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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-16223

In the Matter of

SANDS BROTHERS ASSET MANAGEMENT, LLC, STEVEN SANDS, MARTIN SANDS AND CHRISTOPHER KELLY,

Respondents.

DIVISION OF ENFORCEMENT'S OPPOSITION TO CHRISTOPHER KELLY'S MOTION FOR SUMMARY DISPOSITION

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The Division respectfully submits this Memorandum of Law in Opposition to the Motion for Summary Disposition of Respondent Christopher Kelly.

Preliminary Statement

Christopher Kelly is not entitled to summary disposition. Kelly's arguments fail as a matter of law and his concessions actually support the Division of Enforcement's (the "Division's") own motion for summary disposition.

First, nothing in Kelly's submission disputes that SBAM distributed its audited financial statements to investors after the 120-day deadline. Because violation of the Custody Rule is a strict liability offense, the Division is entitled to summary disposition as to SBAM. Also notably, Kelly does not dispute that he knew that the audited financial statements were being distributed after the deadline, thus conceding an element of the aiding and abetting claims against him.

Second, Kelly's contention that he was not responsible for SBAM's compliance with the Custody Rule is unsupportable, both legally and as a matter of undisputed facts. As Chief Compliance Officer and Chief Operating Officer, Kelly had responsibility for the firm's compliance with the Rule, and he explicitly assigned that responsibility to himself in the SBAM Compliance Manual he drafted. Kelly had a shared obligation with Steven Sands and Martin Sands, SBAM's principals, to make sure SBAM complied with the Custody Rule and the Commission's 2010 Cease-and-Desist Order against SBAM. He did not do that.

Third, Kelly's efforts to lay the blame for his own failings on others cannot insulate him from liability. The failure of SBAM's compliance consultant, Richard Slavin, to uncover SBAM's Custody Rule violations does not help Kelly because Slavin testified that Kelly was his sole source of information about SBAM's compliance. And any purported "approval" by the

Division of SBAM's late deliveries has no consequence as a matter of law and, in any event, is belied by the record, which shows that the Division was actively investigating SBAM's late delivery of audited financials through the period Kelly says it gave tacit approval. Kelly's claimed reliance on a Q&A that counseled that the Division of Investment Management would not refer to the Division of Enforcement advisers in *certain* circumstances – circumstances that were inapplicable to SBAM – was, at the very least, reckless. It is undisputed that by 2010, SBAM and its Custody Rule issues had already been referred to Enforcement, resulted in a Commission Cease-and-Desist Order to which Kelly consented on behalf of the adviser and, by 2012, the Division was re-investigating SBAM for those same issues. Kelly knew all of this.

Separately, Kelly's brief asserts numerous and unsworn allegations of what he describes as staff "misconduct" and purported ethical violations. These allegations are false. They are also irrelevant to the merits of the Division's claims. In any event, because Kelly has levied allegations of misconduct, the staff addresses and corrects those claims below.

ARGUMENT

I. KELLY CONCEDES SBAM'S LIABILITY

Kelly admits that SBAM missed the 120-day Custody Rule deadline for each of its 10 Funds in the 2010, 2011 and 2012 fiscal years. (Kelly's Motion for Summary Disposition, dated January 14, 2015 ("Kelly Br.") at 16 ("[T]he Staff appears to be taking the position that the mere fact of the delivery of the audits after the 120-day period proves a violation of the Custody Rule . . . .").) Because the Custody Rule imposes strict liability on advisers, neither Kelly's "reliance-on-others" claims (id. at 8-11), nor his interpretation of the IM Division's Q&A (id. at 11-16), has any relevance to SBAM's liability for its violation of Rule 206(4)-2 because those defenses go to a respondent's state of mind – an issue not relevant to SBAM's violation of this Rule. See

SEC v. Steadman, 967 F.2d 636, 647 (D.C. Cir. 1992) ("[S]cienter is not required under [Advisers Act] section 206(4) . . . ."); SEC v. Nutmeg Grp., LLC, No. 09-civ-1775, 2011 WL 5042094, at *3 (N.D. Ill. Oct. 19, 2011) (same); see generally 17 C.F.R. § 275.206(4)-2 (the "Custody Rule").

II. KELLY CANNOT ESCAPE HIS RESPONSIBILITY FOR SBAM'S CUSTODY RULE COMPLIANCE

Kelly tries to walk away from his responsibility for SBAM's compliance with the Custody Rule in a number of ways, all of which are unavailing. He argues that he could not have had responsibility for enforcing SBAM's Custody Rule obligations because he has no background in auditing or finance (Kelly Br. at 6-7); because he is not a "guarantor of employee compliance" – insisting that others, including Martin Sands ("M. Sands") and Steven Sands ("S. Sands") (collectively, "the Sands"), bore the responsibility (id. at 6-8); and because he "did not have a legal title at SBAM." (Id. at 11.)[1]

These arguments miss the point. Kelly's obligation was not to audit the funds. As Chief Compliance Officer and Chief Operating Officer, his responsibility was to make whatever personnel or programmatic changes were necessary to ensure that SBAM complied with the Custody Rule and the Commission's 2010 Cease-and-Desist Order prohibiting future Custody Rule violations. If that meant that SBAM needed additional resources, new auditors, new lawyers, new personnel or new policies, Kelly should have secured or sought to secure them. He did not do that. See generally Matter of vFinance Invs., Inc., 3-12918, 2010 WL 2674858, at *13-14 (S.E.C. July 2, 2010) (holding CCO aided and abetted broker-dealer's delay in

[1] Kelly supports none of the many factual assertions he makes in his brief by sworn statement, and thus those statements have no evidentiary value as support for his own motion or in opposition to the Division's. They are, however, admissible against him as admissions of a party opponent.

producing, and failing to preserve, records where he failed to act in the face of obvious violations).

Kelly's responsibility to ensure SBAM's compliance with the Custody Rule was confirmed by Kelly himself when he redrafted SBAM's compliance manual. In 2008, when he assumed the positions of Chief Compliance Officer and Chief Operating Officer, Kelly revised the manual to provide: "Where the Firm maintains possession or custody of client funds/securities, the **Chief Compliance Officer** shall ensure compliance with the restrictions and requirements of *Rule 206(4)-2 adopted under the Advisers Act*."[2] (Div. Mot. at 14[3]; Brown Jan. Decl.[4], Ex. 8 (Kelly Wells Submission) at 6 (noting Kelly revised SBAM's Compliance Manual in 2008); Ex. 39 (Nov. 15, 2009 Compliance Manual) at Section IX.D.4 (emphasis in the original).) In assigning the responsibility to himself, Kelly carved out no situations in which he would not be responsible, or assigned sub-tasks to anyone else at SBAM. See Matter of Ronald S. Bloomfield, 3-13871, 2014 WL 768828, at *16-17 (S.E.C. Feb. 27, 2014) (finding CCO aided and abetted broker-dealer's failure to file SARs where the firm's anti-money laundering compliance manual assigned the compliance responsibility to him); see also Nutmeg Grp., 2011 WL 5042094, at *3-4 (refusing to dismiss aiding and abetting Custody Rule claim against CCO where the amended complaint alleged that the CCO was given custody-related responsibilities).

Kelly gave himself this responsibility even though he knew that SBAM had had trouble complying with the Rule in the past. In 2009, the SEC's Office of Compliance Inspections and

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[2] SBAM acknowledges that it had custody of Funds assets. (SBAM Answ. ¶ 19.)

[3] References to "Div. Mot." are to the Division of Enforcement's Motion for Summary Disposition Against Respondents Sands Brothers Asset Management, LLC, Steven Sands, Martin Sands and Christopher Kelly and Memorandum of Law in Support, dated January 15, 2015.

[4] References to "Brown Jan. Decl." are to the Declaration of Nancy A. Brown, executed January 15, 2015, and submitted in support of the Division's Motion for Summary Disposition.

Examinations ("OCIE") examined SBAM. As one of their requests, they asked Kelly for evidence that SBAM had delivered its fiscal year 2007 audited financial statements to investors in compliance with the Rule. (Brown Jan. Decl., Ex. 13 at 1.) Under the Custody Rule, the audited financial statements were due to be delivered for most SBAM-managed funds by April 30, 2008 (shortly after Kelly arrived at SBAM).[5] Kelly responded to OCIE's request by producing written answers, audit reports and one email, all evidencing that SBAM circulated the FY 2007 audited financial statements to investors in eight funds and four funds of funds after the Custody Rule deadlines (if they were distributed at all). (Div. Mot. at 5; Brown Jan. Decl., Exs. 13, 14 (OCIE Request to Kelly and SBAM Responses).)

That production resulted in a Commission Order, on consent, finding that SBAM violated the Custody Rule (among other violations) for failing to timely distribute the fiscal year 2007 audited financial statements, and that M. Sands and S. Sands willfully aided, abetted and caused those violations. (See Div. Mot. at 5-6; Brown Jan. Decl., Ex. 15 (2010 Order) at ¶¶ 4, 9, 13(c) & (e).) It imposed a Cease-and-Desist Order against SBAM and the Sands, prohibiting future Custody Rule violations. (Div. Mot. at 5-6; Brown Jan. Decl., Ex. 15 at Section IV.A.) Kelly signed the consent on behalf of SBAM.[6] (Div. Mot. at 5; Brown Jan. Decl., Ex. 16 (2010 Offer of Settlement) at 8.)

For the next 3 years, SBAM continued to violate the Custody Rule, a fact Kelly knew because he signed management representation letters after the deadlines. (Div. Mot. at 14, 24;

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[5] SBAM's "Select Access Funds," which were "fund of funds," had a different deadline. They are not at issue here.

[6] Kelly's assertion that all of the conduct in the 2010 Order predated his arrival at SBAM is incorrect. (Kelly Br. at 10.) Indeed, the Custody Rule violations underlying the 2010 Order occurred shortly after Kelly's arrival. (Brown Jan. Decl., Ex. 8 (Kelly Wells Submission) at 3 (noting Kelly joined SBAM "on or about April 28, 2008").)

Brown Jan. Decl., Ex. 31 (FYs 2010, 2011, 2012 Management Representation Letters).) Kelly disputes none of this.

And yet Kelly, the CCO and COO, did nothing to remedy the situation. As he confirms in his brief, he merely reminded the audit working group of the 120-day rule. (Kelly Br. at 5-6, 8.) And he "assisted" the audit process "to the extent he was able." (Id. at 8.) But that is all.[7]

Kelly argues that the Division charges him with doing nothing, and also with being "very active." (Kelly Br. at 8.) There is no inconsistency. Kelly's activity – engaging the auditors, signing management representation letters and serving as principal contact for the auditors (id.) confirms that Kelly had the responsibility for overseeing the audit and compliance with the Rule that the Compliance Manual assigned him. But as CCO and COO, he had the responsibility to do much more. Kelly does not dispute that he did not change the firm's policies or procedures. He did not engage auditors to conduct a surprise audit (an alternative way to satisfy the Custody Rule). See 17 C.F.R. § 175.206(4)-2(a)(4). He did not call the staff for guidance once it became clear that the deadlines would, once again, be missed. He did not devote or seek additional resources for the audit. He did not hire new auditors (to the extent he believed that the Funds' auditors failed each year to do the job timely or well). SBAM cannot act except through its control persons. Here, the CCO and COO was (along with the principals) responsible for bringing SBAM into compliance with the Custody Rule. He unequivocally failed at that task.

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[7] Kelly also acknowledges that he was President of one of the funds' portfolio companies - Trinity Cable LLC ("Trinity") – and that that company's valuation held up (at least in part) the 2012 audits because the auditors requested a contemporary and independent appraisal to support SBAM's valuation. (Kelly Br. at 15-16.) But he does not explain why he did not anticipate that the auditors might demand such an appraisal, nor what he did to expedite the request once it was made. Nor does he explain why Trinity delivered investment confirmations to the auditor days after the 120-day deadline in the following year – conduct that delayed the timely completion of the audit in that year too. (Declaration of Janna I. Berke in Support of the Division's Opposition to Christopher Kelly's Motion for Summary Disposition, executed February 12, 2015 ("Berke Decl."), Ex. M at SEC-NY8127-000097925-32.)

III. KELLY'S "RELIANCE" ARGUMENTS HAVE NO MERIT

After denying he bore responsibility for compliance with the Custody Rule, Kelly tacitly acknowledges that responsibility in arguing that he was excused from it. Kelly claims that the silent approval of others – Compliance Consultant Richard Slavin, the SEC and the Connecticut Department of Banking – led him to reasonably conclude that SBAM was in fact in compliance with the Rule. Kelly presumably argues that such "reasonable" reliance negates his scienter, making claims against him for aiding and abetting unsupportable.

Each of these reliance arguments fails.

A. Kelly's Purported Reliance on SBAM's Compliance Consultant Is Unfounded

Kelly's claims of reasonable reliance on the conclusions of Richard Slavin, SBAM's Compliance Consultant, are unfounded. In Kelly's view, Slavin's statement in some of his Compliance Reports that "no surprise audits were required" gave Kelly reasonable comfort that SBAM had satisfied its obligations under the Rule. (Kelly Br. at 9.) But since Slavin never assessed SBAM's compliance with the Custody Rule and, more importantly, based his statement solely on information he obtained from Kelly, his reports gave Kelly nothing to rely on, as Kelly knew.

(i) Slavin's Retention

SBAM was compelled to hire a compliance consultant by the terms of a Stipulation and Agreement it entered into with the Connecticut Department of Banking in 2009 (the "2009 Order"). (Brown Jan. Decl., Ex. 11.) The 2009 Order arose out of allegations by the Department of Banking that SBAM had violated a prior order to which it had consented in 2004. (Id. at 1.) As a term of the 2009 Order, the Department of Banking required SBAM to retain an independent consultant "to conduct an initial written review" and "four (4) subsequent

compliance reviews" to ensure that SBAM's "compliance policies and procedures safeguard against violations of the [Connecticut Uniform Securities] Act . . . ." (Id. at 2.)[8] SBAM hired Slavin, who had represented SBAM in the investigation that led to the 2009 Order. (Berke Decl., Ex. A (Slavin Tr.) at 12:5-14:8; 21:4-21.)

(ii) Slavin Stated No Opinion About SBAM's Custody Rule Compliance

Slavin's Reports on SBAM's compliance systems included no opinion on SBAM's Custody Rule compliance. Slavin wrote five reports on the state of SBAM's compliance program. In the first two reports, submitted to the Connecticut Department of Banking on December 7, 2009 and June 7, 2010, he does not discuss the Custody Rule at all. (Berke Decl., Ex. B (Slavin Inventory, identifying the first two reports); Ex. C (Slavin 2009 Analysis of Compliance System); Ex. D (Slavin Cover Letter to Connecticut Department of Banking, dated June 7, 2010); Ex. E (Slavin June 2010 Analysis of Compliance System).)

It was only after the Commission's October 2010 Order was entered – by which SBAM consented to findings of Custody Rule violations and the Sands consented to aiding and abetting such violations – that Slavin's Reports began to discuss the Rule. His third report, submitted December 7, 2010, notes:

> SBAM takes the position that it has custody of its clients' assets as it has custody of some securities; however, it is not subject to the SEC's surprise audit rule for brokers with custody. It provides monthly reports to its fund investors as well as sending its audits to them. The audits are done by PCAOB accountants.

(Id., Ex. F (Slavin Cover Letter to the Connecticut Department of Banking, dated December 7, 2010); Ex. G (Slavin December 2010 Analysis of Compliance System) at II.8 (p. 4).) That is the

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[8] The 2004 Order had required SBAM to make quarterly disclosures of "securities-related complaints, actions or proceedings" involving Martin Sands. (Brown Jan. Decl., Ex. 11 at 1.) The 2009 Order alleged that SBAM filed materially false and misleading disclosures because of a failure to inform the Department of three separate such events. (Id.)

whole of Slavin's Custody Rule analysis that Kelly purports to rely upon to conclude that SBAM complied with the Custody Rule.

Slavin's two subsequent reports add no substance to that analysis. (Id., Ex. H (Slavin Cover Letter to Connecticut Department of Banking, dated December 7, 2011); Ex. I (Slavin 2011 Analysis of Compliance System) at II.8 (p. 4); Brown Jan. Decl., Ex. 9 (Slavin 2012 Analysis of Compliance System) at II.8 (p. 4).) In none of his Compliance Reports does Slavin make any reference at all to the 120-day delivery requirement or SBAM's satisfaction of it. Indeed, in his 2012 Analysis of SBAM's Compliance System, although Slavin notes that the Division had "inquired as to the timing of the distribution of the audited financial statements for funds advised by the Firm," his Report provides no information about what SBAM's response to that inquiry was, nor why he apparently made no inquiry into SBAM's compliance with the Custody Rule based on that request. (Brown Jan. Decl., Ex. 9 at 14.)

Thus, Slavin's Reports offer no opinion one way or the other on SBAM's compliance with the Custody Rule, giving Kelly nothing on which he could have relied.

(iii) Slavin's Findings Were Based on What Kelly Told Him

If Kelly relied on anything in Slavin's Reports, he was relying on himself. Slavin testified that his sole source of information about SBAM and its compliance procedures was Kelly or documents he requested and received from Kelly. Kelly told him that SBAM was complying with the 2010 Cease-and-Desist Order prohibiting Custody Rule violations. (Berke Decl., Ex. A (Slavin Tr.) at 85:19-86:1.) And Kelly told him that SBAM was not subject to surprise examination. (Id. at 95:11-97:9.) As to whether the financial statements had been delivered by the Custody Rule's deadlines, Slavin conceded that he had never inquired. (Id. at

97:23-98:5.) Nor did he look at documents evidencing the timing of delivery of audited financials that he understood SBAM had provided the Division. (Id. at 133:9-17.)

Since Slavin did not know that SBAM had failed to comply, his Reports are no testament at all to the sufficiency of SBAM's compliance program in that regard. And because Kelly himself was Slavin's sole source of information, Slavin's conclusions – whatever Kelly believed them to be – provides him with no defense. Cf. Matter of John P. Flannery, No. 3-14081, 2014 WL 7145625, at *34 (S.E.C. Dec. 15, 2014) (rejecting Respondent Flannery's claim that he relied on attorney's review where "the record shows that the attorneys on whom Flannery contends he relied in fact relied on *Flannery*") (emphasis in original).

B. Kelly's Purported Reliance on the SEC's Silence Does Not Foreclose the Division's Claims

Kelly cannot excuse his failures by blaming the Division for not complaining about SBAM's late deliveries sooner than it did. In Kelly's view, because the SEC staff received, and never complained about, Slavin's Compliance Reports and SBAM's Compliance Manual, he was "entitled to rely on [the Division's] acceptance." (Kelly Br. at 10.) But that defense is unavailing, both as a matter of law and undisputed fact.

In arguing that he was entitled to rely on the fact that the Division received, but did not object to, Slavin's Reports, Kelly is asserting that the Division is estopped from proceeding against him. Presumably Kelly is taking the position that he changed his conduct to his detriment (by failing to ensure SBAM's compliance) in response to the Division's actions (or inactions). See Heckler v. Cmty. Health Servs. of Crawford Cnty., Inc., 467 U.S. 51, 59 (1984) (setting out the elements of estoppel).

As a matter of law, estoppel is not a defense in these circumstances. As the Commission has long held, "'[a] regulatory authority's failure to take early action neither operates as an

estoppel against later action nor cures a violation.'" Matter of Application of G.K. Scott & Co., No. 3-7745, 1994 WL 17114, at *3 n.21 (S.E.C. Jan. 14, 1994) (quotations omitted), pet. denied, 56 F.3d 1531 (D.C. Cir. 1995); accord Graham v. SEC, 222 F.3d 994, 1008 & n.26 (D.C. Cir. 2000) ("[T]he SEC's failure to prosecute at an earlier stage does not estop the agency from proceeding once it finally accumulated sufficient evidence to do so.") (collecting cases). Thus, Kelly's reliance on regulators' tacit "approval" of SBAM's compliance failures does not estop the Division from asserting its claims.

Further, as a matter of undisputed fact, Kelly's reliance argument lacks any basis. Kelly could not have relied on the Division's silence after it received Slavin's Reports because the Division was not silent. In fact, in 2012 – during the period when it was receiving Slavin's Reports – the Division issued subpoenas to SBAM that specifically targeted the firm's compliance with the Custody Rule. (Brown Jan. Decl., Ex. 38.) While the Division had no obligation to make any comment at all on Slavin's Reports, the issuance of subpoenas to SBAM in June and September 2012 regarding its compliance with the Custody Rule should have made clear to Kelly that the Division was not satisfied with SBAM's compliance, irrespective of Slavin's Reports. Any reliance Kelly placed on the Division's failure to "take issue with any of [Slavin's] findings" was entirely misplaced. (Kelly Br. at 10.) And, in any event, Slavin's Reports contain no conclusion about SBAM's compliance with the Custody Rule. So, just as it would be unreasonable to "rely" on Slavin's Reports as assurance that SBAM was in compliance with the Rule, it would be equally unreasonable to read the Division's purported "silence" in response as assurance against liability.

Of equal irrelevance is Kelly's observation that neither the Division nor OCIE commented on SBAM's compliance manual. (Kelly Br. at 10.) On the topic of when the audited

financials had to be sent out to investors, the Compliance Manual accurately identifies "120 days of the end of [each fund's] fiscal year," giving neither the Division nor OCIE anything to comment on, even if they had been required to do so. (Brown Jan. Decl., Ex. 39 at Section IX.D.5.) To the extent that Kelly argues that OCIE's 2009 examination uncovered no violations, giving him a false sense of comfort, he ignores that the 2009 examination resulted in the 2010 Order. (See Div. Mot. at 5-6; Brown Jan. Decl., Exs. 13-15.) Here, too, because neither OCIE nor the Division was silent, Kelly's reliance argument fails.

C. Kelly's Purported Reliance on the Connecticut Department of Banking's Silence Does Not Foreclose the Division's Claims

Kelly next points to the Connecticut Department of Banking's silence after receiving Slavin's Reports, noting that it has "never taken issue with any aspect of such Reports." (Kelly Br. at 10.) But that bears no relevance here, in an SEC proceeding. In fact, it bears no relevance whatsoever given the lack of conclusions in Slavin's Report on SBAM's compliance with the Rule.

IV. THE DIVISION OF INVESTMENT MANAGEMENT'S "Q&A" DOES NOT INSULATE KELLY FROM LIABILITY

Nothing in a "Q&A" that the Investment Management Division published could have given Kelly any comfort – and certainly not any reasonable comfort – that SBAM's compliance failures were permissible. Therefore, nothing he read there could negate his scienter in aiding and abetting SBAM's violations.

A. The Q&A Provides No Exemption from the Rule's Deadline

The "Staff Responses to Questions About the Custody Rule" ("Q&A") published by IM, which Kelly points to in his motion (at 11-16), reads:

> **Q:** If a pooled investment vehicle is subject to an annual audit and its adviser is relying on the "audit provision" under rule 206(4)-2(b)(4),

> would the adviser be in violation of the rule if the pooled vehicle fails to distribute its audited financial statements within 120 days after the end of its fiscal year?
>
> **A:** The Division would not recommend enforcement action for a violation of rule 206(4)-2 against an adviser that is relying on rule 206(4)-2(b)(4) and that reasonably believed that the pool's audited financial statements would be distributed within the 120-day deadline, but failed to have them distributed in time under certain unforeseeable circumstances. (Modified March 5, 2010.)

(Berke Decl., Ex. J at Question VI.9.)

While Kelly calls the Q&A an "exemption" (e.g., Kelly Br. at 11), the Q&A itself makes clear that it is not – – and in language that Kelly, an experienced lawyer, must have read and understood. The Q&A notes that, if unforeseeable circumstances prevented the adviser from complying with the deadline, "[t]he [Investment Management] Division would not recommend enforcement action ***for a violation*** . . . ." (Berke Decl., Ex. J (emphasis added).) Thus, the Q&A actually confirms what the Rule provides – that late delivery under any circumstances is a violation. The Q&A simply states IM's view that such a violation would not be referred to Enforcement under the limited and "unforeseeable circumstances" it contemplates.

Furthermore, the Q&A itself warns against the reliance Kelly claims he placed on it. It cautions: "These responses represent the views of the staff of the Division of Investment Management. ***They are not a rule, regulation, or statement of the Securities and Exchange Commission, and the Commission has neither approved nor disapproved this information.***" (Id. (emphasis added) at 1.) Kelly could not reasonably interpret the Q&A as exempting SBAM from the 120-day deadline imposed by the Rule because it explicitly warned him not to do so.

B. Kelly's Reading of the Q&A Would Render the Custody Rule Meaningless

Kelly's reading of the Q&A would render the Custody Rule's 120-day deadline not just "not sacrosanct," as Kelly puts it (Kelly Br. at 13); it would render it meaningless. Kelly says

that the Q&A removes the 120-day deadline for any adviser who begins the audit process with the reasonable belief that it can get its statements out within that time.[9] (Id. at 12-13.) But surely any adviser could claim that it began the audit process with well-meaning hopes that it would meet the deadline. In fact, it is difficult to imagine circumstances in which an adviser would know definitively that it could not produce an audit in 120 days. The Q&A only reflects IM's recognition that there may be instances in which an adviser legitimately encounters unforeseeable circumstances during an audit – if the auditor suddenly resigns, for example – and that IM will take those unique situations into consideration in determining whether to hold the adviser accountable for its missed deadline. It cannot be read to encourage an adviser, such as SBAM and its principals, to view the deadlines as aspirational so long as they start each year's audit process with optimism that audited financials could be delivered by April 30.[10]

In this case, in any event, it is difficult to understand how SBAM could have started its audit for fiscal year 2012 (in calendar year 2013) reasonably believing that it could make the deadline, when it had missed it in the two prior years. This is particularly so when a large percentage of nine of the 10 Funds' portfolios were, year after year, Level 3 investments – those for which no market prices were available, requiring the adviser to value them "in the absence of readily ascertainable market values." (E.g. Brown Jan. Decl. Exs. 18, 21, 13 (FY 2010, 2011 and

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[9] Kelly's argument that he relied on the Q&A to conclude that "[t]he 120-day period is clearly not sacrosanct" (at 13) is at odds with his claim that he reminded everyone repeatedly about the importance of the 120-day rule. (Kelly Br. at 5-6 ("[Kelly] made all relevant parties aware of the 120 Day Provision as part of his CCO responsibilities. . . . The importance of the 120 Day Provision has been a constant theme underlying the audit efforts.") There would have been no need for such reminders if Kelly truly had believed that the Q&A provided the exemption Kelly claims.

[10] In support of his argument, Kelly points to the Form ADV, which asks only whether audited financials were completed, and does not ask when they were delivered. (Kelly Br. at 17.) But the Form ADV also does not ask about the adviser's satisfaction of other requirements with which it must comply. That cannot mean that the Adviser is exempt from those requirements.

2012 Audit Reports).) And it is particularly so when, year after year, the 10 Funds held the same investments that had proved troublesome for the auditors to audit in prior years. (See, e.g., Berke Decl. Ex. K (emails reflecting O2HR, LLC issues after April 30 for fiscal years 2010, 2011, 2012); id., Ex. L (emails reflecting Progressive Capital Solutions, LLC issues after April 30 for fiscal years 2011, 2012); id., Ex. M (emails reflecting Trinity Cable, LLC issues after April 30 for fiscal years 2011, 2012); id., Ex. N (emails reflecting M&D Fragrance & Cosmetics, Inc. issues after April 30 for fiscal years 2011, 2012).

Moreover, Kelly admits that whatever the initial optimism, in some years, SBAM did not in fact encounter any unforeseeable circumstances; for some funds whose audit reports were ready to go, the principals just refused to approve them. (Kelly Br. at 8 ("Martin and Steven Sands . . . in some cases delayed signing representation letters."); see also Div. Mot. at 10-11; Brown Jan. Decl., Exs. 26-30, 32.) Clearly, the 10 Funds' own auditor concluded that circumstances encountered during the audit were not unforeseeable; they formally complained that SBAM had failed to anticipate auditor information requests that should have been predictable. (Brown Jan. Decl., Ex. 44 (Auditor's SAS 115 Letter) at 3 ("There was a delay in the timely receipt from management of the information supporting the valuation of non-performing loans . . . which significantly affected the completion of the audit and the timely issuance of the financial statements. . . . [T]hese conditions were known or identifiable before the commencement of the audits . . . .").) Because Kelly admits that there were no unforeseeable circumstances for some of the audits, even his own reading of the Q&A as an exemption cannot defeat the Division's claim against him.

C. Kelly's Reliance on the Q&A Was Reckless After the 2010 Order Because Enforcement Had Already Taken Action on SBAM's Late Delivery

If Kelly understood the Q&A to mean that there would be no enforcement recommendation against SBAM or its control persons so long as they believed that they could get the 10 Funds' audits done by April 30, he was reckless to do so, at least after the date in 2010 when he learned that the Division was recommending that the Commission sue SBAM and the Sands for delivering late audit reports. By that time, he knew that the Division of Enforcement saw SBAM's repeated Custody Rule violations, which included its late deliveries, as violations notwithstanding what he understood IM's interpretation of the Rule to be. And if he was not reckless on that date in 2010, he certainly was by June 2012, when the Division served its first subpoena seeking information about SBAM's late delivery of audited financials. By that time, it would be patently unreasonable to take comfort in the Q&A's statement that IM "would not recommend enforcement action," because Enforcement had already begun investigating. Nonetheless, Kelly proceeded in the face of that risk and did nothing to ensure that the audited financials were sent to investors, resulting in audited financials that were delivered months after they were due both in 2012 (for FY 2011) and in 2013 (for FY 2012).

The Commission has not hesitated to hold compliance officers liable for proceeding in the face of a known danger. For example, in vFinance, 2010 WL 2674858, at *14, the Commission held that a CCO had recklessly aided and abetted document destruction by a firm employee where he had reason to believe the employee was using a personal email account to conduct business and took few steps to stop him or to preserve those communications. "[The CCO] must have known of and ignored obvious risks and clearly knew of others . . . . He received or was copied on correspondence establishing, and participated in telephone calls

evidencing, red flags regarding the Firm's and [the employee's] record preservation and production that [the CCO] recklessly disregarded." Id.

So too here. If Kelly thought that the Q&A would insulate him from an enforcement action for SBAM's violations of the Custody Rule deadline, he was reckless to rely on it, especially when he knew that Enforcement (1) had already recommended an action against SBAM for its past deadline violations under the same circumstances; and (2) had once again launched an investigation into SBAM's delivery of its audit reports after the 2010 Cease-and-Desist Order and subsequent violations by SBAM of Custody Rule deadlines.

V. KELLY MAY ONLY ASSERT AN ADVICE OF COUNSEL DEFENSE IF HE MAKES FULL DISCLOSURE OF EVIDENCE SATISFYING EACH OF ITS ELEMENTS

To the extent that Kelly asserts an advice of counsel defense, he is precluded from doing so until he satisfies its elements – a requirement he makes no effort to meet. (See Kelly Br. at 10-11 (noting "Kelly discussed custody matters with the Gusrae Firm"; "[t]he legal component with respect to custody matters was handled by the Gusrae Firm, Cohen & Wolf, and other outside counsel").)[11]

If Kelly plans to argue that he relied on the advice of counsel, he must demonstrate that he (1) made a complete disclosure of the relevant facts to counsel; (2) sought and received advice from counsel that the conduct in question was legal; and (3) relied on that advice in good faith. Markowski v. SEC, 34 F.3d 99, 104-05 (2d Cir. 1994); Schoemann, 2009 WL 3413043, at *12 & n. 41; see also Matter of Edgar R. Page, No. 3-16037, 2015 SEC LEXIS 130, at *1-2 (ALJ Order

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[11] As to SBAM, this defense is of no relevance at all since, even if proved, it is "a relevant consideration in evaluating a defendant's scienter." Howard v. SEC, 376 F.3d 1136, 1147 (D.C. Cir. 2004); accord Matter of Rodney R. Schoemann, No. 3-12943, 2009 WL 3413043, at *12 (S.E.C. Oct. 23, 2009) (holding that advice of counsel defense is irrelevant to liability under Section 5 of the Securities Act since that provision provides for strict liability), aff'd, 398 F. App'x 603 (D.C. Cir. 2010).

Jan. 13, 2015) (ordering respondents, if they intend to assert an advice of counsel defense, to "produce to the Division all documents reflecting that . . . Respondent: (1) made a complete disclosure of the relevant facts of the intended conduct to counsel; (2) sought advice on the legality of the intended conduct; (3) received advice that the intended conduct was legal; and (4) relied in good faith on counsel's advice."). Kelly has offered no evidence on any of those elements.

Nor can Kelly establish that any reliance on such advice – if it were rendered – would have been reasonable, in any event. Regardless of what the Gusrae firm was advising, Kelly was a seasoned lawyer, and had just consented to a Commission Cease-and-Desist Order that found SBAM in violation of the Custody Rule because it missed the 120-day deadline. If he did receive advice that there was no merit to the Division's subsequent investigation into SBAM's continued late delivery, "he had an obligation to exercise his own, independent, judgment." Flannery, 2014 WL 7145625, at *33 (holding Respondent's reliance on what he claimed was review and approval by counsel of a disclosure was unreasonable and did not excuse his negligence because he understood that the disclosure was misleading irrespective of what the lawyers said).

Kelly may be arguing a variation of the "lawyers in the room" defense – that while he may never have explicitly sought or received any advice, the presence of lawyers, and their silence, negate his scienter because he relied on them to speak up if they perceived a problem with his conduct. (Kelly Br. at 10 ("At no time did the Gusrae Firm ever counsel Mr. Kelly that the SEC's claims in this matter had merit.").) But courts routinely bar such an amorphous defense. In SEC v. Tourre, for example, where the defendant conceded that he was unable to meet the four factor advice of counsel defense, the court prohibited him from arguing that a

lawyer's presence in meetings or review of documents lessened his scienter. 950 F. Supp. 2d 666, 682-85 (S.D.N.Y. 2013).

Thus, Kelly cannot rely on any purported advice he received from SBAM's lawyers to negate his scienter.

VI. KELLY'S ALLEGATIONS OF UNFAIR TREATMENT ARE MERITLESS

Kelly's unsworn allegations of improper and unethical conduct by the Division staff in handling his unsolicited pre-filing communications are wholly irrelevant to resolution of his motion for summary disposition – as he admits. (Kelly Br. at 5, 21 (listing the purported consequences of the staff's alleged misconduct, none of which goes to Kelly's liability).) They are also false and without merit. When Kelly made unsolicited contact with the staff unaccompanied by the attorney who had represented him in testimony, and who claimed to continue to represent him (Martin Kaplan), the Division staff responded appropriately under the Rules of Professional Conduct and the Commission's policies and Rules of Practice. While Kelly could not or would not confirm that he was acting pro se, the staff refused to discuss the case with him. When Kelly then insisted he was acting pro se, the staff asked Kelly to inform Kaplan of his choice to do so before the staff would speak with him substantively about the case. And when Kelly ultimately stated that he was represented by counsel, the staff discussed matters pertaining to Kelly only with the counsel he identified.

The situation of which Kelly now complains was one of his own making. On February 11, 2014, Kelly left an unexpected and unsolicited voice mail for the staff. (Kelly Br. at 2.) Over the next month, he left the staff four voicemails in total, either requesting information about the investigation or providing – again unsolicited – his views on the facts underlying the

investigation. (Declaration of Nancy A. Brown, executed February 12, 2015 ("Brown Feb. Decl.") ¶¶ 6, 9, 14, 16; id., Exs. 1-3, 5 (Transcripts of Kelly's Voicemails).[12])

Over that same period, the staff had a few brief telephone calls with Kelly. (Kelly Br. at 2; Brown Feb. Decl. ¶¶ 7, 11, 12.) In each call, the staff refused Kelly's attempts to engage in a substantive discussion of the investigation (Brown Feb. Decl. ¶¶ 7, 11, 12) because – as the staff told him in the very first conversation – the staff would not speak to him unless he provided confirmation that he no longer was represented by Mr. Kaplan. (Id. ¶ 7.) In taking that position on this and subsequent calls, the staff was following standard ethics guidance on how a lawyer should proceed when approached by a previously represented person claiming to be no longer represented. See, e.g., ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 95-396, Section VIII (1995) ("Communications with Represented Persons") (sub-headed, "When Contact Is Initiated by a Person Who Is Known to Have Been Represented by Counsel in the Matter But Who Declares That the Representation Has Been or Will Be Terminated, the Communicating Lawyer Should Not Proceed Without Reasonable Assurance That the Representation Has in Fact Been Terminated").

The staff believed that Kelly was represented by Kaplan for three reasons. First, Kaplan had represented Kelly leading up to and during Kelly's investigative testimony. (Brown Feb. Decl. ¶¶ 2, 3; Berke Decl. Ex. P (Kelly Tr.) at 6:17-25.) Second, Kaplan either explicitly told the staff that he represented Kelly, or gave no indication that he no longer did, in several telephone conversations with the staff both before and after Kelly's first voice mail. (Brown Feb. Decl. ¶¶ 4, 5, 8 and 10.) Third, in the staff's first conversation with Kelly, he refused to confirm whether he was represented or not. (Id. ¶ 7.)

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[12] The recordings themselves have been produced to all Respondents. (Brown Feb. Decl. ¶ 6, n.1.)

On February 18, 2014, Kelly left another voice mail for the staff in which he stated unequivocally that he was not represented by Kaplan. (Kelly Br. at 2-3; Brown Feb. Decl., Ex. 2 ("I have never been represented by Marty Kaplan").) Hearing one thing from Kelly (that he was not represented) and another from counsel (that he was represented), on February 20, 2014, the staff asked Kelly to inform Kaplan that Kelly was no longer represented by him, and again, put Kelly off from any discussion about the substance of the matter until the issue of representation was fully resolved. (Kelly Br. at 2 (acknowledging that Kaplan had "persuaded" the staff that "the law firm of Gusrae Kaplan Nusbaum PLLC . . . represented Kelly (which was not the case)"); Brown Feb. Decl. ¶ 11.) The staff offered to call Kaplan to inform him of this understanding, but Kelly promised to make the call himself. (Kelly Br. at 3; Brown Feb. Decl. ¶ 11.) On March 2, Kelly reported in a voicemail that he had made an appointment to speak with Kaplan on March 3, 2014. (Brown Feb. Decl. ¶ 14 and Ex. 3.) In his brief, Kelly alleges that he spoke to Kaplan on March 3, 2014, and then left a voicemail for the staff to explain that he spoke to Kaplan. (Kelly Br. at 3.)[13] He suggests that when he told the staff that he had spoken to Kaplan, the staff left Kelly a return voice mail in which the staff "threatened" Kelly with disclosure of his communications (presumably to Kaplan) if he did not choose counsel by the next morning. (Kelly Br. at 3.) That "threat," according to Kelly, compelled him to retain Kaplan, "forc[ing] him to choose counsel overnight without even knowing whether he was a target." (Id. at 3-4.)

No such "threats" were ever made to Kelly. (Brown Feb. Decl. ¶ 15.) In any event, the documents show that on February 26, a full week before he claims the staff forced him to retain

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[13] Kelly may be referring to his March 2, 2014 voice mail, in which he told the staff that he had set up a time to speak to Kaplan on March 3. (Brown Feb. Decl. ¶ 14 and Ex. 3.) If he believes he left a different voice mail for the staff on March 3, the staff did not receive it. (Id. ¶ 15.)

Kaplan, Kelly had already signed an engagement letter with Kaplan. (Id., Ex. 4 (Engagement Letter, dated February 18, 2014, with Kelly's signature of acknowledgement and acceptance, dated February 26, 2014).) Thus, whatever the staff said to Kelly in its voice mail, it could not have "forced [him] to choose counsel overnight," because he had already done that.[14]

Kelly never told the staff of his decision until early March 4, 2014, when he left the staff another voice mail to announce his decision to retain Kaplan. (Brown Feb. Decl. ¶ 16 and Ex. 5.)

Kelly implies that the staff promised to keep the substance of his communications confidential. But as he himself admits, it was he who tried to impose a confidentiality restriction on his unsolicited communications. (Kelly Br. at 2 (noting that in his first voice mail to Ms. Tepperman on February 11, 2014, Kelly "stat[ed] unequivocally that the communications with the Staff were to be confidential.").) At no time did anyone from the staff agree to that condition, but Kelly continued to leave unsolicited and substantive voice mails thereafter and did so despite the staff's repeated insistence that he not discuss the substance of the case with them until the representation issue was resolved. (Brown Feb. Decl. ¶¶ 7, 11 and Exs. 2, 3, and 5.)[15]

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[14] Apart from being wholly inaccurate (Brown Feb. Decl. ¶ 15), Kelly's claim of a staff threat makes no sense. From the staff's perspective, Kelly could choose new counsel, old counsel or no counsel at all. There is no bar to the staff's interactions with pro se parties, so the staff had no reason to insist that he retain a lawyer. But the staff did insist that Kaplan be notified of Kelly's position on representation in order to resolve the apparent disparity between Kelly's and Kaplan's understanding of the situation, and Kelly had promised to do so.

[15] Contrary to Kelly's contention, there is no Commission or Division policy that required the Staff to keep Kelly's communications confidential. Form 1662, which the staff provided to Kelly on at least two separate occasions prior to his February 2014 contacts (Berke Decl., Ex. P (Form 1662 attached to Kelly subpoena for testimony; and Form 1662 marked as Exhibit 1 in Kelly's testimony)), states that the Commission may use any information provided to it in any enforcement proceeding, or for any of the routine uses of information described in the form. (Id. at G-H (describing Principal and Routine Uses of Information given to the Commission).) It further states that, "[u]nless the Commission or its staff explicitly agrees to the contrary in writing" no one who provides information to the SEC should assume that the SEC is limited in

In any event, the staff made an appropriate and considered decision to disclose Kelly's communications to a limited audience: Kelly's own lawyer. Kelly does not dispute that on April 25, 2014, when the staff did disclose the voicemails, it disclosed them only to Kaplan, who, at that time, was Kelly's lawyer and representative, and the staff specified that the disclosure was made in his capacity as attorney to Kelly. (Brown Feb. Decl., Ex. 6 (April 25, 2014 Berke Letter to Kaplan "in [his] capacity as attorney to Christopher Kelly," enclosing voice mail recordings).)

The staff's purpose in disclosing Kelly's voice mails to Kaplan was also both appropriate and considered. As the staff explained in its letter to Mr. Kaplan, Kelly's voicemails raised a concern that Kaplan's joint representation of SBAM and the Sands, and Kelly was burdened by a significant conflict of interest for Kaplan – a conflict that Kelly now acknowledges. In his unsolicited voicemail messages, Kelly placed the blame for SBAM's Custody Rule violations squarely on the Sands, Kaplan's other clients. (Brown Feb. Decl., Ex. 6.)

> However, [Mr. Kaplan] previously told [the staff] that Steven Sands and Martin Sands relied on Kelly in connection with the late audits. Thus it appears that Mr. Kelly may have interests in this investigation that are divergent from, and potentially adverse to, those of Messrs. Sands and the Adviser.

(Id. at 1 (citing NEW YORK RULE OF PROF'L CONDUCT 1.7).) Further, the fact that one client (Kelly) expressed a desire that Mr. Kaplan's other clients (the Sands) not know about certain communications he had had with the staff presented another potential conflict for Mr. Kaplan. (Id. at 1-2 (citing NEW YORK RULE OF PROF'L CONDUCT 1.6).) The staff provided this information so that Mr. Kaplan could evaluate the potential ethical issues before him – in particular prior to making Wells submissions – and thereby help avoid a situation where Kaplan was representing his clients unaware of a potential conflict that was apparent to the staff. Cf.

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its ability to use or disclose information provided to it in accordance with applicable law. (Id. at G.)

United States v. Stringer, 408 F. Supp. 2d 1083, 1091-92 (D. Or. 2006), rev'd on other grounds, 535 F. 3d 929 (9th Cir. 2008) (faulting government lawyer for failing to call opposing counsel's attention to significant information suggesting a conflict of interest). Kelly never informed the staff in his communications, and the Staff did not know until much later (when Kaplan provided the staff with the engagement letter that Kelly signed) that Kelly had agreed to waive any conflict, and that the waiver included Kelly's acknowledgement that Kaplan could and would share whatever confidential information he learned from Kelly with the Sands and SBAM.[16] (Brown Feb. Decl., Ex. 4.) Moreover, the staff was not in a position then, nor is it in a position now, to know whether those waivers were appropriate under Mr. Kaplan's ethical obligations to Kelly and his other clients.

Although Kelly is an attorney himself, he claims not to understand why the Staff would apprise his counsel, Mr. Kaplan, of his voice mails. (Kelly Br. at 4 (claiming that the reasons that the Staff shared the voice mails "remain shrouded in mystery").) But in the very next sentence, he acknowledges the conflict that the voice mails illustrate. "[W]ithout any notice to, or consent from, Mr. Kelly, and despite Mr. Kaplan's claim, and professional obligation, to represent the interests of Mr. Kelly, Mr. Kaplan immediately shared the confidential voicemail messages with Martin and Steven Sands, who were adverse to Mr. Kelly." (Id.; see also id. at 21 (describing SBAM as "adverse" to Kelly).)

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[16] The Division still does not know whether Kaplan has obtained a similar waiver from the Sands, but for the reasons noted in Matter of Morgan Asset Mgmt., Inc., No. 3-13847, 2010 WL 7765366, at *9 (ALJ Order July 19, 2010), the Division may have to bring this issue to the Court's attention for resolution should Kelly, Mr. Kaplan's former client, take the stand. That issue is why the Division alerted the Court to the possible conflict of interest issues present here at the first pre-hearing conference in this matter on December 2, 2014. (Berke Decl., Ex. O at 8:13-9:7.)

Nor would the staff have had any basis to withhold the voicemails from Kaplan in any event. Under Rule of Practice 230, the Division must turn over its investigative file to Respondents. Kelly's voice mails are part of the Division's investigative file, and not subject to any privilege or protection from disclosure. For that reason, Kaplan, the Sands and SBAM would have obtained Kelly's voice mails at some point, even if the Division could have avoided its ethical obligation in April to alert Kaplan to the conflict of interest that Kelly's voice mails raised.

In summary, the staff's conduct here was, at all times, consistent with its obligations under every governing code and principle: the Rules of Practice, the New York Rules of Professional Conduct, and the Commission's policies on the routine uses of information it learns. It provides no defense to the Division's claims against Kelly, nor any other basis for relief.

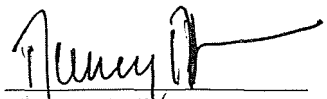
CONCLUSION

For the reasons discussed above, the Court should deny Kelly's motion for summary disposition.

Dated: New York, New York
February 12, 2015

Respectfully submitted,

DIVISION OF ENFORCEMENT

By: 

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