**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**


**ADMINISTRATIVE PROCEEDING**
**File No. 3-15764**

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| **In the Matter of**<br><br>**GARY L. MCDUFF,**<br><br>**Respondent.** | **DIVISION OF ENFORCEMENT'S RESPONSE TO COURT'S OCTOBER 2, 2015 SHOW CAUSE ORDER** |

Dated: November 6, 2015

Respectfully submitted,

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The Division files this Response to Court's October 2, 2015 Show Cause Order, and respectfully shows the Court the following:

## PROCEDURAL BACKGROUND

1. On February 21, 2014, the Order Instituting Proceedings ("OIP") initiating this case was filed. Respondent Gary L. McDuff ("McDuff" or "Respondent") filed his answer on April 14, 2014. Both the Division and McDuff filed motions for summary disposition.

2. On September 8, 2014, the Court issued its Initial Decision. The Court granted the Division's Motion for Summary Disposition, denied McDuff's Motion for Summary Disposition, and ordered that McDuff be permanently barred from associating with a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.

3. On November 13, 2014, McDuff filed a petition for review. The Division filed a motion for summary affirmance on December 2, 2014, and McDuff responded on December 21, 2014.

4. On April 23, 2015, the Commission vacated the Initial Decision and remanded this matter for further development of the record. First, the Commission held that the record before it did not contain any evidence that McDuff is associated, is seeking to become associated, or at the time of the alleged misconduct, was associated or was seeking to become associated with a broker or dealer as required by Exchange Act Section 15(a)(1). Order Remanding for Additional Proceedings, Exchange Act Release No. 74803 (April 23, 2015), at 2 (Apr. 23, 2015 Comm. Order).

5. Specifically, the Commission noted that the default judgment in the underlying case against McDuff was insufficient, by itself, to provide an adequate basis for finding that McDuff acted as an unregistered broker-dealer, as were two affidavits from McDuff's criminal trial that referenced the Government's allegations that McDuff put Lancorp Fund money into Megafund. (Apr. 23, 2015 Comm. Order, at 3-4). Second, the Commission held that the Initial Decision incorrectly relied on a superseding indictment against McDuff in a parallel criminal action and on the allegations in the Complaint the Commission filed against McDuff. In determining the proper sanction against McDuff. (*Id.* at 5-6).

6. In light of the Commission's opinion, on April 30, 2015, the Court directed the parties to submit supplemental briefing and additional evidence pertaining to the issues in the Commission's April 23, 2015 remand order. On June 24, 2015, the parties timely filed their supplemental briefs and additional evidence.

7. On October 2, 2015, the Court issued its order ("Oct. 2, 2015 Order"), denying the Division's Motion for Summary Disposition. The Court further ordered the Division to show cause by October 30, 2015, as to why this matter should not be dismissed.

8. Upon the Division's motion, the October 30, 2015, deadline was extended to November 6, 2015.

## ARGUMENTS AND AUTHORITIES

### A. Introduction.

In the Oct. 2, 2015 Order, the Court held that the Division's evidence was legally insufficient to support granting the Division's Motion for Summary Disposition. Oct. 2, 2015 Order, at 6. The Court further indicated that, assuming the Division's evidence was undisputed,

that evidence did not establish that McDuff acted as a broker because it (i) was inconsistent as to the number of investors McDuff brought to Lancorp, (ii) did not sufficiently show the methods McDuff used to solicit investors, and (iii) did not show that McDuff received "transaction-based compensation." (*Id.*, at 6-7). The Court then ordered the Division to show what evidence and legal theory it would present on the broker issue at a hearing and show cause why the proceeding should not be dismissed. (*Id.*, at 9).

The Division files this Response to further demonstrate that the evidence in the record, including additional testimony and evidence from McDuff's criminal trial, establish as a matter of law that McDuff acted as a broker. At a minimum, this evidence is sufficient to preclude summary disposition in McDuff's favor.[1]

**B. While the evidence in the record demonstrates McDuff acted as an unregistered broker, the Division only needs to raise a genuine issue of material fact to be entitled to a hearing.**

When challenging a motion for summary disposition, the non-movant must present specific facts showing a genuine issue of material fact for resolution at a hearing. ROP Rule 250(b); *Daniel Imperato*, 2015 WL 1389046, at *6 (March 27, 2015) (to challenge a motion for summary disposition, the opposing party may not rely on bare allegations or denials but must present specific facts showing a genuine issue of material fact for resolution at a hearing). In considering whether to grant McDuff's Motion for Summary Disposition and dismiss this proceeding, the Court must only find that the Division has raised a genuine issue of material fact as to whether McDuff acted as a broker. The Division does not need to conclusively prove that

[1] The Division continues the same shorthand conventions for its Supplemental Appendix filed June 24, 2015, which was "Supp. App., at xx," and cites to the new appendix, filed on this date, as "2d Supp. App., at xxx." The page numbers in the second supplemental appendix are consecutive to the first supplemental appendix.

fact.[2] Nevertheless, the Division's previously submitted evidence and additional evidence submitted now establish McDuff acted as a broker; at the very least, raises a genuine issue as to the material fact, precluding dismissal of this matter.

**C. Determining whether a person acts as a "broker" is not an inflexible analysis but instead an overall review of a variety of factors, none of which is exclusive.**

Section 3(a)(4)(A) of the Exchange Act of 1934 defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." The definition connotes "a certain regularity of participation in securities transactions at key points in the chain of distribution." *Massachusetts Fin. Serv., Inc. v. Secs. Investor Protection Corp.*, 411 F. Supp. 411, 415 (D. Mass.), *aff'd*, 545 F.2d 754 (1st Cir. 1976); *see also SEC v. Martino*, 255 F. Supp. 2d 268, 283 (S.D.N.Y. 2003). The statute, however, does not define the phrases "engaged in the business" and "effecting transactions."

Consequently, courts and the Commission have examined a variety of factors to determine whether a person acts as a "broker." In *SEC v. Hansen*, 1984 WL 2413, at *10 (S.D.N.Y. Apr. 6, 1984), the court identified the following factors as "relevant" to determining whether someone acted as a broker:

(1) Whether the person is an employee of the issuer;

(2) Whether he received commissions as opposed to a salary;

(3) Did he sell, or previously sell, the securities of other issuers;

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[2] For example, the Court noted inconsistencies regarding the number of investors McDuff recruited. While the Division does not believe such differences are material, because the more important issue is not necessarily the number of investors but the fact that it cannot seriously be disputed that McDuff in fact brought in some number of investors, the Division is entitled to explain such differences with testimony at a hearing. McDuff has flouted every court proceeding at issue here, limiting the evidence available on certain issues. If he were to testify at an administrative hearing, his credibility would be subject to the same scrutiny as the other witnesses. Indeed, such testimony may in fact provide further support for the Division's theories.

(4) Was he involved in negotiations between the issuer and the investor;

(5) Did he make valuations as to the merits of the investment or give advice; and

(6) Is he an active rather than passive finder of investors.

*Id.* (citing N. Wolfson, R. Phillips & T. Russo, *Regulation of Brokers, Dealers and Securities Markets*, § 1.06 (1st ed. 1977), at 1-12); *SEC v. Martino*, 255 F. Supp. 2d at 283 (citing *Hansen*). In *SEC v. U.S. Pension Trust Corp.*, 2010 WL 3894082, at *21 (S.D. Fla. Sept. 30, 2010), the court identified 11 factors for determining whether the person acted as a broker. These factors included whether the individual:

(1) actively solicited investors;

(2) advised investors as to the merits of an investment;

(3) acted with a 'certain regularity of participation in securities transactions';

(4) received commissions or transaction-based remuneration;

(5) is an employee of the issuer;

(6) is selling, or previously sold, the securities of other issuers;

(7) is involved in the negotiations between the issuer and the investor;

(8) analyzes the financial needs of an issuer;

(9) recommends or designs financing methods;

(10) discusses the details of securities transactions; and

(11) makes investment recommendations.

2010 WL 3894082, at *21 (S.D. Fla. Sept. 30, 2010) (citations omitted). These factors are not exclusive, and not all of them, or any set number of them, must be satisfied for a person to be

considered a "broker" under the statute. *See SEC v. Benger*, 697 F. Supp. 2d 932, 944-945 (N.D. Ill. 2010) (six factors listed in *Hansen* are "relevant" to determinations of whether a person acted as a broker but "were not designed to be exclusive.").

In addition to the judicial factors noted above, the Commission addressed this issue in a 2001 release, when it considered whether to require bank trust department employees, who would be selling securities, to register as brokers. *Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Interim Final Rule, Exchange Act Release No. 34-44291, 2001 WL 1590253, at *20 n. 124 (hereinafter "Exchange Act Release No. 34-44291). In that release, the Commission stated:

> Effecting transactions in securities includes more than just executing trades or forwarding securities orders to a broker-dealer for execution. Generally, effecting securities transactions can include participating in the transactions through the following activities: (1) identifying potential purchasers of securities; (2) screening potential participants in a transaction for creditworthiness; (3) soliciting securities transactions; (4) routing or matching orders, or facilitating the execution of a securities transaction; (5) handling customer funds and securities; and (6) preparing and sending transaction confirmations (other than on behalf of a broker-dealer that executes the trades).

*Id.*, at *20.[3] The Commission footnoted the third item on the list, "soliciting securities transactions," and stated, "Solicitation is one of *the most relevant factors* in determining whether a person is effecting transaction." *Id.*, at n. 124 (emphasis added). The Commission cited *SEC v. National Executive Planners*, 503 F. Supp. 1066, 1073 (M.D.N.C. 1980), where a defendant was held to be a "broker" because it solicited clients actively and sold $4.3 million in securities and "thus had a 'certain regularity of

[3] There is no indication that this list was intended to be a complete and exclusive list of criteria.

participation in securities transactions at key points in the chain of distribution." *Id.* at 1073.

Interpreting the Division's earlier evidence, the Court paid particular attention to whether McDuff received transaction-based compensation. As discussed below, the Division believes several factors establish that McDuff acted as a broker, including the fact that when his actions are viewed in substance, not form, he received transaction-based compensation. Moreover, while courts have looked at the receipt of transaction-based compensation as an indicator of broker-dealer activity, such compensation is not a *requirement* to be considered to be acting as a broker—it is only one of many factors. In fact, in *SEC v. George*, 426 F.3d 786 (6th Cir. 2005), a defendant was held to be a "broker" even though he had not received *any* compensation for his work because he was "regularly involved in communications with and recruitment of investors for the purchase of securities." *Id.*, at 797.

Moreover, in evaluating whether a person received transaction-based compensation, it is not necessary to tie compensation to a specific transaction. For example, in *George*, much like here, the defendant solicited investors, held himself out as an intermediary, and "received transaction-*related* compensation in the form of investors' money." *Id.*, at 793 (emphasis added). Notably, the defendant in *George* was not paid based on securing a particular transaction. Instead, he deposited investors' funds into a commingled account, from which he paid returns to other investors and paid himself to support his lavish lifestyle. In other words, misappropriated investor funds were considered "transaction-*related* compensation" and supported the finding that defendant acted as a broker. *See also U.S. v. Elliot*, 62 F.3d 1304, 1310-11 (11th Cir. 1995) (manager of a Ponzi scheme received "transaction-based compensation" whenever a customer

relied on his advice and purchased the offered investment product; the manager "received the investment principal, which he commingled with his personal funds").

**D. Applying these criteria, McDuff acted as a broker.**

*1. Previously submitted evidence.*

The Division's previously submitted evidence that McDuff acted as a broker included: (1) the declaration of the court-appointed Receiver over Megafund and Lancorp Fund, Michael Quilling; (2) the investigative testimony of Gary Lancaster; (3) two Lancorp Fund records, subscriber data sheets, identifying McDuff as the person responsible for introducing the investor to the investment; and (4) the joint venture agreement between Lancorp Group and MexBank, in which Lancaster and McDuff agreed to divide Lancorp Funds' profits between their two entities, and McDuff's letter admitting that the joint venture payment was for the express purpose of compensating McDuff, acting through his company Secured Clearing Corporation, for recruiting investors.[4]

This evidence demonstrates that McDuff was indeed recruiting investors for Lancorp Fund. The Court criticized this evidence on the grounds it was inconsistent in showing the numbers of investors McDuff recruited. But, as the Court itself noted, *Hansen* states that the *number* of investors recruited is not one of the indicia of broker activity. Oct. 2, 2015 Order, at 6 (quoting *Hansen*, 1984 WL 2413, at *10). Thus, discrepancies in the numbers of investors

[4] Quilling's declaration proves that McDuff acted through Secured Clearing Corp., MexBank, and Secured Trust. (Supp. App., at 002, ¶ 5). Quilling also testified that McDuff maintained a number of accounts at Cash Cards International ("CCI"), an online depository. At the criminal trial, a CCI representative, Eric Roseland, authenticated account statements for MexBank, Secured Clearing, and Southern Trust Co., and testified they were part of a master account owned McDuff. (2d Supp. App. 617-622 [174:8-178:25]. The account statements are included in the Second Supplemental Appendix. (2d Supp. App. 938-940 [Trial Ex. 36]; 941-944 [Trial Ex. 37]; 945-947 [Trial Ex. 38]; 948-950 [Trial Ex. 40]).

should be considered immaterial. Even so, such discrepancies are easily explained by the witnesses' different positions. Quilling, as the Receiver, stepped into the shoes of the Lancorp Fund and had possession of its business records. (Supp. App., at 002, ¶¶ 4-8). His testimony that McDuff was responsible for recruiting at least 100 investors, to both Megafund and the Lancorp Fund, was based on his examination of Megafund and Lancorp Fund business records.[5] (Supp. App., at 003, ¶ 9). There is no reason to dispute his sworn testimony on this issue, especially when it is considered that Lancaster's testimony on this issue, when he estimated that McDuff brought in a "dozen, maybe," investors, was given without access to records. (Supp. App., at 78 [74:14-24]). Moreover, at that stage of the staff's investigation, Lancaster likely had reason to try to minimize the number of investors. In any event, the significance to this testimony is not the actual numbers, or any inconsistency, but the fact that both witnesses confirm that McDuff was indeed soliciting investors.

In addition, Lancaster's testimony that McDuff also checked the financial background of investors satisfies one of the criteria identified by the Commission as evidencing "effecting transactions." Exchange Act Release No. 34-44291, at *20, n. 124. ("screening potential participants in a transaction for creditworthiness") (Supp. App., at 131[239:24-240:22]; 144 [292:12-18]).

*2. Criminal trial evidence.*

In addition to the previously-filed testimony of Quilling and Lancaster, two investors testified in more detail at McDuff's criminal trial about how McDuff solicited them to invest in

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[5] Quilling's testimony that McDuff recruited at least 100 investors to both Megafund *and* Lancorp Fund, demonstrates that McDuff satisfied another one of the factors in showing he acted as a broker: he was recruiting investors for more than one issuer. *See Hansen*, 1984 WL 2413, at *10.

the Lancorp Fund, as well as the conversations they had with him. (2d App. Supp., at 538-590 [95:1-147:1]). In particular, these investors demonstrate how involved McDuff was in bringing in investors.

*Testimony of Francis Lynn Benyo.*

Investor Francis Lynn Benyo testified she first met McDuff at a meeting of an internet business group, where McDuff "made a pitch for his investments that he had going at that time," which was called Overseas Bank & Trust. (2d Supp. App., at 539-540 [96:11-97:3]). She invested in that offering. (*Id.*) McDuff later approached this same group to pitch the Lancorp Fund. (2d Supp. App., at 540-541 [97:4-98:1]). He described to the group that Lancorp Fund was an "excellent opportunity" because the fund was secure and the investments would be insured. (*Id.*) McDuff recommended the investment as having no risk. (2d Supp. App., at 540-541 [97:14-98:1]).

After that meeting, McDuff spoke with Benyo numerous times, by telephone, answering her questions, describing in detail how the investment worked, and describing how the insurance worked. (2d Supp. App., at 541-547 [98:2-104:20]). McDuff sent her written materials about the investment and discussed the materials with her. (2d Supp. App., at 542; 547 [99:16-21; 104:12-20]). McDuff knew that the money she was investing was the only money she had, as it was what her late husband left her. (2d Supp. App., at 541-542 [98:25-99:15]). McDuff also discussed with Benyo the insurance coverage that the Lancorp Fund investment offered, with the premiums paid out of the investor's funds. (2d Supp. App., at 541; 544 [98:2-16; 101:20-23]). Benyo told McDuff she wanted to obtain the insurance. (2d Supp. App., at 545-546 [102:7-

103:1]). McDuff also discussed with her how she could still invest, even though she was not an accredited investor. (2d Supp. App., at 546-547 [103:13-104:17]).

When Benyo had questions about the fact that her investment funds would be coming from an IRA, she talked to McDuff about whether that would disqualify her as an investor. (2d Supp. App., at 557-562 [114:16-119:17]). McDuff told her it would not, explained how to mark the subscription agreement as "N/A" with respect to accreditation status (2d Supp. App., at 560-562 [117:17-119:17]), and told her where to send her IRA funds into a rollover IRA account to complete her purchase. (2d Supp. App., at 562 [119:11-20]).

*Testimony of Jay Biles.*

Investor Jay C. Biles testified that McDuff was "a business friend or something of my wife's cousin," but when Biles began speaking with McDuff, he believed McDuff was a salesman for Lancorp. (2d Supp. App., at 574-575 [131:14-132:25]). Biles only met with McDuff in person one time, but McDuff made Biles "feel comfortable" with the investment, told him about the insurance on the investment, and provided him with the documents about Lancorp Fund. (2d Supp. App., at 576-579 [133:1-136:15). Biles told McDuff that he would invest his retirement funds (2d Supp. App., at 582-586 [139:7-143:9]) and elect the insurance coverage. (2d Supp. App., at 579 [136:16-25]).[6]

The testimony of both of these investors clearly raises a genuine issue as to the material fact that McDuff was acting as a broker. Indeed, this evidence, combined with the previously

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[6] McDuff submitted documents—subscriber data sheets—that purport to show that Benyo and Biles identified someone other than McDuff as the person who initially introduced them to Lancorp Fund, although as the Court noted, Benyo's refers to the People's Avenger Fund, not the Lancorp Fund. Oct. 2, 2015 Order, at 5 n. 2. There is no evidence that these investors completed these forms. Their sworn testimony thus carries considerably more weight than a business form, where no testimony exists as to who completed the forms.

submitted evidence, demonstrates that McDuff was acting as a broker, as it shows him satisfying many of the other criteria for brokers identified in *Hansen*, *U.S. Pension Trust Corp.*, and *George*. McDuff was actively soliciting investors by attending group meetings; advising investors as to the merits of the investment; acting with a certain regularity of participating in securities transactions; sold securities of other issuers (Overseas Bank & Trust, Megafund); was involved in negotiations between the issuer and the investor (*e.g.*, by helping Benyo figure out how to invest her IRA funds and elect the insurance coverage); discussed the details of securities transactions; and made investment recommendations. These are precisely the sort of activities that constitute acting as a broker. *U.S. Pension Trust Corp.*, 2010 WL 3894082, at *21; *Hansen*, 1984 WL 2413, at *10. That is particularly true when it is considered that the Commission has explained that solicitation is especially important. *See* Exchange Act Release No. 34-44291 (Commission considers solicitation as one of the most relevant factors to determining status as a "broker").

**E. McDuff's compensation for recruiting investors to Lancorp Fund came from investor funds.**

The Court held that the Division's evidence of McDuff's compensation for his investor-recruitment activities was not "transaction-based," but instead was "profit-sharing." Oct. 2, 2015 Order, at 7. The Court stated that, as the compensation "was generated by Megafund's activities, illicit or otherwise, it was not tied to the successful completion of a securities transaction." *Id.*

As noted above, it is not necessary to establish that McDuff received transaction-based compensation. But, applying the precepts discussed above, the evidence in the record, when

viewed in substance and not just form, establishes that McDuff received transaction-based compensation.

The Court, quoting Lancaster's description of McDuff's compensation, held that it was profit-sharing, not transaction-based compensation. But, that testimony should be placed within the context of the fraudulent offering Lancaster described. For example, Lancaster was clear that he and McDuff came up with this payment concept as a means of circumventing the legal prohibition against paying a commission to someone who was not licensed. In other words, they did not want it to appear to be a commission, even though McDuff's role was limited to bringing in investors and the investors' funds were then used to pay him. (Supp. App., at 76-77 [66:19-67:11; 69:3-16]; 123-125 [205:11-206:5; 207:17-214:13]; *see also* Supp. App. 002-004, ¶¶ 8, 10-14 [Quilling Declaration, stating that Megafund had no revenues other than investor funds and tracing McDuff's compensation from Megafund directly and indirectly]). The label that Lancaster attached to the compensation—payments "out of the profit of the underwriting activity itself"—should not obscure the fact that this payment was, in fact, nothing more than paying McDuff a commission for securing investors. Lancaster admitted as much. (Supp. App., 124 [211:13-17] ["We never could come to terms on how it could be done legally until this agreement," referring to the Joint Venture agreement, at Supp. App. 398-399]).

The *George* case supports consideration of this type of payment as an indication of broker activity, at least in the context of a Ponzi scheme. It held that one defendant acted as a "broker" because he received "transaction-*related* compensation" derived from misappropriated investor proceeds. *See SEC v. George*, 426 F.3d at 793. McDuff received misappropriated investor funds, as well. The source of McDuff's compensation was the purported Megafund

profit, and Megafund had virtually no revenues other than investor funds. (Supp. App. 002-003, ¶¶ 8, 10 [Quilling Declaration]). The fact that McDuff's compensation, derived from investor funds, was routed first through Megafund and described as Megafund's alleged "gross monthly profit," should be immaterial when the declared purpose was stated to be compensation for recruiting investors.

## CONCLUSION

For the reasons discussed above, the evidence in this case establishes that McDuff acted as a broker because he acted "with a certain regularity of participation" in securities transactions. This is demonstrated by his acts, which fall squarely within the factors courts look to in determining whether a person is a broker. McDuff actively solicited investors by attending group meetings and recommending the investment. And, he did not merely reach out to investors. He advised investors as to the merits of the investment. He discussed the details of the securities transactions—their purchase of the Lancorp Fund investment—with the investors. He was involved in negotiations between the issuer and the investor, even helping with the mechanics of rolling over IRA funds into the investment and how the investors could elect the insurance coverage on their Lancorp Fund investment. He also determined the creditworthiness of investors. Through his efforts, he recruited and secured more than 100 investors to Lancorp Fund and Megafund. And he was compensated for his solicitation activities with investor funds recycled through Megafund to make them appear to be profits, when in fact he was simply getting paid money originally provided by the very investors he secured – virtually same "transaction-based" compensation at issue in cases such as *SEC v. George.* Finally, in addition

to his activities securing investments into Lancorp Fund, McDuff sold securities of other issuers, specifically Overseas Bank & Trust and Megafund.

These are precisely the sort of activities that constitute acting as a broker. *U.S. Pension Trust Corp.*, 2010 WL 3894082, at *21; *Hansen*, 1984 WL 2413, at *10; Exchange Act Release No. 34-44291, at *20, n. 124. At a minimum, this evidence establishes a genuine issue of material fact that precludes granting McDuff's motion for summary disposition.

Moreover, the record evidence is more than sufficient to demonstrate that the public interest requires McDuff to be permanently barred from associating with a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization.[7]

Dated: November 6, 2015.

Respectfully submitted,

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[7] In addition to McDuff's criminal conviction in 2013 (*see* Initial Decision, September 5, 2014, at 4 & n.7), McDuff was convicted of money laundering in 1994. (2d Supp. App., at 1043-1049 [Ex. 34 admitted in *United States v. McDuff*, 4:09-cr-90 (E.D. Tex.), which is the criminal judgment from *United States v. McDuff*, 4:93CR 00161-001 (S.D. Tex. Feb. 7, 1994)]).

## SERVICE LIST

In accordance with Rule 150 and 151 of the Commission's Rules of Practice, I hereby certify that a true and correct copy of the foregoing ***DIVISION OF ENFORCEMENT'S RESPONSE TO OCTOBER 2, 2015 SHOW CAUSE ORDER*** was served on the persons listed below on the 6th day of November, 2015, *via* certified mail, return-receipt requested:

Honorable Brenda P. Murray
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Honorable Cameron Elliot
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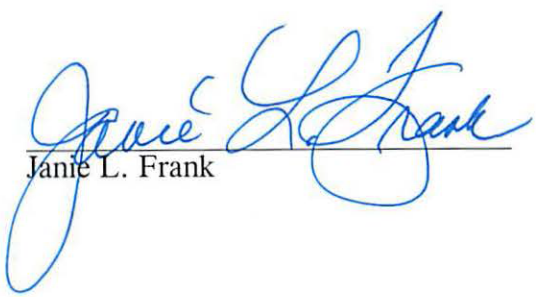

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