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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-16386

In the Matter of

TIMOTHY W. CARNAHAN AND CYIOS CORPORATION,

Respondents.

DIVISION OF ENFORCEMENT'S BRIEF IN OPPOSITION TO PETITION FOR REVIEW

The Commission should affirm Judge Cameron Elliot's December 21, 2015 Initial Decision (I.D. Rel. No. 930). That decision correctly found that Respondents Timothy Carnahan and CYIOS Corporation violated Securities Act Section 17(a) (3) and Exchange Act Section 13(a) and Rules 13a-1, 13a-13, 13a-14, and 13a-15. The Respondents' appeal is based on a false premise. They argue that because they were found—based on a legal technicality—not to have violated SOX Section 105, they therefore also did not commit the other violations for which they were found liable.[1] However, these other violations are distinct legally and factually from the SOX Section 105 charges. Virtually all of the Division's evidence showing the Respondents' culpability on these other charges remains undisputed to this day. Therefore, Judge Elliot's finding of liability on these other charges was appropriate. It should be affirmed.

[1] Former Respondent Traci Anderson, who was CYIOS' CFO, was charged with violating SOX Section 105. That was the only charge against her. CYIOS was also charged with directly violating this provision. Carnahan was charged with causing that violation. As detailed below, Judge Elliot held SOX Section 105—which was amended by the Dodd Frank Act—to be impermissibly retroactive as applied in this case. The Division did not appeal that holding.

I. PROCEDURAL HISTORY

These proceedings were instituted on February 13, 2015. *See Securities Act Rel. No. 9725.* The Respondents were charged with three categories of illegal conduct:

(1) allowing CYIOS' former CFO to remain associated with CYIOS in an accountancy or financial management capacity after she had been barred by the PCAOB from associating with a registered public accounting firm, in violation of SOX Section 105;

(2) failing to file annual and quarterly reports, in violation of Exchange Act Section 13(a) and Rules 13a-1 and 13a-13; and

(3) failing to assess CYIOS' internal controls over financial reporting ("ICFR") and then making false public statements about those assessments, in violation of Securities Act Section 17(a)(2)-(3) and Exchange Act Rules 13a-14 and 13a-15.

On June 9, 2015, Judge Elliot granted full or partial summary disposition in the Division's favor on each claim. *See A.P. Rulings Rel. No. 2786.* The Court left the following issues for a hearing: (i) whether Carnahan knew or should have known of the PCAOB Order and therefore whether CYIOS violated, and Carnahan caused CYIOS' violation of, SOX Section 105; (ii) with respect to the 17(a) claims, whether CYIOS' public misstatements were material, in the offer or sale of securities, and whether CYIOS obtained money or property as a result of the misstatements; and (iii) the proper amount of disgorgement for any 17(a) violations.

The hearing was held in Washington on September 2, 2015. On October 30, 2015—before issuing the Initial Decision—Judge Elliot ordered the Division to show cause why SOX Section 105 was not impermissibly retroactive as applied in this case. *See A.P. Rulings Rel. No.*

3278. That order was based on the D.C. Court of Appeals' July 14, 2015 decision in *Koch v. SEC,* 793 F.3d 147.

After the parties briefed the retroactivity issue, Judge Elliot issued his Initial Decision on December 21, 2015. *I.D. Rel. No. 930.* He found SOX Section 105 to be impermissibly retroactive as a matter of law under the facts of this case, and thus dismissed those charges against all respondents. *Id.* at 9-15. Because CYIOS failed to file annual and quarterly reports, he found that CYIOS violated Section 13(a) and Rule 13a-1 and 13a-13 and that Carnahan caused CYIOS' violations. *Id.* at 16. Because Carnahan filed false management certifications, he found him liable for violating Rules 13a-14 and 13a-15. *Id.* at 16-17. Because CYIOS' and Carnahan's actions constituted fraudulent practices or courses of business, he found them liable on the Section 17(a)(3) charges. *Id.* at 17-18. He dismissed the Section 17(a)(2) charges, finding that by receiving consulting services CYIOS' did not receive money or property. Judge Elliot imposed cease and desist orders against Carnahan and CYIOS, ordered CYIOS to disgorge $37,500 (plus prejudgment interest thereon), and ordered Carnahan and CYIOS to pay civil penalties of $75,000 and $375,000, respectively.

CYIOS and Carnahan appealed on January 12, 2016. *A.P. Rel. No. 3499.* Their appeal was granted on February 2, 2016. *Securities Act Rel. No. 10031.* The Division did not appeal or cross appeal.

II. EVIDENCE AND ARGUMENT

Judge Elliot correctly determined that the Respondents committed intentional and repeated violations of the securities laws. The Commission should affirm that holding.

On appeal, the Commission's standard of review is *de novo.* It has broad discretion not only to consider the ALJ's findings and conclusions, but also to make its own independent

determinations and interpretation of the evidence offered during the proceedings. *See, e.g., In the Matter of Gary M. Kornman*, AP File No. 3-12716, 2009 SEC LEXIS 367, at *36 n. 44 (Feb. 13, 2009); *In the Matter of Gregory M. Dearlove, CPA*, AP File No. 3-12064, 2008 SEC LEXIS 223, at *34 (Jan. 31, 2008).

A. *It is undisputed that CYIOS purposefully failed to file required periodic reports in violation of Section 13(a) and Rules 13a-1 and 13a-13.*

Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 require issuers with securities registered under Exchange Act Section 12 to file annual and quarterly reports with the Commission. 15 U.S.C. § 78m(a); 17 C.F.R. §§ 240.13a-1, 13a-13. *Scienter* is not required to establish violations of Section 13 or the rules thereunder. *SEC v. McNulty*, 137 F.3d 732, 740-41 (2d Cir. 1998); *SEC v. Wills*, 472 F. Supp. 1250, 1268 (D.D.C. 1978).

It is undisputed that CYIOS had a class of securities registered under Exchange Act Section 12 as of November 21, 2012.[2] It is also undisputed that between November 21, 2012, and May 30, 2014, CYIOS filed none of its required periodic reports. Finally, it is undisputed that it was Carnahan's decision not to make the required filings and that this decision was purposeful. As the Respondents admit in their Petition for Review: "CYIOS was having financial hardship and was not able to continue paying for auditors and lawyers for the filings so Timothy Carnahan did voluntarily file Form 15-12G as the appropriate paperwork May 29th, 2014 Notice of Termination of Registration." *Pet. for Review* at 9. They further admit: "[W]e knew that we were still responsible for filing delinquent periodic reports." *Id.*[3]

[2]Judge Elliot took judicial notice of all filings that occurred during the relevant period. The Division also separately entered some of CYIOS' public filings into the record.

[3] These admissions mirror admissions made in the Respondents' Answer, in which they acknowledge that CYIOS quit making its required Commission filings because "CYIOS was

The evidence admitted during the administrative proceedings echoes the Respondents' admissions. It was this evidence that formed the basis for Judge Elliot's holding that the Respondents acted in deliberate disregard of regulatory requirements when they purposefully decided not to make the required filings. *Initial Decision* at 16 (citing Commission filings, which were judicially noticed, and Carnahan's testimony that he was responsible for these filings). Thus, Judge Elliot correctly held that the Respondents purposefully violated these statutory provisions. The Respondents have offered the Commission no legal or factual basis to overturn Judge Elliot's holding. The Commission should therefore uphold it.

B. Carnahan filed false certifications in violation of Rules 13a-14 and 13a-15.

Rule 13a-14(a) requires Forms 10-K and 10-Q to include certifications signed by the issuer's principal executive and principal financial officer. 17 C.F.R. § 240.13a-14(a). Management must certify that the report "does not contain any untrue statement of material fact." 17 C.F.R. § 229.601(b)(31)(i). If a report contains materially false or misleading information, Rule 13a-14 is violated. *See SEC v. Kalvex, Inc.*, 425 F. Supp. 310, 315-16 (S.D.N.Y. 1975); *Russell Ponce*, 54 S.E.C. 804, 812 n.23, (2000), *pet. denied*, 345 F.3d 722 (9th Cir. 2003). Rule 13a-15(c) requires an issuer's management to evaluate the effectiveness of the issuer's ICFR as of the end of each fiscal year. 17 C.F.R. § 240.13a-15(c). 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 criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control – Integrated Framework (the "COSO Framework"). If the COSO Framework is not used, Rule 13a-15(c) still requires management to use another suitable, recognized control framework.

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having financial hardship and was not able to continue paying for auditors and lawyers." Respondents' Answer at 4.

Scienter is not required to establish a violation of these rules, which fall under Exchange Act Section 13. *McNulty*, 137 F.3d at 740-41.

It is undisputed that CYIOS' Forms 10-K for fiscal years 2009, 2010, and 2011 stated that CYIOS management had assessed the effectiveness of its ICFR using the COSO Framework and that CYIOS' ICFR was effective. It is likewise undisputed that CYIOS' Forms 10-Q filed between the first quarter of 2010 and third quarter of 2012 contained these same representations. Finally, it is undisputed that Carnahan signed and certified each of CYIOS' periodic filings in the capacities of principal executive and principal financial officer.

The evidence shows that these statements were materially false. The Division proved that Carnahan did not assess ICFR effectiveness at all—much less using the COSO Framework. The Division also proved that CYIOS' ICFR was not effective. For example, when asked about how he had assessed CYIOS' internal controls, Carnahan was unable to describe how the assessments were done. *See, e.g.*, Div. Ex. 2 at 63-75. And he admitted that the assessments were not documented. *Id.* In reality, the assessments were never done. Carnahan simply assumed that CYIOS' controls were effective because, as he admitted, "[he was] the internal control." *Id.*[4] Neither he nor anyone else ever assessed CYIOS' ICFR. Rather, Carnahan simply copied boilerplate management certifications from year to year—sometimes forgetting to even change the date. *Id.*

Even if Carnahan's activities could be somehow construed to include ICFR assessments, they were admittedly not done using the COSO Framework: "Our Internal Controls are governed

[4] His testimony regarding CYIOS payroll function also illuminates this point: "I wrote the payroll system. So it can't be flawed." *Id.*

and assessed using our in-house product CYIPRO."[5] *Pet. for Review* at 11. Carnahan claims that CYIOS' assessments were adequate because the CYIPRO product and some of CYIOS' business processes were mapped to ISO 9000, which "is a recognized standard." *Pet. for Review* at 11-12; 14-15. But he offers no evidence in support. Nor does he offer evidence that ISO 9000 is a recognized framework for assessing internal controls—or that it is related in any way to internal controls. Rather, the uncontroverted evidence—offered by the Division's expert—is that compliance with COSO standards cannot be achieved merely by compliance with ISO standards. *See Hearing Tr.* at 213-15. Finally, the certifications signed by Carnahan state unequivocally that the ICFR assessments were done using the COSO Framework. *See, e.g., Div. Ex. 13 at 310; Div. Ex. 21 at 505.* Not using CYIPRO. Not using "something similar." And not using ISO 9000. Thus, even crediting Carnahan's unsupported version of the facts, the certifications are false.

To the extent CYIOS had any internal controls at all, Carnahan admitted that they were not effective. For instance, at the hearing Carnahan stated "we don't have a human resources control." Tr. 213. And in his investigative testimony, Carnahan stated "I am the internal control." Div. Ex. 2 at 72. By definition, one person cannot be an effective system of internal controls. Tr. 207-08; Tr. 217-20 (testimony by Division's expert regarding control risk created by inadequate segregation of duties). Thus, CYIOS' ICFR was ineffective.

Finally, these misstatements were material. The Division's expert testified that these statements were material. Div. Ex. 24 at 6-11. The Respondents offered no evidence to the contrary. Further, as the Initial Decision correctly notes, these particular types of misrepresentations are material as a matter of law: "Because Carnahan personally certified the

[5] When questioned about the assessments during the Division's investigation, Carnahan never mentioned the COSO Framework or any other framework. *See* Div. Ex. 2 at 63-65, 72-75.

false statements in this case, they can be seen as impugn[ing] the integrity of management, which in itself would be material to investors." Initial Decision at 18 (citing *In re Monster Worldwide, Inc. Sec. Litig.*, 251 F.R.D. 132, 139 (S.D.N.Y. 2008); *United States v. Hatfield*, 724 F. Supp. 2d 321, 328 (E.D.N.Y. 2010)) (internal quotations omitted).

C. CYIOS violated and Carnahan caused violations of Section 17(a)(3) by making repeated material misstatements in CYIOS public filings.

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 a 17(a)(3) violation. *See In the Matter of Anthony Fields*, 2015 WL 728005, Securities Act Rel. No. 9727 at 17-18 (Feb. 20, 2015). *Scienter* is not required to prove a 17(a)(3) violation. *See, e.g., SEC v. O'Meally*, (2d Cir. 2014), 752 F.3d at 569 (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)). The conduct must be in the offer or sale of securities and in interstate commerce. *SEC v. Smart*, 678 F.3d 850, 856-57 (10th Cir. 2012).

Where, as here, the fraud alleged involves misstatements in public Commission filings the "in the offer or sale" requirement may be met by proof of the means of dissemination and the materiality of the misrepresentation or omission. *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1171 (D.C. Cir. 1978); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 861-62 (2d Cir. 1968) (en banc)). 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. *See, e.g., Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 38 (2011).

As detailed above, CYIOS' public filings repeatedly contained misstatements that CYIOS' ICFR had been assessed using the COSO Framework and that its ICFR was effective. As also detailed above, these misrepresentations were material.

Finally, it is undisputed that the conduct involved interstate commerce. Carnahan testified that he personally "EDGARized" CYIOS's filings—transmitting them electronically across state lines. Tr. 64. Thus, the Court should reject the Respondents' arguments that they did not violate Securities Act Section 17(a)(3).

III. CONCLUSION

The Respondents do not actually challenge the findings made against them. Instead, their appeal is based on a misguided premise: that because the SOX Section 105 charges were dismissed, the other charges should likewise be dismissed. However, the other charges are based on different legal theories and different facts. Those facts are almost completely undisputed. Thus, the Commission should affirm the Initial Decision holding the Respondents liable for their violations of the securities laws.

Respectfully submitted,

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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 Opposition to Petition for Review was served on the following on March 31, 2016 via United Parcel Service, Overnight Mail:

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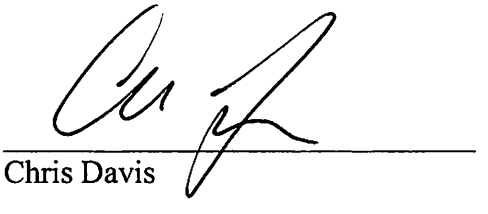

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