the promotional campaigns were, in and of themselves, fraudulent or illegal. The Division's claim is that the stock prices in December were not "real" because they reflected the promotional activity. Jarkesy knew this and used those prices anyway.

Jarkesy also knew or recklessly disregarded that JTF was not going to raise sufficient money for Radiant and Galaxy. As such, his recommendation that the portfolio companies hire JTF was unreasonable and hurt the Funds. Jarkesy knew this because JTF failed to raise sufficient interest in the Funds to meet the Funds' target investments of $25 million and $250 million respectively. JTF failed to raise sufficient funds for America West, resulting in America West being unable to repay many of its debt obligations. Moreover, Belesis sought unreasonable compensation, including demanding that one of the America West directors give Belesis stock that the director's family owned. Notwithstanding all of this, Jarkesy approved an investment banking agreement between Radiant and JTF that, in addition to the customary fees, made JTF the second largest shareholder in the company – even greater than the Funds.

Finally, Jarkesy ceded control over the Funds' investment in Galaxy to Tommy Belesis who made decisions about how the Fund's money would be used. As one example, when Belesis promised Galaxy's lawyer that he would be paid $49,000 from the Funds, the Funds that supposedly Respondents controlled paid as Belesis ordered. Belesis also ordered Fund money to be used for other Galaxy expenses and directed who would be Galaxy officers and directors. Jarkesy participated in this and allowed it to happen.

JTCM is accountable for the actions of its responsible officers, including Jarkesy. *See C.E. Carlson, Inc. v. SEC*, 859 F.2d 1429, 1435 (10th Cir. 1988) (citing *A.J. White & Co. v. SEC*, 556 F.2d 619, 624 (1st Cir.), *cert. den.*, 434 U.S. 969 (U.S. 1977)). A company's scienter is imputed from that of the individuals controlling it. *See SEC v. Blinder, Robinson & Co.*, 542 F. Supp. 468, 476 n.3 (D. Colo. 1982) (citing *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1096-97 nn.16-18 (2d Cir. 1972)). Thus, Jarkesy's conduct and scienter are attributed to JTCM.

1. Reliance on Accountants and Experts is not a Sufficient Defense

Respondents may argue that because they relied on the opinions of outside valuation experts as well as the Funds' outside accountants and auditors, the Division cannot demonstrate that they had the required scienter. This argument is contrary to the evidence. First, the outside accountants and auditors did not actually value any of the positions. Instead, they relied on Respondents' valuations and merely sought support from Respondents for those valuations. Moreover, because Respondents did not provide full and complete information to their accountants and their auditors (and knew that the accountants and auditors were relying on the incomplete information), Respondents cannot argue that their reliance on the accountants and auditors was in good faith. Similarly, Respondents cannot assert a defense based upon their "expert" insurance valuations because they did not, in fact, rely on those valuations and ultimately had those experts create spreadsheets using Respondents' own baseless discounrt rate assumptions. Furthermore, two of three valuation "experts" were not independent.

To establish a reliance-on-professional-advice defense, Respondents must show that they (1) sought professional advice; (2) completely disclosed the issue to the professional; (3) received advice; and (4) relied on that advice in good faith. *SEC v. Bankatlantic Bancorp., Inc.*, No. 12-60082, 2013 U.S. Dist. LEXIS 146699 *59 (S.D. Fla. Oct. 10, 2013); *SEC v. Huff*, 758 F. Supp.2d1288, 1349 (S.D. Fla. 2010); *Markowski v. SEC*, 34 F.3d 99, 104-05 (2d Cir. 1994); *In the Matter of David F. Bandimere*, 2013 SEC LEXIS 3142 *146-47 (Initial Decision Oct. 8, 2013). It is Respondents burden to establish that they made full and fair disclosures to the professionals of all facts known and that they relied in good faith on that advice. *Stokes v. S. States Coop., Inc.*, 651 F.3d 911, 920 (8th Cir. 2011); *U.S. v. Scott*, 37 F.3d 1564, 1583 (10th Cir. 1994), *cert. den.,* 513 U.S. 1100 (U.S. 1995) ("reliance upon advice of counsel is a defense that the defendant must establish"); *SEC v. AIC, Inc.*, 3:11-CV-176, 2013 U.S. Dist. LEXIS 130249 *22 (E.D. Tenn. Sept. 12 2013) (burden on defendant); *In the Matter of the Application of Louis Feldman*, 1994 SEC LEXIS 3428 *6 (Commission Opinion Nov. 3, 1994) ("Feldman has fallen far short of the meeting the threshold requirement for invocation on the defense of reliance on counsel").

With respect to the third-party accountants, Spectrum did not actually value any of the portfolio positions. Instead, it relied on Respondents' valuations for the non-publicly traded stock, the restricted stock, the notes, the warrants, and the insurance policies, Spectrum. Even when Spectrum elevated concerns over Galaxy's share value in September 2010, its role was limited to obtaining information supporting Respondents' valuation. Spectrum did not opine on whether such valuation was correct or whether such valuation was in accordance with GAAP.

Respondents also cannot demonstrate their lack of scienter by relying on the fact that the auditors at MFR issued a clean opinion on the Funds' financial statements. First, MFR did not review any of the monthly financial statements for the Funds. Consequently, Respondents cannot claim reliance on their auditors with respect to the monthly valuations. Second, in order to invoke the principle of reliance on their auditors, Respondents must show "that [they] made complete disclosure ...." *In re Bank of Am. Corp. Sec. Deriv. & ERISA Litig.*, No. 09 MD 2058, 2011 U.S. Dist. LEXIS 84831 *15 (S.D.N.Y. July 29, 2011) (failure to update counsel about growing losses impeded counsel's ability to make a fully informed analysis and, as such, court rejects reliance on counsel defense). Therefore, in *SEC v. Johnson*, No. 04-4114, 2006 U.S. App. LEXIS 8230 (3d Cir. April 5, 2006), the Third Circuit Court of Appeals rejected a reliance on advice defense where the defendant "did not tell the auditors about a state court injunction and security agreement that effectively prevented MERL from exercising control over Essex. In addition, [defendant] supplied to the auditors various baseless assumptions about a customer list acquired from the Hanold entites, which resulted in their giving the list an inflated value."[6]

Respondents here have not demonstrated that they made complete disclosure to their auditors. There is no evidence in the record that Respondents disclosed to MFR, as examples, (a) that the America West and Galaxy notes were in default, (b) that the valuations from the purported experts were based on Respondents' own 12% NPV assumption and that the consultants had valued the policies based upon a 15% NPV assumption with much lower resulting values, (c) all of the facts concerning the lawsuits brought by Ohio National Life Assurance Corp., or (d) all of the facts about Galaxy's financial condition. Given the amount of information that they failed to disclose to their auditors, Respondents cannot rely on the audit opinions that MFR rendered.

Moreover, while Respondents received valuations for the insurance policies, they did not actually follow the valuations that they originally received. Instead, Jarkesy repeatedly requested new valuations using his own 12% NPV assumption, which he knew did not reflect the market price. By using the 12% NPV values instead of the 15% NPV values originally received from their purported experts, Respondents grossly and unreasonably inflated the value of the insurance policy portfolio. As such, Respondents cannot argue that they relied on experts.

The valuation opinions from Abacus and Life Settlement Solutions were also not independent as Respondents had purchased the policies from those companies. Clearly, the companies that sold the policies to the Funds had an interest in giving Respondents high

[6] *See also SEC v. Melzer*, 440 F. Supp.2d 179, 190 (E.D.N.Y. 2006) (no reliance on counsel defense where defendant did not make a complete disclosure, including failure to discuss specific disclosures with counsel); *Renner v. Townsend Fin. Servs. Corp.*, 98 Civ. 926, 2002 U.S. Dist. LEXIS 8898 *22 and n.8 (S.D.N.Y. May 20, 2002) (defendant's selective disclosure would render unavailable the defense of advice of counsel); *Leaddog Capital Markets,* 2012 SEC LEXIS at *45 ("[a]ny claim analogous to a reliance on advice of counsel claim must fail because Respondents did not disclose the related-party transactions to [the auditors]").

valuations because they wanted additional business. Professional opinions must be disinterested and independent. *S.E.C. v. O'Meally.* No. 06 Civ 6483, 2010 U.S. Dist. LEXIS 107696, *4 (S.D.N.Y. Sept. 29, 2010) (citing *C.E. Carlson, Inc. v. SEC*, 859 F.2d 1429, 1436 (10th Cir. 1988)); *Illes v. Commissioner*, 983 F.2d 163, 166 (6th Cir.), *cert. den.*, 982 F.3d 163 (U.S. 1992) (Reliance on a professional is not reasonable where the professional is not disinterested). The only "independent" consultant hired by Respondents to value the policies was Steve Boger. Respondents, however, did not use Boger's valuation at 14-16% NPV, and did not seek values from him for any of the policies purchased in 2009.

Finally, professionals cannot sanction something that Respondents should have known was wrong. *FTC v. Commerce Planet, Inc.*, 878 F. Supp.2d 1048, 1084 (C.D. Cal. 2012). Thus, in *United States v. Smith*, 523 F.2d 771, 778 (5th Cir. 1975), *cert. den.,* 429 U.S. 817 (U.S. 1976), the court held that the defendant's reliance on a CPA could not be in good faith if he had knowledge contrary to the conclusions of the CPA. Moreover, the court held that "[t]he fact that material is not intentionally hidden fails to meet the requirement that it be fully disclosed." *Id.* In *In the Matter of the Application of Harold B. Hayes*, 1994 SEC LEXIS 2870 *13 (Commission Opinion Sept. 13, 1994), the Commission similarly held that where the impropriety of the Respondent's actions should have been obvious, Respondent could not excuse his activities even if he had received advice that his actions were proper." Respondents knew that their valuations did not have a reasonable basis. Consequently, even the receipt of professional opinions supporting those valuations (or not contradicting those valuations) does not eliminate their fraudulent intent.

D. Respondents are Separately Liable for their Participation in the Scheme

In addition to liability for misrepresentations, Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act also generally prohibit any wrongdoing by any person that rises to the level of a deceptive practice. *See Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U.S. 6, 10 (1971). For the purposes of the securities laws, a "'scheme to defraud' is merely a plan or means to obtain something of value by trick or deceit." *SEC v. Kimmes*, 799 F. Supp. 852, 858 (N.D. Ill. 1992), *aff'd*, 997 F.2d 287 (7th Cir. 1993). Thus, scheme liability is established where a defendant "engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme." *Middlesex Retirement Sys. v. Quest Software Inc.*, 527 F. Supp.2d1164, 1191 (C.D. Cal. 2007).[7] The case for scheme liability against Jarkesy and JTCM is predicated on the same facts that form the basis of their liability under Section 17(a)(2) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5(b) thereunder. While the misrepresentations and failures to disclose were parts of the scheme, and in and of themselves violative of the statutes, the overall scheme involved a multi-year campaign to falsely induce investments in the Funds, to routinely inflate the valuation of the Funds' holdings, and to steadily divert the Funds' assets to Belesis and JTF. Thus, scheme liability is appropriate for Jarkesy and JTCM.

E. Respondents Violated the Advisers Act

Respondents, through the same conduct described above, also violated Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. JTCM and Jarkesy, as the

[7] *See also SEC v. Fraser*, 2009 U.S. Dist. LEXIS 70198, *25 (D. Ariz. Aug. 11, 2009); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 158 (2008) (holding that "[c]onduct itself can be deceptive" and, as such, liability under Section 10(b) or Rule 10b-5 does not require "a specific oral or written statement"); *SEC v. Dorozhko*, 574 F.3d 42, 50 (2d Cir. 2009); *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp.2d319, 335-36 (S.D.N.Y. 2004) ("a cause of action exists under [Rule 10b-5] subsections (a) and (c) for behavior that constitutes participation in a fraudulent scheme, even absent a fraudulent statement by the defendant

alter ego of JTCM, can be charged directly as investment advisers because they meet the definition under the Advisers Act. *See* Advisers Act Section 202(a)(11). As defined in Section 202(a)(11) of the Advisers Act, Respondents, for compensation, engaged in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. In addition, as part of their work, Respondents, for compensation and as a part of their regular business, issued or promulgated analyses or reports concerning securities.

There is ample evidence of misconduct establishing violations of Sections 206(1), 206(2) and 206(4) and Rule 206(4)-8. Primarily, the violative conduct was Respondents' fraudulent valuation of the Funds' holdings, which deceived investors and inflated the management fees, resulting in a misuse of Fund assets that directly defrauded the Funds. Moreover, Respondents knowingly solicited investments in the Funds on the basis of false and misleading misrepresentations about (1) the insurance component of the portfolio; (2) the identity of the Funds' service providers; (3) the manner in which Respondents would value the portfolio positions; and (4) the concentration of the Funds' assets. In similar circumstances, investment advisers and fund managers have been found in violation of the antifraud provisions of the Advisers Act based on misrepresentations regarding, among other things, valuations of funds' portfolios, concentrations of assets, and manipulation of assets in the portfolio. *See e.g., Lauer*, 2008 U.S. Dist. LEXIS 73026 at *77-78; *Seghers*, 2006 U.S. Dist. LEXIS 69293 at *3-5 *Evergreen,* 2009 SEC LEXIS 1853 *31-32.

Finally, by repeatedly favoring Belesis's and JTF's pecuniary interests over those of the Funds (including by negotiating and/or approving investment banking agreements that paid JTF excessive fees and fees for performing no services), Respondents breached their fiduciary obligations to the Funds. By allowing Belesis and JTF to influence certain decisions on behalf of the Funds as to the disposition of certain Funds' assets, Respondents further violated their fiduciary duty to the Funds. The fact that Jarkesy actively sought to maximize Belesis's and JTF's fees was never disclosed in the offering documents. Nor did Jarkesy and JTCM disclose that they would permit Belesis to drive utilization of the Funds' assets, a decision that was directly contrary to Jarkesy's supposedly exclusive role as manager of the Funds. Based on the foregoing Respondents are liable under the Advisers Act. *See Tambone*, 550 F.3d at 146; *Batterman*, 2002 U.S. Dist. LEXIS 18556 at *23.

III. Respondents Should Receive Maximum Sanctions

The Division seeks the following relief against Respondents: (i) censure pursuant to Section 203(e) of the Advisers Act; (ii) an order directing Respondents to cease and desist from committing or causing violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, pursuant to Section 8A of the Securities Act, Section 21C(a) of the Exchange Act, and Section 203(k) of the Advisers Act; (iii) disgorgement, pre-judgment interest, and third-tier penalties on a joint and several basis, pursuant to Section 21B(a) and (e) and 21C(e) of the Exchange Act, Section 8A(e), (g) of the Securities Act, and Section 203(i)-(j) of the Advisers Act; (iv) permanent officer and director bars against Jarkesy pursuant to Section 20(d)(2) of the Exchange Act and Section 20(e) of the Securities Act; (v) permanent collateral bars against Jarkesy pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), Section 15(b) of the Exchange Act, and Section 203(f) of the Advisers Act; (vi) permanent penny stock bars against

Jarkesy pursuant to Section 21(d) of the Exchange Act and Section 20(g) of the Securities Act; and (vii) an accounting of all JTCM operations and investments.

In *In the Matter of Daniel Bogar*, 2013 SEC LEXIS 2235 (Initial Decision, Aug. 2, 2013) (Foelak, ALJ), this Hearing Officer stated that "in determining sanctions, the Commission considers such factors as: the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations." *Id.* at *79 (*citing Steadman v. SEC*, 450 U.S. 91, 97-104 (1981). "The Commission also considers the age of the violation and the degree of harm to investors and the marketplace resulting from the violation." *Id.* at *80 (*citing Marshall E. Melton*, 56 S.E.C. 695, 698 (2003).) "Additionally, the Commission considers the extent to which the sanction will have a deterrent effect." *Id.* (*citing Schield Mgmt. Co.*, Exchange Act Release No. 53201 (Jan. 31, 2006), 87 SEC Docket 848, 862 & n.46.) "As the Commission has often emphasized, the public interest determination extends to the public-at-large, the welfare of investors as a class, and standards of conduct in the securities business generally." *Id.* (*citing Christopher A. Lowry*, 55 S.E.C. 1133, 1145 (2002), *aff'd*, 340 F.3d 501 (8th Cir. 2003); *Arthur Lipper Corp.*, 46 S.E.C. 78, 100 (1975)).

Based on these factors, Respondents should receive the most severe sanctions available. Their conduct was egregious and they had a high degree of scienter. Their conduct took place starting in 2007 and continues through today. Respondents have not accepted or recognized the wrongful nature of their conduct. Indeed, at no point during the hearing, did Jarkesy even suggest that he did anything wrong. To the contrary, Jarkesy blamed investor losses on the financial meltdown and credit crunch and on the failure of JTF to raise sufficient capital for portfolio companies. Jarkesy also sought to blame others by repeatedly stating during the hearing that he did not value the positions – that the values came from others – and that he was not responsible for the financial statements or their notes. Jarkesy's attempt to place the blame on others underscores his culpability. *Leaddog Capital Markets*, 2012 SEC LEXIS 2918 at *45.

In addition, the fraudulent conduct was recent and the harm to investors was significant. Millions of dollars of investor funds were squandered and lost. Jarkesy cannot even quantify the amount of the loss even though he continues to claim that the Funds are still in existence. Moreover, Jarkesy's occupation presents further opportunity for future violations. He is highly engaged in the securities industry. In addition to the Funds, he provides investment advice through his syndicated radio show and through the National Eagles and Angels Association, which he chairs. As such, he has ample opportunity to commit future violations even though he claimed at the hearing that he has no present intention to manage any funds in the future.

A. Respondents Should Receive a Cease and Desist Order

The showing required to obtain a cease and desist order is "significantly less than that required for an injunction." *In the Matter of Fields*, 2012 SEC LEXIS 3747 *43 (Initial Decision, Dec. 5, 2012) (Foelak, ALJ). As described above, based on the *Steadman* factors, a cease and desist order is warranted. *See In the Matter of Koch*, 2012 SEC LEXIS 1645 * 43-44 (Initial Decision, May 24, 2012) (Foelak, ALJ) (Respondents' conduct was egregious and recurrent over a period of three months. The conduct involved at least a reckless degree of scienter. The lack of assurances against future violations and recognition of the wrongful nature of the conduct goes beyond a vigorous defense of the charges. Koch's chosen occupation in the financial industry will present opportunities for future violations).

B. Respondents Should Pay Disgorgement, Interest, and Penalties

In addition to the censure and the cease and desist order, the Division seeks disgorgement, penalties, and prejudgment interest. In *In the Matter of Gerasimowicz*, 2013 SEC LEXIS 2019 *6 (Initial Decision July 12, 2013) (Foelak, ALJ), this Hearing Officer described the standard for ordering monetary relief. "Sections 8A(e) of the Securities Act, 21B(e) of the Exchange Act, and 203(j) of the Advisers Act authorize disgorgement of ill-gotten gains from Respondents. Disgorgement is an equitable remedy that requires a violator to give up wrongfully-obtained profits causally related to the proven wrongdoing." With respect to advisors such as Respondents, "[m]anagement and incentive fees are appropriately disgorged where they constitute ill-gotten gains earned during the course of fraudulent activities. However, the Commission distinguishes between amounts earned through legitimate activities and those connected to violative activities, and it falls on the Division to show what a reasonable approximation of the fees constituted unjust enrichment." *Id* at *6-7 (internal citations omitted). "The amount of the disgorgement ordered need only be a reasonable approximation of profits causally connected to the violation." Id. at *7 (internal citations omitted). After the Division meets its burden, "the burden shift[s] to Respondents to demonstrate that a lesser amount was appropriate." *Id.* at *11. Once disgorgement is ordered, prejudgment interest shall be paid. *Id.* at *14. Pursuant to 17 C.F.R. § 201.600(a), interest shall be due from the first day of the month following the violation . . . through the last day of the month preceding the month in which payment of disgorgement is made." *Id.* at *15 n.7.

In this case, the Division is seeking an order for Respondents to disgorge all of the incentive fees Respondents paid themselves (approximately $260,000) plus the $1.3 million in management fees that Respondents received for "managing" a fraudulent operation. The incentive fees would not have been earned by Respondents had they accurately valued the positions. Moreover, Respondents would not have been able to attract investors (and obtain the management fees) had their disclosures (including concerning the risk associated with the investment) not been fraudulent. *Leaddog Capital Markets*, 2012 SEC LEXIS 2918 *51-52 (ordering disgorgement of management fees).

With respect to penalties, "Sections 21B of the Exchange Act, 203(i) of the Advisers Act, and 9(d) of the Investment Company Act authorize the Commission to impose civil money penalties for violations of the Securities, Exchange, Advisers, or Investment Company Acts or rules thereunder. Six factors are to be considered when determining whether a penalty is in the public interest: (1) fraud; (2) harm to others; (3) unjust enrichment; (4) previous violations; (5) deterrence; and (6) such other matters as justice may require." *Gerasimowicz*, 2013 SEC LEXIS 2019 at *16. In this case, multiple units of third-tier penalties should be ordered, particularly in light of the nature of the conduct, the number of Funds harmed, the number of investors harmed, and the amount of the loss. Units of third-tier penalties are $150,000 for natural persons (including Jarkesy) and $725,000 for other persons (including JTCM). 17 C.F.R. § 201.1004.

In *Gerasimowicz*, penalties were determined by multiplying the statutory third-tier penalty by the number of fund investors harmed by the conduct. *Id.* at *18 (*citing Steven E. Muth*, 58 S.E.C. 770, 813 (2005) ("we believe that a civil money penalty based on the number of customers that [the respondent] defrauded . . . is appropriate."); *see also SEC v. Glantz*, 94 CV 5737, 2009 U.S. Dist. LEXIS 95350 *17 (S.D.N.Y. Oct. 13, 2009) (multiplying the penalty by the number of victims); *SEC v. Milan Capital Group, Inc.*, 00 Civ. 0108, 2001 U.S. Dist. LEXIS 11804 (SDNY 2001) (multiplying the penalty by each of the 200 defrauded investors, resulting in a $10 million penalty); *SEC v. Kenton Capital Ltd.*, 69 F. Supp.2d1, 17 & n.15 (D.D.C. 1998) (assessing a $1.2 million penalty calculated by "multiplying the maximum third tier penalty for natural persons ($100,000) by the number of investors who actually sent money to [defendant] (12)"). In this case, Jarkesy testified that there were more than ninety investors in Fund I and a document produced by Respondents and offered into evidence by the Division (but not admitted) shows that there were at least 103 investors harmed by the conduct. Thus, it would be appropriate for the Hearing Officer to issue a penalty equaling ninety times the statutory amount and up to 103 times the statutory amount.

Alternatively, the Hearing Officer might calculate the penalty by multiplying the statutory amount by the number of false statements. Because each monthly account statement starting in March 2009 was fraudulently inflated (based upon the first use of the 15% NPV calculation), it would be appropriate to multiply the statutory penalty by a large number. In addition to the false account statements there were numerous additional false and misleading marketing materials and periodic investor communications. *SEC v. Pentagon Capital Mgmt., PLC*, 725 F.3d 279, 288 n. 7 (2d Cir. 2013) ("although we vacate the civil penalty award, we find no error in the district court's methodology for calculating the maximum penalty be counting each trade as a separate violation"); *SEC v. Coates*, 137 F. Supp.2d413, 430 (S.D.N.Y. 2001) (multiplying the penalty amount by the number of violations); *In the Matter of Gualario & Co.*, LLC, 2012 SEC LEXIS 497, *55-56 (Feb. 14, 2012) (multiplying the statutory penalty by three (representing the operation of the fund, and the sale of two notes)).

C. Jarkesy Should Receive Collateral Bars

The Division also seeks bars against Jarkesy from association with brokers, dealers, investment advisers, municipal securities dealers, municipal advisors, transfer agents, nationally recognized statistical rating organizations, and investment companies. Such collateral bars are authorized under Sections 15(b) of the Exchange Act and 203(f) of the Advisers Act.

Respondents may argue that the Division cannot obtain collateral bars because most of their conduct pre-dates the effective date of the Dodd-Frank Act. This argument was specifically rejected in *Bogar*, where this Hearing Officer ruled:

> While Respondents' misconduct antedates the July 22, 2010, effective date of the Dodd-Frank Act, the Commission has determined that sanctioning a respondent with a collateral bar for pre-Dodd-Frank wrongdoing is not impermissibly retroactive, but rather provides prospective relief from harm to investors and the markets. *John W. Lawton*, Advisers Act Release No. 3513 (Dec. 13, 2012), 105 SEC Docket 61722; *see also Alfred Clay Ludlum, III*, Advisers Act Release No. 3628 (July 11, 2013); *Johnny Clifton*, Securities Act Release No. 9417 (July 12, 2013); *Tzemach David Netzer Korem*, Exchange Act Release No. 70044 (July 26, 2013).

2013 SEC LEXIS 2235 at *89 n.40; *see also In the Matter of Siris*, 2012 SEC LEXIS 4075 *13 n.3 (Initial Decision, Dec. 31, 2012) (Foelak, ALJ); *In the Matter of Seeley*, 2013 SEC LEXIS 3156 * 34-35 (Initial Decision, Oct. 9, 2013); *In the Matter of Constantin*, 2013 SEC LEXIS 3134 *5 n.3 (Initial Decision, Oct. 4, 2013).

The fact that Respondents were not engaged in all of these activities during the time that they engaged in the fraud is also not a barrier to imposing the collateral bars. *See LeadDog Capital Markets*, 2012 SEC LEXIS at *57 n.22. Indeed, the collateral bars are particularly appropriate where, as here, the violators are fiduciaries and "their abuse of the trust placed in them is particularly reprehensible." *Id.* at *57.

D. Jarkesy Should Receive Penny Stock and Officer and Director Bars

The Division also seeks orders barring Jarkesy from engaging in penny stock activity and from serving as an officer or director of a public company. Since the fraud at issue concerned numerous "penny stocks," including America West and Radiant, a penny stock bar is particularly appropriate. Likewise, since Jarkesy was an officer and director of several of the portfolio companies that were fraudulently overvalued and used his power as an officer and director of these companies to inappropriately direct money to Belesis and JTF, he should be barred from serving as an officer and director.

Section 21(d)(2) of the Exchange Act provides that officer and director bars are appropriate where "the person's conduct demonstrates unfitness to serve as an officer or director of any such issuer." Even if Jarkesy's fraudulent conduct was unrelated to his activities as an officer and director, his conduct to his fiduciaries and investors demonstrates "unfitness." Jarkesy's securities laws violations were egregious. And he was not a low-level employee taking directions from higher ranking individuals. As Jarkesy stated in his Answer to the OIP, "Jarkesy does not 'purportedly' control all operations and activities of JTCM and the Funds because, in fact, he does control all operations, etc." Jarkesy had an economic stake in the violations receiving fees, he directed the fraud, and he had a high degree of scienter.

CONCLUSION

For the reasons set forth in this memorandum, the Division respectfully requests that the Hearing Officer find that Respondents violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The Division also respectfully requests that the Hearing Officer grant all of the requested relief against Respondents.

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Respectfully Submitted,

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