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UNITED STATES OF AMERICA

Before the

SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15446

In the Matter of

J.S. OLIVER CAPITAL MANAGEMENT, L.P., IAN O. MAUSNER, AND DOUGLAS F. DRENNAN,

Respondents.

POST-HEARING BRIEF OF RESPONDENT DOUGLAS F. DRENNAN

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I. INTRODUCTION

It is impossible to sit through the Hearing in this matter and disregard the evidence that J.S. Oliver Capital Management, L.P.'s ("JSO") owner, Ian Mausner, may have betrayed the trust of JSO's investors and engaged in cherry-picking. The Division presented evidence that Mr. Mausner potentially began cherry-picking just after Douglas Drennan, who was the former main trader, left JSO.

It is challenging for even the most fair-minded judge to evaluate the allegations against Douglas Drennan, the former owner of the independent research firm Powerhouse Capital, Inc. ("Powerhouse"), without being affected by Mr. Mausner's conduct during these events. But Mr. Drennan's actions must be judged without the clarity of this hindsight and under the circumstances as he reasonably perceived them in 2009 and 2010, keeping in mind that Mr. Drennan and JSO's own employees (including Melanie Kartes), had never seen much of the evidence of Mr. Mausner's conduct until this Hearing.

When viewed objectively, a clear picture emerges of Mr. Drennan's state of mind and good faith decision making in the face of unfamiliar and complicated circumstances in 2009. As a threshold matter, Mr. Drennan should not have to answer for deficiencies in JSO's disclosures (if any exist) because he was neither an officer, director, nor employee of JSO and lacked any control over Mr. Mausner's diclosures to his investors. As explained below, it is virtually unprecedented to impose aider, abettor and causing liability under such circumstances.

But the disclosures that the Division says were misleading were in fact in line with JSO's expenses for 28(e) research, non-28(e) consulting fees, salaries and rent as Mr. Drennan understood them at the time. This fact alone ends the Division's case against Mr. Drennan. Moreover, the evidence at the Hearing convincingly proved that:

- Mr. Drennan acted consistent with the advice of JSO's attorney, Mark Whatley, who drafted JSO's soft dollar disclosures, on issues pertaining to Powerhouse and the payment to Ms. Kloes.

- Mr. Drennan was transparent in his discussions with Instinet, JSO's soft dollar broker, regarding his relationship with JSO and Powerhouse as well as the information he had at any given time regarding the evolving settlement terms between Mr. Mausner and Ms. Kloes as they affected JSO.

- Mr. Drennan is not an attorney and repeatedly reached out to Instinet and Mr. Whatley for guidance to confirm (in the words of Instinet) that everything was done "by the book."

Mr. Drennan's transparency and attempt to understand and comply with regulations strongly refutes fraudulent intent. The Division's post-trial brief practically concedes the absence of evidence against Mr. Drennan. Although the Division seeks the maximum penalties against Mr. Drennan, it devotes merely two pages to outlining the evidence of Mr. Drennan's alleged aiding, abetting and causing liability, with hardly any evidentiary cites, effectively conceding it cannot satisfy its burden of proof and dropping its case against Mr. Drennan in substance. (Div. Br. 60-62.) That is the fair result given the evidence adduced at the Hearing. Mr. Drennan's submission, in contrast, offers a detailed record of the facts, in which every disputed fact is anchored in evidentiary cites from the Hearing.

Mr. Drennan has an unblemished disciplinary record. The Hearing has shown that the allegations against him are unsupported and the evidence proved he acted reasonably and in good faith under the circumstances as he perceived them in 2009 and 2010. Accordingly, Mr. Drennan respectfully requests a ruling in his favor with respect to the allegations in the Order Instituting Proceedings.

II. STATEMENT OF FACTS

A. Douglas Drennan - Background

Mr. Drennan is 42 years old and lives with his wife, Jennifer Drennan, and their two children [redacted], in San Diego, California. Mr. Drennan holds a Bachelor of Science in Finance from the University of Illinois. Mr. Drennan is the main income-earner for his family, which has been forced to sell its home in light of the legal costs of defending this case.

Mr. Drennan is not an attorney and has not had any legal training concerning soft dollars. Nor is Mr. Drennan a registered representative. Mr. Drennan has never been disciplined in any sort of governmental proceeding. (Tr. (Drennan) 1059:25-1060:2.)

B. Mr. Drennan's Employment with JSO (2004-2008)

In January 2004, Mr. Drennan commenced work as a research analyst at J.S. Oliver Capital Management L.P. ("JSO"), a small registered investment adviser in San Diego that was owned by Ian Mausner, a business acquaintance. JSO is a Delaware limited partnership that is registered as an investment adviser with the Commission. JSO was located at 4370 La Jolla Village Drive, Suite 660 in San Diego, California 92122. Its new mailing address is 2711 N. Sepulveda Blvd. #319, Manhattan Beach CA 90266.

Upon joining JSO, Mr. Drennan's duties included: discussing the portfolio and asset allocation, discussing sector weightings, conducting research, reviewing client accounts, participating in weekly investment meetings with Mr. Mausner, preparation of client presentations, and dealing with clients on a direct basis. (*Id.* 1061:22-1062:7.) As an employee, Mr. Drennan was also in charge of all trading and managed the brokerage commissions in the firm. (*Id.* 1063:11-23.) He attended multiple conferences and spoke to analysts extensively on behalf of J.S. Oliver. (*Id.* 1066:8-22; 1067:21-25.)

C. The Law Firm Howard Rice Creates "Broad" Soft Dollar Disclosures for JSO

From its inception through 2008, JSO's outside counsel, Howard Rice Nemerovski Canady Falk & Rabkin, P.C. ("Howard Rice"), a highly respected corporate law firm[1], drafted the disclosure documents for JSO's investment funds. JSO has waived the attorney-client privilege with respect to Howard Rice's advice regarding soft dollars, so the Court will have the benefit of that evidence. Mr. Drennan and J.S. Oliver employees alike understood that Howard Rice viewed J.S. Oliver's disclosures as very broad. (Tr. (Kartes) 714:8-714:12; 715:17-716:7; Tr. (Drennan) 914:18-915:8.)

D. Mr. Drennan's Employment with aAd Capital (2008)

In May, 2008, Mr. Drennan decided to leave JSO because its funds had negative returns, reducing or eliminating the potential for incentive bonuses. Around that time, Mr. Drennan became aware of a technology analyst position at aAd Capital, which was a well-performing hedge fund. aAd Capital offered Mr. Drennan the position of technology analyst with ownership in the firm after an initial trial period. Mr. Drennan viewed the aAd capital position as an opportunity to increase his income.

E. Mr. Drennan establishes Powerhouse Capital, Inc.

Due to the economic downturn in the summer/fall of 2008, aAd Capital informed Drennan that they would be laying him off. (Tr. Drennan 1068:19:1069:1.) In early December 2008, Drennan met with Ian Mausner about various ways to work together.

After consulting with his accountant, Gregory Block, on how to track expenses for tax purposes and set up an S Corporation, Mr. Drennan established Powerhouse as an independent entity to provide research services. Through Mr. Block, Mr. Drennan

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[1] Howard Rice merged with Arnold & Porter LLP on January 1, 2012.

[2] The Division may cite the fact that Mr. Drennan occasionally used an old JSO email account when he worked through Powerhouse. Those emails are backed up using Global Relay, a system that preserves emails for compliance reasons. Mr. Drennan's occasional use of the account

filed the required form with the State of California to establish Powerhouse and followed proper incorporation formalities. He also filed separate tax returns for Powerhouse and himself. The Division alleges that Powerhouse was not a genuine research business and that Mr. Drennan was simply an employee of Ian Mausner at JSO. The evidence showed that – contrary to the Division's allegations – Mr. Drennan's roles at Powerhouse were fundamentally different than the roles and responsibilities he held as a JSO employee between 2004 and 2008.[2]

F. The Relationship Between Powerhouse Capital and JSO.

Mr. Drennan unsuccessfully pursued other clients for Powerhouse.

Mr. Drennan pursued other potential clients for Powerhouse Capital. At the Hearing Mr. Drennan testified he maintained a dialogue with Dan Wimsatt at aAd Capital about working together. (Tr. (Drennan) 1143:9-1144:6, Dr. Ex. 1279.) Mr. Drennan corresponded and dined with other investors and fund managers he met through Dan Wimsatt to speak with them about Powerhouse and pursued them as possible new clients. (Tr. (Drennan) 1147:12-1148:20; Drennan Ex. 1278.) Mr. Drennan also corresponded with multiple individuals about his new company, even as he explored doing research with J.S. Oliver. For example, Mr. Drennan corresponded with Sean Wright, a friend and fund manager, and Marie Helene Palant, who was married to another good friend and investor. (Tr. (Drennan) 1144:11-1145:11; 1146:6-1147:3; Dr. Exs. 1276; 1277.)

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[2] The Division may cite the fact that Mr. Drennan occasionally used an old JSO email account when he worked through Powerhouse. Those emails are backed up using Global Relay, a system that preserves emails for compliance reasons. Mr. Drennan's occasional use of the account simply assured that certain communications pertaining to JSO were kept confidential and protected. But Mr. Drennan was careful to remove the old signature block on that email account, which previously identified him as a JSO employee, since he no longer was one.

Mr. Drennan was consistent in representing to his business contacts and friends that he had started his own research firm. Notwithstanding his efforts, Mr. Drennan was unable to locate other Powerhouse clients, largely due to an adverse market and economic downturn. (Tr. (Drennan) 1145:15-21.)

Mr. Drennan's work for JSO through Powerhouse was materially different than his former role as a JSO employee.

On or around early January 2009, Mr. Drennan began working for J.S. Oliver as a research consultant. As such, he had materially different duties than his tenure as an employee of JSO from 2004 to 2008. Mr. Drennan made a concerted effort not to perform duties that would be normally associated with a J. S. Oliver employee. At the Hearing, Mr. Drennan testified that everyone at J.S. Oliver "tried to make it very, very clear that, because I wasn't an employee, I was not going to be taking on a set of specific roles or tasks." (Tr. (Drennan) 1062:23-1063:1.)

As an employee, Mr. Drennan contacted clients as part of his duties and placed nearly all orders. (Tr. (Drennan) 1062:17-1063:21.) By contrast, as a consultant, Mr. Drennan tried not to have any client contact at all and did not answer the phones at J. S. Oliver for that purpose. (Tr. (Drennan) 1063:1-10.) As for trading, Mr. Drennan "very, very seldom[ly]" relayed trades from Ian Mausner to a broker, and only when Ian Mausner requested it. (Tr. (Drennan) 1064:6-1065:4.) According to the Division, Mr. Mausner was engaged in cherry picking during some of this time, which provides an additional explanation for Mr. Mausner's tight grip on JSO trades during this period.

Drennan estimated that he may have handled one to two individual trades per month in 2009, compared to the roughly ten to fifty trades on any given day. (*Id.*) For 2010, Mr. Drennan acknowledges he relayed more trades than the previous year, but still estimated he had any involvement in "well less than 1 percent" of the total number of trades happening at JSO during that time. (Tr. (Drennan) 1065:5-19.)

In addition, while Mr. Drennan had previously attended conferences and dealt with analysts on behalf of JSO as an employee in 2004 through 2008, he did not attend conferences or have any contact with analysts on behalf of JSO, while he was an employee of Powerhouse Capital. (Tr. (Drennan) 1066:24-1068:5.)

Mr. Drennan's was occasionally referred to as a "Team Leader", which was a term coined by Ian Mausner's life coach, Michelle Saul (Tr. (Drennan) 1167:6-14.) The label, however, is misleading as Mr. Drennan had no actual management authority over JSO employees. Id., 1167:15-25. While Mr. Drennan would occasionally troubleshoot problems that the J. S. Oliver employees could not address, Drennan performed such services as a favor to Ian Mausner (whom he considered a client of Powerhouse.) Drennan readily acknowledges he engaged in some non-research activities while providing services to JSO through Powerhouse, but also notes they were a "very limited part" of his daily routine and probably amounted to less than five percent of his total time spent working. (Tr. (Drennan) 1059:16-1162:4.)

The bulk of Drennan's workday consisted of monitoring the market and conducting longer-term research projects and analyses. (Tr. (Drennan) 1139:8-1140:23.) Drennan communicated with Ian Mausner throughout the day in person and via instant messaging in a constant back-and-forth exchange to Ian's questions. (Tr. (Drennan) 1140:24-1141:14.)

G. Mr. Drennan Helps Set Up J. S. Oliver's Account with Instinet.

After his conversations with Mr. Mausner about possible research relationships, Drennan contacted Neil Driscoll at Instinet to inquire about setting up an account for J. S. Oliver. Mr. Driscoll conveyed information from Mr. Driscoll to Mr. Mausner, and Mausner requested that Drennan continue helping with efforts to set up the account.

J. S. Oliver's Controller, Melanie Kartes, also worked to set up J. S. Oliver's soft dollar account with Instinet. (Tr. (Drennan) 1069:19-1070:20; Drennan Ex. 1122.) Mr. Drennan initiated the process and handed off the documentation to Melanie Kartes. (Tr. (Drennan) 845:13-15; 1070:10-15.) Sometime in early February, Mr. Drennan informed Mr. Driscoll that Ms. Kartes would be handling more administrative issues for the account. (Tr. (Driscoll) 315:24-316:13; Drennan Ex. 1157.) Ms. Kartes began transmitting invoices to directly to Mr. Driscoll after that point. (Div. Ex. 54; 56; Tr. (Driscoll) 284:20-285:14.)

The February 6 communications.

On Friday, February 6, 2009, Neil Driscoll and Drennan engaged in correspondence via instant message. (Tr. (Drennan) 1074:8-1075:9; 1088:8-9; Div. Exs. 330; 335; 709.) Driscoll asked if Drennan had a copy of JS Oliver's LP Agreement or Offering Memorandum. (Tr. (Drennan) 1075:15-1076:1; Div. Exs. 330; 335; 709.) Drennan did not understand why Mr. Driscoll wanted the documents and asked why he needed them. (Tr. (Drennan) 1076:10-13; Div. Exs. 330; 335; 709.) Among other things, Driscoll explained that: research on proxy voting was not reimbursable under the Rule 28(e) safe harbor, but Instinet's soft dollar group had advised him that non 28(e) expenses could be reimbursed with soft dollars as long as they were discussed in the offering memorandum. (Tr. (Driscoll) 323:18-324:5; Div. Exs. 330; 335; 709.) Mr. Drennan was not aware of this information until he was told by Driscoll. (Tr. (Drennan) 1076:14-24; Div. Exs. 330; 335; 709.) This was the first time Mr. Drennan learned that non-28(e) expenses could be paid with soft dollars. It was Instinet that informed him of this. As Mr. Drennan began to educate himself about soft dollar issues, Mr. Driscoll also he tried to provide answers to Mr. Drennan's later questions through Instinet's commission management department (also known as the "soft dollar group"). Tr. (Driscoll) 345:24-346:6.

That same day, in response to Mr. Driscoll's request for an offering memorandum, Mr. Drennan asked J. S. Oliver employee Melanie Kartes to send him a copy of an offering memorandum (or "OM"). (Tr. (Drennan) 1081:1-5, Div. Ex. 335.) Drennan does not recall asking for any specific offering memorandum, but believes he may have requested the Fund II Offering Memorandum because it had previously been J.S. Oliver's largest fund. (Tr. (Drennan) 1081:6-11.) In any event, Drennan believed the offering memoranda for all the J.S. Oliver funds were the same. (Tr. (Drennan) 1081:11-12.)

At 10:07am PST that same day, Ms. Kartes replied to Mr. Drennan's email and included a copy the Fund II offering memorandum. (Tr. (Drennan) 1080:5-10; 1082:6-10; Drennan. Ex. 1294.) Over the next half hour, Drennan read and sent a total of twelve emails and quickly gave a cursory glance at the soft dollars disclosure in the offering memorandum sent by Ms. Kartes. (Tr. (Drennan) 1082:17-1086:3; Drennan Exs. 1295-1305.) Approximately 30 minutes after receiving the Fund II offering memorandum from Ms. Kartes, Mr. Drennan instant messaged to Mr. Driscoll "our offering mem is out of hand" – indicating that the thought the soft dollar disclosures were very broad. (Div. Ex. 335.)

At approximately 10:47am PST that same morning, Drennan forwarded an email from Mr. Driscoll to J.S. Oliver employees Melanie Kartes and Jim Donahue. (Div. Ex. 137.) Tr. (Drennan) 1089:4-11.) The email included an attachment that outlined the differences between 28(e) and non-28(e) uses of soft dollars, which Mr. Drennan wanted to share with Ms. Kartes and Mr. Donahue to help them better understand the differences between the two categories. (Div. Ex. 137; Tr. (Drennan) 1089:22-1090:3.)

Later that same morning, Mr. Drennan noticed that the attached Fund II OM included his name and those of Lindsay Back and Carl Adams as J. S. Oliver employees. This information was inaccurate since Back and Adams were former

employees and Mr. Drennan was employed by Powerhouse. (Tr. (Drennan) 1087:7-1088:3; Div. Ex. 1294, 10-11.) Accordingly, at 11:39 am PST, Drennan emailed Ms. Kartes back with comments requesting, among other things, that all three names be taken out of the offering memorandum. (Tr. (Drennan) 1087:7-22; Drennan Ex. 1306.)

The February 9 communications

The following Monday, February 9, 2009, at 8:20am PST, Ms. Kartes sent an email to Mr. Drennan with an attached copy of the CGF Offering Memorandum. (Tr. (Drennan) 1090:22-1091:11; Drennan Ex. 1307.) It was Mr. Drennan's understanding that because the Concentrated Growth fund had been formed sometime in the summer of 2008 while he was not a J.S. Oliver employee, the CGF offering memorandum would not have listed his name or the other former J.S. Oliver employees. (Tr. (Drennan) 1091:11-19; 1093:15-1094:12.)

Because Howard Rice had drafted all the J.S. Oliver offering memoranda, Mr. Drennan believed that the soft dollar disclosures for the CGF OM were the same as those for the other J.S. Oliver funds and did not compare them against the Fund II offering memorandum he had received on February 6. (Tr. (Drennan) 1090:22-1091:19; 1093:15-1094:12; 1095:1-2.) Mr. Drennan transmitted the CGF offering memorandum to Mr. Driscoll approximately fourteen minutes later. (Tr. (Drennan) 1092:15-1093:14; Div. Ex. 331.)

Ms. Kartes also notified J. S. Oliver's attorneys of record, Howard Rice, of the necessary changes that Drennan had flagged regarding the Partner funds' offering memoranda. (Tr. (Kartes) 709:16-490:1; Drennan Ex. 1309.)

Mr. Drennan Informed Instinet That
He Was an Employee of Powerhouse Capital.

Mr. Drennan provided an IRS Form W-9 to Instinet and expressly discussed Powerhouse with Neil Driscoll of Instinet. (Tr. (Kartes) 642:3-6; 643:2-20; Div. Ex. 316(G).) Mr. Drennan identified himself on his Linked In website profile as President of Powerhouse and an Instinet employee, Jonathan Ranello, invited Mr. Drennan, through Mr. Drennan's Linked In account, to "link in" with Mr. Drennan in May 2009. (Dr. Ex. 1280.) The Division's brief does not contend that Mr. Drennan hid this fact from Instinet.

Mr. Drennan regularly consulted
JSO's counsel on soft dollar matters.

During his correspondence with Instinet around February 2009, Mr. Drennan only had a basic understanding of the Rule 28(e) safe harbor with respect to soft dollars. (Tr. (Drennan) 1077:3-7.) As he continued to learn more about the subject through his interactions with Instinet, Mr. Drennan and JSO consulted with the legal team at Howard Rice many times about the appropriate use of soft dollars for JSO. (Tr. (Drennan) 1077:3-19.) One of the Division's witnesses, former JSO Controller Melanie Kartes, also testified that she worked with several attorneys at Howard Rice and participated in several phone calls with them. (Tr. (Kartes) 703:17-704:18.) Kartes recalls that JSO was transparent in communicating with its attorneys at Howard Rice in the course of seeking legal advice. (Tr. (Kartes) 704:20-16.) According to Kartes, JSO contacted its counsel to confirm it was acting appropriately:

> JUDGE MURRAY: Do you know why you contacted the attorneys?
>
> THE REPORTER: I'm sorry?

> THE WITNESS: Yeah, because we didn't know the legal aspects, and we wanted to make sure what we were doing was correct.

(Tr. (Kartes) 750:11-16.)

According to Ms. Kartes, JSO's counsel at Howard Rice was consulted on issues and questions surrounding the use of soft dollars for non 28(e) matters at JSO, and she and Drennan participated in multiple calls with counsel (Tr. (Kartes) 721:3-14.) Ms. Kartes never heard from counsel at Howard Rice "that JSO was doing anything that was not compliant with the law." (Tr. (Kartes) 719:12-21.)

H. JSO's Payment to Gina Kloes.

Gina Kloes ("Ms. Kloes" or "Gina Kloes") was a co-founder of JSO, Ian Mausner's spouse, and served as the company's CFO until sometime in 2005 when she and Ian finalized their divorce proceedings. (Tr. (Kloes) 475:20-476:6.) She is a graduate of one of the top law schools in the United States, Boalt Hall law school. (*Id.* 474:20-22.)

Though she left her position as CFO sometime in 2005, Ms. Kloes agreed to be reasonably available to help JSO employees in 2006, according to the terms provided in paragraph 22 of the marital settlement agreement ("MSA") executed on or around October 31, 2005. (Tr. 480:15-481:4; Div. Ex. 22.) The terms regarding the payments to Ms. Kloes were amended on February 6, 2006. (Div. Ex. 25; Tr. 488:21-490:1.)

The Division claims Ms. Kloes "was under no obligation to perform any work for JSO as of December 31, 2006 and did not perform any work after 2007." (Div. Br. 25.) That is wrong:

- Mr. Mausner and Ms. Kloes engaged in further negotiation regarding the amount of salary she would be given and the amount of work she would do for JSO after January 1, 2007. (Div. Ex. 23; Tr. 493:9-23.)
- Ms. Kloes testified she corresponded with JSO's outside counsel Mark Whatley regarding the termination of Carl Adams, one of JSO's

> employees at the time, at some point after 2006. (Tr. (Kloes) 515:10-16.) Ms. Kloes also testified that she helped answer questions from Lindsay Back, another JSO employee at various times after 2006. (*Id.* 516:14-21.)

Ms. Kloes, an attorney, herself equivocated on whether she was technically an employee after leaving her position as JSO's CFO.

> Q: And, in fact, you were not an employee of JSO from 2007 to 2010; correct?
>
> A: I don't know that I would be considered an employee. I was getting payments, so -- I was getting payments. If that equals being an employee, then maybe. But I wasn't an employee working there.

(Tr. (Kloes) 482:22-483:2.) However, Ms. Kloes knew she was receiving payments through J. S. Oliver's payroll and referred to such payments as "salary", even as she opined that she was not an employee at J. S. Oliver. (Tr. (Kloes) 501:1-19; 502:18-24; Div. Ex. 31.)

What did Mr. Drennan know about Ms. Kloes' relationship with JSO?

Mr. Drennan understood that Ms. Kloes had a business relationship with J.S Oliver between 2006 and 2008 and that Gina was "there as a consultant if anything came up." (Tr. 1097:4-14.) He knew that JSO employee Lindsay Back was "very close friends with Gina" and understood that Back "consulted her often on matters with J.S. Oliver." (*Id.* 1097:20-23.)

Mr. Mausner informed Mr. Drennan that he continued to communicate with Ms. Kloes about business issues after Mr. Drennan left JSO in 2008. (*Id.* 1103:8-18-1103:20.) Mr. Drennan understood Ms. Kloes was on JSO's payroll in 2009 and had been removed around February 2009 as part of her divorce settlement negotiations with

Mr. Mausner. (*Id.* 1104:7-11.) Mr. Drennan did not have a clear understanding of Mr. Mausner's business relationship with Ms. Kloes as of January 2009, but assumed that Mr. Mausner continued to talk to her on occasion and share ideas. (*Id.* 1097:24-1098:6.)

What information was Mr. Drennan not provided about Ms. Kloes' relationship with JSO?

The evidence is clear Mr. Drennan was not aware of the sordid incidents the Division cites in its case, which means that information cannot be used to judge his actions: There is no evidence Mr. Drennan was ever shown the troubling emails between Ms. Kloes and Mr. Mausner that the Division relies on to argue it was unreasonable to believe Ms. Kloes would consult with JSO after 2006. (Div. Br. 27, *citing, e.g.,* Div Exs. 21, 24, 594.) Mr. Drennan testified that he had a limited understanding of the documents regarding the Mausners' marriage settlement:

> JUDGE MURRAY: You hadn't seen that on some documents?
>
> THE WITNESS: No, I had never seen the language agreement between the three. And the only language that I had focused on was the marriage settlement agreement in '05 in the c, d, e area.

(Tr. 1130:1-6.) In short, Mr. Drennan was unaware of the details of the conflict between Mr. Mausner and Ms. Kloes and believed Ms. Kloes was still involved with the business.

Mr. Drennan believed Instinet understood and vetted the JSO payment to Ms. Kloes

In early 2009, Mr. Mausner and Ms. Kloes were renegotiating the terms of their contract regarding the dissolution of their marriage and separation of their business interests in JSO. At Mr. Mausner's request, Mr. Drennan asked Instinet if Ms. Kloes as a consultant could be compensated with soft dollars in a sum of $275,000. (Tr. (Drennan) 1102:9-13; Drennan Ex. 1117.) Mr. Drennan relayed that information to Jonathan Ranello, an associate at Instinet, as requested. (Tr. 1102:13-1102:15.) The email string included a message from Mr. Ranello, who had written "Doug, please see below. This is what they have asked for." (Tr. (Drennan) 1098:18-1099:9; Drennan Ex. 1117.) To support the hypothetical payment to Ms. Kloes, Instinet requested an "opinion" from JSO's counsel stating that monthly payments to Ms. Kloes of $25,000 are permitted. (Tr. (Drennan) 1107:11-12.)

From the correspondence between Instinet's soft dollar group and Instinet's counsel on that email string, Mr. Drennan understood that Instinet was vetting and reviewing the proposed transaction with its internal counsel to make sure that payments to Ms. Kloes were permissible. (Tr. (Drennan) 1104:12-1106:1.)

Mr. Drennan also believed – quite reasonably – that Instinet's soft dollar and legal team were both thoroughly reviewing the transaction against JSO's soft dollar disclosures to assure compliance. The May 8, 2009 email trail Mr. Ranello forwarded to Mr. Drennan showed extensive evaluation of the transaction by members of Instinet's legal team (Ms. Kenniff) as well as the Instinet soft dollars group (Ms. Shankar and others). (Dr. Ex. 1117.) That same email trail showed Mr. Drennan that Instinet's team

was vetting the transaction against JSO's Form ADV and its offering memoranda. (*Id.*, JSO 299952.)

Mr. Drennan was also aware that Instinet's employees Giacoma and Driscoll both personally met with Mr. Mausner to vet the transaction and solicited specific detailed information from Mr. Mausner. (Tr. (Driscoll) 297:19-298:2, 374:16-22; Tr. (Kellner) 429:8-16; Tr. (Drennan) 1020.)

For its part, Instinet understood from Mr. Drennan that he was not fully informed on the situation and needed to go to Mr. Mausner for details. Instinet also understood that Mr. Drennan wanted everything done properly and within the rules. (Tr. 1170:24 – 1171:3.)

Mr. Drennan relied on advice from JSO's counsel, Mark Whatley, who advised JSO on the transaction.

The negotiations between Ms. Kloes and Mr. Mausner involved both personal and business issues. As JSO's attorney, Mark Whatley, was directly involved in counseling Mr. Mausner in the negotiations on the business side, and Mr. Mausner had separate family law counsel. (Tr. (Kartes) 758:1-3.) Melanie Kartes also testified that Mark Whatley had parts of the marital settlement agreement between Mr. Mausner and Ms. Kloes, but did not know if Mr. Whatley had received the agreement in its entirety. (Tr. (Kartes) 758:5-12.)

On **Friday, May 8, 2009**, Mr. Drennan forwarded the email string between himself and Mr. Whatley to get Whatley's opinion (as of JSO's counsel) regarding payments to Ms. Kloes with soft dollars. (Drennan Ex. 1117.)

Mr. Drennan then spoke with Mr. Whatley immediately after forwarding that email string to him around 11:50 am. Tr. 1106:25-1107:3. Because Mr. Whatley was preparing for another phone call at 12:30 pm, he asked Mr. Drennan to postpone their conversation until after that call.

During the interim, additional information became available to Mr. Drennan. Also at 11:50 am – probably just as Mr. Drennan had his initial call with Whatley – Mr. Mausner emailed Mr. Drennan asking if the transaction could be structured differently: "Can it also be compensation for *past* consulting rendered since she left the firm?" (Ex. 1314 (emphasis added); Tr. Drennan 1109.)

As far as Mr. Drennan knew, Mr. Mausner's questions reflected his ongoing negotiations with Ms. Kloes, to which he was not privy.

At Mr. Mausner's request, Mr. Drennan raised Mr. Mausner's new question with Mr. Whatley by writing him "I know you have a 12:30 call, so I'm sending this email. Please give me a call to discuss the clarification of this payment. I have a different way of describing it." Tr. Drennan 1108; Ex. 1118.

Mr. Drennan and Mark Whatley then had a phone conversation regarding Mr. Drennan's email, after which Drennan formed the belief that in order for Ms. Kloes to be compensated with soft dollars, it had to be disclosed and there needed to be a contract in place. Tr. (Drennan) 990:19-991:4. A Howard Rice Invoice dated May 8, 2009 corroborates a "Telephone conference with D. Drennan regarding trading and expense issues, review emails, telephone conference with D. Drennan." Tr. 1112; Ex. 1103. It was Mr. Drennan's understanding that Mark Whatley was involved in the

conversation because there was a business component to the negotiations between Ms. Kloes and Ian Mausner that affected JSO. (Tr. (Drennan) 1110:14-22; 1113:1-5.)

On Monday, May 11, 2009, Mr. Drennan spoke with Mark Whatley by phone and Mr. Whatley informed him that Ms. Kloes' salary as an employee "could be reimbursed through soft dollars per the disclosures in the documents." (Tr. (Drennan) 1118:6-15.) At approximately 10:38am, Drennan emailed Mr. Mausner and wrote "**Just got off the phone with Mark** and wanted to update you and see what you want to do next." (Drennan Ex. 1315 (emphasis added); Tr. 1117:14-1118:15.) Howard Rice's invoice corroborates this call too. (Tr. (Drennan) 1115:7-17; Drennan Ex. 1103.)

On May 15, 2009, Ms. Kloes and Ian entered into an amended settlement agreement. (Tr. (Kloes) 507:2-16; Div. Ex. 26.) It is clear Mr. Whatley advised on the use of soft dollars in connection with that agreement, as corroborated by a May 15 line entry in a Howard Rice invoice stating "**Telephone call with Ian Mausner regarding soft dollars**." (Drennan Ex. 1103 (emphasis added); Tr. Drennan 1123:18-23.) That entry refers to the conference call that Mr. Drennan participated in with Mark Whatley regarding the proposed payment to Ms. Kloes and whether it could be paid with soft dollars. (Tr. 1123:24-1124:4.) Mr. Drennan understood that Mark Whatley was involved in helping finalize the settlement agreement between Mausner and Kloes, though Drennan himself was not involved in negotiating the final agreement and only occasionally relayed information between them. (*Id.* 1126:7-21.)

Mr. Drennan's email to Instinet.

On or about June 1, 2009, Mr. Mausner asked Mr. Drennan to retype the portion of the Marital Settlement concerning the obligation of JSO to Gina Kloes which reflected a separate, free-standing contract, as Mr. Drennan understood it. (Tr. (Drennan) 1126:21-23.) Mr. Mausner also asked him to remove references to personal expenses in the re-typed excerpt. Because Mr. Drennan believed that personal expenses were not relevant to the employment agreement between Gina Kloes and JSO, Mr. Drennan removed references to country clubs in the re-typed excerpt. (*Id.* 1137:6-13; Div. Ex. 348; Div. Ex. 349A.)

A critical point is that Mr. Drennan believed the new settlement agreement with Ms. Kloes *did* include personal payments but that those were provided for separately and would not be paid using soft dollars. On May 13, 2009, Mr. Mausner emailed Ms. Kartes, Mr. Donahue, Mr. Drennan and Ms. Babaie to inform them of the terms of his settlement with Ms. Kloes:

> From: Ian Mausner
> Sent: Wednesday, May 13, 2009 7:52 AM
> To: Jim Donahue, Melanie Kartes, Doug Drennan, Nina Babaie
> Cc: Ian Mausner
> Subject: To do's re Gina
> Importance: High
>
> In addition to the payroll check can you please prepare the following by Friday am:
>
> 1. Add [redacted] (until 12/31/13) to health benefits and add Gina (until 12/31/10 or until she gets married whichever is first) to health benefits or just take over her COBRA since she is not an ongoing employee.
> 2. Make copy of the firm's insurance policies

3. Issue check to Gina for $20,000 repayment of her loan to the firm and reduce the balance outstanding accordingly

4. Write down policy number and other identifying info for [redacted] health coverage and make sure their insurance cards have been sent. Make sure [redacted]'s card is sent to Gina as well.

5. Issue check for $10,000 made out to "Seltzer Caplan McMahon Vitek" it is a legal expense payment for the final agreement

6. Print out all of the emails re the recent SEC interaction but NOT the firm info we provided to the SECOND

7. Make copy of all Enterprise accounts

8. Separate check made out to Gina in the amount of $36,000.

9. Separate check made out to Gina in amount of $3,065.70

10. Separate check made out to Gina in the amount of $1,700.

11. Separate check made out to Gina in amount of $10,200

(Div. Ex. 340, JSO301113). Mr. Drennan reasonably interpreted this email to distinguish between parts of the Kloes/Mausner/JSO settlement that were personal and parts that were business:

> [Referring to Div. Ex. 340]
>
> Q: And what's your understanding?
>
> A: In my view, it was the – the details of the renegotiated agreement where they so-called separate between church and state – it separates the business aspect with the payroll and then all of the personal obligations and payments that Ian would be required to pay through the agreement.
>
> Q: When you say "separates the business aspect with the payroll from the personal obligations," do you see any personal obligations indicated here in this email dated May 13, 2009, from Ian Mausner to those individuals?
>
> A: It – basically everything besides the payroll. So any checks that were issued were personal obligations in my mind.

(Tr. 1119:24 – 1120:13)

It was with this understanding, and at Mausner's request, that Mr. Drennan typed and sent the contract excerpt to Mausner by email at 11:08 am on June 1. (Tr. 1128:9-12; Div. Ex. 348.) Mr. Mausner reviewed the excerpt and instructed Mr. Drennan to change the language from "contract between Mausner and Gina Kloes" to "J.S. Oliver Capital Management, L.P. and Gina Kloes." (Tr. 1128:15-22; Div. Ex. 348; Div. Ex. 349A.) Mr. Drennan made the edit at Mausner's directions because it was consistent with his understanding of the settlement based on the limited understanding he had, and re-sent it to Mr. Mausner at 12:11pm. (Tr. 1128:9-22; Div. Exs. 348 and 349A.)

In typing out the contract excerpt and sending it to Mr. Mausner by email, Mr. Drennan considered his role to be clerical in nature. Mausner had directed him to the marriage settlement agreement, which Mr. Drennan had no prior knowledge or exposure to. He simply typed and formatted according to Mr. Mausner's instructions. (Tr. 1136:14-1137:1.) When Mr. Mausner received the version he wanted, he (not Mr. Drennan) then forwarded that information to Instinet. (Div. Ex. 70.)

Mr. Drennan genuinely – and appropriately based on the information available to him – believed that while the marriage settlement was between Mausner and Kloes, the edits made to the contract excerpt reflected the agreement between JSO and Kloes regarding her salary and employment. (Tr. 1129:9-16; 1130:7-12.) Mr. Drennan is not a lawyer and did not scrutinize the agreement from a legal perspective. (Tr. (Drennan) 1130:18-23.) Further, Mr. Drennan had no reason to believe that as of June 1, 2009,

Mr. Mausner was characterizing his settlement agreement with Gina Kloes in an inaccurate manner. (Tr. 1132:6-10.) Drennan's understanding at the time was that:

- Ms. Kloes was owed salary for employment with JSO from 2007 through 2010 (Tr. 1135:3-10.)
- JSO, Kloes, and Mausner had entered into an agreement for Ms. Kloes to get a salary from JSO (Tr. 1135:24-1136:2.)
- JSO's counsel, Mark Whatley, was involved in the transaction (Tr. 1136:4-5.)
- The payment to Gina was for employment and salary, and was JSO's obligation. (Tr. 1136:6-8.)

For comparison, Melanie Kartes also had a very similar understanding of the payment to Ms. Kloes. Ms. Kartes believed :

- That the payment was part of the marital agreement, but also involved JSO (Tr. (Kartes) 744:11-15)
- Understood the payment to Ms. Kloes was business related (Tr. 744:16-17)
- Believed the payment to Ms. Kloes related to Ms. Kloes' employment and leaving JSO (Tr. 744:23-745:2)
- That the payment to Ms. Kloes only applied to her activities within JSO, except for "the piece that exclusively stated the personal expenses." (Tr. 745:4-10.)

Based on the information available, Mr. Drennan independently calculated that Ms. Kloes was owed approximately $330,000 in strictly salary payments, apart from any personal expenses. (Tr. 1137:6-1138:7.) With this in mind, Mr. Drennan removed references to personal expenses from the excerpt precisely because he believed that the excerpt only pertained to salary due to Gina Kloes.

To the extent Mr. Mausner and Ms. Kloes did not genuinely believe that JSO owed her money but put that in their settlement agreement with the guidance of their attorneys, Mr. Drennan was not made aware of that.

I. JSO Hires Mr. Drennan as Chief Compliance Officer

In June of 2011, Melanie Kartes, JSO's then controller, left JSO. At the time, she oversaw the accounting at JSO. Around the same timeframe, the SEC was completing its normal audit of JSO. (Tr. (Drennan) 877:6-7.) In an effort to create a more robust compliance environment, JSO decided to separate the roles of CEO and Chief Compliance Officer and add an independent outside compliance consultant. (*Id.*, 877:8-10) Mr. Mausner decided to hire Mr. Drennan as an employee with the title of Chief Compliance Officer. Id., 877:10-11. Mr. Drennan's duties as an employee of JSO differed substantially from his role as a consultant through Powerhouse. His new role as CCO required significant time, was largely unrelated to research, and required him to manage JSO employees. Id., 877:12-21.

The Division has not alleged that Mr. Drennan aided and abetted any violations during his tenure as an employee of JSO either before 2008 or after 2011.

III. LEGAL STANDARDS

A. Aiding and Abetting

1. Knowledge requirement

The standard formulation for aiding and abetting and causing liability is 1) an independent securities law violation committed by a third party; 2) the person who

aided and abetted and caused the violation knew that his or her role was part of an overall activity that was improper; and 3) the aider and abettor and causer knowingly and substantially assisted the conduct that constituted the violation. *In the Matter of Lisa B. Premo,* Admin. Proc. File No. 3-14697, Initial Decisions Rel. No. 476, 2012 SEC LEXIS 4036, at *62-63 (Dec. 26, 2012). The critical issue is the knowledge element.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which was signed into law on July 21, 2010, amended Section 20(e) of the Exchange Act and Section 209(f) of the Advisers Act by providing that aiding and abetting liability may be supported by reckless rather than only knowing substantial assistance. Dodd-Frank also created aiding and abetting liability under the Securities Act. These provisions cannot be applied retroactively. *See Securities and Exchange Commission v. Daifotis,* No. C 11-00137 WHA, 2011 LEXIS 60226, at *31-38 (N.D. Cal. June 6, 2011)(aiding and abetting provisions of the Investment Company Act of 1940 created by Dodd-Frank could not be applied retroactively); *Jones v. Southpeak Interactive Corp.,* No. 3:12cv443, 2013 U.S. Dist. LEXIS 37999, at *19-26 (E.D. Va. Mar. 19, 2013) (Dodd-Frank does not have retroactive application). Thus for any allegations concerning conduct prior to July 21, 2010, which comprise the bulk of the allegations in the OIP, the Division of Enforcement is *required to prove actual knowledge*, not simply recklessness, for aiding and abetting liability; and there could not be aiding and abetting liability under the Securities Act.

There must be a multitude of "red flags" and suspicious events to support a conclusion that the aider and abettor, or causer, knew [or recklessly disregarded] that he

was contributing to an improper scheme. *In the Matter of Stephen J. Horning,* Admin. Proc. File No. 3-12156, Initial Decision Rel. No. 318, 2006 SEC LEXIS 2082, at *51-52 (Sept. 19, 2006) (citing *Howard v. SEC,* 376 F.3d 1136, 1142-43 (D.C. Cir. 2004)), *aff'd,* SEA Rel. No. 56886, 2007 SEC LEXIS 2796 (Dec. 3, 2007); *In the Matter of Amaroq Asset Mgt., LLC,* Admin. Proc. File No. 3-12822, Initial Decisions Rel. No. 351, 2008 SEC LEXIS 1612, at *33-34 (July 14, 2008).[3]

Even providing substantial assistance to the primary violation does not result in liability unless there was knowledge of the improper scheme. *In the Matter of Paul A. Flynn,* Admin. Proc. File No. 3-11390, Initial Decision Rel. No. 316, 2006 SEC LEXIS 1766, at *77-90 (Aug. 2, 2006)(respondent involved in activities that facilitated market timing but had no knowledge that activities were fraudulent); *In the Matter of Russo Securities Inc.,* Admin. Proc. File No. 3-8573, Securities Exchange Act. Rel. No. 39181, 1997 SEC LEXIS 2075, at *19-28 (Oct. 1, 1997) (respondents provided opinion to reset interest on bonds but insufficient evidence that respondents knew principal was trying to manipulate bond prices). As the *Horning* decision stated, "there must be proof that the person was aware or had knowledge of wrongdoing . . . In the absence of knowledge . . . an aider and abettor must have a state of mind close to conscious intent." 2006 SEC LEXIS 1766, at *52 (citing *Howard,* 376 F.3d at 1142) (emphasis added).

In short, aiding and abetting liability cannot be predicated on gross or heightened negligence. Further, the alleged aider and abettor must have acted with scienter regardless of the level of proof required to establish the primary violation. *In*

[3] Several Commission decisions hold that recklessness would suffice if the respondent were a fiduciary of the clients of a money manager or broker-dealer. But Mr. Drennan was not an officer or employee of JSO during the relevant time period and therefore did not have a fiduciary duty to JSO's clients.

the Matter of Harrison Securities, Inc., Admin. Proc. File No. 3-11084, Initial Decision Rel. No. 256, 2004 SEC LEXIS 2145, at *128 (Sept. 21, 2004) (collecting cases).[4]

2. Substantial Assistance

Generally, aiding and abetting cases concern individuals who were officers or senior employees of a company, a fund or a broker-dealer, and who engaged in conduct that significantly facilitated the illegal scheme, usually to their own benefit. Thus aiding and abetting or causing allegations were brought against a managing director of an investment adviser who prepared fake invoices to misappropriate client funds, *In the Matter of Brendan E. Murray,* Admin. Proc. File No. 3-12436, 2008 SEC LEXIS 2924, at *15-25 (Nov. 21, 2004); a corporate controller who knowingly recorded reserves that he knew were excessive, *In the Matter of Robert W. Armstrong,* Admin. Proc. File No. 3-9793, Initial Decisions Rel. No. 248, 2004 SEC LEXIS 789 (April 6, 2004); the director of a clearing broker who ordered a sham money market transaction to be entered on the firm's books, *Securities and Exchange Commission v. Goble,* 682 F.3d 934, 947 (11th Cir. 2012); a successful, sophisticated investment manager who knowingly concealed from a firm's valuation committee that there was a missed bond payment that affected fund valuation, *In the Matter of Lisa B. Premo,* 2012 SEC LEXIS at *44-71; and the chief executive officer and sole shareholder of a broker-dealer who

[4] Causing liability is often deemed to have a negligence standard. But scienter is still required to be held liable for causing a primary violation that required scienter. *In the Matter of John A. Carley,* Admin. Proc. File No. 3-11626, Initial Decision Rel. No. 292, 2005 SEC LEXIS 1745, at *149-50 (July 18, 2005), *aff'd,* SEA Rel. No. 57246. 2008 SEC LEXIS 222 (Jan. 31, 2008), *modified,* SEA Rel. No. 61966, 2010 SEC LEXIS 1358 (April 23, 2010).

created false accounting records and consciously violated net capital requirements, *In the Matter of Harrison Securities, Inc.*, 2004 SEC LEXIS, at *126-31.

By contrast, aiding and abetting liability is not found where the respondent did not control the entity that committed the primary violation. *See In the Matter of Douglas W. Powell,* Admin. Proc. File No. 3-11086, Initial Decisions Rel. No. 255, 2004 SEC LEXIS 1796, at *63-64 (Aug. 17, 2004) (rejecting aiding and abetting allegations against respondents who were not involved in day-to-day management of broker-dealer).

In related decisions, two individuals were found to have aided and abetted an investment adviser that directed a broker-dealer to provide client commissions to another broker-dealer that had referred a pension fund to be a client of the investment adviser. One respondent was found to have aiding and abetting liability where he negotiated the arrangement to direct client commissions to the second firm, which he knew provided no brokerage services; was told not to mention the second firm to the fund's trustees; and was aware of trips to the Cayman Islands for offshore banking. The other respondent was found to have aiding and abetting liability where he was an officer of the investment adviser having a fiduciary duty to the firm's clients and knew that directing commissions to the second firm violated the firm's internal policy. *In the Matter of Clarke T. Blizzard,* Admin. Proc. File No. 3-10007, Initial Decisions Rel. No. 229, 2003 SEC LEXIS 1419 (June 13, 2003), *rev'd, In the Matter of Clarke T. Blizzard,* Admin. Proc. File No. 3-10007, 2004 LEXIS 1298 (June 23, 2004); *In the Matter of Chris Woessner,* Admin. Proc. File No. 3-10607, Initial Decisions Rel. No. 225, 2003 SEC LEXIS 646 (March 19, 2003).

In another soft dollar matter, the chief portfolio manager of an investment adviser was held to have aiding and abetting liability where he affirmatively misrepresented the existence of soft dollar arrangements in soliciting investors and misled the Board of Directors concerning soft dollar arrangements. *In the Matter of Fundamental Portfolio Advisors, Inc.*, Admin. Proc. File No. 3-3-9461, 2003 SEC LEXIS 1654, at *55-56 (July 15, 2003).

As discussed below, the evidence presented at the Hearing does not support a finding by a preponderance of the evidence that Mr. Drennan knowingly engaged in conduct that he knew contributed to an improper scheme. Instead, the evidence shows that Mr. Drennan:

- Was not responsible for managing JSO
- Did not record entries in JSO's books and records
- Did not solicit clients or prepare disclosures
- Knew that the disclosures in question were drafted by attorneys who understood his role at Powerhouse
- Was aware that Instinet and its internal soft dollar diligence team were aware of Powerhouse and its arrangement with JSO, vetted that arrangement, and concluded that it complied with applicable laws

The evidence proved that Mr. Drennan lacked knowledge of any violation and did not substantially assist in aiding and abetting or causing liability.

IV. ARGUMENT

A. Mr. Drennan Did Not Violate Any Securities Laws in Connection with Instinet's Payments to Powerhouse

The Division of Enforcement alleges Mr. Drennan should be liable for the benefit that JSO realized in utilizing soft dollars to compensate Mr. Drennan's research firm, Powerhouse Capital. Specifically, the Division alleges JSO "misused" soft dollars to make payments of $480,000 to Powerhouse Capital between 2009 and 2011 for research services. The Division claims Powerhouse Capital was not a legitimate research firm because Mr. Drennan worked from JSO's offices and that, when Mr. Drennan created Powerhouse, "he returned to JS Oliver and essentially resumed his prior duties at the firm." OIP ¶ 30. The division further alleges that "JS Oliver misrepresented to two soft dollar brokers that Powerhouse Capital was an outside research firm that provided research analysis to JS Oliver." *Id.* ¶ 29. The Division's allegations are factually and legally unsupported.

1. JSO's Payments to Powerhouse Were Consistent With Its Soft Dollar Disclosures

The Division's claims regarding Powerhouse are precluded as a matter of law because JSO publicly disclosed that soft dollar payments could be used for non-research activities. The Division does not deny that Mr. Drennan performed research for JSO through Powerhouse, but rather claims that Mr. Drennan also performed non-research services that are not reimbursable with soft dollars – *e.g.*, in his role as a "team leader" for certain activities. (Div. Br. 6) These claims never get off the ground because JSO's numerous disclosures – drafted by experienced counsel at Howard Rice – clearly anticipated the use of soft dollars to pay for both research *and non-research* services.

a. JSO'S Form ADV Disclosures

JSO's Form ADV, dated March 30, 2007, contained fulsome disclosures regarding the potential use of soft dollars to pay for research and non-research services. That document discloses, in relevant part, that:

> The Firm may also use Clients' soft dollars to acquire **services** and products that provide benefits to the Firm or its affiliates and that **may not qualify as research** or brokerage and/or to pay expenses otherwise payable by the Firm. These may include (but are not limited to): expenses of and travel to professional and industry conferences and hardware and software used in the Firm's or its affiliates' administrative activities. They may even include such "overhead" expenses as telephone charges, legal and accounting expenses of the Firm or its affiliates and office services, equipment and supplies. The use of soft dollars to pay costs of these types may not be directly proportionate to the benefits to the Client from which the soft dollars were generated. Using soft dollars for these purposes would not be protected by Section 28(e) and the Firm will have a conflict of interest if it does so.

(Div. Ex. 86, at JSO 000384-85; emphasis added). JSO's Form ADV dated March 25, 2009 – also drafted by Howard Rice – contained virtually identical disclosures. (Div. Ex. 89, at JSO 000368.)

Instinet had access to and reviewed JSO's Form ADVs, but never informed Mr. Drennan – who is neither an attorney nor an expert on soft dollar regulations – that the payment of Powerhouse using soft dollars was in any way problematic. (Tr. (Drennan) 1104:12-1105:6.)

b. The Offering Memoranda for JSO's Investment Funds

In addition to JSO's Form ADVs, the offering memoranda for JSO's four funds also disclosed the use of soft dollars for non-research services. The offering memorandum for JSO Investment Partners, I, L.P. ("Fund I"), dated June 2006, disclosed, in relevant part:

> The Fund will bear all of its ongoing operating costs. These include, among other things, brokerage commissions... expenses incurred by the Investment Manager for investment research and due diligence... other professional fees...and all other reasonable expenses related to the management and operation of the Fund or the purchase, sale or transmittal of Fund assets, all as the General Partner determines in its sole discretion. The Investment Manager may cause some or all of those costs to be paid using "soft dollars".

(Div. Ex. 160, at JSO 001354; emphasis added). The offering memorandum for J.S. Oliver Investment Partners, II, L.P. ("Fund II") contains identical language. (Div. Ex. 372 at JSO 001141.)

The offering memoranda for J.S. Oliver Offshore Investments, Ltd. ("Offshore") and J.S. Oliver Concentrated Growth Fund, L.P. ("CGF") also contain similar, if not stronger, language. The August 2008 memorandum for CGF specifically disclosed that the Investment Manager (i.e. JSO) may pay a variety of non-research overhead and office expenses with soft dollars, including "rent, salaries, benefits and other compensation of employees or of consultants to the Investment Manager." (Div. Ex. 135; at INST-4th 025921; emphasis added).

Howard Rice drafted these disclosures for JSO to be as broad as possible in order to protect JSO. (Tr. (Kartes) 714:8-714:12; 715:17-716:7). Significantly, the disclosures above not only allow for research services, but they also allow for non-research services, unspecified professional and consulting services, and even employee salaries. Accordingly, JSO's payments to Powerhouse were covered by the disclosures even if we assume, *arguendo*, that Mr. Drennan's work through Powerhouse should be construed as non-research consulting work or the work of an employee.

It is well established that such disclosures cure any potential violation from the use of soft dollars to pay for non-research activities. *See In the Matter of Value Line, Inc.*, Admin. Proc. File No. 3-13675, 2009 SEC LEXIS 3923, at *13-14 (Nov. 4, 2009);

In the Matter of Putnam Inv. Mgt., LLC, Admin. Proc. 3-11868, 2005 SEC LEXIS 675, at *18-20 (March 23, 2005); *In the Matter of Founders Asset Mgt. LLC,* Admin. Proc. File No. 3-10232, 2000 SEC LEXIS 762, at *5-7 (June 15, 2000); *In the Matter of Renaissance Capital Advisors, Inc.,* Admin. Proc. File No. 3-9514, 1997 SEC LEXIS 2643, at *7-9 (Dec. 22, 1997); *see also Securities and Exchange Commission v. St. Anselm Exploration Co.,* Civil Case No. 11-cv-00668-REB-MJW, 2013 U.S. Dist. LEXIS 45547, at *35-36 (D. Colo. March 29, 2013) (subscription agreement stating that investor funds could be used for any purpose was not misleading for failing to specifically identify debt service as one possible use).

2. Mr. Drennan Acted Reasonably and in Good Faith

Faced with these detailed disclosures, the Division suggests the Hearing Officer should disregard them in determining liability because several JSO investors testified they did not review the disclosures. (Div. Br. 24.) If JSO failed to provide investors with copies of the proper disclosures, that is a serious issue. But the Division has never alleged, much less offered evidence, that such a hypothetical failure was Mr. Drennan' fault. The Division's brief includes these arguments to deflect the actual contents of the disclosures, but the OIP does not allege that JSO withheld disclosures from investors.

As to Mr. Drennan, they key questions in determining his state of mind are straightforward.

What did Mr. Drennan believe were proper soft dollar expenditures under the offering memoranda?

Mr. Drennan believed that, based on his brief review of the soft dollar disclosures, they covered the uses he was discussing with Instinet. JSO used soft dollars to pay its rent and that was obviously disclosed in the CGF offering memorandum. Mr. Drennan was aware that JSO was paying consultants (including Powerhouse) and that too is covered by the disclosures. And JSO paid employee salaries with soft dollars, which was also disclosed. (Tr. (Driscoll) 356:21-357:11; Div. Ex. 50.)

The Division asserts Mr. Drennan flyspecked the soft dollar disclosures in all of the offering memoranda and hand-picked the one that "would give the firm the most leeway in its use of soft dollar credits." (Div. Br. at 23.) The Division's claim that Mr. Drennan acted fraudulently depends on this theory. If Mr. Drennan did not have any reason to believe that the CGF memo had especially lenient soft dollar disclosures and did not intentionally withhold the other memos that supposedly had less "leeway", then the Division has failed to carry its burden of proving corrupt intent.

Why did Mr. Drennan Send Instinet the CGF OM?

The evidence proves beyond any doubt that Mr. Drennan decided to forward the CGF OM to Instinet precisely because he wanted Instinet to have accurate documents:

- On Friday, February 6, 2009
    - At 10:07 AM

      Ms. Kartes sent Mr. Drennan a copy of the Fund II OM (Dr. Ex. 1294), Mr. Drennan noticed that the document had inaccuracies and required updating by the attorneys. For example, it included employees that were no longer at JSO. (Tr. (Drennan) 1080:5-10; 1082:6-10.)

- By 10:37 AM (1:37 PM Eastern)

  During a 30 minute window in which Mr. Drennan also read and sent a total of 12 email messages on unrelated topics, he did a cursory review of the soft dollar disclosures for Fund II and wrote Neil Driscoll that "our offering mem is out of hand," meaning the soft dollar usage disclosed in Fund II was very broad. (Div. Ex. 335; Tr. (Drennan) 1082:17-1086:3; Drennan Exs. 1295-1305.)

- At 11:07 AM (2:07 PM Eastern)

  Mr. Driscoll informed Mr. Drennan that "**it is not uncommon for folks to soft what you have mentioned** . . . as long as it is in the offering memorandum to investors: ie. They have total disclosure". (Div. Ex. 335) (emphasis added.) Importantly, it was Instinet that first informed Mr. Drennan that non-28(e) expenses could be reimbursed with soft dollars at all. (Div. Ex. 335, 709.) Up to this point, Mr. Drennan had not been aware or inquired about the possibility of reimbursing expenses that fell outside the 28(e) safe harbor. As a result, Mr. Drennan relied heavily on Instinet's representations about what reimbursements were permitted.

- At 11:39 AM

  Mr. Drennan asked Ms. Kartes (who, unlike Drennan, was a JSO employee at this time) to follow up with JSO's attorneys to make corrections to the Fund II OM in order to make sure JSO was using accurate disclosures. (Dr. Ex. 1306; Tr. (Drennan) 1087:7-22.)

- On Monday, February 9, 2009

  - At 8:20 AM

    Ms. Kartes sent Mr. Drennan a copy of the OM for CGF. (Tr. (Drennan) 1090:22-1091:19; Dr. Ex. 1307.) Mr. Drennan believed this was the proper OM to send to Instinet because CGF was the most recent fund. (Tr. (Drennan) 1093:15-1094:12; 1095:1-2.)

  - At 8:34 AM (11:34 AM Eastern)

    Ms. Drennan sent the CGF memo Ms. Kartes provided to Mr. Driscoll at Instinet. (Div. Ex. 331.)

The Division tries to turn these facts on their head by holding Exhibit 331 out as their smoking gun. (Div. Br. at 23.) It is exactly the opposite: Mr. Drennan made a

reasonable judgment that JSO's most recently created OM, which was for the CGF fund that was formed in late 2008, would contain the same soft dollar disclosures as JSO's other OMs. How was it reckless (or even negligent) to assume otherwise? Howard Rice drafted the soft dollar disclosures for all of JSO's OMs and there is no logical reason that Mr. Drennan would be aware the OMs contained different soft dollar disclosures. (Tr. (Drennan) 1093:15-1094:12; 1095:1-2.) Mr. Drennan is not an attorney and was not part of the process of creating these soft dollar disclosures. There is absolutely no evidence to support the Division's theory that...

In addition, Mr. Drennan reasonably assumed that Instinet had access to JSO's form ADVs. Instinet's own in-house attorneys clearly had access to the ADVs and were actively reviewing them to confirm compliance with soft dollar requirements (Div. Ex. 1314) (5/8/09 email from A. Kenniff referencing Instinet's review of JSO's form ADV filings.)

What was Mr. Drennan's state of mind in dealing with Instinet?

The Division tries hard to ignore Instinet's internal communication about Mr. Drennan. Instinet understood from its conversations with Mr. Drennan that he wanted to comply with soft dollar regulations. Indeed, Mr. Driscoll understood he was at times "educating" Mr. Drennan on soft dollar issues. (Tr. 346:9-12.) An internal February 11, 2009 IM from Neil Driscoll to Sean Steinmetz summarizes Instinet's candid perception of Mr. Drennan's desire to act in good faith:

Driscoll: ". . . I need either u or maureen to get on the phone with him first thing tomorrow. I can't stall him anymore. **He said he wants things done by the book**. Ur saying its strange but we told him we could send money back to the fund . . . ."

(Dr. Ex. 1012 at 2.) This is an internal communication between Instinet employees discussing their interactions with Mr. Drennan. And it corroborates Mr. Drennan's testimony that he repeatedly asked Instinet and attorneys at Howard Rice to make sure the applicable rules were followed (the opposite of recklessness). (Tr. (Drennan) 1170:24 - 1171:14.) The Division can not meet its burden of establishing scienter in the face of such evidence.

The Division also fails to mention that it was Instinet which informed Mr. Drennan about soft dollar coverage for non-28(e) expenses in the first place. (Div. Ex. 335, 709.) Doug had not been aware or inquired about the possibility of reimbursing expenses that fell outside the 28(e) safe harbor until Mr. Driscoll messaged him on February 6, 2009. (*Id.*) As a result, Mr. Drennan relied on Instinet's representations about what reimbursements were permitted. When JSO's account with Instinet had been fully configured, Neil Driscoll sent an instant message to Mr. Drennan explaining that JSO's OM's had a "wide scope":

> AIM: drsneil (2:51:47pm): Doug guys are all set. Everything we spoke about is fine...and we do similar payments for other firms that have wide scoping OM's like yourself. We can do it however you prefer....

(Dr. Ex. 332.) Mr. Driscoll was aware that Drennan would rely on Instinet's policies regarding reimbursements. (Tr. (Driscoll) 365:22-366:8.)

Mr. Drennan informed Instinet that he was an employee of Powerhouse Capital.

Mr. Drennan was always transparent with Instinet about his role with Powerhouse and work with JSO. Some Instinet employees even thought he was a JSO employee while also knowing he was Powerhouse. Mr. Drennan provided an IRS Form W-9 to Instinet and expressly discussed Powerhouse with Neil Driscoll of Instinet. Mr. Drennan identified himself on his Linked In website profile as President of Powerhouse and an Instinet employee, Jonathan Ranello, invited Mr. Drennan, through Mr. Drennan's Linked In account, to "link in" with Mr. Drennan in May 2009. The Division's brief does not contend that Mr. Drennan hid this fact from Instinet. Instinet had this information and never raised any flags to Mr. Drennan. Accordingly, Mr. Drennan had no reason to believe the soft dollar payments to Powerhouse were questionable.

3. Mr. Drennan Believed He Was Acting Appropriately In Compliance with the Legal Advice of Howard Rice

JSO's soft dollar disclosures – and evidence that Mr. Drennan's conduct conformed with his understanding of them – are sufficient to end the Division's case against Mr. Drennan. But even if JSO's disclosures, drafted by Howard Rice, are found to be imperfect, that does not result in liability by Mr. Drennan, who did not control JSO at the time in question.

The key issue with respect to Mr. Drennan is not whether knowledgeable lawyers, with benefit of hindsight, can debate the adequacy of JSO's disclosures. The issue is whether Mr. Drennan, a non-lawyer with no formal training in soft dollar regulation, had a reasonable good faith belief that JSO's disclosures satisfied legal requirements. *See In the Matter of Kingsley, Jennison, McNulty & Morse, Inc.*, Admin. Proc. File No. 3-7446, Initial Decision Rel. No. 24, 1991 SEC LEXIS 2587, at *69-70 (Nov. 14, 1991) (sanctions not imposed where respondent was uncertain concerning law on soft dollars and believed that arrangements at issue and disclosures were lawful); *aff'd,* IA Rel. No. 1396, 1993 SEC LEXIS 3551 (Dec. 23, 1993).

As mentioned above, *see supra,* Section II(B), the standard formulation for aiding and abetting and causing liability requires proof that the accused *knew* that his or her role was part of an overall activity that was improper and *knowingly* and substantially assisted the conduct that constituted the violation. *In the Matter of Lisa B. Premo,* Admin. Proc. File No. 3-14697, Initial Decisions Rel. No. 476, 2012 SEC LEXIS 4036, at *62-63 (Dec. 26, 2012). The evidence at the Hearing proved Mr. Drennan was not aware of any violations and acted in conformity with the advise of JSO's counsel and soft-dollar broker.

A case on point is *Securities and Exchange Commission v. Shanahan,* 646 F.3d 536 (8th Cir. 2011), where the evidence produced at the Hearing showed that a director had been involved in "backdating" option grants. The court held that there was no primary or secondary liability because the director lacked knowledge that backdating was improper or that a compensation charge was required. The court also emphasized that the director made no effort to conceal his actions, stating that "[T]his transparency

is not the behavior one would expect from an intentional or severely reckless violator of the securities laws." *Id.* at 545. The key question, therefore, is:

What Did the Evidence Show Regarding Mr. Drennan's Transparency with Howard Rice and what advice did Howard Rice provide?

A good starting point to understand the communications between Howard Rice and JSO is the Division's own witness, former JSO Controller Melanie Kartes. Ms. Kartes participated in several phone calls with Howard Rice in 2009. (Tr. (Kartes) 703:17-704:18.) and testified that JSO was transparent in communicating with its attorneys at Howard Rice in the course of seeking legal advice. (*Id.* 704:20-16.) According to Kartes, JSO contacted its counsel to confirm it was acting appropriately:

> JUDGE MURRAY: Do you know why you contacted the attorneys?
>
> THE REPORTER: I'm sorry?
>
> THE WITNESS: Yeah, because we didn't know the legal aspects, and we wanted to make sure what we were doing was correct.

(Tr. (Kartes) 750:11-16.)

According to Ms. Kartes, JSO's counsel at Howard Rice was consulted on issues and questions surrounding the use of soft dollars for non 28(e) matters at JSO, and she and Drennan participated in multiple calls with counsel at Howard Rice (Tr. (Kartes) 721:3-14.) Critically, Ms. Kartes ***never heard*** from counsel at Howard Rice "that JSO was doing anything that was not compliant with the law." (Tr. (Kartes) 719:12-21.)

To the contrary, Howard Rice advised JSO that it was not required to pay hard dollars for the limited non-research activities that Mr. Drennan would provide and that it was possible to pay for the non-research activities in a different fashion. (Tr. (Drennan) 1159:16-1162:4.) While Mr. Drennan was not an employee of JSO at the time the advice was given, Howard Rice freely shared its advice with Mr. Drennan knowing that he would rely on it. (*Id.*)

On one call with Mark Whatley, Mr. Mausner asked whether the in-kind compensation that JSO provided to Mr. Drennan, such as the use of a computer and the Bloomberg terminal, telephones, and access to the Internet – could be considered as compensation by JSO for Mr. Drennan's non-research activities. (Tr. (Drennan) 1162:5-17.) Mr. Drennan understood Mr. Whatley to agree that such compensation would be legally sufficient. The Division has offered no evidence to rebut this.

Mr. Drennan also had a conversation in 2009 with Anita Krug, another Howard Rice attorney, about soft dollar payments to Powerhouse. (Tr. (Drennan) 1163:20-1164:2.) Ms. Krug also confirmed that Mr. Drennan could be compensated for research and yet do some non-research activities. *Id.* at 1164:5-12.

During his correspondence with Instinet around February 2009, Mr. Drennan barely had any understanding of the Rule 28(e) safe harbor with respect to soft dollars. (Tr. (Drennan) 1077:3-7.) As he continued to learn more about the subject through his interactions with Instinet, Mr. Drennan and JSO consulted with the legal team at Howard Rice many times about the appropriate use of soft dollars for JSO. (Tr. (Drennan) 1077:3-19.)

Corroborating Mr. Drennan's testimony, Ms. Kartes also noted that Howard Rice was specifically asked about the use of soft dollars for non-28(e) matters at JSO and that she participated in some of those calls. (Tr. (Kartes) 721:3-14.) Ms. Kartes also confirmed that they

contacted Howard Rice regarding soft dollar issues to make sure that they were doing things correctly. (Tr. (Kartes) 750:11-16.)

Ms. Kartes was not the only JSO employee who was unsure about soft dollar reimbursement. Mr. Mausner was unaware that non 28(e) reimbursement was even possible until learning about it from Instinet and relied on JSO's attorneys at Howard Rice to given them direction on the subject. (Tr. (Mausner) 1268:5-19.) At no point was Mr. Drennan ever told that he could not engage in non-research activities categorically because Powerhouse was being paid with soft dollars. (Tr. (Drennan) 1164:13-22.) Nor was Ms. Kartes aware of any time when Howard Rice said that payments to Powerhouse were inappropriate. (Tr. (Kartes) 722:19-22.)

The evidence at the Hearing overwhelmingly proved Howard Rice provided the advice Ms. Kartes and Mr. Drennan recalled. The Division would have the Hearing Officer categorically ignore the evidence but has presented absolutely no rebuttal evidence to counter it. There is, therefore, simply no evidentiary basis to find that Howard Rice did not provide the advice Ms. Kartes and Mr. Drennan recalled.

4. The Division Has Failed to Rebut Evidence of Reliance on Counsel

The Division offered no evidence whatsoever at the Hearing to rebut the testimony provided by Ms. Kartes and Mr. Drennan regarding the advice of counsel. Since their testimony and Howard Rice's invoices are the *only* evidence on this issue, the preponderance of the evidence shows that Mr. Drennan repeatedly received assurances from counsel that the arrangement between Powerhouse and JSO was in compliance with soft dollar regulations and JSO's soft dollar disclosures.

Unlike Mr. Drennan, who is effectively broke and tried without success to conduct remote testimony of witnesses during the hearing, the Division had the

resources to call Mr. Whatley and Ms. Krug as witnesses (and pay for their flight and accommodations) if it believed they would disagree with the testimony presented at the hearing. Yet it elected not do so and has therefore waived any chance to overcome this evidence and carry its burden of proof.

Thus, the Division has failed to carry its burden to show that Mr. Drennan acted even negligently, much less recklessly or with fraudulent intent, in accepting soft dollar payments for Powerhouse. Accordingly, the Hearing Officer should issue a decision in favor of fully exonerating Mr. Drennan on these claims. *See In the Matter of Kingsley, Jennison, McNulty & Morse, Inc.,* Admin. Proc. File No. 3-7446, Initial Decision Rel. No. 24, 1991 SEC LEXIS 2587, at *69-70 (Nov. 14, 1991) (sanctions not imposed where respondent was uncertain concerning law on soft dollars and believed that arrangements at issue and disclosures were lawful); *aff'd,* IA Rel. No. 1396, 1993 SEC LEXIS 3551 (Dec. 23, 1993).

5. Mr. Drennan's Professional Services to JSO (Through Powerhouse) Were Almost Entirely Research Related

Mr. Drennan established Powerhouse as an independent entity to provide research services. Mr. Drennan filed the required form with the State of California to establish Powerhouse. He also filed separate tax returns for Powerhouse and himself. Mr. Drennan attempted to solicit other clients for his research, but JSO turned out to be the only purchaser. (Tr. (Drennan) 1143:9-1144:6; 1147:12-1148:20; Dr. Exs. 1278-1279.) Thus the record shows that Mr. Drennan established Powerhouse as an independent entity – separate from JSO – to provide third-party research.

Did the Division prove Mr. Drennan "returned" to JS Oliver and essentially resumed his prior duties at the firm"?

The evidence at the Hearing showed that the services Mr. Drennan provided JSO through Powerhouse were materially different from his duties and responsibilities as an employee of JSO both before and after Powerhouse. The Division asserted in its OIP that it could prove Powerhouse was a sham by showing how Mr. Drennan "essentially resumed his prior duties at the firm" when he formed Powerhouse in 2009 (OIP ¶ 30). The Division's brief tries to support this with allegations that Mr. Drennan "moved back into his old desk" and became a "team leader." (Div. Br. at 5, 37.) The Division's case fell apart at the hearing.

The evidence convincingly showed Mr. Drennan, through Powerhouse, provided legitimate third-party services to JSO that came within the safe harbor of Section 28(e) or other professional services that (while outside of the safe harbor) were adequately covered by JSO's disclosures. Mr. Drennan provided eligible research covered by the safe harbor and followed a predictable daily routine that focused on research:

- Mr. Drennan awoke at 4:30am to review the markets, overnight markets, review email and check the news. He would arrive at JSO's office early to continue reviewing news, earnings from the previous day and prepare for the markets when they opened at 6:30am. (Tr. (Drennan) 1139:8-19.)

- Mr. Mausner and Mr. Drennan would begin discussing the markets at 6:00 or 6:15am and review anything that might impact the markets. He would then track the movement of stocks for the first hours after the markets opened to ascertain any unusual activity. If there were significant stock price movements, Mr. Drennan conducted research into the reason for the move and whether the movement appeared justified by economic fundamentals. After the first hour, Mr. Drennan would transition to longer term research projects for several hours. Around noon, Mr. Drennan would again monitor the markets before they closed at 1:00pm. (*Id.* at 1139:20-1140:17.)

- After 1:00pm, Mr. Drennan would review company filings, including financial statements; key industry factors; news concerning competitors; and major macroeconomic factors. Mr. Drennan also participated in earnings conference calls, reviewed conference call notes, and read company releases. Mr. Drennan would conveyed information to Mr. Mausner continuously throughout the day – most often orally but also by email or by instant message when Mr. Mausner was not available in person or by phone. (*Id.* at 1140:18-1141:6)

The Division considers Mr. Drennan's research suspect because it was largely provided to JSO in oral, rather than in written, form.[5] But the 2006 Guidance makes plain that oral research is eligible; the research need not be written or recorded. Information concerning market data, including stock quotes, last sales prices, trading volumes and company financial data, constitutes eligible research. Such research also includes information on specific companies. Eligible research also includes information on stock market trends; economic factors; and earnings calls. All that is required is that the research reflect "substantive content – that is, the expression of reasoning or knowledge." 2006 Guidance at pp. 27-28, 34-36. The evidence proved that Mr. Drennan satisfied this basic requirement.

In addition, Mr. Drennan Mr. Drennan made a concerted effort not to perform duties that would be normally associated with a JSO employee. At the Hearing, Mr. Drennan testified that everyone at JSO "tried to make it very, very clear that, because I wasn't an employee, I was not going to be taking on a set of specific roles or tasks." (Tr. (Drennan) 1062:23-1063:1.)

As an employee in 2004-2008, Mr. Drennan contacted clients as part of his duties and placed nearly all orders. (Tr. (Drennan) 1062:17-1063:21.) By contrast, as a

[5] That Mr. Drennan would verbally report his research findings and recommendations to Mr. Mausner at JSO is unremarkable given that when they were both present in the office, they sat next to each other and when they were not both present in the office, they often spoke on the phone. (Tr. (Drennan) 1140:24-1141:4.)

consultant, Mr. Drennan tried not to have any client contact at all and did not answer the phones at JSO for that purpose. (Tr. (Drennan) 1063:1-10.) As for trading, Mr. Drennan "very, very seldom[ly]" relayed trades from Ian Mausner to a broker, and only when Ian Mausner requested it. (Tr. (Drennan) 1064:6-1065:4.) According to the Division, Mr. Mausner was engaged in cherry-picking during some of this time, which provides an additional explanation for Mr. Mausner's tight grip on JSO trades during this period.

Drennan estimated that he may have handled one to two individual trades per month in 2009, compared to the roughly ten to fifty trades on any given day. (*Id.*) For 2010, Mr. Drennan acknowledges he relayed more trades than the previous year, but still estimated he was involved in "well less than 1 percent" of the total number of trades happening at JSO during that time. (Tr. (Drennan) 1065:5-19.) While that may amount to a dozen trades, it is an infinitesimal fraction of the thousands of trades executed by JSO every…

In addition, while Mr. Drennan had previously attended conferences and dealt with analysts on behalf of JSO as an employee in 2004 through 2008, he did not attend conferences or have any contact with analysts on behalf of JSO, while he was an employee of Powerhouse Capital. (Tr. (Drennan) 1066:24-1068:5.)

The Division makes much of the fact that Mr. Drennan was occasionally referred to as a "Team Leader", which was a term coined by Ian Mausner's life coach, Michelle Saul. (*Id.*, 1167:6-14.). The label, however, is misleading as Mr. Drennan had no actual management authority over JSO employees. While Mr. Drennan would occasionally troubleshoot problems that the J. S. Oliver employees could not address, Drennan performed such services as a favor to Ian Mausner (whom he considered a client of Powerhouse.) Drennan readily acknowledges he engaged in some non-research activities while providing services to JSO through Powerhouse, but also notes they were a "very limited part" of his daily routine and probably amounted to less than

five percent of his total time spent working. (Tr. (Drennan) 1059:16-1162:4. (Tr. (Drennan) 1059:16-1162:4). Again, Mark Whatley told him this limited non-research activity would be paid in-kind by JSO without running afoul of regulation. The Division has no evidence to rebut this.

Finally, Mr. Drennan's private activities and communications also disprove the Division's theory that Powerhouse was a sham invented so that Mr. Drennan could be paid with soft dollars. This theory does not make sense in the first place since JSO *employees* were themselves paid with soft dollars. Mr. Drennan, however, did not want to be an employee. He pursued potential clients for Powerhouse Capital and maintained a dialogue with Dan Wimsatt at aAd Capital about possibly working together. (Tr. (Drennan) 1143:9-1144:6, Drennan Ex. 1279.) Mr. Drennan also corresponded and dined with other investors and fund managers he met through Dan Wimsatt to talk to them about Powerhouse and pursued them as possible new clients. (Tr. (Drennan) 1147:12-1148:20; Drennan Ex. 1278.) Mr. Drennan also corresponded with multiple individuals about his new company, even as he explored doing research with J.S. Oliver. For example, Drennan corresponded with Sean Wright, a friend and fund manager, and Marie Helene Palant, who was married to another good friend and investor. (Tr. (Drennan) 1144:11-1145:11; 1146:6-1147:3; Drennan Ex. 1276; Drennan Ex. 1277.)

Mr. Drennan was consistent in representing to his business contacts and friends that he had started his own research firm. Notwithstanding his efforts, Mr. Drennan was unable to locate other Powerhouse clients, largely due to an adverse market and economic downturn. (Tr. (Drennan) 1145:15-21.)

6. JSO and Instinet – Not Mr. Drennan – Had the Legal Obligation to Assure That Any "Mixed Use" Soft Dollar Payments Were Appropriate

Fundamentally, with respect to all the payments to Mr. Drennan, whether for research or non-research activities, JSO, as the money manager, had the legal obligation to make a good faith determination as to the reasonableness of such payments. 2006 Guidance, at pp. 47-49. Additionally, Instinet, as the broker-dealer paying for the third-party research, had the obligation to review the description of the services paid for with client commissions under the safe harbor for red flags indicating the services were not within the safe harbor and to agree with JSO to use soft dollars appropriately. Instinet also was required to develop and maintain procedures to ensure that research payments were documented. There is simply no evidence that Mr. Drennan, knowingly or recklessly, prevented JSO or Instinet from performing their legal obligations.

Where soft dollars are used to pay for products or services that have a "mixed use" – where some products or services fall within the safe harbor and some do not – it is ***the money manager's obligation*** to keep adequate books and records reflecting a reasonable good faith determination as to the proper allocation of the soft dollars. 2006 Guidance at pp. 45-46.

There is no evidence that Mr. Drennan engaged in any conduct, much less knowing substantial assistance, that prevented JSO from making such an allocation. Mr. Drennan also was aware of communications with Instinet providing support for Mr. Drennan's belief that JSO had provided sufficient disclosure to cover the use of soft dollars for non-research activities.

The Division argues Mr. Drennan should be punished for Mr. Mausner's decisions. Specifically, they cite Mr. Mausner's decision to pay Mr. Drennan payments from Screaming Eagle and Instinet in the first four months of 2009 (Div. Br. at 20) as a

misuse of soft dollars. (Div. Br. 20-21). The question as regards Mr. Drennan, however, is whether he should have objected to these payments for his research services. Although Ms. Kartes vaguely recalled that the April $100,000 2009 payment to Powerhouse was for "bringing that idea [of soft dollars] to the firm", that does not make much sense. (Tr. 650:23-651:5). JSO was already using soft dollars before it signed up with Instinet. (Tr. 898:9-13.).

Mr. Drennan testified the $100,000 payment was for research and Mr. Mausner (who paid it) said his motivation was to pay for research. (Tr. (Drennan) 981:14:-24..) Setting up the account with Instinet involved little more than a few communications and would not justify a payment of $100,000 according to anyone. The Division is relying on fading recollections about a hallway conversation to paint a conspiracy that did not exist. It simply does not make sense that Mr. Mausner would have thought that arranging the Instinet account merited $100,000 and the Division was unable to solicit such testimony. In the end, Mr. Drennan's compensation in 2009 for research services through Powerhouse was approximately $300,000, which was well within industry norms for such work, considering that Mr. Drennan had been earning $200,000/yearly (Candian) when he had just five years of industry experience, but he had 15 years of experience when he started Powerhouse. (Tr. 1060:17-1061:6.)

Instinet was aware that Mr. Drennan was providing research services to JSO through Powerhouse. Mr. Drennan provided an IRS Form W-9 to Instinet and expressly discussed Powerhouse with Neil Driscoll of Instinet. Mr. Drennan identified himself on his Linked In website profile as President of Powerhouse and an Instinet employee, Jonathan Ranello, invited Mr. Drennan, through Mr. Drennan's Linked In

account, to "link in" with Mr. Drennan in May 2009. (Dr. Ex. 1280.) When a JSO employee sent an email to Instinet stating that payment for research should be made payable to Mr. Drennan, Mr. Drennan advised her to send a follow-up email to Instinet stating that the payment should be made payable to Powerhouse. Thus Mr. Drennan did not seek to mislead Instinet concerning his provision of research to JSO.

7. Summary

In summary, the evidence at the Hearing proved Mr. Drennan, who is not an attorney and lacked formal training in the nuances of the legal requirements for soft dollars, had no reason to believe that he was contributing to an illegal scheme by providing Powerhouse invoices to Instinet. To the contrary, he took pains to seek advice from Howard Rice when he had doubts and repeatedly asked Instinet if everything was being done "by the book" knowing that his own familiarity with soft dollars was limited.

Mr. Drennan provided research to JSO that came within the safe harbor. He believed that there was sufficient legal support, including JSO's substantial disclosures, for the payments to him for non-research activities. He knew that Instinet was aware of his activities and raised no objection and was transparent in his dealings with JSO and Instinet.

Furthermore, to the extent Mr. Drennan performed non-research work for JSO, that does not support any legal claim against him because the disclosures discussed above specifically anticipated *non*-research professional services. *See, supra,* Section IV(A)(1). Such non-research activities were minimal after the early 2009 period. (Tr. (Drennan) 1059:16-1162:4; 1064:6-1065:4.) Again, the issue is not whether

experienced attorneys in hindsight can find fault with the detailed disclosures. The issue is whether Mr. Drennan, a non-lawyer with no formal training in soft dollars regulation, had a reasonable good faith belief that JSO's disclosures satisfied legal requirements.

The evidence here is substantially similar to those decisions in which aiding and abetting allegations were rejected because the defendant/respondent lacked conscious knowledge that he or she played a role in furthering an improper scheme. *Matter of Stephen J. Horning,* 2006 SEC LEXIS 2082, at *49-53 (respondent lacked conscious knowledge of principal's violations); *Flynn,* 2006 SEC LEXIS 1766, at *77-91 (respondent participated in market timing activities but had no knowledge they were fraudulent and was not involved in management decisions); *Monetta Fin. Serv., Inc. v. Securities and Exchange Commission,* 390 F.3d 952, 956-67 (7th Cir. 2004) (insufficient evidence that defendant was aware of legal requirements for IPO allocations).

Likewise, the evidence does not support a finding that Mr. Drennan substantially assisted or caused any primary violation. Unlike the respondents in the cases discussed above, who were officers or key employees of the registered entity, Mr. Drennan was a third-party with no control over JSO. The Division acknowledges that "Mausner approved each soft dollar invoice before it was submitted to Instinet." (Div. Br. at 18; citing Tr. 602:12-19) (emphasis added). Mr. Drennan was not an officer or employee of JSO. He had no responsibility for maintaining JSO's books and records. Mr. Drennan did not prepare JSO's disclosures or solicit clients for JSO. Mr. Drennan did not direct, nor was he in a position to direct, Instinet to use soft dollars to pay him for his activities.

See In the Matter of Clarke T. Blizzard, 2004 LEXIS at * 27-29 (aiding and abetting claim rejected where respondent had no compliance oversight responsibilities, and no responsibility for preparing or reviewing public disclosures). Mr. Drennan simply provided research to JSO in exchange for payment that he had every reason to assume complied with the necessary legal requirements.

B. JSO's Payment to Gina Kloes

The OIP also alleges that Mr. Drennan should be liable for JSO's payment of $329,365 to Mr. Mausner's ex-wife and former JSO employee Gina Kloes. OIP ¶¶ 19-23. The evidence at trial proved by a preponderance that this transaction was fully vetted by Mr. Mausner and JSO's attorneys at Howard Rice, who counseled JSO on disclosure issues *and* advised Mr. Mausner in connection with his divorce matters. Mr. Drennan had no substantive involvement with this transaction and was not even shown the May 15, 2009 settlement agreement pursuant to which the payments was made. Under the circumstances – particularly the deep and prolonged involvement of Mr. Whatley of Howard Rice in navigating this payment – Mr. Drennan (who was not even a JSO employee at the time JSO made the payment) had no reason to protest the payment.

1. Mr. Drennan Had Limited Information About the Transaction

Gina Kloes was a co-founder of J.S. Oliver, Ian Mausner's spouse, and served as the company's CFO until sometime in 2005 when she and Ian finalized their divorce proceedings. (Tr. (Kloes) 475:20-476:6.) She is a graduate of one of the top law schools in the United States, Boalt Hall law school. (*Id.* 474:20-22.)

On or around October 31, 2005, Mr. Mausner and Ms. Kloes entered into a Final Executed Marital Settlement Agreement ("Marital Agreement"), providing, *inter alia,* that Mausner would cause JSO to make payments to Gina Kloes in lieu of spousal support, which included payments from January 1, 2006 through December 31, 2006 equal to an annual salary of $250,000, and for the period January 1, 2007 through December 31, 2010, payments equal to an annual salary of $125,000, for a total payment of $750,000. Therefore, as of 2009, a balance remained owing to Gina Kloes.

Though she left her position as CFO sometime in 2005, Ms. Kloes agreed to be reasonably available to help JSO employees in 2006, according to the terms provided in paragraph 22 of the Marital Agreement. (Tr. 480:15-481:4; Div. Ex. 22.) The terms regarding the payments to Ms. Kloes were amended on February 6, 2006. (Div. Ex. 25; Tr. 488:21-490:1.)

The Division claims Ms. Kloes "was under no obligation to perform any work for J.S. Oliver as of December 31, 2006 and did not perform any work after 2007." (Div. Br. 25.) That is wrong:

- Mr. Mausner and Ms. Kloes engaged in further negotiation regarding the amount of salary she would be given and the amount of work she would do for J.S. Oliver after January 1, 2007. (Div. Ex. 23; Tr. 493:9-23.)

- Ms. Kloes testified she corresponded with J.S. Oliver's outside counsel Mark Whatley regarding the termination of Carl Adams, one of J.S. Oliver's employees at the time, at some point after 2006. (Tr. (Kloes) 515:10-16.) Ms. Kloes also testified that she helped answer questions from Lindsay Back, another J.S. Oliver employee at various times after 2006. (*Id.* 516:14-21.)

Ms. Kloes, an attorney, herself equivocated on whether she was legally an employee after leaving her position as JSO's CFO.

> Q: And, in fact, you were not an employee of J.S. Oliver from 2007 to 2010; correct?

> A: I don't know that I would be considered an employee. I was getting payments, so -- I was getting payments. If that equals being an employee, then maybe. But I wasn't an employee working there.

(Tr. (Kloes) 482:22-483:2.)

However, Ms. Kloes's testimony reflects her knowledge that she was receiving payments through J. S. Oliver's payroll and referred to such payments as "salary" herself, even as she opined that she was not an employee "working there.". (Tr. (Kloes) 501:1-19; 502:18-24; Div. Ex. 31.) Given Ms. Kloes' own equivocation, it is curious that the Division expected Drennan to definitely conclude she was not legally an employee even while on payroll. The Division's case does not add up.

What Did Mr. Drennan Know About Ms. Kloes' Relationship with JSO?

Mr. Drennan understood that Ms. Kloes had a business relationship with J.S Oliver between 2006 and 2008 and that Gina was "there as a consultant if anything came up." (Tr. 1097:4-14.) He knew that J.S. Oliver employee Lindsay Back was "very close friends with Gina" and understood that Back "consulted her often on matters with J.S. Oliver." (*Id.* 1097:20-23.)

Mr. Mausner informed Mr. Drennan that he continued to communicate with Ms. Kloes about business issues after Mr. Drennan left J.S. Oliver in 2008. (*Id.* 1103:8-18-1103:20.) Mr. Drennan understood Ms. Kloes was on J.S. Oliver's payroll in 2009 and had been removed around February 2009 as part of her divorce settlement negotiations with Mr. Mausner. (*Id.* 1104:7-11.) Mr. Drennan did not have a clear understanding of Mr. Mausner's business relationship with Ms. Kloes as of January 2009, but assumed that Msr. Mausner continued to talk to her on occasion and share ideas. (*Id.* 1097:24-1098:6.)

*What Information Was Mr. Drennan **Not Provided** About Ms. Kloes' Relationship with JSO?*

The Division devotes much attention to showing Ms. Kloes and Mr. Mausner had a "strained" relationship at times following their divorce. (Div. Br. 27.) This evidence, however, does not disprove that during those several years Ms. Kloes did occasionally work for JSO and remained on payroll to the knowledge of Mr. Drennan and others at JSO.

In evaluating the reasonableness of Mr. Drennan's assumptions about the Kloes/JSO relationship, a relevant question is what information was Mr. Drennan **not** provided? The evidence is clear Mr. Drennan was not aware of the sordid incidents the Division cites in its case, which means that information cannot be used to judge his actions: There is no evidence Mr. Drennan was ever shown the troubling emails between Ms. Kloes and Mr. Mausner that the Division relies on to argue it was unreasonable to believe Ms. Kloes would consult with JSO after 2006. (Div. Br. 27, *citing, e.g.,* Div Exs. 21, 24, 594.) Mr. Drennan also had a limited understanding of the documents regarding the Mausner's marriage settlement:

> JUDGE MURRAY: You hadn't seen that on some documents?
>
> THE WITNESS: No, I had never seen the language agreement between the three. And the only language that I had focused on was the marriage settlement agreement in '05 in the c, d, e area.

(Tr. 1130:1-6.) In short, Mr. Drennan was unaware of the details of the conflict between Mausner and Kloes and believed she was still involved with the business.

2. Mr. Drennan Acted in Good Faith and Lacked Information to Conclude The Transaction Was Improper

Mr. Drennan believed Instinet, understood and vetted the transaction.

The gravamen of the Division's claim against Mr. Drennan is that he knew the payment from JSO made to Ms. Kloes was improper and knowingly misled Instinet about it. The relevant inquiry, therefore, must center around Mr. Drennan's state of mind and transparency with regards to Instinet.

In May 2009, Mr. Mausner and Ms. Kloes were renegotiating the terms of their contract regarding the dissolution of their marriage and separation of their business interests in JSO. At Mr. Mausner's request, Mr. Drennan asked Instinet if Ms. Kloes as a consultant could be compensated with soft dollars in a sum of $275,000. (Tr. (Drennan) 1102:9-13; Drennan Ex. 1117.) Mr. Drennan communicated that information to Jonathan Ranello, an associate at Instinet, as requested. (Tr. 1102:13-1102:15.) Mr. Ranello then followed up on May 8 by forwarding an email string to Mr. Drennan, which stated, in relevant part: "Doug, please see below. This is what they have asked for." (Drennan Ex. 1117; Tr. 1098:18-1099:9.) The email string also included a request from Instinet for an "opinion" from JSO's counsel stating that monthly payments to Ms. Kloes of $25,000 are permitted. (Tr. (Drennan) 1107:11-12.)

From the correspondence between Instinet's soft dollar group and Instinet's counsel on that email string, it was clear to Mr. Drennan that Instinet was vetting and reviewing the proposed transaction with its internal counsel to make sure that payments to Ms. Kloes were permissible. (Tr. (Drennan) 1104:12-1106:1.) In fact, the May 8, 2009 email trail showed extensive evaluation of the transaction by members of Instinet's legal team (Ms. Kenniff) as well as the Instinet soft dollars group (Ms. Shankar and others). (Dr. Ex. 1117.) Mr. Drennan could see that Instinet's counsel was comparing JSO's Form ADV and its offering memoranda to the terms of any proposed transaction to ensure compliance. (*Id.*, JSO 299952)

Mr. Drennan was also aware that Instinet's employees Giacoma and Driscoll both personally met with Mr. Mausner to vet the transaction and solicited specific detailed information from Mr. Mausner. (Tr. (Driscoll) 297:19 – 298:2, 374:16-22; Tr. (Kellner) 429:8 – 16; Tr. (Drennan) 1020.)

For its part, Instinet understood from Mr. Drennan that he was not fully informed on the situation. Instinet knew it needed to go to Mr. Mausner for details and did so. Instinet also understood that Mr. Drennan wanted everything done properly and within the proper rules. (Tr. 1170:24 – 1171:3.)

Under the circumstances, the evidence shows it was reasonable (and certainly not negligent) for Mr. Drennan to conclude that if Instinet and its army of compliance professionals believed the transaction was compliant, it had to be so. Instinet actually prodded Mr. Drennan to inquire about whether JSO's disclosures covered the payment by getting "an opinion from their counsel". (*Id.*) Mr. Drennan interpreted this to mean a verbal opinion from Mr. Whatley and accordingly checked with Mr. Whatley (Tr. 1106:2-14.) But Whatley ultimately relief on information from Mausner, not Mr. Drennan, in making their decision.

Mr. Drennan Relied on Advice from JSO's Counsel, Mark Whatley, Who Was Closely Involved in the Transaction.

There is no question that the negotiations involved both personal and business issues as JSO's attorney, Mark Whatley, was directly involved in counseling Mr. Mausner in the negotiations on the business side, and Mr. Mausner had separate family law counsel. (Tr. (Kartes) 758:1-3.)

Mr. Drennan'a involvement was simply to pass on … Having presented a prima facie defense that JSO relied on the advice of Mr. Whatley; soft dollar payments, it is the Division's burden to overcome the defense with evidence, not bald assertions.

But the Division made no effort to rebut this defense and chose not to call the Howard Rice attorneys it initially listed on its witness list. More importantly, the contemporaneous evidence corroborates Mr. Drennan's testimony about his reasonable reliance on the conclusions JSO reached in reliance on Whatley's advice.

On **Friday, May 8, 2009**, Mr. Drennan forwarded the email string between himself and Mr. Ranello to get Whatley's opinion (as of JSO's counsel) regarding soft dollar payments to Ms. Kloes. (Drennan Ex. 1117.)

Mr. Drennan then spoke with Mr. Whatley immediately after forwarding that email string to him around 11:50 am. Tr. 1106:25-1107:3. Because Mr. Whatley was preparing for another phone call at 12:30 pm, he asked Mr. Drennan to postpone their conversation until after that call. During the interim, additional information became available to Mr. Drennan.

Also at 11:50 am – probably just as Mr. Drennan had his initial call with Whatley – Mr. Mausner emailed Mr. Drennan asking if the transaction could be structured differently: "Can it also be compensation for *past* consulting rendered since she left the firm?" (Ex. 1314 (emphasis added); Tr. Drennan 1109.)

As far as Mr. Drennan knew, Mr. Mausner's questions reflected his ongoing negotiations with Ms. Kloes, to which he was not privy.

At Mr. Mausner's request, Mr. Drennan raised Mr. Mausner's new question with Mr. Whatley by writing him "I know you have a 12:30 call, so I'm sending this email. Please give me a call to discuss the clarification of this payment. I have a different way of describing it." (Tr. Drennan 1108; Ex. 1118.)

Mr. Drennan and Mark Whatley then had a phone conversation regarding Mr. Drennan's email, after which Drennan formed the belief that in order for Ms. Kloes to be compensated with soft dollars, it had to be disclosed and there needed to be a contract in place. (Tr. 990:19-991:4.) A Howard Rice Invoice dated May 8, 2009 corroborates a "Telephone conference with D. Drennan regarding trading and expense

issues, review emails, telephone conference with D. Drennan." (Tr. 1112; Ex. 1103.) It was Mr. Drennan's understanding that Mark Whatley was involved in the conversation because there was a business component to the negotiations between Ms. Kloes and Ian Mausner that affected J.S. Oliver. (Tr. 1110:14-22; 1113:1-5.)

On Sunday, May 10, 2009, Mr. Drennan responded to an earlier email from Mr. Mausner in which he asked, "This doesn't apply if you run it through normal payroll, right?" (Tr. 1116:2-22; Drennan Ex. 1313.) Drennan's response affirmed that a consulting contract (as requested by Instinet) would not be needed in that instance. (*Id.*)

On Monday, May 11, 2009, Mr. Drennan spoke with Mark Whatley by phone and Mr. Whatley informed him that Ms. Kloes' salary as an employee "could be reimbursed through soft dollars per the disclosures in the documents." (Tr. (Drennan) 1118:6-15.) At approximately 10:38 am, Drennan emailed Mr. Mausner and wrote "**Just got off the phone with Mark** and wanted to update you and see what you want to do next." (Drennan Ex. 1315 (emphasis added); Tr. 1117:14-1118:15.) Howard Rice's invoice corroborates this call too. (Tr. (Drennan) 1115:7-17; Drennan Ex. 1103.)

On May 15, 2009, Ms. Kloes and Ian entered into an amended settlement agreement. (Tr. (Kloes) 507:2-16; Div. Ex. 26.) It is clear Mr. Whatley advised on the use of soft dollars in connection with that agreement, as corroborated by a May 15, 2009 line entry in a Howard Rice invoice stating "**Telephone call with Ian Mausner regarding soft dollars**." (Drennan Ex. 1103 (emphasis added); Tr. Drennan 1123:18-23.) That entry refers to the conference call that Mr. Drennan participated in with Mark Whatley regarding the proposed payment to Ms. Kloes and whether it could be paid with soft dollars. (Tr. 1123:24-1124:4.) Mr. Drennan understood that Mark Whatley was involved in helping finalize the settlement agreement between Mausner and Kloes, though Drennan himself was not involved in negotiating the agreement and only relayed information between Ian Mausner and Mark Whatley. (*Id.* 1126:7-21.)

The Division suggests – but is careful not to assert as a fact – that Mr. Whatley did not advise that the use of soft dollars to pay Ms. Kloes was acceptable. (Div. Br. 4) But if that were the case, then why did the Division not call Whatley as a rebuttal witness? Having failed to do so, the preponderance of the evidence supports Mr. Drennan's recollection of what Mr. Whatley did advise JSO as he recalled, which is supported by invoices showing the calls took place.

Among other things, the amended settlement agreement that Mr. Whatley helped Mr. Mausner negotiate called for the payment of a "one-time net after tax salary payment of $214,500" to Ms. Kloes, after a tax rate of 32.5%. (*Id.* 509:5-23; Div. Ex. 26.) However, Mr. Drennan does not recall ever seeing the amended settlement agreement in May, 2009, which is Div. Ex. 26. (Tr. (Drennan) 1133:10-16).

In short, the evidence is overwhelming (and unrebutted) that Mr. Whatley was aware Mr. Mausner intended to cause JSO to pay Ms. Kloes with soft dollars and advised him on that aspect of the transaction. (Dr. Ex. 1103) Mr. Drennan was aware that Mr. Whatley – whose own law firm had drafted JSO's soft dollar disclosures in the first place – was advising on the transaction. Mr. Drennan therefore reasonably believed the structure of the payment would be compliant with soft dollar regulations.

3. Mr. Drennan Did Not Provide Substantial Assistance With The Transaction

The Division's brief ignores virtually every detail of the preceding seven pages that provide contemporaneous evidence of Mr. Drennan's very limited involvement in the transaction and actual state of mind in May 2009. The Division instead focuses on a single clerical task that Mr. Drennan performed for Mr. Mausner, and seeks to permanently destroy his professional life for that act without considering the totality of the circumstances. However, Mr. Drennan's role was ministerial and that of a scrivener, not as a "prime mover" of an illegal action. As such, it could not have provided substantial assistance to any primary violation. *See In the Matter of Clarke T.*

Blizzard, Admin. Proc. File No. 3-10007-EAJA, 2005 LEXIS 1940, at *24 (July 29, 2005) (record showed that respondent provided substantial assistance where he was "prime mover" in arranging illegal scheme).

Indeed, given that Mr. Mausner and his attorneys at Howard Rice structured the underlying arrangement with Gina Kloes, initiated and directed the implementation of the transaction, and the disparity of sophistication between Mr. Mausner and Mr. Drennan, it borders on the absurd to contend that Mr. Drennan's actions were vital or provided essential assistance to Mr. Mausner in effecting these transactions.

Mr. Drennan's Ministerial Act Was Performed in Good Faith.

On or about June 1, 2009, Mr. Mausner asked Mr. Drennan to retype the portion of the Marital Settlement concerning the obligation of JSO to Gina Kloes which reflected a separate, free-standing contract, as Mr. Drennan understood it. (Tr. (Drennan) 1126:21-23.) Mr. Mausner also asked him to remove references to personal expenses in the re-typed excerpt. Because Mr. Drennan believed that personal expenses were not relevant to the employment agreement between Gina Kloes and JSO, Mr. Drennan did not object to removing the references to country clubs in the re-typed excerpt. (*Id.* 1137:6-13; Div. Ex. 348; Div. Ex. 349A.)

A critical point is that Mr. Drennan believed the new settlement agreement with Ms. Kloes *did* include personal payments but that those were provided for separately and would not be paid using soft dollars. On May 13, 2009, Mr. Mausner emailed Ms. Kartes, Mr. Donahue, Mr. Drennan and Ms. Babaie to inform them of the terms of his settlement with Ms. Kloes:

> From: Ian Mausner
> Sent: Wednesday, May 13, 2009 7:52 AM

To: Jim Donahue, Melanie Kartes, Doug Drennan, Nina Babaie
Cc: Ian Mausner
Subject: To do's re Gina
Importance: High

In addition to the payroll check can you please prepare the following by Friday am:

1. Add [redacted] (until 12/31/13) to health benefits and add Gina (until 12/31/10 or until she gets married whichever is first) to health benefits or just take over her COBRA since she is not an ongoing employee.
2. Make copy of the firm's insurance policies
3. Issue check to Gina for $20,000 repayment of her loan to the firm and reduce the balance outstanding accordingly
4. Write down policy number and other identifying info for [redacted] and [redacted]'s health coverage and make sure their insurance cards have been sent. Make sure [redacted]'s card is sent to Gina as well.
5. Issue check for $10,000 made out to "Seltzer Caplan McMahon Vitek" it is a legal expense payment for the final agreement
6. Print out all of the emails re the recent SEC interaction hut NOT the firm info we provided to the SECOND
7. Make copy of all Enterprise accounts
8. Separate check made out to Gina in the amount of $36,000.
9. Separate check made out to Gina in amount of $3,065.70
10. Separate check made out to Gina in the amount of $1,700.
11. Separate check made out to Gina in amount of $10,200

(Div. Ex. 340, JSO301113). Mr. Drennan reasonably interpreted this email to distinguish between parts of the Kloes/Mausner/JSO settlement that were personal and parts that were business:

> [Referring to Div. Ex. 340]
>
> Q: And what's your understanding?
>
> A: In my view, it was the – the details of the renegotiated agreement where they so-called separate between church and state – it separates the business aspect with the payroll and then all of the personal obligations and payments that Ian would be required to pay through the agreement.
>
> Q: When you say "separates the business aspect with the payroll from the personal obligations," do you see any personal obligations indicated here in this email dated May 13, 2009, from

Ian Mausner to those individuals?

A: It – basically everything besides the payroll. So any checks that were issued were personal obligations in my mind.

(Tr. 1119:24 – 1120:13)

It was with this understanding, and at Mausner's request, that Mr. Drennan typed and sent the contract excerpt to Mausner by email at 11:08 am on June 1. (Tr. 1128:9-12; Div. Ex. 348.) Mr. Mausner reviewed the excerpt and instructed Mr. Drennan to change the language from "contract between Mausner and Gina Kloes" to "J.S. Oliver Capital Management, L.P. and Gina Kloes." (Tr. 1128:15-22; Div. Ex. 348; Div. Ex. 349A.) Mr. Drennan made the edit at Mausner's direction because it was consistent with his understanding of the settlement based on the limited understanding he had, and re-sent it to Mr. Mausner at 12:11pm. (Tr. 1128:9-22; Div. Exs. 348 and 349A.) Mr. Drennan believed that while the 2005 Marriage Settlement was between Mausner and Kloes, the edits made to the contract excerpt accurately reflected the agreement between J.S. Oliver and Kloes regarding her salary and employment. (Tr. 1129:9-16; 1130:7-12.)

In typing out the contract excerpt and sending it to Mr. Mausner by email, Mr. Drennan considered his role to be clerical in nature. Mausner had directed him to the marriage settlement agreement, which Mr. Drennan had no prior knowledge or exposure to. He simply typed and formatted according to Mr. Mausner's instructions. (Tr. 1136:14-1137:1.)

Mr. Drennan is not a lawyer and did not scrutinize the agreement from a legal perspective. (Tr. 1130:18-23.) Further, Mr. Drennan had no reason to believe that as of June 1, 2009, Mr. Mausner was characterizing his settlement agreement with Gina Kloes in an inaccurate manner. (Tr. 1132:6-10.) It is fundamentally unfair to attribute fraudulent motive to Mr. Drennan when he only had a fraction of the information the

Division now relies on to challenge this payment. *See supra*, p.53. Again, Mr. Drennan's understanding at the time was that:

- Ms. Kloes was owed salary for employment with J.S. Oliver from 2007 through 2010 (Tr. 1135:3-10.)
- JSO, Kloes, and Mausner had entered into an agreement for Ms. Kloes to get a salary from JSO (Tr. 1135:24-1136:2.)
- JSO's counsel, Mark Whatley, was involved in the transaction in some capacity (Tr. 1136:4-5.)
- The payment to Gina was for employment and salary, and was J.S. Oliver's obligation. (Tr. 1136:6-8.)

Based on the information available, Drennan independently calculated that Ms. Kloes was owed approximately $330,000 in strictly salary payments, apart from any personal expenses. (Tr. 1137:6-1138:7.) With this in mind, Mr. Drennan removed references to personal expenses from the excerpt precisely because he believed that the excerpt only pertained to salary due to Gina Kloes.

To the extent Mr. Mausner and Ms. Kloes did not genuinely believe that JSO owed her money but put that in their settlement agreement with the guidance of their attorneys, Mr. Drennan was not informed of that. There is simply no evidence that Mr. Drennan was in a position to make such a determination from the limited view he had into these matters. He was also not in a position to make the decision for JSO to seek soft dollar reimbursement for the payment. That was a decision JSO made, with the advice of its counsel, and the ultimate approval of Instinet and its entire soft dollar and legal team.

The Division did not come close to carrying its burden to prove that Mr. Drennan somehow substantially assisted in this transaction that was handled by Mr. Mausner, Mark Whatley, Gina Kloes, their marital attorneys and Instinet.

4. Summary

Mr. Drennan believed that the Marital Agreement created a valid contractual obligation of JSO to Gina Kloes. (Tr. (Drennan) 1135:3-1136:8.) Further, Mr. Drennan was aware that Gina Kloes had approved the payment by completing a W-9 and that as an attorney and co-owner of JSO, she must have believed that that the payment was for legitimate services rendered to JSO.

Mr. Drennan also received an email from Mr. Ranello at Instinet stating that an opinion of counsel from JSO would be required in order for Instinet to agree to the payment. Mr. Drennan forwarded that email to Mark Whatley at Howard Rice, JSO's outside counsel. As a result of this email, Mr. Drennan believed that Instinet had obtained whatever legal and factual basis it needed for the payment to Ms. Mausner. (Dr. Ex. 1117; Tr. 1105:16-1116:1) Why would he assume otherwise? No one advised Mr. Drennan that Instinet had not obtained an opinion by outside counsel, nor did Mr. Drennan believe that Instinet would make the payment without obtaining such legal authority.

Mr. Drennan was aware that Mr. Mausner had discussions with JSO's outside counsel at Howard Rice, and believed that the attorney had agreed that the soft dollar payment to Gina Kloes was proper. Mr. Drennan also (correctly) believed that Howard Rice had been involved in preparing the Marital Agreement and therefore knew the basis of the proposed payment to Ms. Mausner.

Thus Mr. Drennan did not believe that he was participating in a ruse to mislead Instinet into making an illegal payment to Gina Kloes. Rather, he believed that he was being asked to put into a more formal format a valid contractual obligation of JSO to Gina Kloes that was for services rendered and to be rendered; that Instinet had fulfilled its legal obligations by performing appropriate due diligence into the payment; and that Instinet and Howard Rice understood that the payment to Gina Kloes arose from the Marital Settlement.

C. JSO's Rent Payments

The Division alleges that Mr. Drennan is liable for JSO's use of soft dollars to pay the rent for JSO's offices, which also served as Ian Mausner's residence. The Division's Initial Post-Trial Brief claims: (1) that Mr. Drennan "worked with Instinet to ensure that it would pay J.S. Oliver's rent payments"; and (2) that Drennan knew that Mausner directed JSO employees (including Drennan himself) to distribute excess rent money back to Mausner. (Div. Br. at 62.) The Division fails to carry its burden.

1. Mr. Drennan Acted Reasonably and in Good Faith in Working With Instinet on J.S. Oliver's Rent payments.

The Division's assertion that Mr. Drennan intentionally submitted only the CGF offering memorandum is untrue. The evidence convincingly proved Mr. Drennan submitted the CGF memo because the initial Fund II memo he viewed had factual errors, despite having very broad soft dollar disclosures. *See*, *supra*, Section IV(A)(1)(c). It is undisputed that the CGF offering memorandum's disclosures cover rent payments. (Div. Ex. 135 at INST000064.) Further, the disclosure documents for other JSO funds also contained similar language that disclosed soft dollars may be used to pay rent. (Div. Ex. 160 (Fund I OM), JSO 001354) (stating that the Investment Manager may cause overhead expenses such as "office space" to be paid "using soft dollars"); (Div. Ex. 411 (Fund II OM), JSO 001141) (same); (Div Ex. 86, JSO 000384-85)(JSO Form ADV, dated March 30, 2007) (disclosing use of soft dollars to pay for "expenses otherwise payable by the Firm", including "but not limited to" "overhead expenses", which obviously includes rent). Thus, the rental payments would have been covered by the disclosures regardless of fund or Form ADV used by Instinet.

The crux of the Division's argument is that the rent payments were improper because they ultimately went to Mr. Mausner himself and because they were allegedly "inflated". (Div. Br. 62.) The evidence indicates Mr. Drennan took reasonable steps to consult with counsel and with Instinet about the propriety of the rent payments and was completely transparent with them.

Ms. Kartes' testimony corroborated that Mr. Drennan consulted JSO's attorneys on this issue when she was in the room. Tr. (Kartes) 777:2- 778:14. And the Instinet witnesses testified that they were well aware JSO was based out of Mr. Mausner's home, which was not uncommon for investment advisors in San Diego. (Tr. (Kellner) 464:15-22; Tr. (Driscoll) 378:3-10.)

As to the question of whether the rent was "inflated", the Division baldly asserts the claim without any evidence. It's difficult for the Division to carry its burden of proof without citing a single shred of evidence. Though Mr. Drennan need not rebut this unsupported allegation, the evidence indicates that although JSO's rent was increased in 2009, it appeared to have been artificially low before that point and the rates that were charged in 2009 were in line with previous rates when JSO was not paying rent with soft dollars. (Tr. (Mausner) 1311:25-1312:5.)

But it is not Mr. Drennan's burden to prove that the rent was perfectly set at market rates. The facts show Mr. Drennan did not hide from Instinet the fact that JSO's offices were in Mr. Mausner's home and he received the rent. Instinet admitted it was well aware of that. JSO's attorneys also knew that. Under these circumstances, the Division has provided no persuasive authority that Mr. Drennan should have unilaterally objected to the use of soft dollars by JSO (an entity he did not control) to pay its rent.

Even weaker is the Division argument that Drennan "approved" the payment of at least three inflated rent invoices in Instinet's soft dollar system. (Div. Br. at 34.) The evidence at trial was overwhelming that all soft dollar expenses were approved solely by Mr. Mausner. (Tr. (Drennan) 1022:20-25; Tr. (Kartes) 602:12-19.) The Division's brief admits this. (Div. Br. 18.) As Ms. Kartes testified:

> Q So before anyone went on the Plazma website at Instinet to make sure the payment was made, it had to be approved by Mr. Mausner before that step was taken, correct?
>
> A Yes.

> Q Okay. So that final step of going to Instinet's website and, you know, making the payment happen, that was a clerical act, was it not?
>
> A Yes.
> ...
>
> JUDGE MURRAY: And -- and that -- that step was always approved by Mr. Mausner, the submission?
>
> THE WITNESS: Yes.

(Tr. (Kartes) 728:17-729:11.) Only Ian Mausner could provide actual approval for any invoice on the Plazma system.

V. THE DIVISION SEEKS IMPROPER RELIEF AGAINST MR. DRENNAN

The Division did not carry its burden of proving that Mr. Drennan violated any securities laws. Nonetheless, for the sake of completeness, we respond below to their requested sanctions and relief against Mr. Drennan and reserve the right to submit supplemental information regarding Mr. Drennan's financial condition as necessary.

Rule 630(a) of the SEC's Rules of Practice provides that in any proceeding in which an order requiring payment of disgorgement, interest or penalties may be entered, a respondent may present evidence of an inability to pay any or all of these items. The hearing officer may, in her discretion, consider evidence concerning ability to pay in determining whether disgorgement, interest or penalties are in the public interest. Rule 630(b) requires a respondent asserting an inability to pay to submit a financial disclosure statement (the "Statement"), which Mr. Drennan attaches as Attachment A hereto. Mr. Drennan provides this information subject to a request for Protective Order pursuant to Rule 322 of the Commission's Rules of Practice. (17 CFR 201.322.)

Regarding a party's ability to pay, it is noted that "(l) financial sanctions should be imposed with due regard to collectability, so as to avoid to the extent possible the imposition of sanctions that are likely to be uncollectible, and (2) the collection of financial sanctions is as much, if not more, of a deterrent to misconduct as the imposition of showplace sanctions." *In the Matter of John A. Carley,* 2005 SEC LEXIS 1745, at *205-13. The Hearing Officer may consider evidence of a respondent's ability to pay in determining an appropriate penalty in an administrative proceeding. *See* Section 21B(d) of the Exchange Act and Section 203(i)(4) of the Adviser's Act.

A. Mr. Drennan's Net Worth.

As reflected in the asset calculation in the Form A-D filed simultaneously with this brief, Mr. Drennan estimates his individual net worth (excluding property he shares jointly with his wife) – assets minus liabilities – at $141,437. (Form A-D). However, as evidenced by the detail provided on the Form A-D, that number does not represent a "liquid" sum available to Mr. Drennan to use to settle the dispute.

For example, Mr. Drennan estimates that he and his wife have, collectively, approximately $134,087 of equity in the smaller home they recently purchased. (Form A-D at B:5 and C:1). They were forced to sell their previous home because they could no longer afford it in light of the economically devastating impact of this administrative proceeding, which will effectively bar Mr. Drennan from ever working in his chosen profession again, regardless of the outcome of this proceeding.
To assess the true "net equity" associated with their home, some amount would need to be reduced by the transaction costs of selling the home and paying any federal and state taxes as well as moving costs. Moreover, the level of equity actually existing in

the home would be protected by the California homestead exemption even in the event of a judgment.

Likewise, various individual retirement accounts (IRAs) and 401(k) accounts make up a significant portion of the Drennans' net worth. Approximately $236,278 (which constitutes more than half of the total net worth listed on the Statement) comes from these accounts. (Form A-D at B:12). However, that does not mean that these accounts are able to contribute their face value to a settlement. If the funds were liquidated for settlement purposes, the Drennans would face early withdrawal penalties of 10% on top of the state and federal taxes which will also be owed on any withdrawals. The effective tax rate on the distributions from these accounts will significantly reduce the amounts available for settlement.

The Statement includes assets belonging to Mr. Drennan's wife and children. However, neither Mr. Drennan's children nor his spouse have any involvement in this legal matter; a judgment premised on liquidating their education and retirement plans is nothing short of punitive and would violate public policy. Thus, as with the case with their home, it is misleading to include much of the $203,000 in IRA and 401(k) accounts when calculating Mr. Drennan's ability to pay any penalty.

B. An Industry Bar is Not Warranted

To the extent JSO's use of soft dollars to pay Powerhouse was a technical violation of any soft dollar regulations, that violation enriched JSO, who would have otherwise had to pay that obligation using other funds. The factors set forth in *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979) do not support an industry bar. Mr. Drennan is not accused of any violations during the period when he served as JSO's

Chief Compliance Officer or was an employee. Mr. Drennan – who is not an attorney and was relying on industry experts at Instinet and attorney Mark Whatley (Tr. (Drennan) 1114:2-22; 1131:10-19; 1159:16-1162:17) – reasonably believed that the transactions he observed or participated in were within the parameters of what was permissible.

No penalty should be imposed where, as here, the respondent has already incurred economic loss and the proposed industry bar will limit his future income. *In the Matter of Stephen J. Horning*, 2006 SEC LEXIS at *73-76 (rejecting any penalty where respondent already incurred economic hardship and 12-month suspension would limit future income). Regardless of the outcome of this proceeding, Mr. Drennan will never again work in the securities industry based on the reputational damage of this administrative proceeding. Even before he was been proven guilty of any misconduct, the only job he could obtain pays $50,000 per year.

It would be inappropriate to impose any penalty with respect to the alleged use of soft dollars for real estate payments or the payment to Gina Kloes, given that Mr. Drennan's conduct was at most negligent, he received no benefit from these transactions and his lack of any prior disciplinary history. See *In the Matter of Parnassus Investments*, Admin. Proc. File No. 3-9317, Initial Decision Rel. No. 131,1998 SEC LEXIS 1877, at *74-76, (Sept. 3, 1998) (rejecting any penalty where respondent did not engage in fraudulent conduct, was not unjustly enriched by alleged misconduct and had no disciplinary history).

C. Disgorgement

Disgorgement is viewed as an equitable remedy intended to deprive a wrongdoer of his illicit profits. The Division alleges that Mr. Drennan "personally benefited by more than $480,000 from the improper Powerhouse Capital payments." Div. at 66. But seeking disgorgement from Mr. Drennan of the full amount received by Powerhouse over approximately two and one half years can only logically be premised on the notion that (1) Mr. Drennan never provided any soft dollar-eligible research and that every penny he earned was fraudulently obtained, and (2) Mr. Drennan would not have otherwise been paid through soft dollars if he was on JSO's payroll – as the Division apparently contends he should have been. Neither proposition is true.

The evidence at the Hearing showed that the overwhelming majority of Mr. Drennan's work was non-research related. Mr. Drennan does not deny that he engaged in some non-28(e) work while consulting with JSO, but the evidence at the Hearing showed that:

- Mr. Drennan's non-research work was minimal. (Tr. (Drennan) 1059:16-1162:4; 1065:5-19.)
- The overwhelming portion of Mr. Drennan's work was research related. (*Id.*, 1139:8-1140:23; 1059:16-1162:4.)
- That attorney Mark Whatley advised Mr. Drennan he could be paid in kind for non-research work through the use of office space, phones and office equipment (*Id.*, 1059:16-1162:4; 1162:12-17.)
- Even if one ignores the in-kind compensation Powerhouse received, JSO paid its employee payroll with soft dollars, which means that if (as the Division would have it) Mr. Drennan were an employee, Ms. Kartes – at Mr. Mausner's direction – would likely have included Mr. Drennan's salary and bonuses along with the regular payroll reimbursement requests to Instinet using soft dollars. (*Id.*, 1155:2-14).

- Mr. Drennan was not over-compensated. Mr. Drennan's compensation in 2009 and 2010 were well within the range of research analysts in his profession and the Division offers no argument or evidence in its brief to the contrary, thereby waiving the argument.

The Division is not seeking to disgorge from JSO employees soft dollar payments that they received through payroll. Similarly, there is no reason to single out Mr. Drennan should the Commission determine that he was acting as an employee.

All of this points to one conclusion, which the Division does not address: to the extent any party unjustly profited from JSO's use of soft dollars to compensate Powerhouse, that party was JSO itself. To disgorge those sums from Mr. Drennan – who performed valuable work for JSO during the two years of these payments – would unjustly enrich JSO and unfairly deprive Mr. Drennan of fair compensation for his work. Any remedy must be directed solely at JSO and Mr. Mausner, who controlled JSO and authorized every decision it made.

D. Civil Penalties

The Division seeks the most extreme third-tier penalties against Mr. Drennan. Even if there is a finding that the transactions Mr. Mausner orchestrated were a violation of technical rules, there is no basis to levy civil penalties against Mr. Drennan. Mr. Drennan did not commit any acts involving fraud, deceit or manipulation, he was not unjustly enriched, he has no prior regulatory record, and there is no basis to believe he presents a risk and requires further deterrence. *See, e.g., In the Matter of Peak Wealth Opportunities, LLC*, Admin. Proc. File No. 3-14979, 2013 SEC LEXIS 664, at *31-33 (Mar. 5, 2013) (setting forth criteria for imposition of penalties). Moreover, he is unable to pay the proposed penalties as discussed above.

In *Securities and Exchange Commission v. Pentagon Capital Management PLC*,

No. 12-1680-cv, 2013 U.S. Dist. LEXIS 16402 (2d Cir. August 8, 2013), the Second Circuit held, in part, that the statutory language in the Securities Act of 1933 ("Securities Act") permitting a court to impose a civil penalty "plainly requires that such awards be based on the 'gross amount of pecuniary gain to such defendant.'" Id. at *23, citing 15 U.S.C. § 77t(d)(2); Securities Act, Section 20(d)(2). Thus the Second Circuit held that the district court erred in imposing a penalty on a third party based on a theory of joint and several liability with the defendants. Id.

Although the action against Mr. Drennan is an administrative proceeding, the identical principle applies. The relevant provisions permitting a penalty in an administrative proceeding provide that the penalty may be imposed only on "such person" who violated or caused a violation of the securities laws. See Securities Act, Section 8A(g)(1)(A); Securities Exchange Act of 1934, Section 21B(a)(2); Investment Advisor's Act of 1940, Section 203(i)(1)(B). Thus, like the third party in Pentagon Capital, the Commission may not impose on Mrs. Drennan the responsibility for paying a penalty based on JSO's or Mr. Mausner's alleged violations.[6]

[6] The Second Circuit held that the district court did not err in imposing a disgorgement requirement on the third party based on a joint and several liability theory, because the third party was an appropriate relief defendant in light of evidence that it had collaborated with the defendants in the alleged misconduct. 2013 U.S. Dist. LEXIS 16402, at *25. Here, of course, the Staff makes no allegation that Mrs. Drennan collaborated with Mr. Drennan in any of the alleged improprieties. Thus there would be no basis for demanding that Mrs. Drennan be responsible for payment of any of the proposed disgorgement or prejudgment interest.

VI. CONCLUSION

As detailed above, the evidence at the Hearing did not substantiate any securities laws violations by Mr. Drennan. Indeed, the Division's post-trial brief was almost entirely lacking of citations to the evidentiary record in its allegations against Mr. Drennan. Having failed to cite evidence for rebuttal in its opening brief, the Division has waived use of that evidence and may not unfairly present it in its reply brief. Accordingly, for the reasons stated above, Mr. Drennan respectfully requests a decision that he did not violate or aid and abet in or cause the violation of any securities laws.

Dated: March 21, 2014

Respectfully submitted,

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