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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-16312

In the Matter of

SCOTT M. STEPHAN,

Respondent.

DIVISION OF ENFORCEMENT'S BRIEF IN RESPONSE TO RESPONDENT SCOTT M. STEPHAN'S POST-HEARING MEMORANDUM

Dated: July 31, 2015

DIVISION OF ENFORCEMENT
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TABLE OF CONTENTS

The Division respectfully submits this brief in response to Respondent Scott M. Stephan's Post-Hearing Memorandum ("Stephan Mem.").[1]

PRELIMINARY STATEMENT

The primary argument Stephan makes in support of his position that monetary sanctions are inappropriate here is that he did not act with "scienter." (Stephan Mem. at 3.) That is, Stephan now conveniently claims that he did not "intend to deceive" any investors in the Prestige Fund. (*Id.*) But the question of whether Stephan defrauded investors with scienter is not before this Court. The Commission already made factual findings demonstrating Stephan's scienter, which "shall be accepted and deemed true" by this Court and Stephan is precluded from arguing that he did not violate the scienter-based antifraud laws described in the OIP. (FoF ¶¶ 2, 4; CoL ¶¶ 1-4, 6.) Furthermore, Stephan admitted the allegations in the OIP in his Answer and he then did so again at the Hearing. (FoF ¶¶ 5, 8.)

As described below, the evidence shows that Stephan intended to deceive investors in the Prestige Fund in two separate and distinct ways, both by generating a "highly misleading" PPM for use with potential investors, and by drastically altering the Fund's trading strategy without disclosing that change (or the problems that led to it) to investors. As a result of his intentional deception, Stephan lost over $3 million of investor funds, mostly from individuals who needed that money for their retirement.

Stephan's other arguments against imposing financial relief—that monetary sanctions "will work only as an excessive and punitive result" (Stephan Mem. at 5) and that Stephan is unable to

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[1] All defined terms used herein have the same meaning as in the Division's Post-Hearing Brief Seeking Relief Against Respondent Scott M. Stephan ("Division Post-Hearing Brief") and the Division's Proposed Findings of Fact ("FoF") and Conclusions of Law ("CoL"), both dated July 2, 2015. The Division is not submitting any Response to Respondent Scott M. Stephan's Proposed Findings of Fact and Conclusions of Law because Stephan did not submit any proposed findings or conclusions of his own.

satisfy any judgment against him (*id.*at 4-5)—are similarly unavailing. Disgorgement is not a "punitive" remedy; it is meant to prevent unjust enrichment and to deter others from engaging in similar misconduct. (Division Post-Hearing Brief at 4.) And while civil monetary penalties are, by their nature, punitive, Stephan's conduct here was sufficiently egregious to warrant the imposition of such penalties. (*Id.* at 5-7.) Stephan's claimed inability to pay likewise should not shield him from paying any monetary relief. Ability to pay to should be given minimal weight, if any, in the disgorgement context, and ability to pay is just one factor among many in determining the appropriate amount of civil penalties.

For these reasons, the Division respectfully reiterates its request that Stephan be ordered to: disgorge his $123,505.91 in Prestige Fund-related profits; pay $9,565.60 in prejudgment interest; and pay substantial third-tier penalties.

ARGUMENT

I. Disgorgement and Substantial Third-Tier Penalties Are Appropriate Because Stephan Acted with Scienter in Committing Fraud

Pursuant to the OIP and the terms in his Offer, Stephan is precluded from arguing that he did not violate the federal securities laws set out in the OIP, which included charges that Stephan violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder—both of which required a finding that Stephan acted with scienter. (FoF ¶¶ 2, 4; CoL ¶¶ 4, 6.) Perhaps more probative of Stephan's scienter, in both his Answer to the OIP and at the Hearing, Stephan admitted to all of the allegations contained in the OIP (but for one paragraph that did not relate to him). (FoF ¶¶ 5, 8.) It is clear, therefore, that for purposes of determining the appropriate amounts of monetary sanctions against Stephan, this Court must accept and deem as true the factual findings made against Stephan, including those detailing his fraud—a fraud that resulted in a finding that Stephan acted with "scienter" when he violated the federal securities laws. (FoF ¶¶ 3-4; CoL ¶¶ 4, 6.)

The parties agree that scienter is "a mental state embracing intent to deceive, manipulate, or defraud." (CoL ¶ 6; Stephan Mem. at 3.) Here, Stephan acted with a high degree of scienter, which "exacerbates the egregiousness" of his misconduct, in two separate and distinct ways. (CoL ¶¶ 7-8.) First, Stephan knowingly and intentionally misstated and omitted material facts to investors in the Prestige Fund when he drafted a biography of his professional experiences to include in the Fund's PPM that misrepresented his investment background and experiences, as well as his time and experiences in the securities industry. (FoF ¶¶ 49, 52-54, 59; CoL ¶ 7, *citing In the Matter of Johnny Clifton*, Securities Act Rel. No. 9417, 2013 WL 3487076, at *10 (July 12, 2013) (finding that respondent acted with a "a high degree of scienter" because "[h]e made statement to prospective investors that he knew were false" and he "knowingly omitted information . . . that made his statements about the project materially misleading"); *In the Matter of Jeffrey L. Gibson*, IA Rel. No. 57266, 2008 WL 294717, at *3 (Feb. 4, 2008) (respondent's conduct evinced a high degree of scienter because he knew the PPM's representations were misleading).) Importantly, Stephan has admitted that the professional biography he drafted for the Prestige Fund PPM was "highly misleading." (FoF ¶ 54.) Those misrepresentations were particularly important given Stephan's role as the only person managing investor money in the Fund. (FoF ¶ 55.)

Second, Stephan began trading the money investors put into the Prestige Fund "manually," which he knew was contrary to the automated trading strategy investors were sold and understood was being used throughout the life of the Fund. (FoF ¶¶ 66-69; CoL ¶ 7, *citing In the Matter of Gualario & Co., LLC and Ronald Gualario*, ID Rel. No. 452, 2012 WL 627198 (Feb. 14, 2012) (investment adviser's failure to disclose change from conservative to high-risk trading strategy violated antifraud provisions).) To be clear, Stephan—who was acting in an advisory capacity—started trading manually very early in the life of the Fund but he never took any steps to inform

investors that he abandoned the computer automation or that he started to trade options. (FoF ¶¶ 11, 13, 66-69; CoL¶ 11, *citing Laird v. Integrated Resources, Inc.*, 897 F.2d 826, 835 (5th Cir. 1990) ("For the purpose of rule 10(b)-5, an investment adviser 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 . . . .") (*citing SEC v. Blavin*, 760 F.2d 706 (6th Cir. 1985); CoL ¶ 12, *citing SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (investment advisers have a duty to deal with their clients in "utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading [their] clients") (quotation omitted).)

Because Stephan's admitted misconduct involved a high degree of scienter, disgorgement and third-tier penalties are appropriate here.

II. Imposing Disgorgement and Substantial Third-Tier Penalties on Stephan Is Not Punitive or Excessive

Contrary to Stephan's position, imposing disgorgement and substantial third-tier penalties on Stephan would not be "excessive and punitive." (Stephan Mem. at 5.) In fact, if the Court does not impose disgorgement against Stephan, Stephan will be allowed to realize and reap ill-gotten gains from his fraudulent conduct in the amount of $123,505.91. (FoF ¶¶ 62-63; CoL ¶ 14, *citing SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1474 (2d Cir. 1996) ("The effective enforcement of the federal securities laws requires that the SEC be able to make violations unprofitable. The deterrent effect of an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illicit profits.") (citations omitted).) Because the purpose of disgorgement is to prevent wrongdoers from profiting from their illegal actions, disgorgement, by definition, is *not* punitive. (CoL ¶ 14, *citing In the Matter of Jay T. Comeaux*, S.E.C. Release No. 3902, 2014 WL 4160054, at *4-5, nn. 32 & 36 (Aug. 21, 2014) (disgorgement is not a "punitive

sanction[ ]," that is, it "is imposed not to punish, but to ensure illegal actions do not yield unwarranted enrichment . . . .") (quotations and citations omitted); *see also SEC v. Contorinis*, 743 F.3d 296, 301 (2d Cir. 2014) ("disgorgement does not serve a punitive function . . . .") (citation omitted).) Instead, disgorgement is meant to ensure that illegal actions do not reap unwarranted enrichment and "has the effect of deterring subsequent fraud." *Contorinis*, 743 F.3d at 301, *quoting SEC v. Cavanagh*, 445 F.3d 105, 117 (2d Cir. 2006).

Similarly, imposition of substantial third-tier penalties against Stephan here would not result in excessive punishment. As discussed in the Division's Post-Hearing Brief, 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, 6), and his acts resulted in substantial harm to others, exposed others to a significant risk of substantial losses, and brought Stephan pecuniary gain. (FoF ¶¶ 60, 62, 70-71; CoL ¶¶ 19-22, *citing In the Matter of Dennis J. Malouf*, ID Rel. No. 766, 2015 WL 1534396, at *41-42 (Apr. 7, 2015) (respondents who willfully violate the federal securities laws should be ordered to pay civil penalties "in any cease-and-desist proceeding . . . after notice and opportunity for hearing where penalties are in the public interest and the person has violated or caused the violation of any provision").)

III. Stephan's Purported Inability to Pay Should Not Allow Him to Retain His Ill-Gotten Gains, Nor Should It Shield Him from Any Imposition of Civil Penalties

Stephan's attempt to shield himself from the imposition of any monetary sanctions because of his purported inability to pay should not preclude monetary sanctions—particularly what he owes in disgorgement. (Stephan Mem. at 4-5.) Indeed, "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." (CoL ¶¶ 16, 29, *citing In the Matter of Edgar R. Page and PageOne Financial Inc.*, ID Rel. No. 822, 2015 WL 3898161, at *12 (June 25, 2015).)

Therefore, at a minimum, the Court should order Stephan to pay the $123,505.91 in Prestige Fund-related profits he received as a result of his fraud. (FoF ¶ 62.) If not, Stephan, the culpable actor, will recognize benefits at the direct expense of the investors he defrauded, and those similarly situated to Stephan in the future will be encouraged to spend ill-gotten gains before a trier of fact has an opportunity to hold them accountable for their misconduct. (CoL ¶¶ 14, 16.)

With respect to civil penalties, even when a respondent demonstrates an inability to pay, the Court has discretion not to waive the penalty, particularly when the misconduct is sufficiently egregious. (CoL ¶¶ 29-30, *citing In the Matter of David Henry Disraeli*, Securities Act Rel. No. 8880, 2007 WL 4481515, at *19, nn. 124-125 (Dec. 21, 2007); *see also In the Matter of Gregory O. Trautman*, Rel. No. 9088A, at 2009 WL 6761741, at *24 (Dec. 15, 2009) ("Even accepting those statements at face value, we find that the egregiousness of [respondent]'s conduct outweighs any discretionary waiver of disgorgement, prejudgment interest, and/or penalties.").) The egregious nature of Stephan's fraud, as discussed in Section I, *supra*, and the fact that he is only 40 years old with the prospect of accumulating the money to pay whatever sanctions are imposed against him in this case, demands a penalty. (CoL ¶ 31, *citing SEC v. Robinson & Cellular Video Car Alarms, Inc.*, 00 Civ. 7452, 2002 WL 1552049, at *8-9 (S.D.N.Y. July 16, 2002) (rejecting defendant's inability to pay argument and ordering defendant to pay disgorgement, prejudgment interest and third-tier civil penalties and finding monetary sanctions appropriate "despite a defendant's inability to pay, [when] that defendant may subsequently acquire the means to satisfy the judgment").)

CONCLUSION

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

Dated: July 31, 2015
New York, New York

Respectfully submitted,

DIVISION OF ENFORCEMENT

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CERTIFICATE OF SERVICE

I hereby certify that I served the foregoing (i) Division of Enforcement's Response to Respondent Timothy S. Dembski's Post-Hearing Memorandum and Division of Enforcement's Response to Respondent Timothy S. Dembski's Proposed Findings of Fact and Conclusions of Law, both dated July 31, 2015, and (ii) Division of Enforcement's Brief in Response to Respondent Scott M. Stephan's Post-Hearing Brief, dated July 31, 2015, by emailing copies of same to ALJ@sec.gov, by faxing copies of same to (202) 772-9324, and by mailing copies of same via UPS Overnight Mail on this 31st day of July 2015 to:

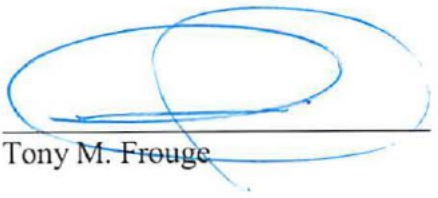
Brent J. Fields
Secretary of the Commission, Office of the Secretary
U.S. Securities and Exchange Commission
100 F Street N.E.
Washington DC 20549

And by email to Respondents:

Timothy S. Dembski through counsel, Paul Batista, Esq., at [redacted]

Scott M. Stephan through counsel, Andrew J. Pace, Esq., at andrew@paceandpace.com

Reliance Financial Advisors, LLC and Walter F. Grenda, J. through counsel, Joseph Makowski, at jmakowski@aol.com



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