UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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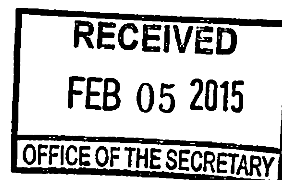

ADMINISTRATIVE PROCEEDING File No. 3-16033

In the Matter of

AIRTOUCH COMMUNICATIONS, INC., HIDEYUKI KANAKUBO, AND JEROME KAISER, CPA,

Respondents.

RESPONDENT JEROME KAISER'S PREHEARING BRIEF

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I. INTRODUCTION

In July 2012, a Florida-based distributor and logistics provider called TM Cell provided AirTouch Communications, Inc. ("AirTouch") with a purchase order for thousands of AirTouch's SmartLinX U250 telecommunications devices. The purchase order stated that the payment terms for the sale were "NET 90." Pursuant to the purchase order, AirTouch shipped thousands of units of product to TM Cell, and sent TM Cell several invoices, all with payment terms of "Net 90." Although a notation in the purchase order stated "pmt terms according to term sheet," Respondent Jerome Kaiser, AirTouch's Chief Financial Officer, understood that the phrase "term sheet" referred to a yet-to-be-finalized distribution agreement which would contain perfunctory terms that were consistent with the purchase order. Accordingly, in AirTouch's Form 10-Q, filed on November 14, 2012, the company reported the revenue associated with the TM Cell shipments. Mr. Kaiser signed a certification accompanying the Form 10-Q.

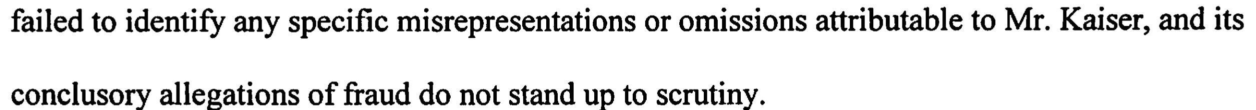
The Division of Enforcement (the "Division") contends that AirTouch should not have recognized the revenue associated with the TM Cell shipments, because the purchase order's reference to a "term sheet" actually referred to a separate logistics agreement (the "Logistics Agreement") which provided that TM Cell's payment obligation was contingent upon TM Cell's future resales of the product. The Division alleges that Mr. Kaiser engaged in a fraudulent scheme to conceal the existence of the Logistics Agreement and defraud investors by reporting false revenue figures, thereby violating the scienter-based anti-fraud provisions of the federal securities laws.

But what the Division sees as fraud was, in reality, nothing more than an honest mistake. Mr. Kaiser did not negotiate the terms of the Logistics Agreement between AirTouch and TM Cell, and does not recall contemporaneously reviewing the terms of the agreement, reasonably believing it to pertain only to logistics and warehousing arrangements, matters outside the scope

of his responsibility. With the benefit of hindsight, Mr. Kaiser recognizes that he could have reviewed the Logistics Agreement more closely. He takes full responsibility for his failure to do so, and for that reason does not contest the Division's allegation, in connection with its claim that Mr. Kaiser violated Section 17(a)(2) of the Securities Act, that he acted negligently in certifying AirTouch's third quarter 2012 Form 10-Q without conducting a more fulsome due diligence process, including, but not limited to, personally reviewing all contracts with the relevant customers.

A finding of scienter, however, requires significantly more than mere negligence. The Division will not be able to meet its burden of establishing that Mr. Kaiser acted with scienter. The Division's allegation that Mr. Kaiser "concealed" the Logistics Agreement is undercut by the fact that a copy of the agreement was located, in plain sight and clearly labeled, on the network shared drive used by AirTouch employees, including the company controller from whom Mr. Kaiser supposedly concealed the agreement. Moreover, the Division has identified no motive for Mr. Kaiser to engage in this supposed fraudulent scheme. Mr. Kaiser received no personal benefit from reporting the revenue associated with the TM Cell transaction; to the contrary, he did not sell his AirTouch stock but instead held onto it until it became essentially worthless. The chairman of AirTouch's Audit Committee, a retired PricewaterhouseCoopers audit partner, extensively reviewed the revenue recognition issue and determined that there was no evidence that Mr. Kaiser committed fraud. The Hearing Officer should reach the same conclusion.

The Division fares no better with its allegation that Mr. Kaiser misled an investor who loaned AirTouch money in the fall of 2012. As set forth in more detail below, the Division has



failed to identify any specific misrepresentations or omissions attributable to Mr. Kaiser, and its conclusory allegations of fraud do not stand up to scrutiny.

Even if the Division meets its burden of establishing that Mr. Kaiser acted with the requisite level of scienter (it will not), it cannot establish that significant sanctions against Mr. Kaiser are in the public interest. Mr. Kaiser did not benefit from the alleged wrongdoing, and expert testimony will show that AirTouch investors suffered little (if any) harm. Mr. Kaiser no longer works for a public company. And perhaps most importantly, Mr. Kaiser takes full responsibility for the fact that he certified the third quarter 2012 Form 10-Q without conducting a more fulsome due diligence process.

Although Mr. Kaiser admittedly failed to review the Logistics Agreement as carefully as he now recognizes that he could have, that failure was an honest mistake—not fraud.

II. STATEMENT OF FACTS[1]

A. Mr. Kaiser and AirTouch

Mr. Kaiser, a CPA and an experienced financial executive, joined AirTouch in 2010 as its Chief Financial Officer. This was the first time that Mr. Kaiser had served as CFO of a public company. Mr. Kaiser, who rose from humble beginnings, has an unblemished record, and has never before in his decades-long career been charged with (let alone found responsible for) the type of misconduct alleged by the Division here. *See* Ex. 118 (Mr. Kaiser's resume); Exs. 546, 547 (Mr. Kaiser's California Board of Accountancy licensing record).

AirTouch was a promising start-up company that developed and sold a range of telecommunications products. One of those products was the SmartLinX U250, a device that

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[1] Citations in this brief to "Ex. __" refer to exhibits that Mr. Kaiser expects to be introduced into evidence at the hearing. Should the Hearing Officer find it useful, Mr. Kaiser will, upon request, provide copies of his exhibits before the start of the hearing.

wirelessly connects a consumer's smartphone to a home landline telephone connection, allowing the user to dial from a smartphone contact list while enjoying the clarity of a landline connection and saving on mobile minutes.[2] The SmartLinX device was well-received by potential customers.

In 2012, AirTouch was focused on obtaining a significant, multi-million dollar order from Telmex, the largest landline carrier in Mexico. Telmex was interested in offering the SmartLinX device to its landline customers as a retention tool that would help staunch the flow of consumers dropping landline service in favor of their cell phones.

In May 2012, Telmex gave AirTouch a purchase order for 2,000 devices, with an additional 18,000 devices to follow pending the results of initial sales in Telmex retail stores. *See* Ex. 72 (Telmex purchase order). Telmex planned to then begin offering the device to its customers as part of its retention strategy, and Telmex executives told AirTouch representatives that Telmex envisioned purchasing as many as 20,000 devices per month.

By June 2012 AirTouch, a small start-up company with limited internal resources, needed a business partner to: (1) invest in AirTouch's business; (2) distribute AirTouch products to customers in the U.S. and abroad; and (3) provide logistics support where necessary to assist AirTouch in moving product to Telmex and other end-users in the U.S. and Latin America. After a company called Brightpoint ended its relationship with AirTouch and decided it wanted out of its investment in AirTouch, AirTouch entered into negotiations with Celistics to fulfill this business partner role. A number of draft agreements were prepared and shared between Airtouch and Celistics relating to an investment, distribution and logistics. *See* Exs. 445, 507. Celistics,

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[2] A short video demonstrating the features of the SmartLinX device is available on YouTube: http://www.youtube.com/watch?v=kEaI07TnNxE

however, began dragging its feet, and AirTouch began looking for another business partner who would be interested in fulfilling all three of these roles.

B. TM Cell Sends AirTouch a Purchase Order for 20,000 SmartLinX Devices.

In late July 2012, TM Cell, a large Miami-based telecommunications provider with extensive operations in Latin America, stepped in to fill the void left by Celistics. AirTouch sales representative Carlos Isaza had a previous relationship with TM Cell, and suggested to AirTouch executives that the company enter into negotiations with TM Cell. Those negotiations were handled entirely by Mr. Isaza, who was on site in Miami at TM Cell's offices, not Mr. Kaiser. Mr. Isaza reported not to Mr. Kaiser, but to AirTouch Executive Vice President of Sales Thomas Quan, who in turn reported to AirTouch Chief Executive Officer Hideyuki Kanakubo. *See* Ex. 127 at 6 (AirTouch organizational chart).

Mr. Isaza's negotiations with TM Cell moved quickly. From the time Mr. Kaiser was made aware of the possibility of reaching a deal with TM Cell to the time the deal was consummated, little more than a couple of hours elapsed. The end-of-July, 2012 negotiations culminated in TM Cell executing two documents: (1) a purchase order for 20,000 SmartLinX units at a purchase price of $1.74 million (Ex. 19); and (2) the Logistics Agreement (*id.*). The Logistics Agreement was signed on behalf of AirTouch by Mr. Kanakubo, not Mr. Kaiser. *Id.*

The purchase order stated that the payment terms were "Net 90." *Id.* Mr. Kaiser understood that this meant that TM Cell was agreeing to pay for the SmartLinX devices it received from AirTouch within 90 days of the invoice date. Although the purchase order included the phrase "pmt terms according to term sheet," there was no accompanying "term sheet." Mr. Kaiser understood that the phrase "term sheet" referred to a yet-to-be-finalized distribution agreement which would contain perfunctory terms that were consistent with the purchase order. The purchase order nowhere suggested that TM Cell's order was in any way

subject to the logistics agreement or contingent on the product being re-sold to Telmex or any other customer. In fact, Mr. Isaza contemporaneously told Mr. Kanakubo that TM Cell was capable of and interested in marketing and distributing the SmartLinX not just to Telmex, but to its large stable of other customers, including AT&T. Mr. Kanakubo, the AirTouch executive who signed the Logistics Agreement and Mr. Kaiser's boss, told Mr. Kaiser that the TM Cell transaction was a sale.

The Division contends that the purchase order was controlled by the Logistics Agreement, and that the Logistics Agreement contained terms suggesting that TM Cell had no obligation to pay AirTouch for the SmartLinX devices until they were re-sold by TM Cell to Telmex. Mr. Kaiser, however, did not contemporaneously understand that to be true. Indeed, Mr. Kaiser does not have any recollection of contemporaneously reviewing the Logistics Agreement. Although Mr. Kaiser acknowledges, with the benefit of hindsight, that reviewing the Logistics Agreement would have been the better course of action, he believed at the time that the Logistics Agreement, like other logistics agreements he had encountered in the past at AirTouch, contained terms related only to warehousing and logistics—areas outside the purview of the Chief Financial Officer. Mr. Kaiser's belief that the Logistics Agreement had no accounting ramifications—which appears in hindsight to have been erroneous, but at the time was honestly held—is exactly the reason Mr. Kaiser did not forward the Logistics Agreement to AirTouch controller Sylvia Chan. It was not, as the Division alleges, to conceal the Logistics Agreement from her. *See* OIP ¶ 26.

Moreover, the Division's allegation that Mr. Kaiser "concealed" the existence of the Logistics Agreement is conclusively refuted by the fact that a copy of the agreement was placed on AirTouch's shared network drive—where it was available to be viewed by AirTouch

employees, including Ms. Chan. *See* Expert Report of Michael Kunkel. If Mr. Kaiser had truly intended to "conceal" the existence of the agreement, it would not have ended up on the company's shared network drive for all to see.

C. AirTouch Ships Product to TM Cell and Recognizes Revenue Accordingly.

AirTouch immediately began shipping product to TM Cell in accordance with the purchase order, and sent three separate invoices to TM Cell before the end of the third quarter of 2012: (1) an invoice for 8,000 units dated July 31, 2012; (2) an invoice for 4,000 units dated August 31, 2012; and (3) an invoice for 2,260 units dated September 30, 2012. Ex. 20. Each of these invoices plainly and prominently stated that the payment terms were "Net 90", and specified payment dates which fell 90 days after the invoice dates. *Id.* Nowhere did the invoices suggest that TM Cell had no obligation to pay AirTouch for the SmartLinX devices until they were re-sold by TM Cell to Telmex. *Id.*

In AirTouch's Form 10-Q filed on November 14, 2012, the company's revenue included revenue associated with the shipments to TM Cell. Ex. 556. The Division asserts that Mr. Kaiser "knew, or was reckless in not knowing, that AirTouch's Form 10-Q contained materially false or misleading statements concerning reported net revenues and compliance with GAAP or AirTouch's revenue recognition policy." OIP ¶ 23. While Mr. Kaiser is prepared to take responsibility for the fact that the third quarter 2012 financials were inaccurate in that it was his job as Chief Financial Officer to ensure their conformity to Generally Accepted Accounting Principles, at no time did Mr. Kaiser engage in fraud. While the Division may argue that certain documents crossed Mr. Kaiser's desk that informed him that the end-of-July TM Cell transaction was not properly bookable because it was a logistics transaction, the Division fails to consider the numerous pieces of evidence suggesting that according to the facts as Mr. Kaiser understood them, as of November 14, 2012, revenue recognition was appropriate.

First, although AirTouch had not yet received any payment from TM Cell, only the first of the three invoices sent to TM Cell during the third quarter had come due and that one just two weeks before the date of the Form 10-Q. Further, AirTouch was interested in a multi-faceted and long-term relationship with TM Cell and for this reason did not rigorously attempt to collect cash from TM Cell precisely when it was due. Second, despite having received several invoices with unambiguous "Net 90" payment terms, TM Cell never, before November 14, 2012, sought clarification from Mr. Kaiser or tried to tell AirTouch that TM Cell's payment obligation was contingent on future sales to Telmex. Conversely, TMCell did not issue any monthly invoices for the logistics services the Division would argue TM Cell was providing. Third, AirTouch's auditors looked at the transaction and never suggested that the TM Cell sales were not properly recorded as revenue. Indeed, our accounting expert will testify at trial that if, as Mr. Kaiser contemporaneously believed, the Logistics Agreement did not apply to the shipments to TM Cell, then the TM Cell-related revenue was appropriately recognized based on the TM Cell purchase order. *See* Expert Report of Eric Poer. Fourth, Mr. Kaiser engaged in a due diligence process for the third quarter of 2012 financial statements which included AirTouch's controller, its Audit Committee, and its outside counsel, and only signed the certification for the Form 10-Q once that due diligence process was complete.

It is also important to note the incredible pressures and challenges faced by Mr. Kaiser in the time period between receiving the TM Cell purchase order on July 30, 2012 and certifying the Form 10-Q on November 14, 2012. While not offered as an excuse, it is relevant to any assessment of Mr. Kaiser's state of mind that AirTouch was a small smart-up company, and Mr. Kaiser was expected and required to be a jack-of-all-trades, handling everything from preparing the company's financial statements to purchasing office supplies. This problem was exacerbated

by the fact that AirTouch had recently laid off numerous staff members in an effort to conserve cash, including the company's Vice President of Operations, who would have been responsible for handling logistics and warehousing arrangements. During the third quarter of 2012, Mr. Kaiser was focused in particular on raising capital to keep AirTouch afloat, making numerous trips to meet with potential investors and responding to due diligence and other information requests. Although with the benefit of hindsight, the Division will argue that Mr. Kaiser should have focused closely on the Logistics Agreement, in reality it was only one of many matters that hit his email inbox during the relevant time period.

Hindsight also suggests that to the extent there was a misunderstanding concerning the details of the end-of-July transaction and TMCell's intentions, miscommunications among AirTouch employees played a role. Mr. Isaza negotiated the arrangements with TM Cell, but his first language is Spanish and his English is not always precise. (He required an interpreter for his investigative testimony session.) Mr. Kanakubo's first language is Japanese. Thus, when information concerning TM Cell was filtered to Mr. Kaiser (through Mr. Isaza or Mr. Kanakubo), it is quite possible that the details became muddled, through no fault of Mr. Kaiser's.

D. The AirTouch Board Questions the TM Cell Receivable and Decides to Restate Revenue, But Concludes There Was No Fraud.

When Telmex did not begin rolling out its SmartLinX sales program as quickly as had originally been expected, and TM Cell was unable to sell the product in its possession, Mr. Kaiser learned for the first time—months after TM Cell issued the purchase order and only *after* Mr. Kaiser certified the third quarter Form 10-Q—that TM Cell contended it did not owe money to AirTouch until it was able to re-sell the product. When the TM Cell receivable became more overdue, the AirTouch Board began looking into the matter, ultimately concluding, based on the

Logistics Agreement, that the TM Cell-related revenue reported on the Q3 Form 10-Q should be reversed. However, Audit Committee Chair Steven Roush (a retired PricewaterhouseCoopers audit partner) concluded based on his review of the facts and interviews that there was no intent by Mr. Kaiser or anyone else to inflate revenues. *See* Ex. 12 (Roush analysis). Mr. Roush concluded that Mr. Kaiser simply failed to read the Logistics Agreement closely.

Mr. Roush's conclusion that Mr. Kaiser lacked any intent to commit fraud is unsurprising, particularly in light of the fact that Mr. Kaiser lacked any ascertainable motive to misrepresent the company's revenues. Mr. Kaiser did not personally benefit, financially or otherwise, as a result of reporting the TM Cell revenue in the third quarter Form 10-Q. The company's stock price barely moved when the Form 10-Q was filed, and in any event Mr. Kaiser did not sell any of his company stock, instead holding onto it until it became essentially worthless. And although the Division correctly asserts that the TM Cell sale was one of AirTouch's largest reported sales, the company's board, management and investors were focused primarily on ensuring stable, long-term, large-volume sales to Telmex and other large landline carriers, not one-off sales to distributors like TM Cell. Board members will testify that they placed no pressure on management to drum up sales for the purpose of meeting monthly quotas. The Division's theory of fraud simply doesn't make sense when applied to the underlying facts.

Moreover, the Division's allegation that Mr. Kaiser engaged in a "revenue recognition scheme" (OIP ¶ 26) hinges entirely on its assumption that Mr. Kaiser had read and understood the terms of the Logistics Agreement as of November 14, 2012, when he certified the third quarter Form 10-Q. We are confident, however, that the Hearing Officer will find Mr. Kaiser credible when he testifies that he was <u>not</u> aware of the Logistics Agreement's terms. Absent

evidence that Mr. Kaiser knew about the Logistics Agreement's terms, the Division's case against Mr. Kaiser crumbles.

Mr. Kaiser's employment with AirTouch ended in early 2013, and the company ceased most operations. Mr. Kaiser is no longer working as a director or officer of a public company.

E. Mr. Kaiser Did Not Mislead an AirTouch Investor.

The Division separately alleges that Mr. Kaiser made materially false and misleading statements to an AirTouch investor, Tony Tang, in connection with a $2 million loan made to the company in October 2012. OIP ¶¶ 29-40. Mr. Kaiser, however, made no material representations to the "investor," Tony Tang—who was not really an investor himself, but rather a representative of another entity connected to his wife's family.

The Division's allegations vis-à-vis Mr. Tang relate to two purportedly fraudulent misstatements and/or omissions: (1) an October 2, 2012 email to Mr. Tang in which Mr. Kanakubo—not Mr. Kaiser—referred to a 20,000 unit purchase order from Telmex (OIP ¶ 30; Ex. 415); and (2) an allegation that Mr. Kaiser "provided [Mr. Tang's] representatives with the Purchase Order, but did not provide them with or disclose the existence of the [Logistics Agreement]." OIP ¶ 31. The Division also alleges that Mr. Kaiser engaged in an "offering fraud scheme" by leading Mr. Tang to believe that "AirTouch would receive a substantial financial commitment" from Telmex. OIP ¶ 38. None of these allegations have merit.

First, the October 2, 2012 email to Mr. Tang was sent by *Mr. Kanakubo*, not Mr. Kaiser. That fact alone should end the Hearing Officer's inquiry. In any event, while it is true there was no 20,000 unit purchase order from Telmex in house at the time, this statement must be evaluated among the hundreds of pages of due diligence materials that were either provided to or made available to Mr. Tang and his representatives. Subsequent to the allegedly false representation regarding a 20,000 unit Telmex purchase order, detailed spreadsheets were

prepared with and by Mr. Tang's representatives, relating to existing purchase orders, and there is nary a reference to this 20,000 unit purchase order from Telmex. *See* Ex. 417 (loan repayment schedule showing no reference to the purported existing Telmex purchase order). Clearly, Mr. Tang was not misled by the stray reference in the October 2 email. Indeed, the context of the document strongly suggests that the reference to Telmex was a mistake, and that it was supposed to be a reference to TM Cell which had issued a 20,000 blanket purchase order at the time.

Second, we are unaware of any evidence that Mr. Kaiser actually provided the TM Cell purchase order to Mr. Tang or his representatives, as the Division alleges. And even if he had done so, there is no evidence that information about the relationship between AirTouch and TM Cell was material to Mr. Tang. Mr. Tang did not focus on the nature of the relationship between AirTouch and TM Cell, because sales to TM Cell would have generated but a small fraction of the revenue necessary to pay back his loan. And perhaps most importantly, Mr. Kaiser would not have provided the Logistics Agreement to Mr. Tang in October 2012 for the simple reason that he himself was not contemporaneously aware of the agreement's importance.

Finally, with respect to the Division's allegation that Mr. Kaiser falsely reported to Mr. Tang that AirTouch expected to do significant business with Telmex, the evidence will show that Mr. Kaiser—and everyone else involved on the AirTouch side of the negotiations with Telmex—reasonably and honestly believed that to be true.

The clear import of the portion of the case related to Mr. Tang is that Mr. Tang's family did not get paid back in full, not because he was defrauded but rather because everyone—AirTouch executives and Mr. Tang—thought the Telmex deal would come through and would generate enough revenue to repay the loan. Through no fault of AirTouch executives, the Telmex deal did not fully materialize. But that in no way suggests there was fraudulent activity

afoot. Tellingly, following AirTouch's announcement that it would be restating the TM Cell revenue, Mr. Tang made another investment in a separate company owned by Mr. Kanakubo—hardly the actions of someone who believes he was defrauded by AirTouch.

III. THE DIVISION CANNOT PROVE THE ALLEGED FRAUD.[3]

A. The Division Cannot Prove That Mr. Kaiser Acted With Scienter.

The Division cannot establish violations of Section 10(b), Rule 10b-5, or Section 17(a)(1) unless it proves that Mr. Kaiser acted with scienter, "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).[4] A respondent cannot have acted with scienter unless his conduct constituted, at a minimum, recklessness. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc). Recklessness is a "form of intent rather than a greater degree of negligence." *In re VeriFone Holdings, Inc. Sec. Litig.*, 704 F.3d 694, 702 (9th Cir. 2012). Scienter is found only in cases of "deliberate recklessness" or "conscious recklessness," a mens rea that "reflects some degree of intentional or conscious misconduct." *SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1093 (9th Cir. 2010); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 976 (9th Cir. 1999).

Reckless nondisclosure is defined as "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of

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[3] In light of the fact that Mr. Kaiser has not yet been made privy to the Division's detailed factual and legal contentions, having seen only the conclusory allegations in the OIP, he reserves the right to raise additional arguments, not set forth herein, at the hearing and/or in post-hearing briefing.

[4] The Division must also prove that Mr. Kaiser acted with scienter in order to prevail on its claim that Mr. Kaiser aided and abetted AirTouch's violations of the Securities Act and the Exchange Act. *See SEC v. Fehn*, 97 F.3d 1276, 1288 (9th Cir. 1996) (aiding and abetting liability requires "actual knowledge by the alleged aider and abettor of the primary violation and of his or her own role in furthering it").

ordinary care, and which presents a danger of misleading buyers or sellers that is *either known to the defendant or is so obvious that the actor must have been aware of it.*" *Hollinger*, 914 F.2d at 1569-70 (citing *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)) (emphasis added). The *Sundstrand* court explained that this definition includes both objective and subjective tests. Under the objective test, the "danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing." *Sundstrand*, 553 F.2d at 1045. The court cautioned that "the circumstances must be viewed in their contemporaneous configuration rather than in the blazing light of hindsight." *Id.* at 1045 n.19. Under the subjective test, "the omission must derive from something more egregious than even 'white heart/empty head' good faith." *Id.* at 1045. The court explained that the subjective component "would defeat a finding of recklessness" if "a defendant genuinely forgot to disclose information or that it never came to his mind" even if a "proverbial 'reasonable man' would never have forgotten." *Id.* at 1045 n.20; *see also id.* at 1047-48 ("an omission caused because [the defendant] genuinely forgot about these facts would not be actionable, even if such an omission derived from inexcusable neglect").

More recently, courts have clarified that scienter is a "subjective inquiry" that "turns on the defendant's actual state of mind." *SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1093 (9th Cir. 2010) (citing *Gebhart v. SEC*, 595 F.3d 1034, 1042 (9th Cir. 2010)). Thus while "the objective unreasonableness of the defendant's conduct" may "raise an inference of scienter," "the ultimate question is whether the defendant knew his or her statements were false, or was consciously reckless as to their truth or falsity" at the time he or she made the statement. *Id.*

Violations of Section 17(a)(2) only require a finding of negligence, not scienter. *SEC v. Glt Dain Rauscher, Inc.*, 254 F.3d 852, 856 (9th Cir. 2001). Mr. Kaiser does not contest a

finding, for purposes of the Division's Section 17(a)(2) claim, that he acted with negligence in connection with his certification of AirTouch's third quarter 2012 Form 10-Q without conducting a more fulsome due diligence process, including, but not limited to, personally reviewing all contracts with the relevant customers.[5] However, scienter requires significantly more than a finding of mere negligence.

Here, there is no evidence suggesting that Mr. Kaiser acted with the level of conscious or deliberate recklessness required to support a finding of scienter. As discussed in detail above, Mr. Kaiser lacked any apparent motive to deliberately or recklessly mislead investors. He achieved no personal gain from the alleged fraud, financial or otherwise. And the Division's allegation that Mr. Kaiser "concealed" the existence of the Logistics Agreement makes sense only if one takes as a given the Division's unfounded assumption that Mr. Kaiser was contemporaneously aware of the Logistics Agreement's terms. Even then, Mr. Kaiser's supposed "concealment" of the Logistics Agreement is rendered implausible by the fact that the agreement sat in plain view on the network's shared drive. The chairman of the Board's Audit Committee, Steven Roush (an experienced CPA himself) concluded after a detailed analysis that Mr. Kaiser engaged in no fraudulent conduct, and the Hearing Officer should come to the same conclusion.

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[5] Mr. Kaiser concedes only the state of mind element of the Section 17(a)(2) claim. The Division bears the burden of establishing that all of the other elements of the claim are satisfied. As set forth in Section III.B., *infra*, the Division will not be able to satisfy its burden of establishing that the alleged misrepresentations and/or omissions were material. In addition, Mr. Kaiser does not concede that he committed any acts in violation of Section 17(a)(3) or that he possessed the requisite state of mind for such a violation.

B. The Alleged Misrepresentations and Omissions Would Not Have Been Material to Reasonable Investors.

In addition, the Division will not be able to prove that the alleged misstatements were material to reasonable investors, as it must in order to establish liability under Section 17(a)(2) and subsection (b) of Rule 10b-5. "[T]o fulfill the materiality requirement there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (citations omitted).

Our economic expert will testify that there is no evidence that AirTouch's stock price was inflated as a result of the alleged misstatements in the third quarter Form 10-Q—suggesting that investors did not consider the reported revenue figures to be material. *See* Report of Allan Kleidon. And with respect to the Tang loan, as set forth above (in Section II.E., *supra*), the alleged misrepresentations relating to the 20,000 unit Telmex purchase order and the TM Cell purchase order would not have been material to Mr. Tang. Mr. Tang had no reason to focus on the relationship between AirTouch and TM Cell, and the "total mix" of information provided to Mr. Tang made clear that the stray reference to a 20,000 unit Telmex purchase order was an inadvertent error by Mr. Kanakubo.

IV. THE SANCTIONS SOUGHT BY THE DIVISION ARE UNWARRANTED.

Even if the Division could meet its burden of establishing that Mr. Kaiser violated the scienter-based provisions of the federal securities laws (it cannot), the Hearing Officer should nonetheless order lenient sanctions, if any. As set forth below, the Division cannot establish that harsh sanctions are warranted under the relevant legal standards.

A. Disgorgement is Not Warranted.

Disgorgement is an equitable remedy designed to deprive wrongdoers of gains flowing from their wrong. *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1474 (2d Cir. 1996). Only profits that are causally connected to the alleged wrongdoing may be disgorged. *SEC v. First City Fin.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989). Disgorgement may not be used punitively. *Id.*

The Division cannot establish that Mr. Kaiser should be subject to disgorgement for the simple reason that he did not receive any ill-gotten profits as a result of or in connection with any of the alleged violations. *See SEC v. DiBella*, 409 F. Supp. 2d 122, 127 (D. Conn. 2006) ("[I]f there were no profits earned as a result of the illegal conduct, disgorgement would not be an available remedy."). Mr. Kaiser did not sell his AirTouch stock or exercise any options following the alleged misstatement in the third quarter 2012 Form 10-Q. To the contrary, Mr. Kaiser held onto his AirTouch stock until it was essentially worthless.

Tacitly acknowledging that Mr. Kaiser received no ill-gotten gains as a result of the statements in the third quarter Form 10-Q, the Division instead alleges that Mr. Kaiser received a bonus of $15,000 following AirTouch's receipt of the proceeds from the Tang loan. *See* OIP ¶ 33. Mr. Kaiser's bonus, however, was tied to all of his capital-raising efforts, not just the Tang loan, and in any event Mr. Kaiser had no inkling that he was going to receive a bonus until after the transaction had closed. There is no basis for disgorgement of any ill-gotten receipts allegedly gained by Mr. Kaiser as a result of his conduct related to the Tang loan. Significantly, when AirTouch was unable to make payroll in the beginning of 2013, Mr. Kaiser continued to work for several additional months without pay. Even if there could be any doubt about the legitimacy of Mr. Kaiser's bonus (there cannot), he has already more than repaid it with his uncompensated labor.

B. Civil Penalties Are Not Warranted.

Section 8A(g) of the Securities Act and Section 21B(a) of the Exchange Act govern the permissible scope of Tier 1, 2, and 3 civil penalties. 15 U.S.C. §§ 77h-1, 78u-2. Second- and third-tier penalties may be ordered only in the event that Mr. Kaiser is found to have acted fraudulently. *See id.* For the reasons discussed above, the Division will not be able to establish that Mr. Kaiser acted fraudulently, and thus second- and third-tier penalties are unavailable.

But even if the Division establishes scienter (and it will not), the Division's case against Mr. Kaiser would still call for, at most, Tier 1 penalties, as anything above this level would not serve the public interest. Pursuant to Section 21B(c) of the Exchange Act, civil penalties may only be issued if they would be in the "public interest," as determined by weighing factors including: (1) whether the violations involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm caused to others; (3) the unjust enrichment; (4) prior violations; (5) deterrence; and (6) such other matters as justice may require. *Id.* § 78u-2(c).

None of these statutory public interest factors suggest that a substantial civil penalty is warranted. Mr. Kaiser gained nothing from the alleged misrepresentations, and has never before been found liable for (or even accused of) violations of the securities laws. Ordering harsh penalties against him would serve no cognizable public interest. Certainly, a Tier 3 penalty against him would be inappropriate, as the alleged violations did not result in substantial gain to Mr. Kaiser or substantial losses (or a significant risk of substantial losses) to others, as required by Section 8A(g) before Tier 3 penalties may be imposed. Mr. Kaiser gained nothing, and AirTouch shareholders lost little, if anything. *See* Report of Allan W. Kleidon at ¶ 4 ("The maximum potential loss to AirTouch shareholders caused by the alleged misstatements concerning reported revenues in third quarter, 2012 is approximately $13,080.").

Moreover, in determining whether a penalty is in the public interest, the Hearing Officer may consider evidence concerning Mr. Kaiser's ability to pay. 17 C.F.R. 201.630(a). Here, Mr. Kaiser has few assets and substantial liabilities, meaning that a large penalty would have no more of a remedial effect than would a more modest penalty. *See* Ex. 548 (Mr. Kaiser's financial disclosure).

C. A Director and Officer Bar is Unwarranted Because Mr. Kaiser Did Not Act With Scienter.

A director and officer bar may be ordered if Mr. Kaiser is found to have (1) violated the scienter-based anti-fraud provisions, and (2) demonstrated "unfitness" to serve as a director or officer. See 15 U.S.C.A. §§ 77h-1, 78u-3. As discussed above, the Division cannot show that Mr. Kaiser acted with scienter, and thus no director and officer bar is warranted.

Even if the Hearing Officer makes a finding of scienter, the Division nonetheless cannot demonstrate that Mr. Kaiser is "unfit" to serve as a director or officer for any substantial period of time. In determining unfitness and the corresponding length of the bar, the Commission and courts consider, among other things, the so-called *Steadman* factors, namely: "the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the likelihood that the respondent's occupation will present opportunities for future violations." *Gary M. Kornman*, Exchange Act Release No. 59403, at 10 (Feb. 13, 2009) (citing *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979)).[6] These factors, as applied here, do not support the imposition of a bar

[6] Courts considering this question also frequently apply the substantially similar "*Patel* factors": (1) the egregiousness of the underlying violation; (2) the defendant's "repeat offender" status; (3) the defendant's role when he engaged in the alleged fraud; (4) the degree of scienter at issue; (5) the defendant's economic stake in the violation; and (6) the likelihood that misconduct will recur. *See SEC v. Patel*, 61 F.3d 137, 141 (2d Cir. 1995).

against Mr. Kaiser. As discussed above, Mr. Kaiser has a clean record. He did not profit from the alleged fraud. He no longer holds a position at a public company. He has expressed remorse for not conducting a more fulsome due diligence process in connection with his certification of the third quarter 2012 Form 10-Q, and has acknowledged that his conduct in certifying the Form 10-Q rose to the level of negligence. In other words, the inaccurate financials resulted not from a genuine desire to mislead or defraud, but rather from a failure of attentiveness. Mr. Kaiser has received, and even embraced this message. Indeed, Mr. Kaiser has recently taken a number of continuing education classes in an attempt to sharpen his accounting expertise. More importantly, a failure of attentiveness can be, and has already been, easily remedied. Given these circumstances, any director and officer bar ordered by the Hearing Officer should be of limited duration.

D. A Cease-and-Desist Order and a Bar on Practicing Before the Commission are Unwarranted.

The Division's request for a cease-and-desist order, as well as its request that Mr. Kaiser be banned from practicing before the Commission pursuant to Rule 102(e)(1)(iii) of the Commission's Rules of Practice, are also unwarranted. "In evaluating the propriety of a cease-and-desist order, the Commission considers the *Steadman* factors, as well as the recency of the violation, the resulting degree of harm to investors or the marketplace, and the effect of other sanctions." *In the Matter of Peak Wealth Opportunities, LLC*, Exchange Act Release No. 69036, at 10 (Mar. 5, 2013). In addition, "[t]he *Steadman* factors are considered in evaluating any sanction under Commission Rule 102(e)." *Id.* (citing *Altman v. SEC*, 666 F.3d 1322, 1329 (D.C. Cir. 2011)). As set forth above, application of the *Steadman* factors here do not compel the conclusion that sanctions against Mr. Kaiser are in the public interest. Moreover, the imposition of serious, career-limiting sanctions such as a Rule 102(e)(1)(iii) bar would likely place Mr.

Kaiser's continued employment in jeopardy, further weakening his financial position and making it even more difficult for him to pay any civil monetary penalties or other financial sanctions.

V. THESE PROCEEDINGS RAISE A NUMBER OF CONSTITUTIONAL CONCERNS.

Even putting aside the deficiencies in the Division's case against Mr. Kaiser on the merits, Mr. Kaiser is entitled to prevail for the separate reason that the proceedings against him suffer from numerous constitutional deficiencies.

First, the SEC's administrative enforcement scheme violates the U.S. Constitution's separation of powers. The SEC is a "department" within the meaning of Article II, and its hearing officers are executive officers under Article II in light of the broad and substantial authority they have to conduct and render decisions in administrative proceedings, whose appointment—and removal—is required to comply with Article II. *See Free Enterprise Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477, 511 (2010); *Freytag v. Commissioner of Internal Revenue*, 501 U.S. 868, 881-82 (1991). The Appointments Clause of Article II vests the President with the power to select and appoint principal officers with the advice and consent of the Senate, while inferior officers may be appointed by the President alone, by the heads of departments, or by the judiciary. U.S. Const., Art. II, § 2, cl. 2. The power to remove executive officers likewise rests with the President. *See Myers v. United States*, 272 U.S. 52, 117 (1926).

The administrative enforcement scheme unconstitutionally confers principal authority on the SEC's hearing officers even though they are not appointed by the President with the advice and consent of the Senate. *See Intercollegiate Broadcasting Sys., Inc. v. Copyright Royalty Bd.*, 684 F.3d 1332 (D.C. Cir. 2012). Moreover, because the SEC's hearing officers enjoy at least two levels of "good cause" tenure protection—that is, they can only be removed by the SEC for "good cause" and the SEC Commissioners are themselves protected by good cause tenure—the

statutory scheme unconstitutionally strips the President of the Article II power to remove an executive officer at will. *See Free Enterprise Fund*, 561 U.S. at 496.

Second, the SEC's administrative enforcement scheme violates the U.S. Constitution's due process and equal protection guarantees. It denies respondents, like Mr. Kaiser, full discovery, application of the Federal Rules of Evidence, the ability to bring counterclaims against the SEC, and, most critically, the right to a jury trial. Among other problems, the SEC's Rules of Practice contain mandatory deadlines, leaving respondents only a few months to familiarize themselves with the Division's voluminous investigative record and prepare for hearing. 17 C.F.R. 201.360. And while the Division may take the testimony of as many witnesses as it likes in the course of its investigation, unlike in federal court respondents may not take discovery depositions unless they meet a very high bar, and are essentially left with the record compiled by the Division. 17 C.F.R. 201.230-201.234. Moreover, contrary to federal court practice, where defendants have the right to cross-examine witnesses, ALJs have complete discretion to admit testimony compiled by the Division during its investigation without any opportunity for the respondents to challenge the testimony. 17 C.F.R. 201.320. And when the Division decides to bring an action administratively, it deprives the respondent of his Seventh Amendment right to trial by jury. Finally, while respondents can eventually appeal the SEC's decision to the federal courts, those courts afford substantial deference to the SEC's findings, 15 U.S.C. § 78y(a)(4), 5 U.S.C. § 706(2), thus offering little meaningful review. These protections are critical to a just adjudication of liability in this action, and, indeed, until very recently were afforded in almost every instance to unregulated entities and individuals, like Mr. Kaiser, accused of willfully violating the antifraud provisions of the securities laws.

Finally, the administrative enforcement scheme violates Article III of the Constitution, which mandates that "[t]he judicial power of the United States, shall be vested in one Supreme Court, and in such inferior courts as the Congress may from time to time ordain and establish." Article III "is an inseparable element of the constitutional system of checks and balances." *Stern v. Marshall*, 131 S. Ct. 2594, 2608 (2011). While certain "public rights" may be adjudicated by ALJs, *see id.* at 2610-15, an enforcement proceeding accusing an unregulated individual of fraud is hardly a "public right." Mr. Kaiser has not reached out to the administrative state to receive a "public right," such as bankruptcy protection or unemployment benefits. He is a private individual whom the SEC has accused of fraud and dragged into administrative proceedings. And there is no "firmly established historical practice" of doing so, *id.* at 2621 (Scalia, J., concurring); to the contrary, until recently, the Division would almost certainly have prosecuted Mr. Kaiser in federal court. This proceeding thus deprives Mr. Kaiser of the "right to have [his] claims decided before judges who are free of potential domination by other branches of government" protected by Article III. *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 850 (1986).

VI. CONCLUSION

Mr. Kaiser regrets that he did not focus more closely on the terms of the TM Cell Logistics Agreement at the time he received it. With the benefit of hindsight, a factfinder could reasonably conclude that Mr. Kaiser should have done so. But Mr. Kaiser's honest mistake does not make him liable for securities fraud.

For the reasons set forth above, the Division cannot, and will not, be able to prove that Mr. Kaiser violated the scienter-based anti-fraud provisions of the securities laws.

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Respectfully submitted,

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