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THE UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

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ADMINISTRATIVE PROCEEDING
File No. 3-15627

In the Matter of

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

Respondents.

SURREPLY BRIEF IN SUPPORT OF RESPONDENTS' MOTION FOR SUMMARY DISPOSITION PURSUANT TO RULE 250 OF THE RULES OF PRACTICE OF THE COMMISSION

Respectfully submitted,

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

Respondents Tri-Star Advisors, Inc. ("TSA"), William T. Payne ("Payne"), and Jon C. Vaughan ("Vaughan") respectfully submit this surreply brief in support of their motion for summary disposition as to all claims against them.

SUMMARY OF SURREPLY

The Division again incorrectly argues that negligence is the standard for "causing" liability. As already shown, the Division must demonstrate that Payne and Vaughan acted recklessly.

To support its negligence argument, the Division submits an eleventh-hour declaration of Linda Shirkey, Respondents' outside independent compliance advisor. Ms. Shirkey's declaration does nothing to rebut Respondents' showing that Respondents hired Ms. Shirkey advise them on complying with all aspects of the Act, Ms. Shirkey knew that TSA was handling trades through TSF, and she failed to advise them that the Commission considers this principal trading. Nor does the case law cited by the Division do anything to rebut Payne's and Vaughan's showing that they acted reasonably in relying on Ms. Shirkey.

LEGAL ARGUMENT

PAYNE AND VAUGHAN DID NOT HAVE THE REQUISITE SCIENTER

A. Recklessness is Required for Liability for Causing the Alleged Violations

The Division argues that it need only show that Payne and Vaughan were negligent in order to establish their liability for causing the alleged violations because the alleged primary violation does not require scienter. In support, the Division cites only *In re Daniel Bogar*, SEC Rel. No. ID-502, 2013 WL 3963608, at 20; and *KPMG Peat Marwick, LLP,* 54 S.E.C. 1135, 1175 (2001), *recon. denied*, 55 S.E.C. 1 (2001), *petition for review denied,* 289 F.3d 109 (D.C.Cir 2002), *reh'g en banc denied*, 2002 U.S. App. Lexis 14543 (D.C. Cir. 2002). Div. Reply

Br. at 1-2. However, Respondents have already shown that *Bogar* is incorrect on that point because it relies solely on *KPMG.* In *KPMG*, the D.C. Circuit upheld the Commission's use of a negligence standard only because the statute in question, Section 21C(a) of the Securities Exchange Act, 15 U.S.C. § 78u-3(a), specifically contains the phrase "an act or omission the person *knew or should have known* would contribute to such violation." 289 F.3d at 120. *See* Respondents' Reply Brief submitted March 28, 2014 ("Resp. Reply Br.") at 4-5. No such language is present in Section 206(3) or (4) of the Act. The Division does nothing to rebut that showing or to distinguish any of the case law cited by Respondents in their initial brief filed February 27, 2014 ("Resp. Initial Br."), at 6-9, and in Resp. Reply Br. at 4-6.

B. Payne and Vaughan's Reliance on Ms. Shirkey Was Not Negligent

1. Linda Shirkey's Declaration

The Division has now, in effect, conceded that Payne's and Vaughan's reliance on Ms. Shirkey to guide them with all aspects of complying with the Act was not reckless. It now argues only that such reliance was, "at a minimum," negligent. Div. Reply Br. at 2. As its sole factual support for this argument, the Division submitted an eleventh-hour declaration from Linda Shirkey stating that in response to Ms. Shirkey's question, TSA employee Kelly Durham opined that TSA was not engaged in principal trading.[1] Ms. Durham did not have Ms. Shirkey's level of expertise and was herself relying on Ms. Shirkey for guidance.

Whether Ms. Shirkey's statement is true or false, it does nothing to rebut the documentary evidence that Ms. Shirkey *knew clients' securities were being put into the TSF account before being placed in the clients' accounts.* She had full knowledge of how trades were being handled.

[1] Although Ms. Shirkey's declaration is now suddenly the centerpiece of the Division's case against Respondents, the Commission never even deposed her or obtained documents from her during its investigation, which lasted more than two years.

See Resp. Reply Br. at 13-16. This is demonstrated by the 2010 Annual Review and Risk Assessment (*see* Resp. Reply Br. at 13-14 and Exhibit 6 thereto), by the Form ADV that Ms. Shirkey herself helped draft (*see* Resp. Initial Brief at 10 and Exhibit 5 thereto), and by page 5 in exhibit B to Ms. Shirkey's declaration, where among "Regulatory Recommendations" she includes "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." Ms. Shirkey does not deny this. She only claims that, despite her knowledge of TSA's trading process, she did not diagnose this as principal trading under the Act and made no inquiries after Ms. Durham answered her question on principal trading. The Division does not dispute that Respondents did not understand that the practice was considered principal trading. *See* Resp. Initial Brief at 5.

It wasn't for Ms. Shirkey to ask her client whether this practice was principal trading; it was her job to tell her client whether it was. Ms. Shirkey's story is like that of a physician expecting the patient to give the diagnosis.

The Division continues to misrepresent the record by arguing that Ms. Shirkey was not hired to advise about the practice in question. Div. Reply Br. at 4 fn. 3. There were no limitations on Ms. Shirkey's retention to advise on all aspects of compliance with the Act. *See* Resp. Reply Br. at 11-13. The Division submits no facts that suggest otherwise.

Ms. Shirkey's declaration therefore does nothing to establish Payne's and Vaughan's liability for causing the alleged violations.

2. The *Lucia* Opinion and Other Case Law

The Division relies heavily on *In re Raymond J. Lucia Companies, Inc.*, SEC Release No. 540, 2013 WL 6384274, at *44-*45 (Dec. 6, 2013), *petition for review granted*, SEC Release

No. 3784, 2014 WL 668867 (Feb. 21, 2014), as support for its argument that Payne and Vaughan cannot claim the "mere existence of a compliance review" as a defense. Div. Reply Br. at 3-4.

The Division again misstates the facts. Respondents do not argue that the "mere existence of a compliance review" is a sufficient defense. In addition to their reliance on Ms. Shirkey's independent professional advice, several other facts demonstrate their good faith and the lack of any scienter or negligence:

- There was not just a single cursory review, as the Division suggests, but rather repeated reviews and ongoing compliance advice by Ms. Shirkey over more than two years.
- Once they were apprised of the problem, Respondents voluntarily brought the issue to the Commission's attention during its 2011 examination.
- Clients were individually informed about the practice in advance; no clients were actually misled; and not a single client was harmed or even complained about the practice.
- Respondents have fully remedied the concern by instituting new compliance guidelines even before receiving a deficiency letter from the Commission.

See Resp. Initial Br. at 10-11. The Division does not dispute any of these facts.

Lucia supports Respondents' case because of its stark contrast with Payne's and Vaughan's situation. *Lucia* involved a long series of affirmative misrepresentations in investor road shows and webinars intended to induce potential customers to invest with the respondents' investment program. These misrepresentations concerned the use of false historical inflation rates, misleading and false rates of returns on certain REIT investments, misleading characterizations of so-called "backtests" used in the shows to illustrate hypothetical returns on the respondents' investment program as compared with other strategies, and several other misrepresentations discussed in great detail in the opinion. *Id.* at *7-*37. As Respondents have

shown previously, it is, and should be, far more difficult for a respondent to claim unawareness of impropriety when that respondent has engaged in a series of affirmative misrepresentations. Resp. Reply Br. at 7-8, citing *Bogar*. Here, by contrast, the Division does not contend that Respondents misled anyone and does not dispute that clients were informed of the trading practice at issue.

Secondly, the *Lucia* respondents claimed that the road shows were approved in compliance reviews. Those reviews were invalid because they were done by affiliated broker-dealers who had a monetary interest in the outcome. Respondents therefore knew that these affiliates "could not be relied upon as true independent arbiters." *Id.* at *44. Further, some of the backtests were not reviewed at all. Here, by contrast, Payne and Vaughan relied on an independent outside consultant who was informed about the trading practice in question.

The Division argues that *Lucia* is analogous because its internal compliance officer did not understand the backtests and therefore "could not have concurred that the slides were not misleading if she did not even understand the material." *Id.* at *45. This supports Respondents' point: Respondents' own internal employee, Kelly Durham, admittedly did not understand that TSA's practice constituted principal trading in violation of Section 206(3) and was relying on Ms. Shirkey to advise the firm. Ms. Shirkey knew the pertinent facts, and Respondents reasonably assumed she would understand their implications under the Act because that was her profession and what she was retained for. Also, the *Lucia* respondents knew that the internal compliance person was conflicted by her involvement with one of the affiliated brokers. *Id.*

The Division's continued reliance on *Bogar* is as misguided as ever. First, as shown previously, *Bogar*'s holding that negligence is sufficient for liability for causing a violation of Section 206 is incorrect because it cites *KPMG Peat Marwick, LLP,* 54 S.E.C. at 1175; on

appeal, the D.C. Circuit held negligence to be sufficient because the statute in question explicitly sets forth a negligence standard, which is not the case here. 289 F.3d at 120; *see supra* at 2; Resp. Reply Br. at 4-5. Secondly, *Bogar*'s holding regarding negligence was unnecessary; respondents were clearly reckless because they participated in a vast scheme of lies and cover-ups in the infamous Stanford Ponzi scheme. *See* Resp. Reply Br. at 7-8.

The Division also takes issue with Respondents' reliance on *SEC v. Slocum, Gordon & Co.*, 334 F.Supp.2d 144, 185 (D.R.I. 2004). Resp. Reply Br. at 2. However, *Lucia* supports Respondents by distinguishing *Slocum* as follows:

> *Slocum,* where partial reliance on Commission examinations negated scienter, is inapplicable here. In *Slocum* the defendants brought specific issues regarding account structure, which was later a basis of alleged fraud, to the Commission's attention during two examinations. 334 F. Supp. 2d at 160-61. Further, the defendants in *Slocum* relied upon the advice of counsel to structure its accounts, and after Commission and independent auditor recommendations regarding the specific account structures, tried to remedy them in accordance with those recommendations. *Id*, at 159-60. Here, the 2003 examination did not focus upon the backtest issue, the issue was not specifically brought to the examiners' attention, and there is no evidence of reliance on advice of counsel.

Lucia, 2013 WL 6384274 at *46. Like the *Slocum* defendants, Respondents brought the principal trading issue to the Commission's attention during the April 2011 examination and remedied the problem once it was known to them, even before receiving a deficiency letter from the Commission. *See* Resp. Initial Br. at 11. Again, this is undisputed. Thus, Respondents' situation is far closer to *Slocum* than to *Lucia*.

Regarding TSA's liability, the Division's reply merely rehashes its previous argument and does not address Respondents' argument in any detail; further response is unnecessary. However, Respondents take issue with the Division's assertion that summary disposition as to TSA's liability under Section 206(4) of the Act and Rule 206(4)-7 thereunder is appropriate. If TSA is not liable under Section 206(3), it is also not liable under Section 206(4) and Rule

206(4)-7, which impose liability for failure to implement a compliance program to avoid violations of Section 206(3).

CONCLUSION

For all of the above reasons and those set forth in Respondents' previously-filed briefs, the Division's claims against Respondents should be dismissed in their entirety.

Dated: April 17, 2014

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