UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-16386

In the Matter of

TRACI J. ANDERSON, CPA
TIMOTHY W. CARNAHAN
AND CYIOS CORPORATION,

Respondents.

DIVISION OF ENFORCEMENT'S BRIEF IN RESPONSE TO RESPONDENT TIMOTHY CARNAHAN'S APPEAL OF THE ADMINISTRATIVE LAW JUDGE'S INITIAL DECISION

Dated: March 26, 2021

Respectfully submitted,

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The Division of Enforcement ("Division") respectfully submits this brief in response to Respondent Timothy W. Carnahan's Appeal of the Administrative Law Judge's Initial Decision.

PRELIMINARY STATEMENT

After a hearing in which Carnahan refused to testify or otherwise present any evidence, the Administrative Law Judge ("ALJ") correctly determined that Carnahan caused his company, CYIOS Corporation ("CYIOS"), to fail to assess internal controls over financial reporting ("ICFR") in accordance with the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control – Integrated Framework (the "COSO Framework"). *Traci J. Anderson, et al.*, Rel. no. 1394, 2020 WL 260282 at *10 (Jan. 10, 2010). Because Carnahan had made certifications in CYIOS's public filings that such assessments had occurred, the ALJ found that Carnahan's certifications were materially false. *Id.* at *7. As a result of these false certifications, the ALJ determined that CYIOS violated Section 17(a)(3) of the Securities Act of 1933 ("Securities Act") and that Carnahan caused those violations. *Id.* at *10. Additionally, as a result of the failure to assess CYIOS's ICFR and the related statements assuring investors that such assessments had occurred, Carnahan violated Rules 13a-14 and 13a-15 of the Securities Exchange Act of 1934 ("Exchange Act"). *Id.* Finally, because CYIOS failed to file annual reports in 2012 and 2013 and certain quarterly reports in 2013 and 2014, it violated (and Carnahan caused its violation of) Exchange Act Section 13(a) and Rules 13a-1 and 13a-13. *Anderson*, 2020 WL 260282 at *8. Throughout these violations, the ALJ found that CYIOS and Carnahan acted with a deliberate disregard of these regulatory requirements. *Id.* at *11.

Carnahan has now apparently sold CYIOS and pursues this appeal on his own behalf. (Carnahan's Appeal Brief, February 24, 2021 ("Opening Brief"); *see, also, CYIOS Corp.'s*

Petition for Review (Feb. 3, 2020) and *Order Granting Renewed Motion for Extension of Time*, Rel. No. 33-10933 (March 15, 2021)). On appeal, Carnahan does not specifically contest any of the ALJ's findings listed above, but rather makes conclusory allegations that sections of the Initial Decision were "untrue" and that Division lawyers and ALJs have acted arbitrarily and capriciously in this matter. Reading Carnahan's brief in the light most favorable to him, he appears to make the following claims that are materially inconsistent with the ALJ's Initial Decision:

- Section 15(d) suspended CYIOS's reporting obligation (Opening Brief, ¶3);
- CYIOS's internal controls complied with the ISO 9000:2008 standard and Respondents proved compliance during the investigation (*Id.* at ¶¶5-6, 17);
- The SEC violated Respondent's Due Process rights because of delays in the administrative proceeding and non-compliance with SEC Rule of Practice 900 (*Id.* at ¶¶10, 14-15);
- "[T]he SEC found no fraud and no defects with any 10K filings" (*Id.* at ¶17); and
- This action is barred by the statute of limitations (Opening Brief at ¶18).

As will be explained below, none of these challenges has any basis in the record or in the law. Indeed, aside from pointing to an email that he once sent to Division staff, Carnahan fails to cite a single piece of evidence that could support his challenge to the Initial Decision. Accordingly, the ALJ's Initial Decision was correctly decided and should be affirmed.

PROCEDURAL BACKGROUND

I. Pre-*Lucia* Procedural Background

On February 13, 2015, the Commission instituted this administrative proceeding and directed that it be presided over by an ALJ. On December 21, 2015, Judge Cameron Elliot issued an initial decision finding that: (1) CYIOS violated, and Carnahan caused CYIOS's violations of, Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder; (2) Carnahan violated Exchange Act Rules 13a-14 and 13a-15(c); and (3) CYIOS violated, and Carnahan caused CYIOS's violation of, Section 17(a)(3) of the Securities Act. Judge Elliot entered cease-and-desist orders against Carnahan and CYIOS, ordered CYIOS to disgorge $37,500 in ill-gotten gains, and imposed civil penalties of $375,000 against CYIOS and $75,000 against Carnahan. (Initial Decision Rel. no. 930 (Dec. 21, 2015)). Respondents Carnahan and CYIOS sought Commission review of that decision.[1]

On November 30, 2017, the Commission remanded the matter to Judge Elliot in order for him to conduct a *de novo* reconsideration and reexamination of the record to determine "whether to ratify or revise in any respect all prior actions taken." The parties were allowed to submit new evidence they deemed relevant. On January 12, 2018, Judge Elliot determined, upon reconsideration of the record, to ratify all prior actions and determinations in this proceeding, including the initial decision.

[1] The OIP had also alleged that CYIOS violated, and Carnahan caused CYIOS's violations of, Section 17(a)(2) of the Securities Act and Sarbanes-Oxley Section 105(c)(7)(B). Judge Elliot dismissed the charge under Section 105(c)(7)(B) for impermissible retroactivity and found that the record did not establish a violation of Section 17(a)(2). Judge Elliot also dismissed Traci J. Anderson from this proceeding, an action that was final before the Supreme Court's *Lucia* decision. (Rel. no. 930, pp. 1, 18) The Division no longer pursues its claims under Section 17(a)(2) or 105(c)(7)(B) against CYIOS or Carnahan.

While a supplemental briefing order from Judge Elliot was still pending in this case, the Supreme Court held, in *Lucia v. SEC*, that the SEC's administrative law judges are "Officers of the United States," subject to the Appointments Clause. 138 S. Ct. 2044, 2055 (2018). While *Lucia* was pending, the SEC had issued its order on November 30, 2017 ratifying the prior appointments of its ALJs. In August 2018, following the Supreme Court's decision in *Lucia*, the Commission remanded all pending cases, ordered that they be reassigned, and directed the newly assigned administrative law judges to give each respondent the opportunity for a new hearing. (*See* Rel. no. 6549 (April 24, 2019), p. 4).

II. Post-*Lucia* Procedural Background

As to CYIOS and Carnahan, on September 12, 2018, Chief Administrative Law Judge Brenda Murray then assigned the remaining matters in this case to Judge Carol Fox Foelak, an administrative law judge who had not previously participated in the proceeding. Subsequently, the case was re-assigned to Judge James E. Grimes, who set the matter for rehearing, *de novo*, on July 17, 2019. (Rel. no. 6519 (Mar. 26, 2019)). Judge Grimes heard evidence on July 17, 2019, including testimony of Traci J. Anderson, a former CYIOS employee, and Charles Lundelius, the Division's retained expert witness. The Division also called Carnahan, who asserted his Fifth Amendment privilege against self-incrimination and declined to testify. Representing himself, Carnahan cross-examined Anderson and Lundelius but declined to call witnesses for his own case.

On January 10, 2020, after the parties had filed several post-hearing briefs, Judge Grimes entered the Initial Decision in this case, making the findings described above. As a result of his rulings against Carnahan and CYIOS, taking particular note of the "deceitful nature of the misstatement-related misconduct," Judge Grimes ordered Carnahan to pay a civil monetary

penalty of $100,000 and CYIOS to pay a penalty of $500,000. *Anderson*, 2020 WL 260282 at *12). Additionally, Judge Grimes ordered $37,500 in disgorgement against CYIOS. (*Id.*).

STATEMENT OF FACTS

I. Evidence Developed Prior to the 2019 Rehearing

Under Rule 220(c) of the Commission's Rules of Practice, a respondent must specifically admit or deny each allegation in the OIP. "Any allegation not denied [by a respondent] shall be deemed admitted." COMM. R. PRAC. 220(c). In answering the OIP, Carnahan and CYIOS admitted certain facts, including the following:

- CYIOS ceased making filings required under Section 13(a) of the Exchange Act after it filed its third quarter 2012 Form 10-Q. CYIOS failed to make the following filings: (1) Form 10-K in 2012; (2) Form 10-Q for 2012 Q1-Q3; and (3) Form 10-Q for 2014 Q1. Carnahan authorized each CYIOS filing and was responsible for CYIOS missing the required filings. (OIP ¶¶10-11; Answer §C).

- CYIOS filed Form 15-12G on May 30, 2014 to deregister its stock.

- CYIOS's filings stated that management had assessed its ICFR using the COSO Framework.[2] Carnahan did not, however, assess ICFR using the COSO Framework. Nor did Carnahan assess ICFR using another suitable, recognized internal controls framework.[3] (OIP ¶¶12-19; Answer §D).

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[2] The filings were: CYIOS's Form 10-K for the fiscal years ended December 31, 2009, 2010, and 2011, and its Forms 10-Q for 2010, 2011, and 2012. (Hearing Exs. 3,11,12-21). The statements appear in Item 9A(T) of the Forms 10-K and Item 4-T of the Forms 10-Q.

[3] The Answer states that CYIOS's "CYIPRO program based operating system that Carnahan created was built with ICFR in mind." (Answer §D). It does not say, however, that it employs the COSO Framework or any other suitable, recognized internal controls framework. Nor does it explain how the CYIPRO program was used to assess or document ICFR. Notably, the video on the front page of CYIOS's website (http://cyios.com/; direct video link: https://youtu.be/8aNuW079bZ0) indicates that the CYIPRO program

- Carnahan signed CYIOS's management certifications which stated that the Commission filings did not contain untrue statements of material fact. (OIP ¶¶12-19; Answer §D).

- CYIOS offered securities during the time period in which the misleading Commission filings were made. (OIP ¶¶20; Answer §F).

In addition to Respondents' Answer, the following facts were established through CYIOS's public filings and Carnahan's investigative testimony:

- CYIOS's Forms 10-K for 2009, 2010, and 2011 all include a statement in Item 9(A)(T) that management has evaluated and assessed the effectiveness of ICFR using the COSO Framework and concluded that its ICFR was "effective." (Exs. 3,11,12).[4] Notably, the Forms 10-K for 2010 and 2011 state that this assessment was done as of December 31, 20**07**.[5]

- CYIOS's Forms 10-Q for 2010, 2011, and 2012, which include statements in Item 4T that management has assessed ICFR using the COSO Framework and concluded that it was effective. (Exs. 13-21).

- In investigative testimony, Carnahan stated that he did not document his assessments of ICFR: "I did the internal controls. I am internal controls […] so I don't document myself." (Ex. 2, 72:15-72:19; see also 63:11-64:19; 75:7-16).

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is geared toward project management and makes no mention at all of internal controls or financial reporting.

[4] All references to exhibits refer to exhibits admitted into evidence during the July 17, 2019 hearing before Judge Grimes.

[5] Prior to the rehearing, Carnahan testified that he "would imagine" the reference in the 2011 Form 10-K to 2007 was a typographical error, and would have to look back at all the filings to be sure (although it is unclear how looking at prior filings would help Carnahan answer this question). The existence of the exact same error in both CYIOS's Forms 10-K for 2010 and 2011 strongly suggests that Carnahan merely copied the certificate from year to year. (Exs. 3,12; Ex. 2, 69:6-72:13).

- Carnahan personally entered every CYIOS filing into the EDGAR system. (Ex. 2, 22:15-23:13; 60:6-8).

- Carnahan was personally responsible for all CYIOS accounting policies and procedures; he "ma[d]e all the decisions" on accounting. (Ex. 2, 42:19-25, 45:25-46:2, 82:16-21).

- Carnahan stated that "I am my own quality assurance," that all decisions with the auditors "come back to me," and that he handles and evaluates, but CYIOS does not document, ICFR. (Ex. 2, 63:11-18, 52:14-53:2, 60:12-22, 60:23-61:6, 64:23-65:65:24, 66:8-9, 72:15-19, 74:23-75:22, 76:17-18, 77:2-4, 78:13-16). Carnahan viewed the ICFR certifications as frivolous and a waste of time. (Ex. 2, 67:6-69:4).

- In exchange for $37,500 worth of consulting services and debt conversions, CYIOS issued common stock under a registration statement filed on Form S-8 (No. 333-147695, filed November 29, 2007). (Ex. 12).

II. Evidence Developed at the Rehearing

Carnahan refused to testify at the July 17 hearing, invoking his Fifth Amendment right against self-incrimination. Finding that Carnahan invoked this right strategically to hinder and unfairly prejudice the Division, the ALJ ruled that he would draw an adverse inference from Carnahan's refusal to testify at the hearing, but determined that the record provided sufficient proof of the Respondents' violations without reference to any adverse inference. *Anderson*, 2020 WL 260282 at *3. Nevertheless, Carnahan refused to testify on all topics, including the following:

- His educational background (Hearing Tr. 76:16);

- CYIOS's business as a publicly traded government contractor (*id*., 79:15; 87:19);
- His role as CYIOS's sole officer and director (*id*., 79:21);
- His complete control and creation of the processes used to run CYIOS (*id*., 79 *et seq.*; 86:19);
- The extent of his authority over CYIOS's filings and all of their content, including representations about ICFR (Hearing Tr., 79 *et seq*.; 86:19);
- His responsibility for CYIOS's delinquent filings (*id.,* 84 *et seq.*);
- His personal knowledge about ICFR generally and CYIOS's ICFR in particular (*id.*);
- His personal responsibility for CYIOS's ICFR (*id.,* 85:3);
- CYIOS's lack of evaluation or documentation of ICFR (Hearing Tr., 85:3); and
- His intent to take CYIOS public again, if possible (*id.,* 99:6).

Charles Lundelius, a CPA, forensic accountant, and expert in internal controls and corporate governance, presented his expert report, which reached the following unrebutted and unchallenged conclusions:

- Disclosures indicating whether or not an issuer has implemented effective internal controls are material;
- Disclosures indicating whether or not an issuer has implemented "a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment" are also material;
- Failure of CYIOS to assess ICFR effectiveness using COSO, as stated in its filings, constituted a material misrepresentation;
- Suitable, recognized frameworks for evaluating issuers' internal controls, such as COSO, were publicly circulated and presented for comment from the accounting profession; and
- CYIOS's CYIPRO product was not a suitable, recognized framework for evaluating internal controls.

(Ex. 42[6]). Judge Grimes accepted Lundelius as an expert and considered his expert report as unrebutted. *Anderson*, 2020 WL 260282 at *5-6.

Traci J. Anderson, CYIOS's former independent auditor and later accounting employee, also testified at the hearing, providing the following facts, among others:

- Carnahan was CYIOS's only officer and director. (Hearing Tr. 37:2).
- Carnahan made all of the final decisions about accounting policies and what numbers were ultimately reported. (*Id.,* 39:24-40:8).
- Carnahan personally drafted CYIOS's responses to comment letters from the Commission's Division of Corporation Finance. (*Id.,* 41:4).
- Carnahan was responsible for CYIOS's ICFR. (*Id.,* 46:5).
- Carnahan never conducted formalized risk assessments as part of maintaining internal controls at CYIOS. (Hearing Tr. 47:4).

III. Argument

a. CYIOS Violated, and Carnahan Caused the Violations of, Securities Act Section 17(a)(3).

Judge Grimes correctly determined that Carnahan caused CYIOS to violate Section 17(a)(3) of the Securities Act. *Anderson*, 2020 WL 260282 at *6-8. Section 17(a)(3) makes it unlawful to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon any person in the offer or sale of securities. Repeated misstatements over the course of time can constitute violations of Section 17(a)(3). *See Flannery and Hopkins*, 2014 WL 7145625, Admin. Proc. File No. 3-14081 at 26 (Dec. 15, 2014), *vacated on other grounds*, 810 F.3d 1 (1st Cir. 2015) (noting 17(a)(3) applies where, "as a result of a defendant's negligent conduct, investors receive misleading information about the

[6] In accordance with the Court's directive during the March 18, 2019 pre-hearing conference, the Expert Report of Charles Lundelius served as Lundelius's direct testimony in this case.

nature of an investment or an issuer's financial condition" or where "prospective investors are prevented from learning material information about a securities offering"); *Johnny Clifton*, Securities Act Release No. 9417, 2013 WL 3487076, at *10 (July 12, 2013) (finding a Section 17(a)(3) violation because defendant "conceal[ed] material adverse information" from "sales representatives" and "ensure[d] that sales representatives who learned such information also withheld it from prospective investors"). Scienter is not required to prove a violation under Section 17(a)(3). *SEC v. O'Meally*, 752 F.3d 569, 574 (2nd Cir. 2014) (citing *Aaron v. SEC*, 446 U.S. 680, 696–97 (1980)). A showing of negligence is sufficient. *Id*. (citing *SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 856 (9th Cir. 2001); *Finkel v. Stratton Corp.*, 962 F.2d 169, 175 (2d Cir.1992)).

i. CYIOS's *untrue statements in SEC filings were material.*[7]

CYIOS repeatedly certified that it conducted assessments of its ICFR under a commonly accepted protocol. As the Division's unrebutted expert testimony and the Respondents' admissions show, the untrue statements in CYIOS's public filings were material.[8] Materiality is satisfied if there is a substantial likelihood that an accurate disclosure would have been viewed by a reasonable investor as having "significantly altered the total mix of information made available." *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011); *Flannery and Hopkins*, 2014 WL 7145625 at *20. This means that "a reasonable investor would consider the

[7] Because the Division is not pursuing violations of Exchange Act Section 17(a)(2), the Commission need not determine whether CYIOS obtained money or property. Carnahan's and CYIOS's violations of Securities Act Section 17(a)(3) are independent of CYIOS obtaining money or property in connection with material misstatements. Dkt. 18 at 6-7 (citing *Flannery and Hopkins*, 2014 WL 7145625, at *18.

[8] In addition, Congress recognized the unique importance of these disclosures by specifically mandating them in SOX Section 404, providing further indicia of their materiality.

information important in making a decision to invest." *ABC Arbitrage Plaintiffs Grp. v. Tchuruk*, 291 F.3d 336, 359 (5th Cir. 2002); *Flannery*, 2014 WL 7145625 at *20; *see also SEC v. Seghers*, 298 F. App'x 319, 328 (5th Cir. 2008).

As noted in Charles Lundelius' unrebutted expert testimony, the lack of effective internal controls—as well as the failure to use a recognized framework to evaluate those controls—calls into question both the accuracy of an issuer's public disclosures as a whole as well as the credibility of the issuer and its management. (Ex. 42 at 8; Hearing Tr. pp. 102-129). Thus, this information is material to investors. (*Id.*). This is so because a reasonable investor would find it important that management provided a false assurance that it had assessed a public company's internal controls.

Effective internal controls are important because those controls provide a reasonable assurance of effective operations, reliable financial reporting, and compliance with laws and regulations. (Ex. 42 at 5). Without effective internal controls, the investor is without a critical layer of assurance and cannot be sure that the issuer's public disclosures – including its financial data – are accurate. (*Id*. at p. 6). Thus, representations about internal controls and the effectiveness of those controls are important to a reasonable investor. For the same reasons, representations about the periodic assessment of those controls (typically, using the COSO framework) are important. Those assessments ensure that the controls are, in fact, working effectively. (Ex. 42 at p. 12).

While these representations would be material for any public company, they are particularly important to CYIOS – as the Respondents admit. That is because as a government contractor, it was particularly important for CYIOS to comply with applicable laws and regulations. As CYIOS disclosed in its public filings: "Because we are a federal government

contractor […] failure to comply with applicable laws or regulations could have a *material* adverse effect on our business or reputation." (*See, e.g.*, Ex. 12 at 7-8 (emphasis added); Ex. 13 at 27 (emphasis added)).[9] These applicable laws and regulations include Commission rules and regulations—in particular, the rules and regulations requiring the maintenance and assessment of ICFR and the certification of annual and quarterly reports. (Ex. 42 at p. 10-11). Thus, each time Carnahan and CYIOS certified that ICFR had been assessed in accordance with COSO when, in fact, it had not been assessed at all, they certified an untrue statement of a material fact.

ii. CYIOS's untrue statements were in the offer or sale of securities.

Securities Act Section 2(a)(3) defines "sale" as "every contract of sale or disposition of a security or interest in a security, for value." It defines "offer" as "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." Where, as here, the alleged fraud involves misstatements in public filings on which an investor would presumably rely, the "in the offer or sale" requirement is generally met by proof of the means of dissemination and the materiality of the misrepresentation or omission. *SEC v. Wolfson*, 539 F.3d 1249, 1262 (10th Cir. 2008) (quoting *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1362 (9th Cir. 1993), and citing *Semerenko v. Cendant Corp.*, 223 F.3d 165, 176 (3d Cir. 2000).

As discussed above, the misrepresentations were material. Also, there is no genuine dispute that CYIOS's filings were disseminated through the EDGAR system. Further, CYIOS's shares were offered and sold on the OTC Bulletin Board throughout the relevant period. (Ex. 12

[9] Carnahan had the final say on the public filings, signed them, filed them, and wrote some of these disclosures. (*See, e.g.*, Ex. 12 at 31-32; Ex. 13 at 33; Ex. 2 at 64:1-65:2; Hearing Tr. 79:24-80:11).

at 11 (Item 5); Ex. 26 (NASDAQ report on trading data)). Thus, the "in the offer or sale" requirement is met.

The requirement is also met by CYIOS's multiple offers and sales of stock in exchange for value; in this case, consulting services. As detailed in Note F to CYIOS's 2010 Form 10-K, the value of the stock issued in exchange for consulting services was: $6,000 on March 24, 2010; $18,000 on March 31, 2010; and $13,500 on October 27, 2010. (Ex. 12 at 22 (Note F)). In these transactions, CYIOS offered and then disposed of its stock for services valued at $37,500. Thus, the misstatements in its public filings were made in the offer and sale of securities. Carnahan and CYIOS therefore, acting *at least* negligently, violated Section 17(a)(3) of the Securities Act by conducting a transaction, practice, or course of business that operated as a fraud or deceit on investors. The Commission should therefore confirm the Initial Decision.

b. CYIOS Violated, and Carnahan Caused the Violations of, Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 Thereunder.

Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers with classes of securities registered pursuant to Section 12 of the Exchange Act to file periodic reports with the Commission. *Scienter* is not necessary to establish a violation of Section 13(a) or the regulations thereunder, including Rules 13a-1 and 13a-13 (as well as Rules 13a-14 and 13a-15, discussed below). *SEC v. McNulty,* 137 F.3d 732, 740-41 (2d Cir. 1998). Rules 13a-1 and 13a-13 require, respectively, the filing of accurate annual and quarterly reports (i.e., Forms 10-K and 10-Q). Additionally, Item 308 of Regulation S-K requires an issuer to make certain disclosures with respect to ICFR.

It is undisputed that CYIOS has not made these required filings since the third quarter of 2012. (Order Taking Official Notice, Rel. No. 6622; Hearing Tr. 56:5-57:12; 84:5-17. In

addition, the filings that CYIOS did make are inaccurate. CYIOS inaccurately disclosed in its Forms 10-K for 2010 and 2011 that management assessed the effectiveness of ICFR as of December 31, "2007," and concluded ICFR was effective. CYIOS's Forms 10-K for 2009, 2010, and 2011, and its Forms 10-Q for each quarter of 2010, 2011, and 2012 also inaccurately state that management assessed ICFR in accordance with COSO. Finally, CYIOS's filings included Rule 13a-14 certifications executed by Carnahan that inaccurately stated that the filings did not contain untrue statements of material fact. Anderson testified that Carnahan has final say on the content of CYIOS's filings. (*See*, *e.g.*, Hearing Tr. 39:24-40:8). Even without considering the adverse inference from Carnahan's refusal to testify, Anderson's testimony and the documents themselves establish that Carnahan is solely responsible for CYIOS's filings and for the representations therein, as further evidenced by his certifications. Therefore, Carnahan caused CYIOS's violations of Section 13(a) and Rules 13a-1 and 13a-13. The Commission should affirm the Initial Decision.

c. Carnahan Violated Rule 13a-14 of the Exchange Act.

Rule 13a-14 requires each report filed on Form 10-Q or 10-K under Section 13(a) of the Exchange Act to include certifications signed by each principal executive and principal financial officer of the issuer, or persons performing similar functions. Item 601(b)(31) of Regulation S-K sets forth the precise requirement – that the certifier must confirm that the "report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by [the] report." Carnahan alone signed CYIOS's

certifications for each of the filings, which contained this language.[10] As detailed above, Carnahan controlled every aspect of CYIOS's public filings, accounting procedures, and quality assurance.

CYIOS's Forms 10-K for 2009, 2010, and 2011, and its Forms 10-Q for all quarters of 2010, 2011, and 2012 stated that management had assessed the effectiveness of CYIOS's ICFR using the COSO Framework, and based on those assessments management had concluded that ICFR was effective. (Ex. 3, p.21; Ex. 11, p.38; Ex. 12, p.26; Ex. 13, p.23; Ex. 14, p.11; Ex. 15, p.17; Ex. 16, p.18; Ex. 17, p.12; Ex. 18, p. 16; Ex. 19, p.15; Ex. 20, p.17; Ex. 21, p.16). As detailed above, these statements were false. Consequently, Carnahan's certifications were false, and he violated Rule 13a-14. The Commission should affirm the Initial Decision.

d. Carnahan Violated Rule 13a-15(c) of the Exchange Act.

Rule 13a-15(a) sets forth certain requirements for issuers with a class of securities registered under Section 12 of the Exchange Act that either had been required to file an annual report pursuant to Section to 13(a) or 15(d) of the Exchange Act for the prior fiscal year or had filed an annual report for the prior fiscal year. Rule 13a-15(c) states that management must evaluate, with the participation of the principal executive and principal financial officers (or persons performing similar functions – notably, Carnahan alone served in these roles) the effectiveness of the issuer's ICFR as of the end of each fiscal year. Rule 13a-15(c) states there are many different ways to conduct an evaluation of ICFR, and that an issuer can comply with this requirement by conducting an evaluation in accordance with the COSO Framework. If the

[10] *See* Exhibit 31.1 to each of the filings.

COSO Framework is not used, Rule 13a-15(c) still requires management to use another suitable, recognized control framework.

As detailed above, and based on Charles Lundelius's expert report and testimony, Carnahan did not use the COSO Framework or any other suitable, recognized control framework to evaluate ICFR. As a result, he violated Rule 13a-15(c). The Commission should affirm the Initial Decision.

e. Carnahan's arguments on appeal are without merit

On appeal to the Commission, Carnahan raises several challenges to Judge Grimes's Initial Decision. For the reasons explained below, none of Carnahan's objections survive scrutiny.

i. CYIOS's reporting obligation was not suspended during the relevant time

Carnahan argues that Respondents had filed notices with the SEC sufficient to trigger an automatic suspension of CYIOS's reporting obligation. (Opening Brief, ¶3). If true, this would be relevant to Respondents' violations of Section 13(a) of the Exchange Act and the regulations thereunder, including Rules 13a-1, 13a-13, 13a-14, and 13a-15. Although Carnahan did file a Form 15-12G on May 30, 2014 to deregister CYIOS's stock, such action did not mitigate his or the company's liability for failing to make filings between 2012 and 2014.

> [T]he duty under section 15(d) to file reports required by section 13(a) of the Act with respect to a class of securities specified in paragraph (b) of this section shall be suspended for such class of securities immediately upon filing with the Commission a certification on Form 15 (17 CFR 249.323) *if the issuer of such class has filed all reports required by section 13(a), without regard to Rule 12b-25 (17 CFR 249.322), for the shorter of its most recent three fiscal years and the portion of the current year preceding the date of filing Form 15, or the period since the issuer became subject to such reporting obligation*. If the certification on Form 15 is subsequently withdrawn or denied, the issuer shall, within 60 days, file with the

> Commission all reports which would have been required if such certification had not been filed.

17 C.F.R. § 240.12h-3(a) (emphasis added). Even in light of CYIOS's Form 15 filing, Judge Grimes correctly concluded that Carnahan caused CYIOS's violations of Section 13(a) of the Exchange Act. *Anderson*, 2020 WL 260282 at *8. The Commission should reject this challenge and affirm the Initial Decision.

ii. CYIOS's internal controls did not comply with the COSO framework

Carnahan argues that Respondents had proven CYIOS's software was "ISO 9000:2008 compliant" during the investigation. (Opening Brief at ¶¶5-6, 17). In support of this claim, Carnahan points to an August 2014 email that he sent to SEC staff, including an attachment that purports to describe the CYIPRO software. (*Id.*). At the threshold, this argument fails because it is irrelevant. It is undisputed that ISO 9000 is not an internal control framework compliant with the COSO standards. (Lundelius Report, Ex. 42 at ¶33). Moreover, Carnahan declined to present this evidence at the July 2019 hearing before Judge Grimes. *Anderson*, 2020 WL 260282. Even if compliance with ISO 9000 were the relevant standard here, no evidence supports Carnahan's claim that the company's internal controls were even assessed using CYIPRO. *Id.* at *5. The admitted, undisputed evidence shows that if the ICFR assessments were done at all, they were not done using the COSO Framework, despite the claims in CYIOS's public filings, which Carnahan signed and certified. Thus, the Commission should reject Carnahan's arguments that CYIOS's internal controls complied with any relevant standard.

iii. The SEC Did Not Violate Carnahan's Due Process Rights

Carnahan argues that the SEC violated his Due Process rights because of delays in the administrative proceeding and non-compliance with SEC Rule of Practice 900. (Opening Brief

at ¶¶10, 14-15). Without specificity, he points to *Flynn v. SEC*, 877 F.3d 200 (4th Cir. 2017), for the notion that "the SEC has historically used this Rule 900 in violation of due process rights of other cases." In that case, however, the Fourth Circuit Court of Appeals concluded that:

> We find that a disinterested observer could not reasonably conclude the Commission violated Rule 900(a). In particular, the plain language of Rule 900(a) shows that the relevant aspects of the provision are aspirational and discretionary, such that a failure to strictly adhere to them could not reasonably be seen as a "violation."

Flynn, 877 F.3d at 206. Rather than violate a party's Due Process rights, "Rule 900(a) encourages fairness by ensuring the SEC's deliberative process is not constrained by an inflexible schedule." *Id.* (internal quotes omitted). Moreover, "[t]he deadlines in Rule 900 confer no substantive rights on the parties." (SEC Rule of Practice 900(a)(1)(iii)).

In any event, this administrative proceeding has provided Carnahan and CYIOS appropriate Due Process. Respondents have had two opportunities to present evidence to two different ALJs. Carnahan declined to testify or present evidence to Judge Grimes. Carnahan cannot now claim that his Due Process rights were violated.

iv. CYIOS's Filings Were Defective as Alleged

Without support or further explanation, Carnahan claims that "[t]he SEC found no fraud and no defects with any 10K filings." (Opening Brief at ¶17). Calling this statement "the Smoking Gun," Carnahan concludes that Respondents' Due Process rights were violated. (*Id.*). While counsel for the Division of Enforcement does not understand what Carnahan intends to convey with these statements, the record evidence is clear and undisputed on the issue of misleading and missing filings. CYIOS, controlled by Carnahan, falsely claimed, in several filings with the SEC (including Forms 10-K), that it assessed its internal controls using the

COSO framework. Additionally, CYIOS, controlled by Carnahan, failed to make certain required filings with the SEC. The Commission should affirm the Initial Decision.

v. *This Action Is Not Barred by the Statute of Limitations.*

Carnahan argues that because he and CYIOS started using their software in 2005 and this administrative proceeding only began in February 2015, this action failed to comply with the statute of limitations. (Opening Brief at ¶18). Both ALJs rejected Carnahan's limitations arguments on multiple occasions. *See, e.g.*, Rel. No. 6223 at 3 (October 18, 2018), Rel. No. 6293 at 2 (November 5, 2018), Rel. No. 6549 at 9 (Apr. 24, 2019), Rel. No. 6613 at 3 (June 24, 2019), Rel. No. 6620 at 2 (July 2, 2019), and Rel. No. 6626 at 2 (July 11, 2019). The Commission should likewise reject Carnahan's limitations contention. As the ALJs previously explained, this proceeding does not run afoul of the five-year statute of limitations. This matter was instituted on February 13, 2015, has been pending continuously since then, and all of the allegations in the OIP relate to conduct that occurred within five years of the filing date. *See, e.g., OIP* (Feb. 13, 2015). The earliest alleged conduct occurred on February 26, 2010, when CYIOS filed its 2009 Form 10-K. (Ex. 11). As he has in the past, Carnahan fails to provide any reason for the Commission to reconsider the prior rulings of the ALJs who have considered this matter. The Commission should affirm the Initial Decision.

f. Remedies

Judge Grimes entered a cease-and-desist order against Carnahan and imposed second-tier penalties against him in the total amount of $100,000. The Commission should affirm the Initial Decision. When considering whether an administrative sanction serves the public interest, the Commission considers the factors identified in *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981): the egregiousness of the respondent's actions,

the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the likelihood that the respondent's occupation will present opportunities for future violations (*Steadman* factors). *See Altman v. SEC*, 666 F.3d 1322, 1329 (D.C. Cir. 2011); *Gary M. Kornman*, Exchange Act Release No. 59403, 2009 SEC LEXIS 367, at *22 (Feb. 13, 2009), *pet. denied*, 592 F.3d 173 (D.C. Cir. 2010). Other factors the Commission has considered include the age of the violation (*Marshall E. Melton*, 56 S.E.C. 695, 698 (2003)), the degree of harm to investors and the marketplace resulting from the violation (*id.*), the extent to which the sanction will have a deterrent effect (*see Schield Mgmt. Co.*, 58 S.E.C. 1197, 1217-18 & n.46 (2006)), whether there is a reasonable likelihood of violations in the future (*KPMG Peat Marwick LLP*, 54 S.E.C. 1135, 1185 (2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002)), and the combination of sanctions against the respondent (*id.* at 1192). *See also WHX Corp. v. SEC*, 362 F.3d 854, 859-61 (D.C. Cir. 2004). The Commission weighs these factors in light of the entire record, and no one factor is dispositive. *KPMG Peat Marwick LLP*, 54 S.E.C. at 1192; *see Gary M. Kornman*, 2009 SEC LEXIS 367, at *22.

In this case, as the ALJs concluded, Carnahan and CYIOS committed their violations, and Carnahan caused CYIOS's violations, repeatedly and over the course of years. Their Securities Act violations involved an antifraud provision, and were particularly egregious in light of Carnahan not even bothering to change the dates in CYIOS's ICFR statements. Their reporting violations were also serious. *See China-Biotics, Inc.*, Exchange Act Release No. 70800, 2013 WL 5883342, at *10 (Nov. 4, 2013) (characterizing the failure to file any periodic reports in a year and a half as "serious"). Further, Respondents committed their violations deliberately, and Carnahan has offered no credible assurances against future violations and has

not recognized the wrongful nature of his conduct. A heavy sanction will have both a general and a specific deterrent effect, and even the combination of multiple heavy sanctions would not be unfairly prejudicial to Carnahan. Most importantly, there is a reasonable likelihood of future violations. Indeed, in view of Carnahan's alarming indifference to his legal obligations as the controlling officer of a publicly traded company, they are highly likely if Carnahan ever becomes involved with an entity with registered securities again. Every public interest factor weighs in favor of imposing significant sanctions against Carnahan. The Commission should affirm the sanctions imposed by the Initial Decision.

i. Cease-and-Desist Order

Exchange Act Section 21C and Securities Act Section 8A authorize the Commission to impose cease-and-desist orders for violations of those acts. See 15 U.S.C. §§ 77h-1(a), 78u-3(a). The Commission requires some likelihood of a future violation before imposing such an order. *KPMG Peat Marwick LLP*, 54 S.E.C. at 1185. However, "a finding of [a past] violation raises a sufficient risk of future violation," because "evidence showing that a respondent violated the law once probably also shows a risk of repetition that merits our ordering him to cease-and-desist." *Id*.

As discussed above, the *Steadman* factors weigh in favor of cease-and-desist orders against Carnahan. Two of those factors – the recurrence of the violations and Carnahan's total lack of recognition of the wrongfulness of his and CYIOS's conduct – are particularly significant. The incremental prejudice to Carnahan arising from cease-and-desist orders, compared to other potential sanctions, is minimal. The cease-and-desist order imposed by the Initial Decision against Carnahan should therefore be affirmed.

ii. Civil Penalties

Judge Grimes imposed a second-tier penalty in the amount of $100,000 against Carnahan. The Commission should impose penalties in at least that amount. Under Exchange Act Section 21B(a)(2) and Section 8A(g)(1) of the Securities Act, the Commission may impose a civil money penalty if a respondent violated, or caused any violation of, any provision of these statutes, and if such penalty is in the public interest. 15 U.S.C. §§ 77h-1(g)(1), 78u-2(a)(2). A three-tier system establishes the maximum civil money penalty that may be imposed for each violation found. 15 U.S.C. §§ 77h-1(g)(2), 78u-2(b). Where a respondent's misconduct involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, the Commission may impose a "second-tier" penalty of up to $75,000 for each act or omission by an individual, and $375,000 for any other person (or entity), for violations occurring between March 4, 2009 and March 5, 2013.[11] 15 U.S.C. §§ 77h-1(g)(2)(B), 78u-2(b)(2); 17 C.F.R. § 201.1004, Subpt. E, Table 4. Where a respondent's misconduct further directly or indirectly resulted in substantial pecuniary gain to the respondent or substantial losses to other persons—or created a significant risk of substantial losses to other persons—the Commission may impose a "third-tier" penalty of up to $150,000 for each act or omission by an individual or $725,000 for any other person.[12] 15 U.S.C. §§ 77h-1(g)(2)(C), 78u-2(b)(3); 17 C.F.R. § 201.1004, Subpt. E, Table 4.

Judge Grimes's imposition of significant civil penalties against Carnahan is appropriate in light of his ongoing conduct and multiple violations of the securities laws. Carnahan earned a

[11] Those amounts were adjusted to $80,000 and $400,000, respectively, for the violations occurring between March 6, 2013 and November 2, 2015.

[12] Those amounts were adjusted to $160,000 and $775,000, respectively, for the violations occurring between March 6, 2013 and November 2, 2015.

substantial income from CYIOS in 2010 and 2011, when CYIOS was disseminating false information about its ICFR evaluations. *See, e.g.,* Ex 3 at p. 22. In determining whether a civil penalty is in the public interest, six factors are considered: (1) whether the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, (2) the resulting harm to other persons, (3) any unjust enrichment and prior restitution, (4) the respondent's prior regulatory record, (5) the need to deter the respondent and other persons, and (6) such other matters as justice may require. 15 U.S.C. § 78u-2(c). Within any particular tier, the Commission has discretion to set the amount of the penalty. *See Brendan E. Murray*, Investment Advisers Act of 1940 Release No. 2809, 2008 SEC LEXIS 2924, at *42 (Nov. 21, 2008); *The Rockies Fund, Inc.*, Exchange Act Release No. 54892, 2006 SEC LEXIS 2846, at *25 (Dec. 7, 2006). "[E]ach case has its own particular facts and circumstances which determine the appropriate penalty to be imposed" within the tier. *SEC v. Murray*, No. OS-CV-4643, 2013 WL 839840, at *3 (E.D.N.Y. Mar. 6, 2013) (internal quotation marks and citations omitted); *see also SEC v. Kern*, 425 F.3d 143, 153 (2d Cir. 2005). The securities laws do not describe how to determine the number of violations that occurred for the purposes of calculating a penalty multiplier. *See Anthony Fields, CPA,* Securities Act Release No. 9727, 2015 SEC LEXIS 662, at *105 (Feb. 20, 2015) (noting that penalties may be imposed for violative acts or omissions, but the statutory text left "the precise unit of violation undefined").

In this case, as the Initial Decision concluded, Carnahan acted deceitfully and with deliberate disregard of a regulatory requirement, he has made no prior restitution, and there is a strong need for both specific and general deterrence. Before the ALJ, the Division requested third-tier penalties, arguing that the nature of Carnahan's offenses – undermining the truth and accuracy of information provided to the public – created a "significant risk of substantial losses."

Judge Grimes found that the trading volume in CYIOS stock did not suggest a significant risk of substantial loss. Nevertheless, Judge Grimes found that Carnahan's deceitful conduct merited civil penalties in the second tier. The Commission should affirm penalties in at least the amount ordered by Judge Grimes.

IV. Conclusion

Because of Carnahan's repeated violations of the federal securities laws, the Commission should affirm the Initial Decision and impose a cease-and-desist order and civil penalties against him.

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Respectfully submitted,

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Pursuant to Rule 150 of the Commission's Rules of Practice, I hereby certify that a true and correct copy of the *Division of Enforcement's Brief in Response to Respondent Timothy Carnahan's Appeal of the Administrative Law Judge's Initial Decision* was served on the following on March 26, 2021, via email and/or UPS, Overnight Mail:

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