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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15627

In the Matter of

TRI-STAR ADVISORS, INC., WILLIAM T. PAYNE, and JON C. VAUGHAN,

Respondents.

DIVISION OF ENFORCEMENT'S REPLY BRIEF IN SUPPORT OF ITS MOTION FOR SUMMARY DISPOSITION

The Division of Enforcement ("Division") of the Securities and Exchange Commission ("Commission") files this Reply Brief in Support of its Motion for Summary Disposition against Tri-Star Advisors, Inc. ("TSA"), William T. Payne ("Payne"), and Jon C. Vaughan ("Vaughan") and would respectfully show the Court as follows:

ARGUMENT AND AUTHORITIES

A. Payne and Vaughan's Failure to Exercise Reasonable Care Caused TSA's Violations.

While the OIP in this matter charges Vaughan and Payne only with causing TSA's non-*scienter* based offenses, Respondents attempt to convince the Court to apply a heightened aiding and abetting standard in evaluating their liability.[1] That standard has no application here, where *scienter* is not an element of any violation, and aiding and abetting has not been charged. *See, e.g., SEC v. Steadman,* 967 F.2d 636, 647 (D.C. Cir. 1992) (stating that *scienter* is not required under

[1] The Division's Response and Motion argued in error that Payne and Vaughan both "aided and abetted" and "caused" TSA's violations. The Division apologizes for adding to the confusion and clarifies that the OIP in this matter alleges *only* that Payne and Vaughan *caused* TSA's violations. There are no aiding and abetting charges at issue in this matter. Thus, the Division withdraws any argument that the individuals aided and abetted TSA's violations. The Court need only determine that the individuals' conduct was negligent in order to find Payne and Vaughan liable as a matter of law. Thus, for all the reasons stated in its Motion, summary disposition is proper on the claim that the individuals caused TSA's violations.

Section 206(4) and rules thereunder); *In re Geman,* SEC Rel. No. 34-43963, 2001 WL 124847, at *8 (explaining that Section 206(3) can be violated without a showing of fraud). It is well-established that the standards of causing and aiding and abetting are not identical on non-*scienter* based offenses, such as those alleged in this matter. For non-*scienter* based offenses, a showing of negligence is sufficient to establish liability. *See., e.g., In re Daniel Bogar, et al.,* SEC Rel. No. ID-502, 2013 WL 3963608, at 20; *KPMG Peat Marwick LLP,* 54 S.E.C. 1135, 1175 (2001). Negligence is the failure to exercise reasonable care. *Id.* at 24. Respondents' arguments that the Division cannot prove that the individuals caused TSA's violations all rely on an improper standard and should be rejected.

The undisputed facts of this case conclusively establish that, *at a minimum*, Payne and Vaughan were negligent in causing the firm to conduct principal trades in violation of the federal securities laws and in failing to adopt policies and procedures to prevent the violations. In their defense, Respondents argue that the act of hiring an outside compliance consultant excuses the firm's principals of their fiduciary responsibilities as investment advisers. That is not the law, nor has it ever been, as the Division's Motion demonstrates.

For example, Respondents rely heavily on a single district court case, *SEC v. Slocum*, 334 F. Supp.2d 144 (D.R.I. 2004), to suggest that the mere existence of a compliance review negates any possible liability for even causing the firm's primary violations. But that is not a proper reading of that case. Judge Elliott rejected a very similar argument in *In re Raymond J. Lucia Companies, Inc., et al.*, SEC Release No. 540, 2013 WL 6384274 (December 6, 2013), petition for review granted, SEC. Release No. 3784, 2014 WL 668867 (February 21, 2014). In *Lucia*, Judge Elliot concluded *Slocum* had no relevance because the compliance official that the Respondents pointed to in that case did not understand that the conduct at issue was inappropriate and, therefore, could not have concurred that the conduct was not misleading. *Id.* at *44-45. Thus, as Judge

Elliott properly recognized, a Respondent may not hide behind the fact that a compliance person was involved. (*See* Division's Motion and Response at pp. 9-12 and cases cited therein.) It is important to understand what the compliance person was asked to do and actually did. The facts of this case are even further from *Slocum* than those present in *Lucia.* In the instant case, TSA represented to its outside compliance consultant that the firm did not engage in principal transactions. (*See* Declaration of Linda Shirkey ("Shirkey Dec."), attached hereto as Exhibit "1", at ¶ 5.) Given this false information, the fact that a compliance consultant performed other functions, but did not counsel on whether principal trading was being conducted properly, is wholly irrelevant and cannot shield Respondents from liability.[2]

Similarly, Respondents attack the Division's citation to *In re Bogar, et. al.,* SEC Release No. 502, 2013 WL 3963608 (Aug. 2, 2013), claiming that Judge Foelak was merely reciting boiler-plate language when she noted that liability cannot be avoided merely because the actor claims ignorance of the securities laws. But in fact, *Bogar* provides a good example of why Respondents' core arguments are wrong. In that case, the respondents, employees of a broker-dealer, claimed they should not be held liable for misrepresentations and omissions contained in written materials their broker-dealer provided to investors. In particular, they claimed they did not know it was wrong to distribute those materials because, according to them, in-house and outside counsel were involved in drafting the materials at issue. The court credited their defense with regard to the Division's allegations that the respondents aided and abetted the broker-dealer's violations; however, it ruled that it was irrelevant to whether the respondents caused the broker-dealer's violations of Section 206(2) of the Advisers Act (a non-*scienter* based offense) because, regardless of the involvement of counsel, the respondents were negligent. *Bogar,* 2013 WL 3963608 at **

[2] Further, in *Slocum*, the defendants specifically relied upon the advice of counsel to structure the firm's accounts. In this case, it is undisputed that Respondents never sought any legal advice before the SEC's examination. *See Lucia,* 2013 WL 337919 at *46 (distinguishing *Slocum*).

23-24. That conclusion applies with even greater force in the instant case, where no attorneys were involved, the firm represented to its consultant that it did not engage in principal trading, and the consultant was not aware of, nor did she institute or review the trading at issue. (*See* Shirkey Dec. at ¶¶ 5-6.)

The undisputed record demonstrates that Payne and Vaughan failed to exercise reasonable care, and thus, acted negligently with respect to TSA's violations. Both of these fiduciaries engaged in acts and omissions that directly caused TSA's violations. (*See* Division's Motion and Response at pp. 10-13.) While their hiring of an outside compliance consultant might negate an inference of recklessness under certain factual scenarios,[3] it cannot absolve them of responsibility as firm principals and securities professionals to act with reasonable care. This is particularly true when, as here, the consultant was specifically told that the firm did not engage in principal trading and thus, did not examine that issue. Their direct actions caused TSA's violations. Thus, summary disposition is proper.[4]

B. TSA's Primary Violations Cannot Be Disputed.

Applying a plain language interpretation of the statute establishes that Advisers Act Section 206(3) imposes no *scienter* element, but only requires a knowledge or awareness that the trades occurred. *See Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992) (stating that courts follow one "cardinal canon of interpretation" before all others: Congress "says in a statute what it means and means in a statute what it says there."). A common sense interpretation of the phrase "knowingly to sell any security . . . " in the context of Section 206(3) means knowledge that the

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[3] Such facts are not present here, where, for example, the consultant was provided inaccurate information and was not retained to evaluate the firm's compliance in connection with principal trading—which it told the consultant it did not do.

[4] At a minimum, if the Court is inclined to give any weight to Payne and Vaughan's argument that they cannot be responsible under a negligence standard for TSA's violations because they hired a consultant, *at least* a fact issue exists as to that purported defense, and TSA's motion for summary disposition should be denied.

trades were made—not, as Respondents suggest, that a firm has to "know it was engaged in a principal transaction as defined by the Commission." *See* 2 Tamar Frankel & Ann Taylor Schwing, *The Regulation of Money Managers*, §13.03, at p. 13-57, and n.185, and §14.02[B][2] at pp. 14-80.1 and 80.2 (2d ed. 2013) ("'Knowingly' implies knowledge of the fact that the transaction occurred, not knowledge that the transaction was wrongful.") (cited portions attached to this reply as Exhibit 2). The Court should reject Respondents' strained and illogical interpretation. It is undisputed that TSA engaged in principal trading as defined by the federal securities laws, and the statute imposes no "intent" requirement. Thus, summary disposition against TSA is proper. (*See* Division's Motion at p. 6.)

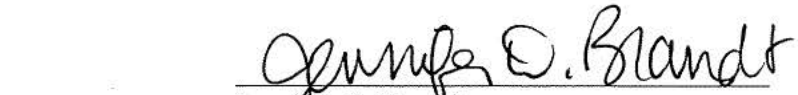
Further, Respondents do not address the Division's Motion for Summary Disposition against TSA on its Adviser Act Section 206(4) and Rule 206(4)-7 claims, and these violations are undisputed. Thus, summary disposition against TSA on these claims is also proper.

CONCLUSION

For the reasons stated herein, the Division respectfully requests that the Court: (1) deny Respondents' Motion for Summary Disposition; (2) grant the Division's Motion; (3) enter an order finding that: TSA willfully violated Advisers Act Sections 206(3) and 206(4) and Rule 206(4)-7 thereunder and that Payne and Vaughan caused TSA's violations of the Advisers Act; and (4) set a briefing schedule to determine what sanctions are appropriate given Respondents' violations.

Dated: April 11, 2014

Respectfully submitted,



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In the Matter of

TRI-STAR ADVISORS, INC., WILLIAM T. PAYNE, and JON C. VAUGHAN,

Respondents.

DECLARATION OF LINDA SHIRKEY

I, Linda Shirkey, do hereby declare under penalty of perjury, in accordance with 28 U.S.C. § 1746, that I have personal knowledge of the matters stated herein and that I am competent to testify to the matters stated herein if called as a witness. The following is true and correct.

1. I am the Founder and President of The Advisor's Resource, Inc. ("TARI"), formerly known as Shirkey Consulting, Inc. I have provided consulting services to registered investment advisors since 1994.

2. In January 2009, Tri-Star Advisors, Inc. ("Tri-Star") hired TARI to register with the State of Texas as an investment advisor and to create a Texas-compliant manual. Later that year, I worked with Tri-Star to register with the Securities and Exchange Commission and develop a Commission-compliant manual.

3. In performing my duties as a consultant for Tri-Star, I worked closely with Respondents William Payne ("Payne") and Jon Vaughan ("Vaughan"); Tri-Star's Chief Compliance Officer ("CCO"), Kelly Durham ("Durham"); and Marcel Theriot (former president and managing director of Tri-Star) prior to his departure from the firm in around August 2010.

4. I was not retained by, nor did I provide consulting services to, Tri-Star Financial

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EXHIBIT
1
PENGAD 800-631-6989

("TSF"), which was a broker-dealer firm also owned and controlled by Payne and Vaughan.

5. To begin preparation of Tri-Star's compliance manual, I developed a checklist of issues regarding Tri-Star's business, practices, and procedures, and spoke with representatives of Tri-Star to learn about its business. I asked whether Tri-Star engaged in principal trades, and was told that it did not. Therefore, TARI omitted policies relating to principal trading from the manual. A true and correct copy of the checklist I prepared, which reflects my contemporaneous handwritten notes, is attached hereto as Exhibit A.

6. I was aware that TSF was effecting trades for Tri-Star clients and was charging a markup; however, I was told that these were not principal trades by Tri-Star. I was not aware, nor was I told, that TSF was buying securities in its inventory account for Tri-Star clients.

7. As part of its consulting agreement with Tri-Star, TARI conducted an annual compliance review. The 2010 Annual Review was conducted in January and February 2011.

8. During the 2010 review process, I again asked whether TSA was engaged in principal trading. I listed it as a possible risk on the Risk Assessment I prepared (referenced in Respondents' Reply at pages 13-14) and asked Kelly Durham to confirm.

9. As a result of the review process, I prepared a written report on the Annual Review, and met with Payne and Vaughan to go over the findings and recommendations. A true and correct copy of the 2010 Annual Review is attached hereto as Exhibit B.

10. As referenced in Exhibit B, I reported as a finding that: "It was unclear as to whether principal trades have been effected by the broker/dealer for TSA clients. *Kelly* [Durham] *to confirm.*" [Exhibit B, page 3 (emphasis in original).]

11. The next time I heard about principal trading was in April 2011. Durham and I attended a compliance seminar in Dallas, Texas, sponsored by the National Society of Compliance Professionals. Based on information presented at the seminar, Durham told me for the first time that Tri-Star "may be" conducting principal trades, and was going to report this to the SEC compliance examiners, who would be on-site the next day.

JES

I declare under penalty of perjury that the foregoing is true and correct.

Dated: April 10, 2014
Dallas, Texas

Linda Shirkey

Tri. Star

[redacted]

TheAdvisor'sResource
Your Compliance Partner +

IA SEC Manual Checklist

Client: _____ Date: Sept. 10, 2009

Shorthand name: Tri. Star

Anti-Money Laundering

Who are the custodians?

SW data only
- 9 fully startups from SW securities
SW Securities - existing also stay setting up w/ FIO - new people Advent?

Asset Valuation

Who prices? from custodian

Illiquid/unpriced assets? none

Outside pricing service?

Do you fair value any securities? NO

Source for checking prices 4-D If discrepancies / trader sets bids separately SW reprices

Is there an Investment Committee?

If not, who is in charge of pricing unpriced assets?

How often do you price to determine fees? - Fees quarterly

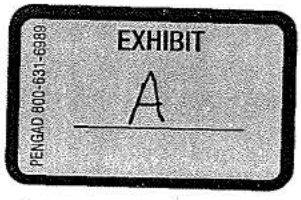
What portfolio management system does the firm use? Advent

Books and Records Retention

Legal entity? Inc.? LLC? LP?

Remote back up?

IT provider?



Email retention?

Retain Bloomberg messaging? IMs allowed?

Backup frequency

Location of backed up information

Business Continuity and Hurricane Preparation

Staff continuity plan

Communications and Advertising

Website?

Emails retained by?

Who reviews ad copy?

Do you have a website?
If so, what is address?
What is on it?
How frequently is it updated?

Custody?

Has? If so, how?

Is anyone a trustee? Does firm pay bills for clients?

Disaster Recovery

Employees

ERISA

Manage ERISA monies?

Bond?

DOL has ADV?

Soft Dollars?

General Compliance

Does anyone serve on board of public company?
Location – if Houston or San Antonio (and surrounding areas), provide Hurricane Preparation Plan.

Intake

Manages _____ and separate accounts?

Oversee custodian AML?

Contract says privacy policy received?

Performance – ~~N/A~~

What benchmarks do you use? NO

Do you report firm-wide performance numbers? 4 IA reps ~~[illegible]~~ profiles. Each mng practice separately

Do you claim GIPS compliance? NO

Who is your GIPS consultant? NO

Please send copy of performance advertising.

Please send language used for calculating performance fees. Not done

~~Who calculates?~~

Portfolio Management

Investments

Predefined investment strateg(ies) or tailored to clients?

How many separate strategies?

Number of Personnel 4

Is CCO also PM? no

Model portfolios (Trade in lockstep (Rule 3(a)4))? NO
Intake separate accounts
Statements
Restrictions
Do you have separate defined investment strategies?
How many?
What are they?

If using models, how do you monitor trading restrictions provided by clients?

Due Diligence – how written

Suitability information gathered? Updated annually?

no approved list
each rep does whatever
no PPS.
life settlements? licensed to do - RR side?
CAS to check

Privacy

Related entities?

Outside service providers?

Sharing office with others? With whom?

Are there any special arrangements?

Files locked? File room locked?

Proxy Voting Principles

Do you vote proxies for clients? If so, do you have a proxy voting policy?

If so, will you usually vote with management?

Hybrid voting?

Do you use an outside service? If so, who?

Does your custodian loan securities?

Regulatory Filings

Solicitation

Yes or no? not currently

Trading

Trade errors? client made whole, rep pays to make whole gain stays w/ client

~~Allocating~~ blocks?

If allocations are rotated, on what basis does the rotation occur?

Who takes gain? client

Soft Dollars? none

Reconciliation process – Advent will reconcile daily?

Does firm allow the following:

-principal trades? No

-cross trades? no

-proprietary trading? no

Does your custodian refer clients to you? 0% ?.

Do clients direct you to use certain brokers? no

TRI-STAR ADVISORS, INC.
ANNUAL REVIEW, 2010

FIRM OVERVIEW

Tri-Star Advisors, Inc. ("TSA" or "Firm"), which had approximately $140 million under management on 12/31/2010, is related to a broker/dealer firm, Tri-Star Financial, that trades fixed income instruments, with significant investments in CMOs. The Firm manages assets for clients by trading through its broker/dealer and hires sub-advisors to manage equity portions of balanced portfolios. This was the first full year of operation for the Firm, which was established in the final quarter of 2009.

METHOD OF REVIEW

Review conducted by: The Advisor's Resource, Inc. The review was conducted January 25, 2011, and covered the period January 2010-December 2010.

Method of review and documentation: The Advisor's Resource, Inc. ("TARI") reviewed TSA's books and records, compliance materials and client correspondence for 2010, as required by Rule 206(4)-7 of the Investment Advisers Act of 1940 ("Advisers Act"). The review also included an onsite visit with Kelly Durham.

CHANGES IN THE REVIEW PERIOD

A sub-advisor relationship was established to enable the firm to offer equity management to its clients requiring balanced portfolios.

Personnel Changes:

The Chief Compliance Officer position went through significant change in the initial year, but has since stabilized. Marcel Theriot, the president and managing director of Tri-Star Advisors, left the Firm on August 5, 2010.

ANNUAL REQUIREMENTS

Date Privacy Policy was given to clients: When accounts were opened

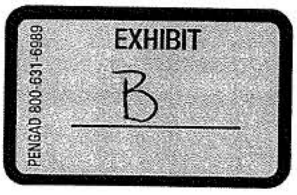
Date clients received Form ADV: When accounts were opened

Date best execution reviews were held and documented: December 2010

Date Form ADV I was last amended: August 18, 2010

Date of latest revision of Form ADV Part II: August 17, 2010

Date last annual review was conducted: This is TSA's first annual review.



MATERIAL REVIEWED; FINDINGS AND RECOMMENDATIONS FOR EACH

THE CODE OF ETHICS UPDATES/BREACHES; POLICIES & PROCEDURES MANUAL UPDATES

Findings:

- The personal trading policy was reviewed and revised as a result of this review. Pre-clearance requirements in the original trading policy had not been used, so the policy (and summary table) was revised to reflect actual practice of the firm. Personal trades were reviewed as required, and it was determined that no clients had been negatively affected as a result of the lack of pre-clearance. (See attached updated Code of Ethics.)

- Several sections of the manual were not updated to reflect changes that occurred with the Firm.

Regulatory Recommendations:

- Update the manual to include discussion of the pay to play rule and add language regarding the sub-advisor arrangement and how it will be monitored.

- All Firm personnel should annually sign the Code of Ethics/policies and procedures acknowledgement page.

Best Practice Recommendations:

- Review the personal trading policy in June 2011 to ensure that it in fact works to minimize potential conflicts with client trades, as well as to ensure that current procedures are in compliance with the policy.

- Review a manual section each month to ensure the policy reflects current business practices. Make changes appropriately.

ADVERTISING; MARKETING; DISCLOSURE DOCUMENTS; PERFORMANCE

Findings:

- The new Form ADV 2A and 2B have been drafted by The Advisor's Resource and are being reviewed by Firm personnel. It will be completed and ready for submission to the IARD as required by March 31, 2011, and will be mailed to all clients thereafter.

- TSA sends clients (and prospects?) a monthly newsletter, which is generic and covers economic news from a macro level. No specific investment recommendations were made or discussed.

- Two principals of the Firm participate in a daily radio show which runs for an hour or two. Topics include general market and news commentary, and listeners are allowed to call in. Both TSA and Tri Star Financial are mentioned as sponsors of the

show. The CCO monitors the radio show on a periodic basis to ensure advertising rules are followed.

- Tri Star Financial markets through seminars, which occasionally surface potential clients for TSA.

Regulatory Recommendations:

- Add insurance information to Form ADV 2A and 2B.
- Add sub-advisor language to Form ADV 2A.

Best Practice Recommendations:

- Prepare a "cheat sheet" for the TSA personnel participating in the radio show as to "Do's and Don'ts."
- Review any disclaimers made on the show.

ALLOCATION OF INVESTMENT OPPORTUNITIES; VALUATION; TRADING AND TRADE ERRORS; BEST EXECUTION

Findings:

- The original tests for best execution were found to be weak, as the Firm trades in fixed income instruments.
- There were no trade errors during the review period.
- It was unclear as to whether principal trades have been effected by the broker/dealer for TSA clients. *Kelly to confirm.*

Best Practice Recommendations:

- The Advisor's Resource recommends two level of tests in the future for best execution: 1) compare prices for a bond offered to clients through the related broker/dealer with those from a third party; 2) compare markups on bonds across Firm IARs to ensure that one IAR is not consistently marking bonds significantly higher than other IARs.

ANTI-MONEY LAUNDERING

Findings:

- Custodians conduct anti-money laundering tests for new clients and monitor account activity for potential money laundering.

No Recommendations

BOOKS AND RECORDS; CLIENT AND INVESTOR FILES; COMPLAINTS FROM CLIENTS/INVESTORS

Findings:

- There were no formal client complaints during the review period.
- No clients terminated their relationships with TSA during 2010.
- Of the client files that were reviewed, one file was missing the client agreement and several files were missing required signatures. Some clients' quarterly update forms were incomplete.

Regulatory Recommendations:

- Conduct an audit of all client files, making sure all client files are up to date and all agreements have required signatures.

Best Practice Recommendations:

- Consider establishing a procedure for reviewing each new client file to ensure all signatures are in place before the first fees are charged, or before trades are placed in a client's account.

CCO TRAINING

Findings:

- The Firm's CCO attended a one-day seminar for CCOs in April which focused on the new custody rule.

Best Practice Recommendations:

- The Firm may want to send the CCO to the NSCP regional conference in Dallas on April 11 and 12, 2011.
- The CCO might also consider attending and participating in the quarterly local "compliance roundtable."

CONFLICTS OF INTEREST

Findings

- TSA has an affiliated broker/dealer through which the fixed income securities recommended for Firm clients are purchased. IARs mark up the individual bonds, with bonds purchased in blocks as appropriate and all clients receiving the same price.
- TSA also offers insurance products through Texas Annuity Group. These insurance transactions generate compensation to the selling individual in the form of commissions which presents a material conflict of interest with TSA clients.

Regulatory Recommendations:

- Check the revised Form ADV 2A to ensure appropriate language is included regarding receipt of markups and investment management fees and insurance offerings.
- Ensure that the new ADV 2A has adequate language concerning the IARs marking up the bonds in addition to the TSA investment management fee being charged on the same assets.
- Review the Form ADV 2B as well for discussion of additional compensation from insurance sales.

Best Practice Recommendations:

- Consider strengthening the language in the new Form ADV 2A regarding competitive pricing for fixed income issues.

CUSTODY

Findings:

- The policies and procedures for TSA were reviewed in light of the new custody rule.
- The affiliated broker/dealer does not hold client assets, nor receives securities for deposit with the custodian.
- Testing on a spot basis confirmed that clients are receiving custodial statements directly from their account custodian.

No Recommendations

DISASTER RECOVERY/BUSINESS CONTINUITY

Findings:

- The disaster recovery plan was not updated to reflect current employee status.
- The disaster recovery plan was tested in November and there were no issues.

Regulatory Recommendations:

- Update the disaster recovery plan with every change in personnel.

Best Practice Recommendations:

- Consider adding "business continuity" to the Firm's website, listing addresses and phone numbers of relocation, so clients will know how to contact the Firm in case of a disaster.

FEES AND FIRM FINANCIALS

Findings:

- Firm financials were provided for the past three months, including trial balances. The Firm appears to be in a positive net worth position with adequate working capital. There are no long-term liabilities, with the only short-term liabilities being payables for management fee and staff salaries.
- Fee calculations were spot-checked, and there were no issues.

No Recommendations

NEW PRODUCTS OR STRATEGIES LAUNCHED

Findings:

- A new sub-advisor relationship was initiated in 2010, providing TSA with access to equity management for its clients requiring balanced portfolios.

No Recommendations

PRIVACY

Findings:

- Only new clients received TSA's privacy policy in 2010; no clients obtained by TSA in 2009 received the policy in 2010.

Regulatory Recommendations:

- Ensure that all clients receive TSA's privacy policy in 2011, in addition to all new clients obtained in 2011.

PROXY VOTING

Findings:

- TSA does not vote proxies for its clients.

No Recommendations

REGISTRATION AND RENEWALS

Findings:

- TSA paid its state renewal fees as required at the close of 2010 for 2011.

Regulatory Recommendations:

- The SEC is requiring renewal fees with the submission of the ADV 1 amendment in 2011.

RISK ASSESSMENT

Findings:

- A separate risk assessment file is attached.

Best Practice Recommendations:

- Address any medium or high risks.

SERVICE PROVIDER DUE DILIGENCE

Findings:

- Custodian relationships were reviewed in terms of financial stability in the initial quarter of the year.
- The Form ADV Parts 1 and 2 and the sub-advisor agreement for the sub-advisor were reviewed both by TSA personnel and by The Advisor's Resource.

No Recommendations

TESTING

Findings:

- TSA initiated a testing program in 2010, which will be continued on an ongoing basis.

Best Practice Recommendations:

- Increase frequency of best execution testing to quarterly during 2011.
- Review manual sections throughout the year as scheduled on the testing calendar, making necessary changes.

NEW REGULATIONS IN 2010

- New Form ADV 2A and 2B are required to be implemented and distributed to all clients in 2011 by May 31. The new Form 2A will be uploaded to the IARD system by March 31, 2011, with the annual amendment of the Form ADV Part 1.
- Requirements for SEC registration have increased to firms with over $100 million under management. TSA clearly exceeds this requirement, so will not have to change its registration to the state level.
- Changes to the custody rule were enacted.

NEW REGULATIONS PENDING IN 2011

- Changes to Regulation S-P pertaining to protecting client information and Anti-Money Laundering regulations may be enacted.

- States appear to become more vigilant regarding protection of client private information. Massachusetts and Nevada have passed more stringent privacy rules. It will become increasingly important to monitor such rules in light of TSA clients living out of state.
- The Financial Reform Act is continuing to generate new studies and new proposed rules. It is likely additional rule changes will occur during 2011.

SCOPE OF REVIEW

This was a preliminary compliance review of Tri-Star Advisors, Inc. Due to the time and economic constraints involved, we were unable to look at every file and every document related to TSA's business. We look forward to assisting Ms. Durham to address those areas where we have recommended action.

Sincerely,

Linda A. Shirkey and Jan Huff
The Advisor's Resource, Inc., Your Compliance Partner +

Date: February 15, 2011

§13.03 REGULATION OF CONFLICTS OF INTEREST UNDER SECTION 206(3) OF THE ADVISERS ACT

Congressional recognition of the fiduciary nature of advisers' relationships with clients is reflected in the 1934 and 1940 Acts and in the Advisers Act.[180] Like other laws dealing with fiduciaries, sections 206(1) and (2) of the Advisers Act have been interpreted to require advisers to disclose to their clients and prospective clients any material facts in connection with conflicting interests that may affect their unbiased service to their clients.[181] Section 206(3) of the Advisers Act requires in certain conflict of interest situations that advisers not only disclose material facts to clients, but also obtain their clients' consent. Section 206(3) makes it unlawful for an adviser

> acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.[182]

Section 206 applies to any adviser as defined in the Act, whether or not registered, including advisers that are exempt from registration.[183] The section provides a minimal standard

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[180] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963); 8 Loss & Seligman 3826-39 (determining fiduciary status); Annot., Construction and Effect of Investment Advisers Act of 1940, 5 A.L.R. Fed. 246 (1970).

[181] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195-97 (1963). The court did not hold that advisers must refrain from self-dealing and confined its holding to a declaration of the duty to disclose conflict of interest.

[182] 15 U.S.C. §80b-6(3) (these prohibitions do not apply "to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction"); Hearings on S. 3580 Before Subcomm. of Sen. Comm. on Banking and Currency, 76th Cong., 3d Sess. 320 (1940) [cited as 1940 Senate Hearings]. See also In re A. Morgan Maree Jr. & Assocs., Inc., IA-1718 (Apr. 27, 1998).

[183] Section 206(3) was amended in 1960 to delete reference to registered advisers. Act of Sept. 13, 1960, Pub. L. No. 86-750, §8, 74 Stat. 887; S. Rep. No. 1760, 86th Cong., 2d Sess. (1960), reprinted in 1960 U.S.C.C.A.N. 3502.

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and does not relieve advisers from any stricter standard imposed by other applicable laws. Furthermore, compliance with subsection (3) does not relieve advisers from disclosure obligations under sections 206(1) and (2).[184]

Being in pari materia, the terms "knowingly," "purchase" and "sale" in section 206(3) probably have the same meaning as these terms in section 17 of the 1940 Act which deals with affiliates' purchase, sale and loan transactions with investment companies and their controlled companies.[185]

Section 206(3) covers two conflict of interest situations: sale and purchase transactions between advisers and clients in which advisers act as principal for their own accounts, and sale and purchase transactions in which advisers act as brokers for another person. The section does not cover borrowings by an adviser, as section 17 of the 1940 Act does. The section also does not cover situations in which the adviser acts as agent *for* the client. When an adviser or a broker in a control relationship with the adviser acts as a broker representing the advised client and the other party to the transaction, Rule 206(3)-2 grants an exemption, subject to certain conditions.[186]

Section 206(3) requires only that the adviser disclose to the client the capacity in which the adviser acts and obtain the client's consent. As mentioned, the Director of the Trading and

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[184] Op. Director Trading & Exchange Division, Adv-40 (1945).

[185] See §14.02 on section 17(a). In 1999, the staff interpreted the meaning of the terms "purchase" and "sale" for purposes of section 206(3) in the context of providing margin credit and short sales. See Goldman, Sachs & Co., Corres. (Feb. 23, 1999). The staff determined that Goldman, Sachs would not be engaging in a sale of a security to or a purchase of a security from an advisory client by reason of extending margin credit. The granting of a security interest in connection with maintaining a margin account does not constitute a purchase or sale of securities for purposes of section 206(3) because such a grant does not create the potential for price manipulation and the dumping of unwanted securities by an adviser into a client's account that section 206(3) was intended to address. Similarly, a transfer or loan of securities on behalf of a client to facilitate a short sale does not constitute the sale a security to or purchase of a security from an advisory client because there is no potential manipulation and the dumping of unwanted securities. In distinguishing between a transfer or loan of securities on behalf of a client and an actual sale of securities by the adviser to the client, the staff determined that a transfer or loan did not present the "same potential for abuse as a sale."

[186] 17 C.F.R. §275.206(3)-2 (2000).

required to include a statement including (1) the landing point, (2) an explanation that the allocation becomes fixed at the landing point, and (3) the intended allocations at the landing point.[254.8]

Third, the advertisement would be required to include a statement that (A) "[a]dvises an investor to consider, in addition to age or retirement date, other factors, including the investor's risk tolerance, personal circumstances, and complete financial situation"; (B) advises an investor that the investment is not guaranteed and that it is possible to lose money, including at and after the target date; and (C) unless disclosed as required by one of the other requirements, advises an investor whether, and the extent that, the intended allocations may be modified without a shareholder vote.[254.9]

Rule 34b-1 would be amended to provide that sales literature with "a more than insubstantial focus" on a target date fund or funds would be required to comply with these provisions.[254.10]

Finally, Rule 156 under the 1933 Act, which provides guidance on information in investment company sales literature that may be misleading, would be amended to state that a statement suggesting that investment securities are "an appropriate investment" may be misleading because of (i) "[t]he emphasis it places on a single factor (such as an investor's age or tax bracket) as the basis for determining that the investment is appropriate"; or (ii) "[r]epresentations, whether express or implied, that investing in the securities is a simple investment plan or requires little or no monitoring by the investor."[254.11]

[2] Intent

The term "knowingly" was designed to exclude from the application of sections 17(a)(1) and (2) inadvertent good-faith violations.[255] "Knowingly" implies knowledge of the fact that the transaction occurred, not

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and (C) whether, and the extent that, the allocations may be modified without a shareholder vote. *Id.* at 35,945.

[254.8] *Id.* at 35,945, *to be codified if adopted at* 17 C.F.R. §230.482(b)(5)(v).

[254.9] *Id.* at 35,944, *to be codified if adopted at* 17 C.F.R. §230.482(b)(5)(ii).

[254.10] *Id.* at 35,945, *to be codified if adopted at* 17 C.F.R. §270.34b-1(c).

[254.11] *Id.* at 35,944, *to be codified if adopted at* 17 C.F.R. §230.156(b)(4).

[255] 1940 Senate Hearings at 257 (David Schenker: "In order to make sure that there is no injustice done, you will notice that the statute says specifically 'shall knowingly sell.' That is to take care of cases of good faith and inadvertence").

knowledge that the transaction was wrongful.[256] For example, when insiders were aware of the transaction but relied in good faith on the opinion of counsel, which had inadvertently overlooked section 17(a), the section applied. The facts, however, were grounds for exemption.[257] Mere negligence in not discovering the transaction is apparently insufficient to negate the existence of good faith.[258] However, if ignorance of the transaction is the result of a breach of duty, or if an intent can be shown to avoid discovering the transaction, as opposed to negligence in not discovering it, then the existence of good faith may be negated.

The requirement of knowledge is directed to the affiliates and their affiliates. If the investment company is deemed to be an aider and abettor to the violations, the element of intent with respect to its management is determined by section 2 of the United States Criminal Code, not by section 17(a).[259]

[3] Sale and Purchase—Value

"Sale" is defined in section 2(a)(34) to include "every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value,"[260] unless the context otherwise requires. In the context of section 17(a), this definition is inappropriate in several aspects. As mentioned, the section expressly applies to other property, in addition to securities.

[*Next page is 14-81.*]

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[256] *Investors Research Corp. v. SEC*, 628 F.2d 168, 176-78 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980), followed in *Howard v. SEC*, 376 F.3d 1136, 1141 n.5 (D.C. Cir. 2004) (dictum); *United States v. Brashier*, 548 F.2d 1315, 1328 (9th Cir. 1976), *cert. denied*, 429 U.S. 1111 (1977) (general-intent crime); see *United States v. Deutsch*, 451 F.2d 98, 113 (2d Cir. 1971), *cert. denied*, 404 U.S. 1019 (1972); Matthews, Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases, 39 Geo. Wash. L. Rev. 901 (1971); §33.03.

[257] Great Am. Holding Co., IC-530175320 (1968).

[258] See *Aaron v. SEC*, 446 U.S. 680 (1980) (scienter requirement applies to injunctive relief for Rule 10b-5 violations), followed in *SEC v. Lyttle*, 538 F.3d 601, 603 (7th Cir. 2008); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977) ("manipulative or deceptive" conduct required to establish a Rule 10b-5 claim); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976).

[259] See §14.02[A][4].

[260] 15 U.S.C. §80a-2(a)(34); see Vestaur Sec., Inc., Corres. (Mar. 24, 1983) (reduce claim by settlement is within section 17(a)).