UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15255

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

PRE-HEARING MEMORANDUM

Pursuant to Rule of Practice 222, the Division submits the following pre-hearing memorandum, which outlines its case against George R. Jarkesy, Jr. ("Jarkesy") and John Thomas Capital Management Group LLC, d/b/a Patriot28, LLC ("John Thomas") (collectively "Respondents") and the legal theories upon which the Division relies.

PRELIMINARY STATEMENT

This case concerns fraudulent conduct by Respondents, the manager of two hedge funds known as the John Thomas Bridge & Opportunity Fund LP I and II ("Fund I" and "Fund II," collectively the "Funds"). Among other things, Respondents: (i) recorded valuations for certain of the Funds' holdings without any reasonable basis; (ii) marketed the Funds on the basis of false representations, and (iii) abused Jarkesy's position as manager of the Funds, and JTCM's position as adviser, to steer millions of dollars in fees to Anastasios "Tommy" Belesis

("Belesis"), the chief executive officer of John Thomas Financial, Inc. ("JTF"), the New York broker-dealer that served as the Funds' placement agent.

MISREPRESENTATIONS CONCERNING THE FUND'S INDEPENDENCE

Respondents represented that all of the investment decisions for the Funds would be made by Jarkesy. Indeed, the Private Placement Memorandum even contained a so-called "key man" provision demonstrating Jarkesy's importance to the Funds. Respondents also specifically represented that the Funds were not affiliated with JTF (except that JTF was the selling agent for the Funds) and that JTF did not own, manage, direct, or make any decisions for the Funds. These representations were all false. Belesis made numerous decisions on behalf of the Funds and directed that Fund money be spent to protect Belesis's interests. The most telling example relates to the Funds' investment in Galaxy, in which JTF (and its customers) also was heavily invested. Belesis directed Jarkesy to have the Funds pay many of Galaxy's expenses. Belesis chose Galaxy's CFO over the objections of Galaxy's other officers, who thought Belesis' choice demanded too high a salary. And Belesis decided the final language of a stock purchase agreement despite revisions by the Galaxy's CFO and Jarkesy.

Jarkesy, in direct contravention of the interests of Fund investors, also directed that unnecessary and excessive fees and commissions be directed to Belesis. Respondents and the Funds, directly or indirectly, were the source of approximately $4 million in revenue for JTF in the form of placement fees, investment banking fees, and bridge loan fees JTF received for doing little or no work.[1] These unnecessary and unearned bridge loan fees were particularly harmful to the investors because the Funds typically extended loans to struggling, cash-poor ventures. Every dollar that went to JTF instead of to the borrowers hurt the borrowers' future prospects

[1] Fees JTF received, directly or indirectly, include approximately $2.5 million in placement fees, $805,000 in bridge loan fees, and more than $700,000 in trading commissions.

and reduced the Funds' chances of ultimately being repaid (and the investors realizing a positive return on their investment). Jarkesy, however, often abandoned his fiduciary duties to the Funds and affirmatively negotiated arrangements whereby the borrowers would divert large fees to JTF from the proceeds received from the Funds. For example, even though Jarkesy, a director of America West, introduced America West to JTF to help arrange long-term financing, JTF received a substantial fee when the Funds extended a short-term loan to America West.

MISREPRESENTATIONS CONCERNING THE FUND'S INVESTMENTS

Respondents repeatedly promised investors that the Fund would not invest more than 5% in a single company. This was a material promise as avoiding concentration was an important means of reducing risk. This representation was false as, at times, the Fund had more than 30% of its investment in a company called Amber Ready (later known as Galaxy Media & Marketing Corp.) ("Amber Ready/Galaxy"), more than 25% of its investment in a company called Radiant Oil & Gas ("Radiant"), and more than 30% of its investment in a company called America West Resources ("America West"). This concentration (contrary to Respondents' representations) caused great harm to the Funds and their investors when the value of these companies fell. Separately, Respondents represented that their corporate investments would be short-term (six to eighteen months). This representation was also false as many of the Funds' investments were much more long-term and could not have been anything but.

MISREPRESENTATIONS CONCERNING THE VALUE OF INVESTMENTS

Respondents assigned values to certain of their holdings that had no reasonable basis and were not based on fair value. As a general matter, Respondents valued restricted stock (which they couldn't sell) at the same value as unrestricted stock, which would be contrary to both

GAAP and common sense because restricted stock cannot be sold, carries greater risk, and thus is valued lower than free-trading stock.

Separately, Respondents' valuation of Radiant and America West was based, at times, on stock prices that they had artificially inflated. With respect to Radiant, between November and December 2010, Respondents marked up the value of this position based upon a drastic increase in that company's share price. Respondents failed to disclose, however, that the reason for the drastic share price increase was that they had used Fund money to pay promotional firms to aggressively tout Radiant. The promotional activity artificially boosted the share price of the stock and enabled the Funds to show relatively level performance even as other holdings (such as Galaxy) declined during the same time period. Likewise, Jarkesy, as a director of America West, voted in early 2011 to hire three different promotional firms to "bring some more awareness" of the company to investors. The promoters were paid in America West shares, in cash that Fund II loaned to the company that was specifically earmarked to pay the promoters, and directly from Fund I's bank account. By boosting the share price through the promotions, Respondents were able to artificially maintain the Funds' overall performance.

Separately, Respondents valuations for positions were arbitrary and inconsistent. One example of this is Amber Ready/Galaxy, a company that did not trade publicly. Internal documents show that Respondents assigned different values to this stock during the same time period. Moreover, Fund I and Fund II utilized different values for the same stock. Another example of inconsistent valuations related to Radiant securities. Respondents increased the value of Fund II by selling shares of Radiant from Fund I to Fund II at a price of twenty-two cents/share, but as soon as the shares were transferred to Fund II, Respondents valued them at $1. With respect to warrants for Radiant, between August and December 2010 Respondents

assigned values ranging from twelve cents to $6.92. In addition to the fact that Respondents knew that the higher valuations were based on the paid promotions, they valued the warrants higher than the price of the common stock, which is generally contrary to GAAP. In addition, in August 2010, Respondents valued Radiant based upon a reverse stock split that the company itself did not report until a month later. Finally, with respect to America West, Respondents failed to write down the value of loans made to the company even though the company itself (in SEC filings signed by Jarkesy) reported that it had defaulted on such loans. Given the company's default on the loans, the failure to write down the value of the loans was unjustified and falsely inflated an asset from which the Funds' overall value was derived.

MISREPRESENTATIONS CONCERNING INSURANCE COVERAGE

One of the major components of the Funds' portfolios were life insurance policies that had been purchased in the secondary market and were intended to hedge the Fund's riskier investments. The Respondents fraudulently and materially overstated the value of these positions, ignoring valuations that had been provided to them by supposed experts. The Respondents also made at least three other misrepresentations concerning these insurance policies: (1) Respondents promised that for each dollar invested, the Fund would own life insurance policies with a face value of 117% of the investment in the Fund -- at various times, the Respondents even represented that the Fund owned policies with a face value of 140% or 130% of the investment in the Fund; (2) at various times, Respondents stated that policies would be purchased only from AA or better rated insurance companies; and (3) Respondents promised that the life insurance policies would be segregated from the rest of the Fund and held in a master trust account. These representations were all false.

With respect to the valuation of the insurance policies for the policies purchased by the Funds in 2007 and 2008, Respondents purported to use values provided by a consultant named Boger & Associates ("Boger"). Boger provided an analysis for year-end 2008 that stated that the net present value of the eight insurance policies then owned by the Fund was $167,986. Underlying this analysis was the conclusion that three of the policies (including the policies with the largest face values) had a negative valuation. Boger also stated that if the analysis excluded the three negative policies, the net present value was $555,149. The schedule of investments contained in the financial statements for year-end 2008 stated that the value of the transferrable life insurance policies (without any limitations) was $555,149. Rather than reporting the value of all eight insurance policies, Respondents only reported the value of the five insurance policies with positive values. There was no basis to omit the three policies with negative value from the total. This blatant omission is not disclosed in the financial statements and the notes to the financial statements state only that "the values [of the policies] have been estimated by the General Partner using a life expectancy model to determine the fair market value in the absence of readily ascertainable market values."

Boger did not provide valuations for life insurance policies purchased in 2009. Instead, it appears that Respondents relied on values provided by the company that sold the life insurance policies to the Funds. Setting aside the tremendous conflicts of interest that arise from utilizing values provided by the seller (and the fact that the Respondents were now relying on inconsistent methods to value the same class of investments), Respondents did not even faithfully follow those seller-supplied valuations. Between February and March 2010, the values Respondents assigned to two of the life insurance policies nearly tripled. One rose from $900,000 to nearly $2.6 million. Another increased from $526,000 to $1.4 million. The calculation tables provided

by the seller did not indicate such an increase. For year-end 2010, the value of the insurance policies represented 25% of the value in Fund I and a material portion of the value of Fund II.

Beyond the valuations, however, there were large periods of time when the Funds did not own life insurance policies with the promised face value of 117% of the money invested, much less 130% or 140% that the Respondents claimed. In addition, while Respondents represented that they would only purchase insurance policies from AA or better rated insurance companies, this was not the case. Moreover, master trust account statements demonstrate that certain of the insurance policies were not transferred to the master trust.

MISREPRESENTATIONS CONCERNING FUND OVERSIGHT

In various marketing materials, Respondents represented that Deutsche Bank was the prime broker for the Funds. In these and other marketing materials, Respondents separately represented that KPMG was the auditor for the Funds. In other marketing materials, Respondents identified Malone & Bailey, P.C. as the auditor. None of these representations was true. In fact, Respondents continued to represent that Deutsche Bank was the prime broker even after Deutsche Bank found out about these representations and told Respondents to stop. The actual auditor of the Funds was MFR P.C., a small Houston-based firm. Respondents also materially exaggerated aspects of JTCM's operations, such as "detailed legal and technical due diligence" that purportedly preceded any Fund investment. In fact, such "detailed ... due diligence" consisted merely of cursory analysis conducted by Jarkesy, including his seeking free advice from academic or industry experts and investors in the Funds.

RELEVANT LAW

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 (1988); *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833 (2d Cir. 1968). In addition, Section 10(b) and Rules 10b-5(a) and (c) thereunder prohibit any "scheme ... to defraud" or "course of business which operates ... as a fraud or deceit upon any person." Furthermore, 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) only require a finding of negligence. *Aaron v. SEC*, 446 U.S. 680, 697, 100 S.Ct. 1945, 64 L.Ed.2d 611 (1980); .*SEC v. Pentagon Capital Mgmt.*, 725 F.3d 279, 285 (2d Cir. 2013).

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

RESPONDENTS ARE LIABLE FOR THE MISREPRESENTATIONS

There is no question that the misrepresentations described above were made by Respondents. The misrepresentations appear in marketing materials disseminated by John Thomas and are directly attributed to Respondents. The account statements to investors based on the fraudulent valuations are also attributed to John Thomas. The false annual financial statements for the Funds sent to investors are also attributed to John Thomas. Jarkesy is responsible for the statements of John Thomas both as the alter ego of John Thomas and also as

the individual with "ultimate authority" over any statements made by John Thomas. Individual misrepresentations are also specifically attributed to Jarkesy.

The Division anticipates that Respondents will argue that the misrepresentations contained in the Private Placement Memorandum ("PPM") and other Fund documents are attributable only to the Fund and not to the Respondents. Because Respondents had "ultimate authority" over the PPM and its contents, they are liable for the misrepresentations contained therein. *See, e.g.*, *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011) (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. 2d 277, 288 (S.D.N.Y. 2012) (reasonable fact finder could conclude that in a company with a few employees, the statements were 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). Likewise, Respondents had "ultimate authority" for statements made by others.

The misrepresentations were material. The applicable materiality standard under Section 10(b) and Rule 10b-5 is set forth in *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988), where the Court held that to fulfill the materiality requirement, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.* To be material, the information does not need to be the type that would cause an investor to change his investment decision. *Ganino*, 228 F.3d at 162; *see also Folger Adam Co. v. PMI Indus., Inc.*, 938 F.2d 1529, 1533 (2d Cir. 1991). Misrepresentations concerning the value of the investments

are material as a matter of law. *See Evergreen Investment Mgmnt. Co., LLC*, Advisers Act Rel. No. 2888, 2009 SEC LEXIS 1853, *31-32 (June 8, 2009) (settled); *Lauer*, 2008 U.S. Dist. LEXIS 73026 at *77-78; *SEC v. Seghers*, 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 (5th Cir. 2008). Likewise, misrepresentations concerning the risks of the investments 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).[2] The representations concerning the 5% concentration limitation, the 117% insurance coverage requirement, and the identity of the prime broker and auditor all relate to risk.

Respondents also had the requisite scienter. While the Division believes that it can establish that Respondents knowingly made these misrepresentations, at the very least the Division will demonstrate Respondents' recklessness. Recklessness "is conduct that is highly unreasonable and '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." *In re BISYS*, 397 F. Supp. 2d 430, 441(S.D.N.Y. 2005), *recon. den.*, 2005 U.S. Dist. LEXIS 28343 (S.D.N.Y. Nov. 16, 2005) (citing *In re Scholastic Corp. Sec. Litig*, 252 F.3d 63, 76 (2d Cir. 2001)). The Division can demonstrate recklessness by showing that the Respondents had knowledge of or access to contradictory information. *See id.* The Division can also demonstrate recklessness by demonstrating that Respondents "failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud." *Novak v.*

[2] *See also Pa. 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. 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) ("[m]isrepresentations regarding ... the risk associated with the investment are material").

Kasaks, 216 F.3d 300, 309 (2d Cir. 2000). Thus, for example, the Division will be able to demonstrate Respondents' recklessness by virtue of the fact that they received valuations from purported experts and then used different valuations.

The Division anticipates that Respondents will argue that because various Fund documents (including the PPMs) generally described the risks associated with investing in the Funds, including that some of the positions would be hard to value, the false valuations cannot be deemed material. This exact argument was rejected in *SEC v. Mannion*, 789 F. Supp.2d 1321, 1333 (N.D. Ga. 2011), where the defendants argued that statements about the value of an investment in a "side pocket" were not material because defendants 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). Moreover, the general warnings in Fund documents did not disclose to investors the actual risks caused by Respondents' fraudulent acts. *See In re Bear Stears Cos., Inc. Sec., Deriv., & ERISA Litig.*, 763 F. Supp. 2d 423, 494 (S.D.N.Y. 2011) ("[t]o be 'meaningful,' a 'cautionary statement must discredit the alleged misrepresentation to such an extent that the 'risk of real deception drops to nil.' True cautionary language must warn[] investors of exactly the risk that plaintiffs claim was not disclosed...[W]arnings of specific risks

... do not shelter defendants from liability if they fail to disclose hard facts critical to appreciating the magnitude of the risks described."); *In re Fannie Mae 2008 Sec. Litig.*, 2012 U.S. Dist. LEXIS 124008 *45-46 (S.D.N.Y. Aug. 30, 2012) (warnings to investors about future risks and losses do not foreclose liability for allegedly failing to disclose FNMA's current inadequate risk control measures); *SEC v. Goldstone*, No. Civ. 12-0257, 2013 U.S. Dist. LEXIS 95987 *514-515 (D.N.M. July 8, 2013) (warnings not specifically specific or cautionary and did not directly relate to the risk at issue); *SEC v. Mudd*, 885 F. Supp. 2d 654, 669 (S.D.N.Y. 2012); *In re Initial Pub. Off. Sec. Litig.*, 358 F. Supp. 2d 189, 211-12 (S.D.N.Y. 2004) (disclosures must "warn investors of exactly the risk that plaintiffs claim was not disclosed").

Respondents might also argue that because the PPM and other Fund documents gave them discretion over valuation of portfolio positions, the valuations 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 (D. Colo. 2012), where the court stated that "[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, this argument would ignore other provisions in the Fund documents specifically stating that fair value would be utilized and that valuations would be reasonable and in good faith. A valuation without basis and/or contrary to the valuations purportedly provided by outside consultants is neither reasonable nor in good faith.

Respondents may also argue that because they relied on the opinions of outside valuation experts and/or the Funds' auditors did not reject any of the valuations, the Division cannot

demonstrate that the valuations were false or that they had the required scienter. First, the evidence will demonstrate that while Respondents received valuation opinions for the insurance policies, they did not follow those opinions. Second, the evidence will demonstrate that some of the valuation opinions received were not disinterested and independent.[3] With respect to the audit opinions, in *Markowski v. SEC*, 34 F.3d 99, 105 (2d Cir. 1994), the court held that reliance on a professional is not a complete defense, but only one factor for consideration in determining whether or not a defendant acted with scienter.[4] Moreover, "in the securities context, a CFO, like other 'corporate executives,' has an independent duty to ensure compliance with disclosure obligations." *In re Bank of Am. Corp. Sec. Deriv. Litig.*, 09 MD 2058, 2011 U.S. Dist. LEXIS 84831 *15 (S.D.N.Y. July 29, 2011). Thus, if a defendant "knows that the financial statements are false or misleading and yet proceeds to file them, the willingness of an accountant to give an unqualified opinion with respect to them does not negate the existence of the requisite intent or establish good faith reliance." *SEC v. Goldfield Mines,* 758 F.2d 459, 467 (9th Cir. 1985). Because Respondents knew the valuations were false, the auditor's willingness to issue an unqualified opinion is irrelevant. Moreover, to invoke the principle of reliance on a professional, the person must show, among other requirements, "that he made complete disclosure ...." *Bank of Am.*, 2001 U.S. Dist. LEXIS 84831 at *15. 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 accountants/auditors defense where the defendant "did not tell the auditors about a

[3] 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)).

[4] *See also In re Reserve Fund Secs. & Deriv. Litig.*, 09 MD. 2011, 2012 U.S. Dist. LEXIS 147723 *19 (S.D.N.Y. Sept. 12, 2012); *SEC v. Yuen*, No. CV 03-4376, 2006 U.S. Dist. LEXIS 33938 *112 (C.D. Cal. March 16, 2006) ("reliance on a professional is not an affirmative defense but merely one factor that a court may consider, along with the rest of the evidence presented, when evaluating whether a defendant acted with scienter").

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."[5] The Division will demonstate that Respondents did not make complete disclosure to their auditors. Consequently, they cannot rely on the audit opinion.

RESPONDENTS ARE LIABLE FOR THEIR PARTICIPATION IN THE SCEHME

In addition to their liability for the 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. 2d 1164, 1191 (C.D. Cal. 2007).[6] The case for scheme liability against Jarkesy and John Thomas 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

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[5] *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).

[6] *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. 2d 319, 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").

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 John Thomas.

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. John Thomas and Jarkesy, as the alter ego of John Thomas, 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, both Jarkesy and John Thomas, 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, both Jarkesy and John Thomas, 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 John Thomas's and Jarkesy's 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, John Thomas and Jarkesy knowingly solicited investments in the Funds on the basis of false and misleading misrepresentations about the identity of the Funds' service providers, fraudulent valuations, and misrepresentations about the concentration of the Funds' assets and investment in life settlement policies. 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 at *31-32.

In addition, John Thomas and Jarkesy had fiduciary duties 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, John Thomas and Jarkesy violated their fiduciary duty to the Funds. Specifically, Jarkesy breached his and John Thomas's fiduciary duty to the Funds by repeatedly favoring Belesis' and JTF's pecuniary interests over those of the Funds, and failing to get the Funds' consent. Jarkesy did not disclose that he intended to pay hundreds of thousands of dollars to Belesis and JTF for services of little or no value to the Funds, or that he would forgo any effort to negotiate lower fees for services of actual value. This favoritism of Belesis and JTF was never disclosed in the Funds' offering documents. *See Tambone*, 550 F.3d at 146; *Batterman*, 2002 U.S. Dist. LEXIS 18556 at *23. Nor did Jarkesy and John Thomas 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.

SANCTIONS SOUGHT

The Division is seeking the following relief against Respondents: (i) Pursuant to Section 203(e) of the Advisers Act, the Division is seeking an order of censure; (ii) Pursuant to Section 8A of the Securities Act, Section 21C(a) of the Exchange Act, and Section 203(k) of the Advisers Act, the Division is seeking the issuance of 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

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 over many years. Respondents have not accepted the wrongful nature of their conduct. Indeed, Jarkesy repeatedly posts to his Twitter account (and also on his website) that conservatives are being targeted by the SEC and appears to be suggesting that he is only being prosecuted because of his political beliefs as opposed to his conduct. The fraudulent conduct is ongoing and the harm to investors has been significant: millions of dollars of investor funds were squandered and lost. 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 to investors on a wider basis through his syndicated radio show and through the National Eagles and Angels Association, which he founded and chairs. As such, he has ample opportunity to commit future violations.

The showing required for a cease and desist order is "significantly less than that required for an injunction." *In the Matter of Fields*, File No. 3-14684, 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*, File No. 3-14355, 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).

In addition to the censure and the cease and desist order, the Division seeks an order requiring disgorgement, penalties, and prejudgment interest. In *In the Matter of Gerasimowicz*, File No. 3-15024, 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 (*citations omitted*). "The amount of the disgorgement ordered need only be a reasonable approximation of profits causally connected to the violation." *Id.* at *7 (*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 to have Respondents disgorge all of the incentive fees that were paid (approximately

$260,000) plus a significant percentage of the total management fees paid ($1.3 million). 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 those concerning the risk associated with the investment -- not been fraudulent.

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. In considering whether a penalty is in the public interest, the Commission may consider six factors: (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. Here, multiple units of third-tier penalties should be ordered. 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. In *In the Matter of Gualario & Co.*, LLC, File No. 3-14340, 2012 SEC LEXIS 497, *55-56 (Initial Decision, Feb. 14, 2012), penalties were determined by multiplying the statutory third-tier penalty by three (representing the operation of the fund, and the sale of two notes).

The Division also requests an order that bars the Respondents from association with brokers, dealers, investment adviser, municipal securities dealers, municipal advisors, transfer agents, nationally recognized statistical rating organizations, and investment companies. Such collateral bars are authorized by Sections 15(b) of the Exchange Act and 203(f) of the Advisers Act. The Division anticipates that Respondents will 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 *In the Matter of Daniel Bogar*, File No. 3-15003, 2013 SEC LEXIS 2235 (Initial Decision, Aug. 2, 2013) (Foelak, ALJ), where this hearing officer ruled as follows:

> 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).

See also, e.g., In the Matter of Siris, File No. 3-15057, 2012 SEC LEXIS 4075 *13 n.3 (Initial Decision, Dec. 31, 2012) (Foelak, ALJ); *In the Matter of Seeley*, File No. 3-15240, 2013 SEC LEXIS 3156 * 34-35 (Initial Decision, Oct. 9, 2013); *In the Matter of Constantin*, File No. 3-15332, 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 In the Matter of LeadDog Capital Markets, LLC*, File No. 3-14623, 2012 SEC LEXIS *57 n.22 (Initial Decision, Sept. 14, 2012). 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." *See id.* at *57.

The Division also requests penny stock bars and officer and director bars. Since the fraud at issue concerned "penny stocks," a penny stock bar is particularly appropriate. Likewise, because 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 were unrelated to his activities as an officer and director, his conduct toward his fiduciaries and investors demonstrates "unfitness." Jarkesy's securities laws violations were egregious. And he was not some low-level employee taking directions from higher ranking individuals – he was the investment manager. Moreover, he had an economic stake in the violations receiving incentive fees as well as management fees. He directed the fraud and had a high degree of scienter.

CONCLUSION

For the reasons set forth in this memorandum and as will be established at the hearing, the Division respectfully requests that the Hearing Officer find Respondents liable for violating 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.

Respectfully Submitted,

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