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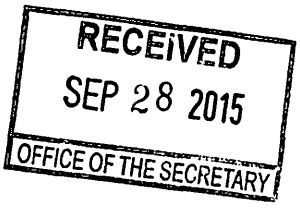

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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 POST-HEARING BRIEF**

Dated: September 25, 2015.

Respectfully submitted,

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I. Background

The issues outstanding in this matter are limited. The OIP alleges that CYIOS Corporation's ("Cyios") management—that is, Timothy W. Carnahan ("Carnahan")—failed to assess internal control over financial reporting ("ICFR") in accordance with the COSO Framework. Therefore, Carnahan's certifications in CYIOS' public filings that such assessments had occurred were materially false. As a result of these false certifications, CYIOS violated Sections 17(a)(2) and 17(a)(3) of the Securities Act and Carnahan caused those violations.[1] In addition, the OIP alleges that Traci J. Anderson, CPA ("Anderson"), worked at CYIOS in an accounting or financial management capacity after having been barred by the Public Company Accounting Oversight Board ("PCAOB") from being associated with a registered public accounting firm. The OIP alleges that this violated Sarbanes-Oxley Section 105(c)(7)(B) and that Carnahan, who made the decision to retain Anderson in that role, caused CYIOS to violate that same provision.

On June 9, 2015, the Court entered its Order on Motions for Summary Disposition. Dkt. 18 (Rel. No. 2786). In that Order, the Court found that: (i) Anderson violated Sarbanes-Oxley Section 105(c)(7)(B) and received ill-gotten gains totaling $244,835.48; (ii) CYIOS violated, and Carnahan caused, CYIOS' violations of Exchange Act Section 13(a) and Rules 13a-1 and 13a-13, and CYIOS and Carnahan acted in deliberate disregard of these regulatory requirements; (iii) Carnahan violated Exchange Act Rules 13a-14 and 13a-15 and acted in deliberate disregard of these regulatory requirements; and (iv) CYIOS made, and Carnahan caused CYIOS to make, repeated untrue statements in interstate commerce. *Id.* at 8.

The Court explained that the hearing would address the following issues:

[1] The OIP further alleged that, as a result of the failure to assess ICFR and the related statements assuring investors such an assessment had occurred, Carnahan violated Rules 13a-14 and 13a-15 of the Exchange Act. As noted below, the Court has already found that such violations occurred.

- with respect to the Division's Securities Act Section 17(a) claims, whether CYIOS' untrue statements in periodic Commission filings were material, in the offer or sale of securities, and whether CYIOS obtained money or property as a result of those misstatements;
- the proper measure of disgorgement for any Section 17(a) violations;
- whether Carnahan knew or should have known of the PCAOB Order, and therefore whether CYIOS violated, and Carnahan caused CYIOS' violation of, Sarbanes Oxley ("SOX") Section 105(c)(7)(B); and
- for purposes of determining the appropriate remedy for her violation, Anderson's state of mind (specifically, whether she deliberately or recklessly disregarded a regulatory requirement, subjecting her to enhanced civil penalties).

The evidence in the record shows that the Division has met its evidentiary burden on each of these issues.

II. Evidence and Argument

a. Cyios is liable for violating Securities Act Section 17(a).

i. CYIOS' untrue statements in SEC filings were material.

As the Division's unrebutted expert testimony and the Respondents' admissions show, the untrue statements in CYIOS' SEC filings were material.[2] 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." Dkt. 18 at 7 (citing *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011)); *In the Matter of John P. Flannery*, 2014 WL 7145625 at *20 (December 25, 2014). This means that "a reasonable

[2] In addition, Congress recognized the unique importance of these disclosures by specifically mandating them in SOX Section 404—which further demonstrates materiality.

investor would consider the 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.

As noted in Charles Lundelius' expert report, 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. 24 at 11. Thus, this information is material to investors. *Id.*

An analysis of why that is so demonstrates that a reasonable investor would find it important that management provided a false assurance that management had assessed 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. 24 at 9. 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. Tr. at 211:3-17. 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—since it is those assessments that ensure that the controls are in fact working effectively. Ex. 24 at 10-11.[3]

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[3] Notably, it is not relevant whether or not the lack of an assessment of internal controls actually results in misstated financial statements. Because it is not an issue in this case, there is little or no evidence regarding whether CYIOS's financial statements were themselves accurate or inaccurate (aside from the fact that CYIOS had to file amended financial statements on multiple occasions—as shown in CYIOS' public filings, which the Court has judicially noticed). The critical issue here is the absence of any internal controls to help assure such accuracy, the failure of management to assess such controls, and management's false assurance to investors that such an assessment had been conducted. Consider the analogy to a car buyer. A reasonable car buyer would consider it important that standard safety measures—e.g., seatbelts—are in place, have been tested, and are operating effectively. That is true even though those safety measures provide only reasonable, rather than absolute, assurance against injury or death in case of accident. And it is true even though there are other safety measures in place, such as airbags. If a car salesman says a car has seatbelts, a reasonable buyer would want to know that the seatbelts are in

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; Ex. 13 at 27.[4] This includes 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. 24 at 7, 10-11; Tr. at 177:25-178:2; Tr. at 203:7-12. 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. The same material, untrue statements formed the basis of the Court's liability finding under Exchange Act Rule 13a-14 Dkt. 18 at 6. Moreover, as Carnahan admits, the violations here have in fact had a material effect on CYIOS—which, in his words, "lost a ton of business" due to the Division's investigation, which was initiated due to these violations. Tr. at 198:9-14. As a result, even he admitted "the shareholders have been harmed." *Id.*

Thus, the evidence conclusively shows that these representations were material.

ii. CYIOS' 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

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fact nonexistent, ineffective, or untested—even if the car has working airbags. Likewise, a reasonable investor would want to know that a public company's purported internal controls are non-existent or ineffective, even though an independent accountant audits the company's financial statements.

[4] 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; Tr. at 64:1-65:2, 151:25-154:16.

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 Commission 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. Dkt. 18 at 7 (citing cases).

As discussed above, it is already established that the misrepresentations were material. The Court has already found that CYIOS' filings were disseminated through the EDGAR system.[5] And it is now established that CYIOS's shares were offered and sold on the OTC Bulletin Board throughout the relevant period. Ex. 12 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' multiple offers and sales of stock in exchange for consulting services. As detailed in Note F to CYIOS' 2010 Form 10-K, the value of the stock issued in exchange for consulting services was: $6,000 on 3/24/10; $18,000 on 3/31/10; and $13,500 on 10/27/10. 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 in the offer and sale of securities.

Therefore, it has been conclusively shown that the misstatements were in the offer and sale of securities.

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[5] "There is no genuine dispute that [. . .] the filings were transmitted to the Commission electronically using the internet, and that the misstatements appeared in periodic Commission filings." Dkt. 18 at 7. Carnahan admits to making all of CYIOS' Commission filings, which the Court has taken official notice of. Tr. at 151:25-152:17.

iii. CYIOS obtained money or property by means of its untrue statements.[6]

CYIOS obtained money or property as a result of the misstatements. Securities Act Section 17(a)(2) requires that the respondent "directly or indirectly [. . .] obtain money or property." This requirement, which allows for even the indirect procurement of money or property, should be construed broadly—and not elevate form over substance. *See generally SEC v. Syron*, 934 F. Supp. 2d 609, 639-40 (S.D.N.Y. 2013) (although not involving provision of services, the court reasoned that Section 17(a)(2) "clearly creates liability where a defendant 'indirectly' obtains money or property"). In the context of interpreting the mail fraud statute (18 U.S.C. § 1341), which prohibits "obtaining money or property by means of false or fraudulent pretenses, representations, or promises," the Eleventh Circuit upheld the conviction of a defendant who obtained services in addition to property from those defrauded. *United States v. Cross*, 928 F.2d 1030, 1043-46 (11th Cir. 1991); *see also SEC v. Stoker*, 865 F. Supp. 2d 457, 463 n.7 (S.D.N.Y. 2012) (stating that Section 17(a) is modeled on the federal mail fraud statute).

As CYIOS' own financial statements show, it obtained money and property in the stock-for-services transactions. The prepaid consulting services were booked as an asset. Ex. 12 at 17 (Balance Sheet reflecting "prepaid and other current assets); Ex. 13 at 5 (same), 16 (Note J, describing prepaids to include the prepaid consulting services). CYIOS' paid-in capital increased as a result of the transactions. Ex. 12 at 18 (Statement of Shareholders' Deficit); Ex. 13 at 7 (Statement of Shareholders' Equity), 12 (table showing capital transactions); Tr. at 77:6-15. And the transactions increased CYIOS' cash flows. Ex. 12 at 18-19 (Statement of Cash Flows); Ex. 13 at 8 (same); Tr. at 75:24-76:6 ("it's a noncash transaction, but, you know, it's

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[6] This requirement only applies to Securities Act Section 17(a)(2). Even if CYIOS did not obtain money or property, Carnahan and CYIOS still violated Securities Act Section 17(a)(3) by virtue of the repeated material misstatements. Dkt. 18 at 6-7 (citing *John P. Flannery*, Securities Act Rel. No. 9689, 2014 WL 7145625, at *18 (Dec. 15, 2014)).

being used as cash. In lieu of cash, this company was receiving stock").[7] Thus, CYIOS received—at a minimum indirectly—money or property in these transactions.

iv. CYIOS should disgorge the $37,500 it obtained by means of its untrue statements.

CYIOS should be ordered to disgorge $37,500, the value it received in exchange for the consulting services. The Court has broad discretion "not only in determining whether or not to order disgorgement but also in calculating the amount to be disgorged." *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1475 (2d Cir. 1996), cert. denied, 522 U.S. 812 (1997). The amount to be disgorged "need only be a reasonable approximation of profits causally connected to the violation," and "the risk of uncertainty" in computing disgorgement "should fall on the wrongdoer whose illegal conduct created that uncertainty." *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989); see also *SEC v. First Pacific Bancorp*, 142 F.3d 1186, 1192 n.6 (9th Cir. 1998), cert. denied, 525 U.S. 1121 (1999); *SEC v. MacDonald*, 699 F.2d 47, 55 (1st Cir. 1983); *Elkind v. Ligget & Myers, Inc.*, 635 F.2d 156, 172 (2d Cir. 1980). Once the Division presents evidence reasonably approximating the amount of ill-gotten gains, the burden of proof shifts to the respondents. *First City*, 890 F.2d at 1232; *SEC v. Hughes Capital Corp.*, 917 F. Supp. 1080, 1085 (D.N.J. 1996), aff'd, 124 F.3d 449 (3d Cir. 1997). The respondent is then "obliged clearly to demonstrate that the disgorgement figure [is] not a reasonable approximation." *First City*, 890 F.2d at 1232; see also *SEC v. Benson*, 657 F. Supp. 1122, 1133 (S.D.N.Y. 1987).

As previously detailed, CYIOS received $37,500 in value from the stock-for-services transactions. These transactions took place when CYIOS' materially misleading periodic reports were publicly available. Tr. at 84:21-86:2. Through these transactions, the consultants became

[7] Carnahan testified that he reviewed and Edgarized the CYIOS financial reports referenced in these paragraphs, and that he would not have filed them if they were incorrect. Tr. at 154:13-155:10. Anderson also corroborated the accounting for these transactions. Tr. at 72:2-73:1; 75:24-76:6; 77:6-15.

CYIOS investors/shareholders. Tr. at 77:16-78:5. As prospective investors, the consultants would have presumably relied on CYIOS' materially misleading public Commission filings. Dkt. 18 at 7. Moreover, for the same reasons that the misstatements are material, it is reasonable to conclude that CYIOS would not have been able to obtain the $37,500 without it's material misrepresentations regarding its assessment of internal controls. At a minimum, the evidence demonstrates that the $37,500 was causally related to the misconduct. The Respondents have offered no evidence rebutting the Division's evidence—much less evidence "clearly demonstrat[ing] that the disgorgement figure is not a reasonable approximation." As a result, CYIOS should be ordered to disgorge $37,500.

b. SOX Section 105(c)(7)(B) Claims

i. Carnahan knew about the PCAOB Order, and thus caused CYIOS' violation of SOX Section 105(c)(7)(B).

It is now undisputed that Carnahan knew about the PCAOB Order, and thus caused CYIOS' violation of SOX Section 105(c)(7)(B). As the Court noted in its June 9 Order, this was the sole remaining issue on these claims: "Because it is genuinely disputed whether Carnahan knew or should have known of the Order, it is genuinely disputed whether Carnahan knew or should have known that his retention of Anderson would contribute to any violation by CYIOS." Dkt. 18 at 5.

Carnahan admitted throughout the hearing that he knew about the PCAOB Order.[8] *See, e.g.*, Tr. at 175:1-176:5. However, in his view, the PCAOB Order simply did not apply to him.[9]

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[8] Anderson also testified that she told Carnahan about the PCAOB Order and directed him to the PCAOB website, where it was available. Tr. at 88:18-89:21.

[9] It is also worth noting that this belief, even if it is credited, constituted a reckless disregard of a regulatory requirement—given that Carnahan, the CEO of a publicly-traded company, took no steps whatsoever to explore the significance of the fact that the PCAOB had made findings against the person acting, in essence, as the company's CFO. Those findings were sufficiently serious to bar Anderson from being associated with a public accounting firm.

Id. Because Carnahan knew about the PCAOB Order, CYIOS violated—and Carnahan caused CYIOS' violation of—SOX Section105(c)(7)(B). Dkt. 18 at 5.

Through his actions Carnahan deliberately or recklessly disregarded a regulatory requirement, subjecting both him and CYIOS to second-tier civil penalties. *Id.* at 4-5. Further, his actions created a risk of substantial loss to CYIOS' shareholders—and in fact, according to his own testimony, actually caused CYIOS to "los[e] a ton of business." Tr. at 198:9-14. Thus, Carnahan and CYIOS are subject to third-tier penalties.

ii. Anderson acted in reckless disregard of a regulatory requirement.

The evidence shows that Anderson acted in reckless disregard of a regulatory requirement—part of a continuing pattern of recklessness. This pattern began with her deficient public-company audits, which led to the PCAOB Order. The PCAOB Order states that Anderson was barred due to "numerous and repeated violations of PCAOB rules and auditing standards." Ex. 5 at 3.

Even after she was barred by the PCAOB, Anderson continued to work for CYIOS in violation of SOX Section 105(c)(7)(B). She claims that this was an innocent mistake based on a misunderstanding of the statute. Her purported interpretation of the statute is, however, "plainly incorrect." Dkt. 18 at 4; see also, Tr. at 215:23-24 (Lundelius describing the statue as "so clear and so basic on its face").[10] In short, the interpretation posited by Anderson is an extreme departure from the plain language of the statute—and goes far beyond even being merely unreasonable. She therefore acted in reckless disregard of a regulatory requirement.

Indeed, despite the Court's summary disposition order to the contrary, Carnahan made it clear through his testimony and arguments at the hearing that he would take the same actions even today. *See, e.g.*, Tr. at 178:3-13.

[10] It is notable that Lundelius holds this view as someone who was on the NASDAQ Listing Qualifications Panel for roughly seven years. Ex. 24 at 3. This punctuates how reckless Anderson's purported interpretation is. Simply put, it is a radical departure from any reasonable interpretation.

But this did not end her pattern or recklessness. After forfeiting her North Carolina CPA license, Anderson continued to hold herself out as a CPA to the IRS in order to obtain a Preparer Tax Identification Number ("PTIN"). *See generally*, Ex. 25. She then used that PTIN to illegally provide tax services to clients from North Carolina. *Id.* As a result, in April 2014, she agreed to cease and desist from further violations of North Carolina law. *Id.* She did not disclose this to the Division's investigative staff when she was asked only two months later about her disciplinary history. Ex. 28 at 7. Anderson claims that the North Carolina cease-and-desist order was the result of her failure look carefully at the IRS form when renewing her PTIN, which still had her listed as a North Carolina CPA. Tr. at 134:12-135:24. She says that the failure to disclose this disciplinary history during the Division's investigation was an "oversight." Tr. at 107:21-23. Even if this is the case, it indicates recklessness—a pattern of failing to act carefully, even after her prior regulatory issues.

Because she acted in reckless disregard of a regulatory requirement, Anderson is subject to second-tier civil penalties.[11]

Dated: September 25, 2015.

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COUNSEL FOR DIVISION OF ENFORCEMENT

[11] The Division has already briefed and the Court addressed the proper remedies that the Division believes should apply to Anderson. The Division thus limits its discussion here to the limited issues that Court stated in its summary disposition order warranted further evidence and discussion.

SERVICE LIST

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 Post-Hearing Brief List was served on the following on September 25, 2015 via electronic mail and/or United Parcel Service, Overnight Mail:

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