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, Martin Sands, Steven Sands and

Christopher Kelly

Respondents,

RECEIVED
FEB 23 2015
OFFICE OF THE SECRETARY

CHRISTOPHER KELLY'S REPLY ("REPLY") TO THE DIVISION OF ENFORCEMENT'S OPPOSITION ("OPPOSITION") TO CHRISTOPHER KELLY'S MOTION FOR SUMMARY DISPOSITION

Introduction

Christopher Kelly is clearly entitled to summary disposition, which is the right and just thing to do. Now is the time to fully dispense with this matter as to Mr. Kelly.

For ease of reference, this Reply generally follows the organization of the Division's Opposition, and certain defined terms herein will correspond to defined terms in Mr. Kelly's Opposition.

First, the Division inexplicably continues to promote the rather astonishing proposition that an adviser's failure to meet the 120-day deadline is by itself all that is needed to find fault with a Chief Compliance Officer. As discussed in Mr. Kelly's Opposition, if this were true then the SEC would currently be prosecuting literally hundreds actions against fund-of-funds, which routinely fail to meet the 120-day deadline. As clearly noted in the Opposition, SBAM manages fund-of-funds itself, yet, as the Division so *clearly and unequivocally* puts it at footnote 4 at page 2 of its own Motion for Summary Disposition, "they" - the SBAM fund-of-funds - "are not at issue here."

It is also noteworthy how the SEC has handled over 100 other Custody Rule matters as recounted in Schulte Roth & Zabel's Alert dated August 15, 2013 (the "Alert"). As noted on page 1 of the Alert (attached hereto as Attachment I), the SEC's Office of Compliance Inspections and Examinations ("OCIE") completed over 400 OCIE examinations, over one-third of which "reportedly revealed Custody Rule compliance issues." (see footnote 6 to page 1 of the Alert). Deficiencies included the failure to satisfy the "audit exemption." What did the SEC's Enforcement Division do with respect to these ***hundreds*** of Custody Rule cases? The answer is revealing:

> ***The examination staff's findings have resulted in a number of actions, ranging from remedial measures taken by advisers to referrals to the SEC's Enforcement Division.***

No further commentary is necessary here, but briefly, it is unequivocally clear that the Division does not view Custody Rule matters through a lens of pure "strict liability." If that were true then the Division would not only be prosecuting hundreds of fund-of-funds, and their CCOs, it would be prosecuting over one hundred other firms with Custody Rule issues (and their CCOs).

It is abundantly clear that the Division is selective in bringing Custody Rule cases, and in this matter it is not right that the Division has gone after Mr. Kelly, who, working for Martin

Sands and Steven Sands, worked tirelessly (and successfully) to protect SBAM investors and establish and maintain a well-regarded compliance program. Mr. Kelly also worked very hard to support the audit program, but without the authority and responsibility for the program, which naturally rested with SBAM's financial professionals and the outsourced financial firm Greenwich Fund Services, it was ultimately impossible for Mr. Kelly to have control over the timing of the audits.

This Custody Rule enforcement action may certainly be justified on the basis of Martin Sand's and Steven Sand's actions in respect of the audits, and their cumulative regulatory record, both of which are well-recounted in the Division's Motion for Summary Disposition. Mr. Kelly suspects that the Sands' regulatory record is the genesis of this matter. Bringing a Custody Rule matter where there are other exigent factors such as the Sands' problematic regulatory record would be consistent with the Division's historical practice, but by any fair measure an action against Mr. Kelly is unjustified, especially in light of his unblemished regulatory record and the good faith reliance on the Q&A Exemption and outside counsel.

The Division notes that Mr. Kelly was aware of the distribution of the audits after the 120-day deadline. Of course he was, as was everybody at SBAM, GFS and Cornick, among others. The SEC, SBAM's regulator from 1999, itself was fully aware of the audit situation. Yet not once, in all of the many years of the SEC's awareness of the situation, did the SEC ever provide Mr. Kelly or anybody else to his knowledge, any concrete guidance on how a CCO could possibly ultimately guarantee that an audit would be delivered by any particular date.

There is a good reason why the SEC has never provided such guidance (this discussion will except the Division's "guidance" that first appeared in its Opposition as discussed below). First, the SEC understands that it operates in the financial marketplace, and that accordingly it would be grossly negligent to provide guidance, or establish precedents, that put non-financial professionals in charge of financial functions. This highlights a fundamental problem with the Division's approach to this case.

Mr. Kelly, like other CCOs, managed the compliance program. He did not manage the audit program. ***The audit program is not the compliance program, and vice versa.*** If the SEC were to take the position that the audit and compliance programs should be conflated, then financial professionals would become compliance professionals, and compliance professionals would become financial professionals. Mr. Kelly's job was to manage the compliance program, not to guarantee any particular results, but to provide a structure that provided a foundation for compliance. Mr. Kelly did that in this case. There is no SEC rule that makes CCOs guarantors of results, and using this matter to establish such a precedent would be negligent and unfair and would have the perverse effect of discouraging professionals from taking compliance roles. Compliance professionals are willing to take tough assignments where they are responsible for managing compliance programs, but having the added liability of guaranteeing results would be fatal to the compliance industry, and thusly the financial industry.

As discussed in more detail in Mr. Kelly's Motion (including attachments), and as conceded by the Division, there is no issue that the 120-day rule was well-known to the participants in the audit program, including Martin Sands, Steven Sands, GFS and Cornick. As argued by the Division itself, Mr. Kelly did a significant amount of work in furtherance of the audit program. There was nothing in the compliance program construct that interfered with compliance, and much that furthered and enabled compliance.

The issue here is not the compliance program, but the failure of Martin Sands and Steven Sands, the managers of the SBAM financial program, to deliver the audits within the 120-day period, together with certain actions of Martin Sands and Steven Sands recounted by the Division (with clear proof) that interfered with Custody Rule compliance.

Another obvious point must be made here, one that the Division apparently doesn't understand. Delivering audits within 120 days of the fiscal year end is a very different task than, for example, filing an ADV within 90 days of the fiscal year end. Completing and delivering audits involves more personnel, including the auditors themselves, and the internal auditor committees. Audits are done in accordance with GAAP. While Mr. Kelly managed the ADV process, and was familiar with the ADV rules, he neither managed the audit process nor was familiar with all the audit rules (GAAP etc.). Martin Sands and Steven Sands ultimately managed the audit process, and it was the auditors who were familiar with the intricacies of the audit rules.

Mr. Kelly did not have supervisory authority over most of the audit participants. Another reason the SEC has never provided guidance on timely delivery of audits "by CCOs" is that a CCO does not have supervisory authority over critical audit players such as the auditors. While the SEC has never suggested any ideas with respect to "CCO management" of the audit process (because it is a very bad idea), if the SEC were to issue guidance that CCOs should exercise supervisory authority over auditors, the backlash would be enormous. Just imagine the response of the audit community to such an SEC pronouncement. The community would rightly criticize the SEC for interfering with the standards of independence currently in place for auditors. The community would rightly criticize the SEC for putting persons in charge, CCOs, who have insufficient or no financial backgrounds.

Another difference between the completion of audits and ADVs is noteworthy. An ADV is a regulatory form through and through. It is designed to be completed by compliance professionals. An audit is done not primarily for compliance reasons, but for bookkeeping, accounting, and client relationship reasons. In other words audits are completed for reasons independent of the regulatory scheme, which is the exact opposite of the case with an ADV, which exists, and is completed, solely because of the regulatory scheme.

This highlights why, besides the other obvious reasons, CCOs are not in charge of audits. Audits are financial constructs, and are managed by financial personnel, the persons who are qualified to prepare and deliver them. The SEC has established a huge regulatory accounting framework that most assuredly puts auditors and financial officers in charge of audits (see Regulation S-X and related Staff Accounting Bulletins). To interject CCOs into this accounting framework would be puzzling at best, and a disaster at worst.

The Custody Rule no more puts a CCO in charge of audits because the Custody Rule mentions audits, then fiduciary duty law puts CCOs in charge of investments because fiduciary duties implicate investment decision making. If the SEC wants to put CCOs in charge of audits, it might as well put CCOs in charge of making investment decisions, because the approach is the same. The reality of course is that either would be a very bad idea, with a massive financial industry backlash if the SEC were to take this route, or even in the slightest suggest this route, in this matter, or any other. To the SEC's credit it has not taken this route.

The audit program is not the compliance program. The Division incorrectly views the audit program through the lens of the Custody Rule when the audit program should be seen as an independent financial function (that the Custody Rule mentions audits is acknowledged). The management of the audit program was not established with reference to the Custody Rule, it was established independently with reference to the expertise needed to manage the audit function. That is why financial professionals are in charge of audits – in SBAM's case Martin Sands, Steven Sands (both highly experienced financial professionals) and the members of GFS, who are experienced financial professionals.

While it is hard to prove a "negative" - that Mr. Kelly was not in charge of the audit function, it should be determinative that (i) Mr. Kelly never had a financial title, (ii) there are no documents delegating the responsibility to Mr. Kelly, (iii) Mr. Kelly, with a History degree and Juris Doctorate, has no particular financial training, (iv) GFS was specifically retained to manage the financial function for SBAM and the SBAM Funds, and was well paid for it (see Attachment 1 to the Affidavit to Mr. Kelly's Opposition and Exhibits 19 and 20 to the Division's Motion (in such Exhibits the GFS President attests to GFS's role with SBAM and the SBAM Funds)), (v) Martin Sands and Steven Sands are Co-Founders, Co-Partners, Co-CEOs and Co-Senior Portfolio Managers of SBAM, (vi) Martin Sands and Steven Sands have significant financial industry experience (see Attachment IV to the Affidavit accompanying Mr. Kelly's Opposition), and finally (vii) it would make no sense to put a non-financial professional in charge of an intensely financial function. To Martin Sand's and Steven Sand's credit they never did put Mr. Kelly in charge of the audit process. Any assertion to the contrary would be a post hoc invention. If Mr. Kelly had been given the audit responsibility, it would have been helpful if he had been told.

Second, Mr. Kelly has never said that he did not have responsibility for managing the compliance program. As discussed elsewhere, however, the SEC does not make CCOs guarantors of compliance, and in this matter Mr. Kelly ultimately had very little control over the timing of the audits, which is the crux of this matter.

In the Matter of *Parallax Investments, LLC ("Parallax"), John P. Bott, II, and F. Robert Falkenberg, Administrative Proceeding File No. 3-15626* (the "Parallax Case") (attached hereto as Attachment II) is instructive as to the SEC's current position on the respective roles and responsibilities of the CCO and a firm's principals.

In the Parallax Case John P. Bott, II was the sole owner and manager of Parallax and F. Robert Falkenberg was the CCO. As to the relationship of a CCO and the firm's principals, the Division provides in this case (Item 10 of the Order Instituting Administrative and Cease-and Desist Proceedings (the "Order")):

> **"Bott has overall responsibility for ensuring that Parallax complies with its regulatory requirements, including Advisers Act requirements. Bott assigned Falkenberg, as CCO, the responsibility for establishing and administering Parallax's compliance program under Bott's direction**."

This passage articulates the SEC's position on the respective roles expertly. In this case "Bott" is the sole owner and manager, comparable to the positions of Martin Sands and Steven Sands. Falkenberg is the CCO, comparable to Mr. Kelly's role. The Parallax Case makes absolutely clear that a principal such as a Martin Sands or Steven Sands "has overall responsibility for ensuring....compliance with regulatory requirements." The CCO's responsibility is the ***establishment and administration of the compliance program***.

There is nothing in this SEC articulation of the CCO role about guaranteeing any results, or becoming responsible for functions outside the compliance program administrative function. The Division suggests, in a number of different ways, that Mr. Kelly is an absolute guarantor of SBAM and SBAM personnel compliance with all regulatory requirements (i.e., if there is non-compliance (which is not the case in this matter as discussed elsewhere), then the CCO is at fault). Mr. Kelly not only is not a guarantor, but he should not be. No CCO should be a guarantor of any particular compliance, and it would be very problematic to overturn decades of precedent through this matter and shift CCOs into guarantors. The SEC has not done so to date, and it should not do so.

The Parallax Case is a proper articulation of a CCO's particular role; the Division's attempt to expand that role in a manner that would upend the financial industry is unwarranted and dangerous.

What does make perfect sense, particularly in the context of audits, is the Parallax Case's correct explanation that it is a firm principal, not the CCO, who "has overall responsibility for ensuring that [the firm] complies with its regulatory requirements, including Advisers Act requirements."

The Parallax Case is also instructive as to the kinds of Custody Rule cases where it may be justified to go against a CCO, but as discussed below there is a huge chasm between the Parallax Case and the case at hand. In the Parallax Case Mr. Falkenberg, the CCO, among other things, (i) "had little if any practical experience with the regulatory requirements applicable to Commission-registered investment advisers when he joined Parallax" (Item 9 of the Order), (ii) "devoted approximately nine hours per month to Parallax's compliance program" (Item 10), (iii) "did not maintain a permanent office at Parallax and delegated daily compliance tasks to other employees in his absence" (Item 10), (iv) knew that the auditor had erred in designating an asset a Level One security instead of a Level Two security, and neither the firm's principal nor he "discussed the valuation issue with the auditor" (Item 18), and (v) allowed inaccurate financials to be sent to Parallax's investors (Item 18). This string of deficiencies, including sending inaccurate financials to investors, suggests the kind of egregious deficiencies of a CCO that add up to an action.

Mr. Kelly, however, (i) arrived at SBAM with a compliance program in disarray and re-established it in good order, (ii) worked tirelessly to protect investors, and succeeded in doing so, (iii) worked diligently to the extent he could be helpful to move the audit process forward, (iv) received annual acknowledgements from SBAM staff certifying as to their understanding of compliance requirements (including Custody Rule requirements), and (v) performed the other tasks required of him as CCO, as attested to by the Cohen &Wolf Compliance Reports (the "C&W Compliance Reports").

In Mr. Falkenberg's case his actions appear to have contributed to the delivery of the audits after the 120-day period and to their inaccuracy, a serious offense. Mr. Kelly assisted in moving the audits forward in various ways and did not do anything that contributed to inaccurate audits (the content of SBAM's audits are not at issue). Mr. Kelly further has taken his responsibilities seriously, and has respect for the regulatory process, in contrast to Mr. Falkenberg's record of failures on many fronts. It would be a gross injustice to throw Mr. Kelly into the same category as a Mr. Falkenberg.

Third, it is unclear what the Division means by "Kelly's effort to lay the blame for his own failings on others…" The failings are unspecified here, but assuming the Division means the failure to deliver the audits within the 120-day period, as discussed elsewhere at length it is hard to understand the basis for the Division's position that somehow Mr. Kelly should be made liable for the distribution of the audits. Mr. Kelly was never in charge of the audit process so it makes little sense to make him liable for something he had no particular authority or responsibility for.

The C&W Compliance Reports are a fact, and even after Mr. Slavin was made aware of the SEC's inquiry into the audits (see the 2012 Litigation Report associated with the C&W

Compliance Report at Attachments VI and VII to Mr. Kelly's Motion for Summary Disposition), Mr. Slavin stood firm in his opinion that no surprise examinations were required. It is further a fact that all of the C&W Compliance Reports were provided to the SEC for its review and the SEC has never objected to the content of the Reports. The Division does not dispute these facts.

It is not clear what the Division is claiming about the Q&A Exemption (merely a defined term) in the "Third" section of its Opposition, but the Q&A Exemption is a fact. The Division cannot wish it away. The practice of relying on SEC guidance is well-established, and the Division has not set forth any proof or provided any hint of proof to come as to why the Q&A Exemption was not available to Mr. Kelly.

As discussed in more detail in Mr. Kelly's Motion, reliance on the Q&A Exemption makes perfect sense because the SEC has permitted many funds to deliver their audits beyond the 120-day period (many hundreds in the case of fund-of-funds), and the circumstances set forth in the Q&A Exemption are consistent with this approach. Notably, during the post 120-day period allowed by the Q&A Exemption, the auditors are engaging in reviews of not just numbers, but the funds and securities that underlie the numbers. It makes less sense to require the auditors to essentially do the same thing twice during the same period. The essence of the Custody Rule is to protect investor assets, which was clearly done in SBAM's case and is not at issue, and to account for those assets, which was also clearly done in SBAM's case and is also not at issue.

If it is the Division's aim to strike down the longstanding industry-wide practice of relying on SEC guidance, this would arguably be a poor choice of matters on which to base that rather consequential change in practice. If the Q&A Exemption is abandoned, then all SEC guidance is thrown out with it.

ARGUMENT

I.

The Division begins this section with its heading "KELLY CONCEDES SBAM'S LIABILITY", which is of course false. The Division continues to ignore the Custody Rule construct, which includes the Q&A Exemption, and the fact that hundreds of advisers are not the subject of enforcement actions even where their funds do not deliver audits within 120 days of the fiscal year end. Mr. Kelly was fully aware of the SEC's position allowing funds to deliver audits after the 120-day period, both with respect to the treatment of fund-of-funds and the reality of the longstanding Q&A Exemption. Mr. Kelly never "knew" that SBAM was violating the Custody Rule (it wasn't) because the SEC's own guidance and behavior said otherwise.

Accordingly scienter is most assuredly absent in this case. The SEC could have withdrawn the Q&A Exemption and could have withdrawn the special treatment for fund-of-funds, but it did not. If it had Mr. Kelly would have taken notice. But in the absence of those actions, Mr. Kelly was fully aware that the Q&A Exemption and fund-of-funds treatment were a part of the Custody Rule construct, and in SBAM's case there clearly was no wrongdoing.

SBAM continued to work with the auditors during the post 120-day period to complete the audited financials and there was nothing wrong with that, and there was nothing reckless about that. Relying on SEC guidance and practice is not "reckless" (if the SEC withdrew the Q&A Exemption and stopped the special treatment of fund-of-funds, but a party were to nonetheless rely on those things, that party might in that case be acting recklessly).

While Mr. Kelly pushed SBAM personnel hard for compliance with the 120-day rule as a ***safe harbor***, the failure to miss the deadline did not dovetail into non-compliance with the Custody Rule. It dovetailed into a consideration of the Q&A Exemption and other factors, and all those factors clearly result in a verdict of compliance. This matter is similar to a private offering that does not meet Regulation D. The failure to meet the Regulation D safe harbor does not mean there is noncompliance with securities law. It means that one has to consider the other factors involved in the situation, and in many if not most cases where an issuer has thoughtfully determined Regulation D compliance is not necessary, there is no securities law violation.

In this case the Q&A Exemption is available (unless the SEC wants to overturn the availability of all SEC guidance post hoc), and any thoughtful consideration of its applicability clearly results in a verdict of compliance as noted above. The Division has failed to provide any evidence that the Q&A Exemption criteria were not met. It has asserted a situation involving Trinity Cable, but Mr. Kelly did not manage that entity. Trinity Cable was managed by Steven Sands and Gavin Watson in their capacities as Senior Portfolio Manager and Portfolio Manager, respectively, of the SBAM Funds that had ownership positions in Trinity Cable. This is a typical management scheme for a limited liability company, which is what Trinity Cable is.

The Division also fails to assert facts with respect to Trinity Cable that would make the Q&A Exemption unavailable as the audit request the Division cites came late in the audit process, exactly the kind of situation for which the Q&A Exemption is available.

The Division cannot treat the large number of advisers who miss the 120-day deadline one way, then (inappropriately) assert "strict liability" with respect to other advisers. The Division's failure to show any hint of facts that would make the Q&A Exemption unavailable is alone a reason to grant Mr. Kelly's Motion for Summary Disposition.

II.

The Division's assertion that "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" is frankly getting into extreme territory. Mr. Kelly does note that this is the first time the SEC has made a concrete suggestion as to what a CCO should do about guaranteeing the timeliness of audits, flawed, and late, as the advice is. Obviously Mr. Kelly could not have acted on this particular advice as it comes in February 2015, more than two years after the last fiscal year, 2012, for which audits were delivered after the 120-day period. Similarly, the Cornick Letter cited by the Division was issued nine months after the 2012 year end.

The Division's advice falls short for many reasons, including most basically that Mr. Kelly did do a number of these things, including helping out himself (new personnel), supporting the participation of SBAM employee Jeffrey Umansky, who had previously acted only in an Executive Assistant capacity (new personnel), and supporting the larger role of David Claroni, who became a Portfolio Manager.

The idea that new auditors would help is unknown as changing auditors is often disruptive.

There were in fact new lawyers involved with the portfolio.

Mr. Kelly, as noted previously, helped set up launch meetings with the auditors (new policy), and Mr. Kelly himself attended those meetings, though Martin Sands and Steven Sands did not.

At the commencement of the audits there was no particular reason to believe the audits would not be delivered within the 120-day period, but despite the efforts of the parties involved in the process, and the significant resources dedicated to the effort, things came up in the process that ultimately delayed the timing. It is notable that not once did Cornick, the auditing firm, or any other financial professional, advise Mr. Kelly that there would be a problem meeting the 120-day deadline (at least until the process neared the deadline).

The idea that CCOs should have authority, independent of senior management, to hire personnel and retain new lawyers and auditors, is far-reaching, novel and without precedent. Obviously there is no SEC rule that gives CCOs this authority. If it is the Division's aim in this matter to upend corporate law, then it should just say so. But in any case there would be no basis for subjecting Mr. Kelly to post hoc corporate law/SEC rule constructs. Mr. Kelly, who managed the compliance program, made it clear to SBAM personnel that the 120-day rule should be met, and significant resources were dedicated to the effort. There was no ambiguity about the goals of the compliance program, and there is no basis for the Division asserting that Mr. Kelly's efforts in administering the compliance program were deficient.

The Compliance Manual has been discussed elsewhere, but briefly, the Compliance Manual is an internal document that puts the onus on all personnel to meet compliance requirements. As the prime drafter of the Compliance Manual, and someone who is familiar with industry standards, Mr. Kelly can stipulate that the Compliance Manual does not in any respect make Mr. Kelly a guarantor of results, nor does it require him to become responsible for functions outside of his CCO role. A review of the Compliance Manual will show that neither the word "guarantor" nor any variant is used in the Compliance Manual, and nor is there any provision that would give Mr. Kelly responsibility outside his CCO role. In particular, the Compliance Manual says nothing about Mr. Kelly preparing and delivering audits.

The Compliance Manual is, however, consistent with the SEC's position that a CCO's role is to establish and administer the compliance program.

The Division makes the astonishing assertion that "Kelly's activity – engaging the auditors, signing management representation letters and serving as principal contact for the auditors confirms that Kelly had the responsibility for overseeing the audit…." Such assertions have been discussed previously, but briefly, this assertion is not true. Mr. Kelly has noted more than once that he acted responsibly by signing engagement letters and representation letters – Martin Sands and Steven Sands would not sign engagement letters and at least Martin Sands signed representation letters late. Mr. Kelly remains proud of his positive role in the audit process and he stands by it, but signing these letters, which are a tiny part of the audit process, do not denote "responsibility for overseeing the audit." Mr. Kelly assisted, but ultimately this financial function was under the purview of Martin Sands and Steven Sands, two highly experienced financial professionals. GFS also aided significantly in the process, which it was retained and well-paid to do.

The assertion that Mr. Kelly was "principal" contact for the auditors is misleading, as the auditors interfaced with all of the professionals at SBAM and at GFS. Mr. Kelly was never designated "principal" contact, he never considered himself "principal" contact and the Division provides no basis for making this assertion.

III.

A.

The C&W Compliance Reports ("Reports") have been discussed elsewhere, but briefly, the Division acknowledges the Reports (they are attached as exhibits to its Opposition), including the opinions regarding surprise audits. Mr. Slavin is a well-regarded Advisers Act expert, with a national practice, who was vetted and approved as an outside compliance consultant by the Connecticut DOB. The Reports are his own and he has never withdrawn any statements contained in the Reports or ever advised that there is anything amiss with the Reports.

They were prepared in connection with interviews of SBAM personnel, including Mr. Kelly, but Mr. Slavin had the final word as to the content and they are issued under the letterhead of his firm.

The assertion by the Division that Mr. Kelly was Mr. Slavin's sole source of information is patently false. Mr. Slavin interviewed various personnel at SBAM, including Martin Sands, Steven Sands and "people in the Manhattan office." (see pages 22 and 24 of the Deposition of Mr. Slavin at Exhibit A to the Division's Opposition (the "Slavin Deposition")). As Mr. Slavin recounted in his Deposition he also reviewed a large number of SBAM documents and familiarized himself with SBAM's operations (see pages 22 and 23 of the Slavin Deposition).

Mr. Slavin also drew on his many years of experience, dealing with the SEC among many other compliance matters, and was able to engage other members of his firm as needed. Mr. Slavin had also worked with SBAM on other compliance matters so had the benefit of those assignments in connection with which he also spoke to SBAM personnel, including Martin Sands and Steven Sands. As Mr. Slavin himself says in the third paragraph of his Reports "I have had significant experience with the Firm and its operations over the last [number of] years."

Mr. Kelly's reliance on the Cohen & Wolf firm was reasonable and justified. In Mr. Slavin's deposition he notes a number of times when he considered custody issues with respect to SBAM (see pages 86, 87, 88, 96, 97 and 98 of the Slavin Deposition). He was fully aware of the Custody Rule construct and how it applied to SBAM. His opinion on surprise audits was an outgrowth of his consideration of custody issues.

Mr. Slavin discussed these matters with Mr. Kelly and issued his Report, which contained his opinion. Mr. Slavin is an Advisers Act expert who had been retained by the Connecticut DOB on multiple occasions, he is the Chair of his firm's Securities Practice Group (see pages 9, 11 and 14 of the Slavin Deposition) and there is no basis to treat Mr. Kelly's reliance as unreasonable.

B.

The Division acknowledges in its section III.B. (page 10) that the SEC received copies of the Reports and did not "complain" about them. It is true that the SEC specifically requested delivery of the Reports and never questioned their content.

The Division notes that it issued a subpoena in June 2012 relating to this matter, focusing on late audits, which was disclosed to Mr. Slavin in writing in the Litigation Report noted above. Mr. Slavin did not change his opinion regarding surprise audits given this information about the Custody Rule. As the Division itself acknowledges in its Opposition, Mr. Slavin's opinion regarding surprise audits runs from his December 7, 2010 Report (see section III.A.(ii) on page 8). Accordingly, Mr. Slavin's opinion covers the entire relevant period (2012 was the last year with respect to which audits were not delivered within the 120-day period).

Based on the Division's own evidence cited in the prior paragraph, all of the Reports did in fact touch on the Custody Rule in a material way because all of them cite Mr. Slavin's surprise audit opinion.

IV.

In this section the Division discusses the Q&A Exemption. Here the Division at least acknowledges the reality of the guidance, though the Division's interpretation of the Q&A Exemption is inconsistent with its language.

The Question asks whether "*the adviser would be in violation of the rule*" as follows:

"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 **[emphasis added] if the pooled vehicle fails to distribute its audited financial statements within 120 days after the end of its fiscal year?**

The Answer is presumably designed to answer the particular question asked, which is whether there would be a violation. The Answer is clear that there would not be any Custody Rule violation, stating that where the conditions of the Q&A Exemption are satisfied, there would be no "enforcement action for a violation of the Custody Rule." There should be no need to parse this language as it means exactly what it says – under the circumstances there would be no enforcement action for a Custody Rule violation. Nowhere does the Answer suggest that there has been a violation. If the Answer were meant to suggest that, in answering the question posed the Answer would have stated something to the effect that "while there would be a violation, there would be no enforcement action with respect to such violation", or more simply, "there would be no enforcement action for **the** violation." But the Answer does not do this.

The Division's attempt to downplay the importance of SEC guidance is game-changing. As noted previously, SEC guidance is a cornerstone of the law, and if this case were to disown SEC guidance, it would have earth-shaking consequences for the entire financial industry.

The Division goes on to acknowledge at page 14 of its Opposition that "IM will take those unique situations into consideration in determining whether to hold the adviser accountable for its missed deadline." ***Here the Division agrees that the Q&A Exemption is real and relevant, and is to be considered***.

The Division tries to argue that Mr. Kelly's efforts on behalf of the 120 Day Provision somehow undermine his position but as stated above the Provision is a safe harbor similar to the Regulation D safe harbor.

The Division tries to argue that Mr. Kelly was "reckless" in relying on the Q&A Exemption, but there is nothing reckless about relying on SEC guidance, and prior and current SEC practice. The SEC issues guidance specifically to be relied on. That is why it is issued. The appropriateness of relying on the Q&A Exemption is further discussed in Mr. Kelly's Motion and elsewhere.

V.

Mr. Kelly clearly has a right to rely on the counsel of the Gusrae Firm. That the Gusrae Firm handled the 2010 SEC Order and this matter is incontrovertible. The Gusrae Firm continues to have a role in this matter. The Gusrae Firm frankly understood the facts of both matters better than Mr. Kelly as it had more direct communications with the SEC. Mr. Kelly in fact had no involvement in the negotiation of the 2010 SEC Order. In the current matter the Gusrae Firm, as noted by the Division itself (see section VI, page 20), apparently convinced the SEC it was Mr. Kelly's counsel when it wasn't, so for most of this matter Mr. Kelly was dependent wholly on the Gusrae Firm, which was in communication with the SEC. The SEC did not communicate with Mr. Kelly, even to the extent this matter related to Mr. Kelly, and ultimately Mr. Kelly was told that he was the possible subject of an enforcement action only in May 2014.

It is incontrovertible that the Gusrae Firm understood this matter – i.e., had access to all of the facts – as it was the Gusrae Firm that was communicating and negotiating with the SEC, from about June 2012. Mr. Kelly did have conversations with Mr. Kaplan of the Gusrae Firm regarding this matter, seeking advice about it. The Gusrae Firm advised Mr. Kelly as an employee of SBAM, not as a target, that the matter related to late audits. The Gusrae Firm further advised Mr. Kelly (in the same capacity) that SBAM and Martin Sands and Steven Sands would fight the matter. Not once did the Gusrae Firm advise Mr. Kelly that any changes should be made or any particular action should be taken. There was no advice suggesting that there was any deficiency in the compliance program. This of course did not prevent Mr. Kelly from taking the various actions discussed elsewhere in furtherance of the audit process. The advice did, however, suggest that Mr. Kelly's efforts to support the audit process were on target, and the significant efforts continued in that regard.

Mr. Kelly relied on the Gusrae Firm in good faith. As noted elsewhere Mr. Kelly did not have a legal role at SBAM, and did not act in a legal capacity, so it is disingenuous for the Staff to suggest he did, or that legal considerations are relevant. The Gusrae Firm was long-time counsel to SBAM on custody and other matters, it is a well-regarded firm with highly experienced regulatory attorneys, and there is no basis for the suggestion that Mr. Kelly's reliance was unreasonable.

The Gusrae Firm had all the "intelligence" on the matter as it was dealing directly with the SEC; Mr. Kelly had no independent basis for acting inconsistently with the advice of the Gusrae Firm, which as noted made clear the investigation would be challenged. The Staff is well aware of the chronology of this matter, and in fact knows it better than Mr. Kelly, and is accordingly well aware that any information on this matter for Mr. Kelly would have come through the Gusrae Firm at least through April 2014, well after the end of the relevant period.

The Gusrae Firm's counsel on this matter makes it even clearer that Mr. Kelly did not "know" there was "wrongdoing" as the Gusrae Firm never once advised Mr. Kelly that there was any wrongdoing. Accordingly, there is no basis for scienter.

VI.

The most relevant aspect of the Division's recounting of its treatment of Mr. Kelly is that the Division acknowledges the material facts of the events at issue. While the Staff dismisses the treatment as irrelevant, and while it may be irrelevant to the Staff, it is not irrelevant to this matter or Mr. Kelly, whose ability to defend himself has been materially compromised.

As of April 25, 2014, Mr. Kelly had a salary, a promised bonus, an attorney and indemnification. In one fell stroke, with the inexcusable delivery of Mr. Kelly's confidential conversations to Mr. Kaplan by the Staff, without notice or explanation, Martin Sands and Steven Sands denied him his salary, his bonus, his attorney and his indemnification (all of which he is entitled to).

It is true that Wendy Tepperman threatened to reveal the confidential conversations if Mr. Kelly did not make an overnight choice of counsel. (The Declaration denying this incident inexplicably comes from Ms. Brown who did not make the threat.) Ms. Tepperman's behavior was disappointing because it was surprising behavior for SEC Staff, but also because Ms. Tepperman had specifically advised Mr. Kelly that once he was able to speak to Mr. Kaplan Mr. Kelly would have a reasonable amount of time to figure out what to do. Overnight was not a reasonable amount of time to figure out what to do.

The confidential conversation transcripts are provided in the Declaration of Nancy A. Brown appended to the Division's Opposition, and they are a must read. As they reveal Mr. Kelly left a message with Ms. Brown on March 2, 2014 advising her that he would speak to Mr. Kaplan on March 3. On March 3 Ms. Tepperman made the threat in a voicemail to Mr. Kelly. Responding to that threat, because Mr. Kelly had little choice, Mr. Kelly then determined the best course was to engage Mr. Kaplan. He returned Ms. Tepperman's call on March 4 and advised her that Mr. Kaplan would be representing him. The agitation in Mr. Kelly's voice on that return call is palpable, and a direct result of the threat. He called Ms. Tepperman as opposed to calling Ms. Brown because he was responding to Ms. Tepperman's March 3 call to him. A relevant declaration on this point would have to come from Ms. Tepperman, not Ms. Brown, but the conversation transcripts by themselves should be sufficiently revealing.

The Division argues that the date of the Gusrae Firm engagement letter means that Mr. Kelly was not forced 'to choose counsel overnight' "because he had already done so." This is not true. The engagement letter is dated February 26, 2014, when Mr. Kelly signed it in his office anticipating a decision one way or another, but it was not delivered to the Gusrae Firm until after March 3, 2014. There was no determination to engage the Gusrae Firm and no engagement until that delivery. The engagement letter was delivered by SBAM email to Gusrae Firm email so there is an email proving this, but Mr. Kelly has been cut off from his emails so he cannot at this time access it. But the email exists and will be accessed if necessary.

The Division argues that it had the right to release the confidential conversations, but Mr. Kelly spoke freely and confidentially because Ms. Tepperman agreed to confidentiality. Mr. Kelly emphasized confidentiality in a material manner in every voicemail, and not once did the Staff rescind its agreement to honor confidentiality. Mr. Kelly emphasized confidentiality because it was important to his ability to mount an independent defense (at the time if necessary).

Whatever technical SEC policies exist, it is an egregious breach of ethics, and inexcusable, to promise confidentiality then breach it (with highly adverse consequences for Mr. Kelly). If the Staff had no intention of honoring confidentiality, all they had to do was tell Mr. Kelly, but they never did.

Conclusion

Mr. Kelly arrived at SBAM in April 2008 and immediately encountered a compliance "program" in disarray. He immediately took actions to establish a compliance program, and the C&W Compliance Reports, all of which were delivered to the SEC, are a testament to the quality and comprehensiveness of the compliance program. As the Division admits, the SEC has never questioned the content of the Reports.

When Mr. Kelly arrived Steven Sands had access to checkbooks. Mr. Kelly put an end to that, moving the checkbooks to the independent administrator GFS and requiring two signatures on checks. All funds were placed safely with independent custodians. When Mr. Kelly arrived, private securities were held in SBAM offices. Mr. Kelly put a stop to that, moving securities under lock and key (in consultation with the SEC) and out of the hands of SBAM.

In six years of working for Martin Sands and Steven Sands, whose regulatory records are well-chronicled, the SBAM investors were protected in all respects, and SBAM maintained a well-regarded compliance program. Mr. Kelly's reward for his success is sadly this enforcement action, but it should not stand.

Mr. Kelly's fault in this case in the eyes of the Division appears to be his reliance on the SEC itself, and outside counsel. The Q&A Exemption, however, is available, as the Division acknowledges, and it does provide relief. The Division has failed to show any hint of proof that would render the Q&A Exemption unavailable. There is not, as a legal matter, any Custody Rule violation in this case. The Division gives relief to hundreds of advisers that do not meet the 120-day timeframe, and this is a case where such relief is also justified.

There is no scienter as to Mr. Kelly as he did not "know" that there was any "wrongdoing." The existence of an SEC investigation does not itself denote wrongdoing. Prior history, whatever it may be, does not denote current wrongdoing. Mr. Kelly relied in good faith on the Q&A Exemption, he was fully aware that the vast majority of firms that do not meet the 120-day deadline do not see enforcement actions, the Gusrae Firm never advised him there was wrongdoing, and the Cohen & Wolf firm, which included a Custody Rule opinion in its Reports, never advised him there was wrongdoing. There is nothing "reckless" about relying on SEC guidance, SEC practice, and the counsel of well-regarded law firms.

For the reasons set forth elsewhere, Mr. Kelly cannot by any fair measure be held responsible for the audit program, a program outside the scope of his responsibilities, and clearly in the hands of the SBAM principals and the well-paid GFS. Mr. Kelly stands by his hard work on behalf of the audit efforts (which is well-documented by the Division). Mr. Kelly stands by sticking his neck out to sign documents Martin Sands and Steven Sands wouldn't (also documented by the Division). But hard work and responsible actions do not denote control, it just denotes hard work and responsible actions, which should not be punished.

While the Division has documented the very positive efforts of Mr. Kelly, it has also documented the rather negative actions of Martin Sands and Steven Sands, including failing to sign representation letters timely, and paying auditor bills late.

In the end the problem was not with the well-vetted compliance program, it was with the audit program (despite the reasonable optimism of the audit team at the beginning periods of each audit and the significant resources dedicated to the audit effort).

Is this a case where the SEC should break new ground and project onto a CCO responsibilities that are clearly those of financial personnel? It is not. Is this a case where the SEC should shatter precedent and render SEC guidance off-limits? It is not. Is this a case where the SEC should make new law by turning CCOs into guarantors? It is not. Is this a case where the SEC should upend corporate law? It is not.

Is this a case that should render Mr. Kelly forever unable to get a job and support his family? It clearly is not. Mr. Kelly has already suffered significantly at the hands of the Staff, losing (to date) salary, bonus, his attorney and indemnification directly as a result of the Staff's inexcusable actions (see in particular the confidential conversation transcripts referenced above). As a result Mr. Kelly is now unable to properly defend himself.

The Division's material makes is abundantly clear that it will not prevail in this matter against Mr. Kelly. Mr. Kelly has shown that there is no legal basis for the Division's claim.

Mr. Kelly's Motion for Summary Disposition should be granted. Anything less would be grossly unjust.

Dated: February 18, 2015

Respectfully submitted,

Christopher Kelly [redacted]

[redacted]

Pro se

ATTACHMENT I

Schulte Roth & Zabel

Alert

SEC Custody Rule Update for Private Fund Managers

August 15, 2013

The Securities and Exchange Commission's Division of Investment Management recently issued a Guidance Update[1] regarding the Custody Rule (Rule 206(4)-2 under the Investment Advisers Act).[2] The Guidance Update states that the Division will not require a registered investment adviser to hold certain certificated "privately offered securities" with a qualified custodian, thereby resolving a Custody Rule issue faced by many private fund managers. The Guidance Update should be evaluated in the context of other actions and statements on the Custody Rule recently issued by SEC staff.[3]

The SEC's National Examination Program[4] issued, in March 2013, a Risk Alert entitled "Significant Deficiencies Involving Adviser Custody and Safety of Client Assets."[5] The Risk Alert highlighted Custody Rule-related deficiencies found by the SEC's Office of Compliance Inspections and Examinations in a number of recent examinations,[6] which fell into four general categories:

- Failures by advisers to recognize that they had custody of client funds and securities;
- Failures to comply with the surprise exam requirement;
- Failures to comply with the "qualified custodian" requirement; and
- Failures to satisfy the requirements of the "audit exception."

The examination staff's findings have resulted in a number of actions, ranging from remedial measures taken by advisers to referrals by OCIE to the SEC's Enforcement Division.

---

[1] IM Guidance Update No. 2013-04 (August 2013), available at http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf.

[2] This *Alert* focuses on advisers to private funds, but all registered advisers should consider their compliance with the Custody Rule. Advisers do not need to comply with the Custody Rule with respect to the account of an investment company registered under the U.S. Investment Company Act of 1940 (*see* Rule 206(4)-2(b)(5)), although Section 17(f) of the Investment Company Act (and related rules) imposes a separate custody regime for registered investment companies. The Custody Rule also does not apply to exempt reporting advisers or to other advisers not registered with the SEC.

[3] In addition to the Guidance Update and the NEP Risk Alert, in July, the United States Government Accountability Office issued a report on the requirements and costs associated with complying with the Custody Rule. The GAO report is available at http://www.gao.gov/assets/660/655754.pdf.

[4] The "National Examination Program" is the collective effort of the SEC's Office of Compliance Inspections and Examinations teams throughout the United States for carrying out the SEC's nationwide examination and inspection program for investment advisers and other financial industry participants and self-regulatory organizations.

[5] Available at http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf.

[6] This report was based on over 400 recent OCIE examinations that found "significant deficiencies" in investment adviser compliance programs. Over one-third of these examinations reportedly revealed Custody Rule compliance issues.

ATTACHMENT II

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 70944 / November 26, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3726 / November 26, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30810 / November 26, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15626

In the Matter of

PARALLAX INVESTMENTS, LLC, JOHN P. BOTT, II, AND F. ROBERT FALKENBERG,

Respondents.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 15(b)(6) OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AND NOTICE OF HEARING

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 (“Exchange Act”), Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”), and Section 9(b) of the Investment Company Act of 1940 (“Investment Company Act”) against Parallax Investments, LLC (“Parallax”), John P. Bott, II (“Bott”), and F. Robert Falkenberg (“Falkenberg”), (collectively, “Respondents”).

II.

After an investigation, the Division of Enforcement alleges that:

A. SUMMARY

1. Parallax, an investment adviser registered with the Commission from March 2010 to November 2012, willfully violated antifraud, custody and compliance provisions of the Advisers

Act and the rules thereunder. From at least 2009 through 2011 ("relevant period"), Parallax: engaged in thousands of securities transactions with advisory clients on a principal basis through an affiliated broker-dealer, without providing prior written disclosure to, or obtaining consent from, the clients; failed timely to provide pooled investment vehicle investors with audited financial statements as required by the Advisers Act custody rule; failed to adopt, implement, and annually review written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder; and failed to establish, maintain, and enforce a written code of ethics that met applicable regulatory requirements.

2. Bott and Falkenberg willfully aided and abetted and caused Parallax's violations. During the relevant period, Bott was Parallax's sole owner and manager, and Falkenberg was Parallax's chief compliance officer ("CCO").

B. RESPONDENTS

3. **Parallax** is a Texas limited liability company based in Houston, Texas. Parallax was created in 1998 and became a Commission-registered investment adviser on March 9, 2010. Effective November 26, 2012, it terminated its Commission registration. As of December 2012, it managed 370 accounts on a discretionary basis and had approximately $81 million in assets under management.

4. **Bott**, age 61, resides in Houston, Texas. Bott is the sole owner and manager of Parallax, an investment adviser that was registered with the Commission from March 9, 2010 to November 26, 2012. He is also an officer and 40% owner of Mutual Money Investments, Inc. d/b/a Tri-Star Financial ("TSF"), an affiliated broker-dealer registered with the Commission.

5. **Falkenberg**, age 51, resides in Allen, Texas. He was a broker-dealer and investment adviser examiner for the State of California Department of Corporations for 13 years before joining FINRA in 2003. Upon his departure from FINRA in 2008, Falkenberg formed a compliance consulting firm, Falkenberg Ventures Corporation d/b/a Solid Rock Consulting ("SRC"); he is SRC's sole owner and employee. He later became CCO of Parallax (January 2010 to September 2011) and TSF (October 2010 to April 2013).

C. OTHER RELEVANT ENTITY

6. **TSF** is a Texas corporation based in Houston, Texas. TSF has been a Commission-registered broker-dealer since 1993 and is jointly owned by Bott and two other individuals.

D. FACTS

Background

7. Parallax provides discretionary investment advisory services to individuals and entities, including a private fund, Parallax Capital Partners, LP ("PCP"). Parallax's investment strategy focused almost exclusively on fixed income securities, such as mortgage-backed bonds.

To execute this strategy, Parallax relied on TSF, its affiliated broker-dealer, for fixed income analysis and trade execution.

8. Bott makes investment recommendations to Parallax clients and, upon the clients' consent, TSF executes the transactions. During the relevant period, TSF used its inventory account to purchase mortgage-backed bonds for Parallax advisory clients and then transferred the bonds to the applicable client account. TSF charged the advisory clients a sales credit for the trades, which was essentially a percentage mark-up (or mark-down). Bott, a registered representative of TSF for the trades, received 55% of the sales credit generated by each trade.

9. In January 2010, Bott hired Falkenberg, to become Parallax's CCO. Falkenberg had little if any practical experience with the regulatory requirements applicable to Commission-registered investment advisers when he joined Parallax.

10. Bott has overall responsibility for ensuring that Parallax complies with its regulatory requirements, including Advisers Act requirements. Bott assigned to Falkenberg, as CCO, the responsibility for establishing and administering Parallax's compliance program under Bott's direction. Falkenberg, however, devoted approximately nine hours per month to Parallax's compliance program. He did not maintain a permanent office at Parallax and delegated daily compliance tasks to other employees in his absence. Falkenberg served as Parallax's CCO during the relevant period.

Parallax Engaged in Thousands of Principal Transactions without Making Required Disclosures and Obtaining Client Consent

11. From at least January 2009 through November 2011, Parallax, through TSF, engaged in at least 2,000 principal transactions with its advisory clients ("Parallax Principal Transactions") without providing prior written disclosure to clients that it would effect the trades on a principal basis, or obtaining consent from clients.

12. TSF collected approximately $1.9 million in gross sales credits from the Parallax Principal Transactions. TSF paid approximately $1 million to Bott for the Parallax Principal Transactions while retaining the rest. None of the gross sales credits was paid to Parallax.

13. Bott initiated and executed the Parallax Principal Transactions. He knew that Parallax did not provide written disclosures to, or obtain consent from, Parallax clients before completing the Parallax Principal Transactions. A compliance manual purchased by Parallax in 2009 contained a chapter on principal transactions that described the policies and procedures for such transactions under Section 206(3) of the Advisers Act. However, Bott failed to read the manual before an SEC examination in April 2011.

Parallax Failed to Comply with the Custody Rule

14. Parallax serves as the adviser to PCP, a private fund with approximately $8.7 million in total assets as of December 31, 2012.[1] PCP's portfolio substantially consists of fixed income products that are generally thinly traded and hard to value, such as inverse floating securities.

15. As a registered investment adviser, Parallax was required to comply with the custody rule as set forth in Rule 206(4)-2 of the Advisers Act. During the relevant period, the custody rule required that an adviser to a private fund must either obtain an annual surprise exam or distribute annual audited financial statements to its investors. In lieu of a surprise annual examination, Parallax elected to distribute GAAP-compliant financial statements audited by a PCAOB-registered auditor to each of PCP's limited partners within 120 days of the fund's fiscal year end. Because PCP's fiscal year end is December 31, Parallax was required to distribute audited 2010 financial statements to PCP's limited partners no later than April 30, 2011.

16. Parallax failed to distribute the 2010 PCP audited financial statements by the April 30, 2011 deadline. Instead, Parallax distributed the 2010 financial statements in early June 2011, more than a month after they were due. PCP's auditor did not begin the 2010 Parallax audit until April 27, 2011. Even though Falkenberg knew about the 120-day deadline by at least February or March 2011, he failed to take any steps to ensure that Parallax met the deadline.

17. Parallax's 2010 financial statement audit was not performed by a PCAOB-registered auditor. Falkenberg knew about the private fund auditor requirements as early as the third quarter of 2010, but he took no steps to ensure that PCP's auditor was PCAOB-registered. By mid-April 2011, Falkenberg discovered that PCP's current auditor was not PCAOB-registered. Falkenberg alerted Bott to the problem, but they decided to go ahead and use the current auditor for the 2010 audit even though they knew the auditor was not PCAOB-registered.

18. Parallax's 2010 financial statements contained fair value disclosures that did not conform with GAAP. As PCP's auditor completed his audit of PCP in late May 2011, he circulated a draft of the financial statements for Parallax's review. Both Bott and Falkenberg reviewed the financial statements and noted that the mortgage-backed securities, which comprised 94% of the fund's value, were categorized as Level One securities under ASC 820 - Fair Value Measurements and Disclosures. A Level One designation indicates that there are quoted prices in active markets for identical assets. Falkenberg told Bott that he believed a Level Two designation (which indicates that quoted prices in active markets do not exist for the identical asset, but the asset's fair value can be calculated directly or indirectly based on observable market inputs) was more appropriate given the difficulty in valuing the securities. Neither Bott nor Falkenberg discussed the valuation issue with the auditor. Instead, Bott ordered that the financial statements – with the Level One designation – be sent to PCP investors.

[1] Parallax Capital, LP is the general partner of PCP. Parallax, in turn, serves as the general partner of Parallax Capital, LP.

19. In August 2011, following an SEC examination, Parallax hired a PCAOB-registered auditor to re-issue PCP's 2010 audited financial statements. Although this auditor did not make any adjustments to the financial statement values, it categorized the fund's mortgage-backed securities as Level Two securities. The auditor issued its audit report for the 2010 PCP financial statements on October 25, 2011, and it was subsequently distributed to PCP investors.

Parallax Failed to Adopt and Implement Written Compliance Policies and Procedures and a Written Code of Ethics

20. For nearly two years after registering with the Commission, Parallax failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. Parallax also failed to perform an annual review of the adequacy of such policies and procedures and the effectiveness of their implementation. Finally, Parallax failed to establish, maintain and enforce a written code of ethics that meets the minimum standards set out in Advisers Act Rule 204A-1. Parallax did not adopt and implement policies and procedures and a code of ethics until December 2011.

21. Following a 2009 Texas State Securities Board ("TSSB") examination of Parallax, the TSSB issued a deficiency letter to Bott citing, among other things, Parallax's failure to establish and maintain written supervisory procedures. In response, Bott approved the purchase of an "off the shelf" compliance manual that was not tailored to Parallax's business (the "2009 Manual"). Bott knew that the 2009 Manual was not tailored to Parallax's business when he hired Falkenberg in January 2010. After Falkenberg became Parallax's CCO, he reviewed the 2009 Manual and concluded that it needed updating.

22. Falkenberg prepared periodic compliance memos addressed to Bott to highlight the "progress and status of compliance efforts" at Parallax. Falkenberg prepared a total of three memos that covered the first and second quarters of 2010 and the full year of 2010.

23. Falkenberg's compliance memos to Bott were brief, consisting of two to three pages. Falkenberg stated in each of them that the 2009 Manual needed to be revised and tailored to the business. Falkenberg's first compliance memo dated April 2010 and emailed to Bott noted explicitly that the 2009 Manual needed "to be updated and made effective." Bott occasionally asked Falkenberg about the status of the compliance manual update and Falkenberg consistently told him that he was working on it. Falkenberg, however, never tailored the 2009 Manual to Parallax's business.

24. Parallax failed to conduct an annual review of its policies and procedures. In late March 2011, Falkenberg received a document request from Commission examination staff in advance of their planned April 2011 examination of Parallax. One of the items requested was documentation for any annual or interim reviews of Parallax's policies and procedures. In response, Falkenberg told exam staff that he performed the 2010 annual review in February 2011 and documented that review in an annual compliance memo. Falkenberg's undated 2010 annual compliance memo states in relevant part:

> Rule 206(4)-7 requires that any Advisor registered with the Commission perform at least an annual review of our compliance

> procedures. We are also required to record and report any violations of our firm's Code of Ethics under Rule 204A-1 ("Material Compliance Matters"). **This memo documents that I have performed that review and reported significant compliance events and Material Compliance Matters.** [emphasis added]

25. The meta data for Falkenberg's 2010 annual compliance memo indicates that Falkenberg created and completed the memo in approximately four hours on Friday, April 8, 2011, not February 2011. Falkenberg drafted the memo after exam staff had notified Parallax of its impending exam and just three days before exam staff was scheduled to begin field work. In addition, the memo is undated and contains no reference to when the annual review was supposedly performed. Falkenberg never emailed the 2010 annual compliance memo to Bott.

26. Parallax failed to establish, maintain, and enforce a written code of ethics. While Parallax's 2009 Manual contained a section titled "Code of Ethics," the ethics policy was never established, maintained or enforced. In addition, Parallax failed to (a) identify and designate all access persons, (b) obtain written acknowledgments from all access persons, and (c) require all access persons to report their securities transactions and holdings as required by Advisers Act Rule 204A-1.

E. VIOLATIONS

27. As a result of the conduct described above, Parallax willfully violated Section 206(3) of the Advisers Act, which prohibits an investment adviser from executing securities transactions with a client on a principal basis without disclosing to such client in writing, before the completion of such transaction, the capacity in which it is acting and obtaining the consent of the client to such transaction.

28. As a result of the conduct described above, Bott willfully aided and abetted and caused Parallax's violations of Section 206(3) of the Advisers Act.

29. As a result of the conduct described above, Parallax willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, which requires an investment adviser with custody of client funds or securities to adequately safeguard those assets by implementing specific procedures.

30. As a result of the conduct described above, Bott and Falkenberg willfully aided and abetted and caused Parallax's violations of Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder.

31. As a result of the conduct described above, Parallax willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require that an investment adviser adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder.

32. As a result of the conduct described above, Bott and Falkenberg willfully aided and abetted and caused Parallax's violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

33. As a result of the conduct described above, Parallax willfully violated Section 204A of the Advisers Act and Rule 204A-1 thereunder, which require that an investment adviser establish, maintain and enforce a written code of ethics.

34. As a result of the conduct described above, Bott and Falkenberg willfully aided and abetted and caused Parallax's violations of Section 204A of the Advisers Act and Rule 204A-1 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondents an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate in the public interest against Bott and Falkenberg pursuant to Section 15(b) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

C. What, if any, remedial action is appropriate in the public interest against Parallax pursuant to Section 203(e) of the Advisers Act including, but not limited to, disgorgement and civil penalties pursuant to Section 203 of the Advisers Act;

D. What, if any, remedial action is appropriate in the public interest against Bott and Falkenberg pursuant to Section 203(f) of the Advisers Act including, but not limited to, disgorgement and civil penalties pursuant to Section 203 of the Advisers Act;

E. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 9(b) of the Investment Company Act including, but not limited to, disgorgement and civil penalties pursuant to Section 9 of the Investment Company Act; and

F. Whether, pursuant to Section 203(k) of the Advisers Act, Respondents should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 206(3), 206(4) and 204A of the Advisers Act and Rules 206(4)-2, 206(4)-7, and 204A-1 thereunder, whether Respondents should be ordered to pay a civil penalty pursuant to Section 203(i) of the Advisers Act, and whether Respondents should be ordered to pay disgorgement pursuant to Section 203 of the Advisers Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondents fail to file the directed answer, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondents personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary