

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING  
File No. 3-16311

3-16311

In the Matter of

SCOTT M. STEPHAN,

Respondent.



**DIVISION OF ENFORCEMENT'S POST-HEARING BRIEF  
SEEKING RELIEF AGAINST RESPONDENT SCOTT M. STEPHAN**

Dated: July 2, 2015

DIVISION OF ENFORCEMENT  
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The Division of Enforcement (“Division”) respectfully submits this post-hearing brief following the hearing (“Hearing”) as to Respondent Scott M. Stephan (“Stephan” or “Respondent”).

### **PRELIMINARY STATEMENT**

The issue before this Court is whether Stephan should be permitted to profit from defrauding more than 40 innocent investors, or whether his misconduct should result in monetary sanctions including the disgorgement of the fruits of his fraud and a civil monetary penalty. As Stephan admits, he defrauded investors out of millions of dollars when he, along with a long-time friend, Timothy S. Dembski (“Dembski”), sold investments in Prestige Wealth Management Fund, LP (“Prestige Fund” or “Fund”) on the back of false and misleading representations about Stephan’s own professional experience. Those misrepresentations were critical, as they described the one person—Stephan—with exclusive authority to make the Fund’s investment decisions.

Stephan, along with Dembski and Walter F. Grenda, Jr. (“Grenda”), marketed the Prestige Fund to long-standing advisory clients of Reliance Financial Advisors, LLC (“Reliance Financial”). Most of those clients were retired, on fixed incomes and lacked sophisticated investment knowledge.

In order to create the false appearance that an investment in the Prestige Fund was less risky than it actually was, Stephan drafted a biography of his professional experiences to include in the Prestige Fund’s private placement memorandum (“PPM”) that misrepresented his investment background and experiences, as well as his time and experiences in the securities industry. Stephan—who, at the time, did not even know what a hedge fund was—admitted this biography was “highly misleading.”

Stephan's deception did not end in the marketing and sale of Prestige Fund investments. As Stephan also admits, when he began trading for the Fund, Stephan quickly realized the Fund's computer based trading strategy, or "algorithm," did not work as he and Dembski intended. Upon realizing this, Stephan abandoned the algorithm—the very strategy investors were told would govern the Fund's trading—in favor of trading "manually," and he also eventually shifted from trading a discrete list of equities to a far riskier options trading strategy. But Stephan never shared with Prestige Fund investors his discovery that his trading strategy was not working as planned, or his decision to change the Fund's trading approach.

Eventually, as a result of his inexperience and manual options trading, Stephan lost approximately 85% of the investments that remained in the Prestige Fund in December 2012, which caused investors to lose over \$3 million collectively. Meanwhile, Stephan reaped over \$120,000 in management and performance fees in profits from his fraud.

Stephan maintains he should not face any monetary sanctions, notwithstanding the weight of evidence against Stephan, based on his claimed inability to satisfy such a judgment. But as this Court recognized just a week ago, "[a]bility to pay . . . is just one factor among many" the Court may weigh in considering whether to impose a penalty, "and it [inability to pay] can be disregarded when the wrongful conduct is sufficiently egregious." *In the Matter of Edgar R. Page and PageOne Financial Inc.*, ID Rel. No. 822, 2015 WL 3898161, at \*12 (June 25, 2015) (citations omitted). Moreover, "giving ability to pay significant weight in the disgorgement context would create a perverse incentive for securities law violators to spend ill-gotten gains quickly and without restraint." *Id.* Accordingly, Stephan, who is only 40 years old, should be required to disgorge all profits—even if he has since spent them on personal bills—with interest, and pay a significant civil monetary penalty that properly addresses the deceptive nature of his misconduct.

## THE FACTS

The facts of this case are set forth in the Division’s Proposed Findings of Fact and Conclusions of Law, dated July 2, 2015.<sup>1</sup> All citations to facts herein will be to “FoF ¶ \_\_\_.” and all citations to law will be to “CoL ¶ \_\_\_.”

## PROCEDURAL BACKGROUND

On December 10, 2014, the Commission entered an OIP, making factual findings, including findings that Stephan willfully violated: Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder; and aided and abetted and caused Prestige’s violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. (FoF ¶ 2.) In the OIP, the Commission also entered a cease-and-desist order against Stephan and ordered that Stephan be subject to a collateral and associational bar without any right to re-apply. (FoF ¶ 2.)

The OIP also ordered additional proceedings solely to determine the appropriate amounts of disgorgement, pre-judgment interest on that disgorgement, and civil penalties against Stephan. (FoF ¶ 3.) For purposes of determining the appropriate remedies against Stephan, the OIP’s factual findings—including those detailing his fraud—are deemed true. (FoF ¶ 4.)

Stephan agreed to the entry of the OIP, pursuant to which he is precluded from arguing that he did not violate the federal securities laws set out in the OIP. (FoF ¶ 4.) Then, both in his Answer to the OIP and at the Hearing, Stephan admitted to all of the allegations contained in the OIP (but for paragraph six, which focused on Dembski’s and Grenda’s conduct and which he did not deny). (FoF ¶¶ 5, 8.)

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<sup>1</sup> All defined capitalized terms used herein have their same meaning as set forth in the Division’s Proposed Findings of Fact and Conclusions of Law.

## ARGUMENT

### **I. Stephan Should Disgorge His \$123,505.91 in Prestige Fund-Related Profits**

The Court should order Stephan to disgorge \$123,505.91, the total he received in management and performance fees from the Prestige Fund (“Prestige Fees”). (FoF ¶ 62.) To be clear, such disgorgement is not “punitive”; it is meant to “ensure [Stephan’s] illegal actions do not yield unwarranted enrichment.” (CoL ¶ 14.)

The \$123,505.91 is the “reasonable approximation of profits causally connected to the violation.” (CoL ¶ 15.) The Prestige Fees were generated entirely from investments in the Prestige Fund (FoF ¶ 63), and as Stephan admits, those investments were obtained through the use of a misleading PPM he played a central role in generating. (FoF ¶¶ 49-54, 59.) Moreover, investors kept their money in the Fund (where fees continued to accrue) as Stephan traded “manually,” which Stephan knew was contrary to the automated trading strategy investors were told the Fund would employ throughout the life of the Fund. (FoF ¶¶ 66-69.)

Disgorging Stephan’s management and performance fees will prevent him from realizing ill-gotten gains from his fraudulent conduct and will deter actors from committing comparable frauds in the future. (CoL ¶ 14.) For this reason, the Court should order Stephan to pay \$123,505.91 in disgorgement.

### **II. Stephan Should Pay \$9,565.60 in Prejudgment Interest**

The Court also should order Stephan to pay \$9,565.60 in prejudgment interest because it, like disgorgement, “serves the important purpose of deterrence, which is central to securities law.” (CoL ¶ 17.) “Except in the most unique and compelling circumstances,” prejudgment interest should be awarded on disgorgement because not imposing prejudgment interest is the equivalent of an interest free loan from the wrongdoer’s victims. (CoL ¶ 17.)

Stephan received fees from the Prestige Fund from July 7, 2011 through December 3, 2012. (FoF ¶ 62.) He has had the benefit of those funds—which he used to cover personal expenses (FoF ¶ 74)—since he first received them. The Division’s proposed prejudgment interest amount is calculated using the Internal Revenue Service underpayment interest rate on \$123,505.91 in disgorgement from December 3, 2012 (the last date on which Stephan received a share of the management and performance fees) to July 31, 2015 (the date responsive briefs are due in this matter). (CoL ¶ 18.)<sup>2</sup>

### **III. Stephan Should Pay Substantial Third-Tier Penalties**

Section 8A of the Securities Act, Section 21B of the Exchange Act, Section 203(i) of the Advisers Act and Section 9(d) of the Investment Company Act authorize the Commission to impose civil money penalties for willful violations of those Acts. (CoL ¶ 19.) The Court may award third-tier penalties of \$150,000 for a natural person “for each” violative “act or omission.” (CoL ¶¶ 23-26.)

In determining whether a civil penalty is in the public interest, the Court should consider: (1) whether the act or omission involved fraud; (2) harm to others; (3) unjust enrichment; (4) prior violations; (5) deterrence; and (6) such other matters as justice may require. (CoL ¶ 21.) A third-tier penalty—the highest penalty range—is appropriate where, *inter alia*, a respondent’s violation (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, and (2) directly or indirectly “resulted in substantial losses or created a significant risk of substantial losses,” or “resulted in substantial pecuniary gain to” respondent. (CoL ¶ 22.)

Here, third-tier penalties against Stephan are appropriate and in the public interest because, among other reasons, Stephan’s conduct involved scienter-based fraud (FoF ¶¶ 2, 4; CoL ¶ 4), and

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<sup>2</sup> Attached hereto as Appendix A is a copy of the Division’s Prejudgment Interest Report showing the \$9,565.60 prejudgment interest calculation.

his acts resulted in substantial harm to others, exposed others to a significant risk of substantial losses, and brought Stephan a pecuniary gain of over \$120,000. (FoF ¶¶ 60, 62, 70-71.) The Court has considerable discretion to determine the magnitude of such a penalty, as the tiered-statutory maximum amounts are not overall limitations but only limitations per violation. (CoL ¶ 24). Thus, the Court has discretion to determine what constitutes “each” violative act on Stephan’s part, and then order Stephan to pay a total civil penalty that is a multiple of the \$150,000 third-tier amount. (CoL ¶¶ 23-26.)

**A. Stephan Acted with Scienter in Committing Fraud**

Among other violations (both primary and secondary), Stephan willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. (FoF ¶¶ 2, 4.) Section 10(b) of the Exchange Act and Rule 10b-5 thereunder require a showing that the wrongdoer acted with “scienter” in committing the actionable fraud. (CoL ¶ 4.)

Scienter is “a mental state embracing intent to deceive, manipulate, or defraud.”<sup>3</sup> (CoL ¶ 6.) A respondent acts with a high degree of scienter when he knows he is misstating or omitting facts in a communication to clients. (CoL ¶ 7.) A high degree of scienter “exacerbates the egregiousness of” a respondent’s misconduct. (CoL ¶ 8.) What is more, “[f]or the purpose of rule 10(b)-5, an investment adviser [like Stephan was here] is a fiduciary and therefore has an affirmative duty of utmost good faith to avoid misleading clients. This duty includes disclosure of all material facts and all possible conflicts of interest.” (CoL ¶ 11.)

Stephan admitted that his professional biography in the final Prestige Fund PPM was “highly misleading” and that he knew or recklessly disregarded that his biography was false or

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<sup>3</sup> Scienter may also be shown through “extreme recklessness,” which is an “extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.” (CoL ¶¶ 9-10.)



misleading. (FoF ¶ 54.) Before co-founding the Prestige Fund, Stephan never invested or traded securities or managed any portfolio of assets for any clients. (FoF ¶ 23.) In fact, Stephan's primary pre-Prestige Fund work experience had been collecting on past due auto loans or managing a call center of collectors who collected on past due auto loans. (FoF ¶¶ 15-17.) But Stephan's true work experience would not have been very attractive to potential Prestige Fund investors, so he drafted a fictional biography that boasted of extensive experience in the investment management business. (FoF ¶ 49.) That biography claimed Stephan had 14 years in the financial services industry, "co-managed a portfolio of over \$500 million" and was "Vice President of a New York based investment company in which he was responsible for portfolio management and analysis." (FoF ¶ 52.) None of those statements were true. (FoF ¶¶ 53-54.)

As Professor Laby explained, the PPM's misrepresentations about Stephan's work experience were particularly important given Stephan's role in managing the Fund's—and therefore investors'—money. (FoF ¶ 55.) "When investors pay a fee to invest, they are effectively paying for the expertise of a particular manager or managers with control over the investors' funds. Thus, information in a PPM about those individuals is of utmost importance." (FoF ¶ 55.) Here, Stephan had "sole" control over the investors' funds in the Prestige Fund. (FoF ¶¶ 39-45.)

In addition to including false statements in the PPM to sell the Prestige Fund, Stephan traded Fund money "manually," which he knew or recklessly disregarded was contrary to the automated trading strategy investors were sold and believed would be implemented throughout the life of the Fund. (FoF ¶¶ 66-69.) Stephan, however, never took any steps to inform investors in the Fund that he started to trade manually. (FoF ¶¶ 66-69.)

By deceiving investors both when offering Prestige Fund investments and when managing the Fund, Stephan's admitted misconduct involved a high degree of scienter. (CoL ¶ 7.)

**B. Stephan's Fraudulent Acts Resulted in Harm to Others and Exposed Others to a Significant Risk of Substantial Losses**

Stephan's fraudulent acts in making and distributing materially false and misleading statements when selling investments in the Prestige Fund, as well as when trading manually in the Fund, resulted in great monetary harm to many investors, and exposed others to significant risk. (FoF ¶¶ 60, 70-71.) Indeed, Stephan lost approximately 85 percent of Dembski's clients' money invested in the Fund as of December 2012, amounting to over \$3 million in tangible investor harm. (FoF ¶ 71.) Grenda's clients, who collectively invested approximately \$8 million in the Fund, were subject to the same risk of loss when they had their money in the Fund. (FoF ¶¶ 60, 70.)

Because Stephan committed (and profited from) fraud, with scienter, while subjecting investors to great monetary losses, and because deterrence requires that such fraud be penalized, the Division seeks third-tier penalties against Stephan. (See CoL ¶ 21.)

**IV. Stephan's Claimed Inability to Pay Should Not Preclude Monetary Remedies**

Stephan has offered a Statement of Financial Condition in an attempt to establish that he is unable to pay the monetary sanctions sought by the Division. (FoF ¶ 72.) Such a claim on his part, however, should not allow him to avoid paying remedies.

Even if the Court finds that Stephan met his burden to demonstrate an inability to pay, such a showing does not provide Stephan with an automatic waiver to pay disgorgement, prejudgment interest on that disgorgement, or civil penalties. (CoL ¶ 29.) Stephan's claimed inability to pay is particularly unconvincing as an argument against disgorgement, as it would allow him to keep profits taken from defrauded investors and suggest an incentive for securities law violators to burn through their profits before they can be held accountable for their misconduct. (CoL ¶¶ 16, 29.) For this reason, Stephan—at a minimum—should be ordered to disgorge the \$123,505.91 he made in ill-gotten gains, regardless of his ability to pay.

With respect to civil penalties, the egregious nature of Stephan's fraud (as discussed in Section III, *supra*) demands a penalty even if Stephan currently lacks the funds to satisfy such a judgment. (CoL ¶ 30.) As courts have recognized when ordering monetary sanctions in similar cases, entries of judgments are appropriate "despite a defendant's inability to pay, [when] the defendant may subsequently acquire the means to satisfy the judgment." (CoL ¶ 31.) Here, Stephan is only 40 years old (FoF ¶ 11), and has the current and future ability and prospect of earning, accumulating or otherwise amassing the money to pay whatever sanctions are imposed in this case, which is a factor the Court should consider when determining the appropriate remedies. (CoL ¶ 31.) Indeed, Stephan currently is employed. (FoF ¶ 72.)

For these reasons, the Court should order Stephan to pay disgorgement, prejudgment interest on that disgorgement, and civil monetary penalties.

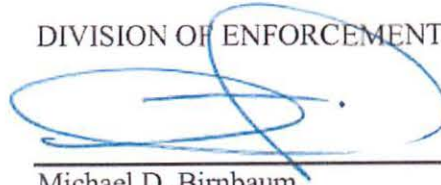
#### CONCLUSION

The Division respectfully requests that the Court grant relief against Stephan as set out above.

Dated: July 2, 2015  
New York, New York

Respectfully submitted,

DIVISION OF ENFORCEMENT



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# **APPENDIX A**

# U.S. Securities and Exchange Commission

## Division of Enforcement

### Prejudgment Interest Report

Quarter Range	Annual Rate	Period Rate	Quarter Interest	Principal+Interest
<b>Violation Amount</b>				\$123,505.91
01/01/2013-03/31/2013	3%	0.74%	\$913.61	\$124,419.52
04/01/2013-06/30/2013	3%	0.75%	\$930.59	\$125,350.11
07/01/2013-09/30/2013	3%	0.76%	\$947.85	\$126,297.96
10/01/2013-12/31/2013	3%	0.76%	\$955.02	\$127,252.98
01/01/2014-03/31/2014	3%	0.74%	\$941.32	\$128,194.30
04/01/2014-06/30/2014	3%	0.75%	\$958.82	\$129,153.12
07/01/2014-09/30/2014	3%	0.76%	\$976.61	\$130,129.73
10/01/2014-12/31/2014	3%	0.76%	\$983.99	\$131,113.72
01/01/2015-03/31/2015	3%	0.74%	\$969.88	\$132,083.60
04/01/2015-06/30/2015	3%	0.75%	\$987.91	\$133,071.51
<b>Prejudgment Violation Range</b>			<b>Quarter Interest Total</b>	<b>Prejudgment Total</b>
<b>01/01/2013-06/30/2015</b>			<b>\$9,565.60</b>	<b>\$133,071.51</b>