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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-17253

In the Matter of **JAMES A. WINKELMANN, SR., and BLUE OCEAN PORTFOLIOS, LLC,** **Respondents.**	**THE DIVISION OF ENFORCEMENT'S RESPONSE IN OPPOSITION TO RESPONDENTS' MOTION FOR SUMMARY AFFIRMANCE**

The Division of Enforcement ("Division") hereby responds in opposition to the Motion for Summary Affirmance filed by Respondents James Winkelmann and Blue Ocean Portfolios, LLC ("BOP"). The Commission should deny Respondents' motion because the Division's Petition for Review makes a reasonable showing both that: (a) the Administrative Law Judge ("ALJ") committed prejudicial error, and (b) the Initial Decision "embodies an exercise of discretion or decision of law or policy that is important and that the Commission should review." Rule 411(e)(2). As discussed below, the Initial Decision contains multiple prejudicial errors and incorrectly applies the reliance on counsel defense in a way that would allow other investment advisers to disregard their duties to clients and would harm investors. For these reasons, and given the Commission's strong disfavor of motions for summary affirmance, *Terry T. Steen*, Exchange Act Rel. No. 38675, 52 S.E.C. 1337, 1338 n.2 (May 27, 1997), Respondents' motion should be denied.

I. Background and Procedural History

This case involves multiple frauds committed by investment advisers – Winkelmann and his advisory firm, BOP – in the course of their offering BOP securities, primarily to their own advisory clients.

Winkelman marketed to his clients the BOP securities, which he called "Royalty Units," by promoting BOP as a conflict-free adviser and falsely representing that his interests were "aligned" with those of the investors. *See* Initial Decision Following Remand, Initial Decision Rel. No. 1261 (Oct. 15, 2018) ("Revised Initial Decision"), at 42-43. Despite these affirmative statements, Winkelmann never disclosed that, as a result of the Royalty Units' investment terms, each month he faced the conflict-riddled decision of whether to increase payments to investors or to increase his own compensation. *Id.* And he concealed that this conflict manifested itself, to investors' detriment, when Winkelmann routinely used investor proceeds to pay himself more, while keeping investor returns at the minimum allowable levels. *Id.* at 44-45.

Winkelmann additionally concealed that Bryan Binkholder – Winkelmann's partner, BOP's co-founder, and the centerpiece of BOP's advertising campaign – was under investigation and ultimately barred by Missouri securities regulators. *See* Revised Initial Decision at 7-9. Winkelmann's failure to disclose Binkholder's bar was even more egregious given that Winkelmann was engaging in the same conduct giving rise to Binkholder's bar: selling his clients securities in his own advisory business, without disclosing the attendant conflicts. *Id.* Nevertheless, Winkelmann hid the bar and its findings while touting Binkholder to clients and other investors in the Royalty Unit offering materials. *Id.* at 16, 18, 69-70.

Winkelmann also made false and misleading statements about BOP's "advertising ratio," a metric quantifying the efficiency of BOP's advertising that Winkelmann considered the "key

driver" to BOP's business. *See* Revised Initial Decision at 23, 32-34. Winkelmann further lied about the Royalty Units in one-on-one emails with clients and other investors. *Id.* at 19-20. In an effort to sell more Royalty Units, he materially overstated both the amounts BOP had paid to earlier investors and BOP's success in raising funds. *Id.*

The investors cumulatively invested $1.4 million, with promises of returns ranging from 2.25 to 3 times their original investment. *See* Revised Initial Decision at 10, 13. But Respondents, who used investors' proceeds to steadily increase Winkelmann's compensation, returned less than half of the investors' principal and none of the promised gains. *Id.* at 13, 44-45.[1]

Following a six-day hearing, the ALJ originally issued an Initial Decision finding that, by offering Royalty Units to advisory clients without sufficient disclosure of conflicts, Respondents acted with scienter and violated the antifraud provisions of the Securities Act, Exchange Act, and Advisers Act. *See* Initial Decision Rel. No. 1116 (Mar. 20, 2017). The first Initial Decision sanctioned Winkelmann by imposing an industry bar, a cease-and-desist order, significant disgorgement, and third-tier penalties. *Id.* However, this Initial Decision held that the following did not violate the antifraud provisions, Respondents': (a) failure to disclose Binkholder's adviser bar; (b) misrepresentations regarding the "alignment" and purported absence of conflicts between Winkelmann's and the non-client investors' interests; and (c) misrepresentations and omissions regarding BOP's advertising ratio. *Id.*

[1] It is striking that Respondents ask the Commission for leniency by claiming that these proceedings have harmed them, yet make no acknowledgement of the harm their conduct has caused their clients and other investors. Respondents' continued instance on placing their interests in front of their clients' shows that Respondents have not learned from or accepted any responsibility for their misconduct. And it demonstrates that the modest sanctions imposed by the ALJ were insufficient and should be reviewed by the Commission.

Respondents then filed a Petition for Review challenging the ALJ's original fraud findings and sanctions.[2] The Division then filed a Cross-Petition for Review appealing the findings that Respondents did not violate the antifraud provisions by making misrepresentations and omissions about Binkholder, the advertising ratio, and the "alignment" of Respondents' and non-client investors' interests. The Division also appealed the ALJ's failure to find that Winkelmann violated the antifraud provisions by misrepresenting the amount of money BOP had repaid investors and had raised in the offerings.

While the parties' appeals were pending, the Commission remanded these proceedings to the ALJ to allow the parties to submit new evidence. *Pending Admin. Proc.*, Securities Act Rel. No. 10440, 2017 SEC LEXIS 3724 (Nov. 30, 2017). On remand, Respondents submitted as new evidence an email between Winkelmann and an attorney which Respondents claim supported their reliance on counsel defense. (Respondents' Exhibit RX-127). Before the ALJ issued a decision on remand, the Commission stayed this case in light of *Lucia v. SEC*. *See Pending Admin. Proc.*, Securities Act Rel. No. 10536 (Aug. 22, 2018). After the Commission lifted the stay and offered Respondents the option of proceeding before a new law judge, the parties consented to have the originally assigned ALJ remain on the case and resume his consideration of newly presented evidence on remand. *See* Order Affirming Assignments, Administrative Proceedings Rulings Rel. No. 6062 (Sept. 21, 2018). In doing so, Respondents waived any constitutional challenges based on the appointment or removal protections of the originally assigned ALJ. *See* Sept. 7, 2018 Letter from Respondents to Chief ALJ Murray.

[2] The first Initial Decision also found that Respondents violated custody-related provisions of the Advisers Act. It held that BOP violated and Winkelmann caused BOP's violations of Advisers Act Section 206(4) and Rules 206(4)-2 and 206(4)-7, and that Respondents violated Advisers Act Section 207. For those violations, the first Initial Decision imposed a $7,500 first-tier penalty against Winkelmann. Respondents did not seek review of those findings.

On October 15, 2018, the ALJ issued a second, revised Initial Decision Following Remand. *See* Revised Initial Decision (Rel. No. 1261). In that revised decision, the ALJ confirmed his original finding that Winkelmann defrauded his clients by failing to disclose conflicts and by breaching his fiduciary duties, but reversed his original findings that Winkelmann acted with scienter. The ALJ found that the single email Winkelmann offered as new evidence, coupled with Winkelmann's own, self-serving testimony, supported a finding of good faith reliance. The ALJ thus limited Winkelmann's liability to the non-scienter fraud charges, premised on Winkelmann's failure to disclose conflicts and breach fiduciary duties, and the custody-related violations. The ALJ did not revisit any of his factual or legal findings regarding the Division's fraud theories at issue in its original Petition for Review. The ALJ reduced Winkelmann's permanent bar to a six-month suspension. He also reduced Winkelmann's penalties from $187,500 in third-tier penalties to $25,500 in first-tier penalties.

On November 5, 2018, the Division filed a Petition for Review of the revised Initial Decision. The Division sought review of the same issues regarding its fraud theories that it advanced in its original Petition. The Division further sought review of the ALJ's finding that Winkelmann did not act with scienter while failing to disclose conflicts and breaching his fiduciary duties. The Division also sought review of the reduction in sanctions based on the revised finding that Winkelmann acted without scienter.

On November 14, 2018, Respondents filed both a conditional Cross-Petition for Review and a Motion for Summary Affirmance.[3]

[3] As with their original Petition for Review, Respondents Cross-Petition does not challenge the ALJ's findings that Respondents violated custody-related provisions of the Advisers Act.

As discussed below, the Commission should not summarily affirm the revised Initial Decision, because it contains multiple prejudicial errors and important decisions of law and policy that the Commission should review.

II. ARGUMENT

A. The Commission Strongly Disfavors Motions for Summary Affirmance.

The Commission, "as a policy matter, strongly disfavors motions for summary affirmance." *Terry T. Steen*, 52 S.E.C. at 1338 n.2. Respondents' motion fails to acknowledge this policy, or that summary affirmance "is rare, given that generally [the Commission] ha[s] an interest in articulating [its] views on important matters of public interest and the parties have a right to full consideration of those matters." *Joseph C. Ruggieri*, Securities Act Rel. No. 9985, 2015 SEC LEXIS 5086, *4 (Dec. 10, 2015) (quotations and citations omitted); *Don Warner Reinhard*, Exchange Act Rel. No. 61506, 2010 SEC LEXIS 1010, *10 (Feb. 4, 2010).

By the express terms of Rule 411(e)(2), "the Commission will decline to grant summary affirmance upon a reasonable showing" of one of two elements: (1) "a prejudicial error was committed in the conduct of the proceeding," or (2) "the decision embodies an exercise of discretion or decision of law or policy that is important and that the Commission should review." Summary affirmance is only justified when there are "compelling reasons" for doing so. *Steen*, 52 S.E.C. at 1338.

Under the foregoing standards, the Commission routinely denies motions for summary affirmance. *See, e.g., Ruggieri*, 2015 SEC LEXIS 5086; *Robare Group, Ltd.*, Exchange Act Rel. No. 75686, 2015 SEC LEXIS 3310 (Aug. 12, 2015); *Reinhard*, 2010 SEC LEXIS 1010; *Kevin Hall*, Exchange Act Rel. No. 57855, 2008 SEC LEXIS 1173 (May 23, 2008); *Salvatore F. Sodano*, Exchange Act Rel. No. 56961, 2007 SEC LEXIS 2921 (Dec. 13, 2007); *America's*

Sports Voice, Inc., Exchange Act Rel. No. 55511, 2007 SEC LEXIS 1241, *18 n.25 (Mar. 22, 2007); *Richard Kern*, Exchange Act Rel., No. 51115, 2005 SEC LEXIS 744 (Feb. 1, 2005); *E-Smart Techs., Inc.*, Exchange Act Rel. No. 50030, 2004 SEC LEXIS 1508 (July 16, 2004); *Christopher A. Lowry*, Exchange Act Rel. No. 45131, 55 S.E.C. 481 (Dec. 5, 2001); *Stonegate Secs., Inc.*, Exchange Act Rel. No. 42720, 54 S.E.C. 624 (Apr. 25, 2000); *Steen*, 52 S.E.C. 1337.

Contrary to the above precedent, Respondents argue the Commission should not review the ALJ's decision because, on review, the Commission "would be required to give deference to Judge Patil's conclusions." Motion at 2. Respondents are incorrect, as the Commission performs a *de novo* review based on an "independent review of the record." *Robare Group, Ltd.*, Advisers Act Release 4566, 2016 SEC LEXIS 4179, *2, *18 (Nov. 7, 2016); *see also* Rule of Practice 411(a). Thus, Respondents are wrong to claim that the Commission evaluates the below errors in the revised Initial Decision with deference to the ALJ.

B. The Division's Petition for Review Makes a Reasonable Showing of Prejudicial Errors and Important Decisions of Law and Policy that Call for Commission Review.

The Division's Petition for Review identifies multiple prejudicial errors and decisions of law or policy the Commission should review. Examples include:

1. Failure to Disclose the Adviser Bar of BOP's Cofounder: Despite touting Binkholder in the offering materials, Respondents failed to disclose that Binkholder, who founded BOP with Winkelmann and served as its spokesman, had been barred from being an investment adviser. Respondents also failed to disclose the reason for Binkholder's bar: Just as Winkelmann would later do, Binkholder offered securities in his adviser firm to his advisory clients without disclosing conflicts. Nevertheless, the ALJ determined that Binkholder's bar was not material. *See* Revised Initial Decision at 69-70.

In *SEC v. Bolla*, the court faced similar facts: One of two co-founders of an advisory firm received an adviser bar shortly after the formation of the firm, and the barred co-founder was removed as an owner of the firm. 401 F. Supp. 2d 43, 48, 50 (D.D.C 2005). The remaining founder failed to disclose to clients that his co-founder had been barred. *Id.* at 56-57. The court found the remaining founder's failure to disclose his co-founder's bar violated the antifraud provisions, with the co-founder's bar being "clearly" material: "Confronted with the fact that his/her investment adviser had been barred, the reasonable investor would likely question the firm, wondering whether the other investment advisers could also be trusted to fulfill their ethical obligations." *Id.* at 68, 72. The D.C. Circuit affirmed. *SEC v. Wash. Inv. Network*, 475 F.3d 392, 404-405 (D.C. Cir. 2007).

The ALJ failed to apply this precedent, or even acknowledge the Division's citations to *Bolla*. In doing so the ALJ committed a clear legal error which the Division is entitled to present to the Commission for review.

2. Winkelmann's False Representations about BOP's Success in Repaying Investors and Raising Funds: The ALJ correctly observed that Winkelmann made false statements in emails to investors and clients about the amount of money BOP had repaid to Royalty Unit investors and its success in selling Royalty Units. *See* Revised Initial Decision at 19-20. However, the ALJ altogether failed to consider whether, as the Division argued, such conduct violated the securities laws or evidenced Winkelmann's scienter. This clear error merits Commission review.

3. Errors in Sanction Analysis: The ALJ likewise erred in determining penalties and non-monetary sanctions. First, the ALJ erred as a matter of law when he held that because Winkelmann acted without scienter, "only first tier penalties *may* be imposed." *See* Revised

Initial Decision at 90 (emphasis added). However, the penalty statutes do not contain the term "scienter." Rather they use the same "fraud" and "deceit" terminology found in Securities Act Section 17(a)(3) and Advisers Act Section 206(2), neither of which contain a scienter element. *See, e.g. Robare Group, Ltd.*, 2016 SEC LEXIS 4179, *43-44 (imposing second tier penalties despite a finding of no scienter). Second, in assessing penalties based on the number of investors, the ALJ excluded investors who invested prior to the five-year limitations period. *See* Revised Initial Decision at 90-91. The ALJ ignored the fact that both Respondents executed valid tolling agreements. (Division Exhibits DX-357; DX-358). Thus, excluding misconduct based on statute of limitations grounds was improper.

Moreover, having determined that Respondents lacked scienter, the ALJ imposed a mere 6-month suspension. Should the Commission conclude, as the Division contends, that Winkelmann did act with scienter, an industry bar is the appropriate remedy for an adviser who fails to disclose conflicts or otherwise defrauds his clients. *See, e.g., Larry Grossman*, Advisers Act Rel. 4543, 2016 SEC LEXIS 3768, *84-85 (Sept. 30, 2016); *Montford & Co., Inc.*, Advisers Act Rel. 3829, 2014 SEC LEXIS 1529, *78-80 (May 2, 2014); *James Tagliaferri*, Advisers Act Rel. 4650, 2017 SEC LEXIS 481, *21-22 (Feb. 15, 2017).

4. Errors Regarding BOP's "Advertising Ratio": In the Royalty Unit offering materials, Respondents touted a metric – the "advertising ratio" – that tracked the efficiency of BOP's advertising efforts. The offering materials referred to the ratio as the "key driver" of BOP's business and the speed in which investors would be repaid. *See* Revised Initial Decision at 23. Respondents represented that a ratio below 1.0 meant that BOP generated more money off its advertising than it spent on that advertising; while a ratio above 1.0 meant that BOP's revenues were less than the cost of the advertising. *Id.* Respondents repeatedly represented to

investors that BOP's 2011 advertising ratio was an efficient 0.79. The ALJ recognized that "Winkelmann was unable to explain how BOP arrived at the 0.79 advertising ratio for 2011 in his investigative testimony, prehearing brief, expert report, or posthearing brief." *Id.* at 32. The ALJ similarly determined that BOP's 2011 ratio, using the data and methodology advanced by Respondents, was significantly worse than 0.79. *Id.* at 32-34.

Despite finding that Respondents could not justify the 2011 advertising ratio they repeatedly touted to investors as the "key driver" of BOP's business, the ALJ failed to address this important misstatement in his legal analysis. This is an error the Commission should review.

The Commission should also review the ALJ's failure to address the cases cited by the Division showing that Respondents defrauded investors by not disclosing that: (a) BOP repeatedly changed methodologies behind the ratios represented to investors; and (b) Winkelmann cherry picked from multiple available ratios and chose the most favorable ones. *See In re BP p.l.c. Secs. Litig.*, 2016 WL 3090779, *15 (S.D. Tex. May 31, 2016) (where BP disclosed the lower of its two oil spill severity estimates but withheld the higher estimate: "If those two estimates are proven to be of equal weight and [BP employee] Suttles merely cherry-picked the more favorable of the two, then the omission of the higher estimate would be misleading to a reasonable investor. Moreover, it would suggest that Suttles acted with 'intent to deceive.'"); *Von Hoffman v. Prudential Ins. Co.*, 202 F. Supp. 2d 252, 255, 261 (S.D.N.Y. 2002) (where Prudential failed to disclose changing its dividend calculation methodology: "a reasonable investor would have wanted to know that the method used to generate the ... results was no longer being used and that a new, perhaps less favorable method was going to be used instead").

5. Errors in and Policy Concerns Resulting from the ALJ's Application of Reliance on Counsel Defense: The ALJ correctly determined that Respondents defrauded their clients and investors by (a) failing to disclose the conflicts of interest inherent in the Royalty Unit offerings and (b) affirmatively misrepresenting a lack of conflicts and that the interests of Winkelmann and the investors were aligned. *See* Revised Initial Decision at 71-74. Respondents made these omissions and misstatements while using investor proceeds – which Respondents told investors BOP would use to grow its business – to steadily increase Winkelmann's compensation. *Id.*

On remand, based on a single exhibit, ALJ Patil reversed his original finding that counsel was unaware BOP's was offering Units to clients. Revised Initial Decision at 79. However, the exhibit was from March 2011, after counsel had approved the first offering memorandum but before Winkelmann began offering Royalty Units. *Id.*, *see also* RX-127. The exhibit shows that Winkelmann generally asked for counsel's comments on a draft letter to clients about the Royalty Units offering. RX-127. While counsel provided comments, Winkelmann did not ask for advice about conflicts or disclosures, or about the general question of offering Royalty Units to clients. Rather, as with the offering memorandum, Winkelmann merely asked for a general review of a letter he had drafted. RX-127.

Because of this exhibit, the ALJ changed his original recklessness finding to one of negligence, holding that even if Winkelmann told his lawyer about offering securities to clients, it was not reasonable to rely on any advice he received. *See* Revised Initial Decision at 79-83. The ALJ reasoned, regardless of the lawyer's advice, Winkelmann should have recognized that a conflict existed and he could not represent to investors that the Royalty Units were conflict-free. *Id.* Nevertheless, the ALJ found that even though Winkelmann could not meet the elements of a reliance defense (he never asked for or received advice that he was adequately

disclosing conflicts), his good faith belief that this lawyer approved the disclosures negates any scienter or recklessness. *Id.* at 80.

The essence of the ALJ's reliance holding is that Winkelmann's scienter is negated merely because his counsel reviewed the offering materials before they were issued and was generally aware BOP would offer Royalty Units to clients. This holding is in error, because the evidence surrounding Winkelmann's interactions with counsel shows that any reliance was not in good faith. Indeed, the ALJ correctly observed that Winkelmann: (a) did not seek or receive specific advice on the issue of whether conflicts were adequately disclosed (Revised Initial Decision at 79-80); (b) was aware that the Subscription Agreements, drafted by counsel, precluded clients from buying Royalty Units (*id.* at 80-81); (c) never disclosed to his lawyer the extent to which he would target advisory clients, or that he would keep investor payments at minimal levels while steadily increasing his own salary (*id.* at 44, 79-80); and (d) as an experienced securities professional, did not need to be told that he couldn't omit important information, misrepresent a lack of conflicts, or prioritize his personal interests (*id.* at 80). Moreover, given that Winkelmann was aware that Binkholder had been barred for selling securities to clients without disclosing conflicts, Winkelmann could not have relied in good faith on any advice that such conduct was permissible.

In addition, affirming the ALJ's reliance holdings would set terrible precedent. It would allow an experienced adviser to draft offering materials that lie about and conceal known conflicts.[4] The adviser could escape liability by merely passing those offering materials to an attorney without asking for specific guidance or providing the attorney with the necessary facts to provide informed advice. It would allow an adviser to make knowing misrepresentations and

[4] Here, there is no dispute that Winkelmann drafted the offering materials at issue. *See* Revised Initial Decision at 39.

omissions to clients, and to put his own interests above his clients', so long as the attorney didn't intervene and direct the adviser to stop.

Should the ALJ's holding become precedent, it is hard to imagine any scenario for a securities professional, simply by virtue of retaining an attorney, to act with scienter. Indeed, the Commission expressly rejects this concept. *See, e.g., Dennis Malouf*, Advisers Act Rel. No. 4463, 2016 SEC LEXIS 2644, *67 (July 27, 2016), *67 ("*regardless of what others may have thought*, Malouf, an experienced securities professional, had an independent obligation to disclose his conflict, understood that obligation, and must have known that clients would be misled by his failure to correct the representation that no conflict existed") (emphasis added); *Rockies Fund, Inc.*, Exchange Act Rel. No. 48590, 2003 SEC LEXIS 2361, *71 (Oct. 2, 2003) ("We see no reason that the auditor's review of the Fund's reports should mitigate our view of Respondents' culpability. Given the recklessness with which the relevant Forms 10-Q and 10-K were prepared by Respondents, they can take no comfort now that the Fund's auditor failed to spot their mistakes."); *WHX Corp.*, Exchange Act Rel. No. 47980, 2003 SEC LEXIS 1350, *44-45 (June 4, 2003) (corporation could not claim good faith reliance, even where attorney approved tender offer, when firm's "sophisticated and experienced chairman" was aware that the Commission staff had informed the attorney that the tender offer was illegal). The Commission should reject Respondents' invitation to create such a misguided precedent that relieves advisers of their fiduciary obligations and puts investors at risk.

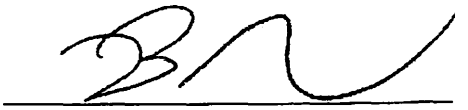
III. CONCLUSION

As described above, the Division has made a reasonable showing that the ALJ committed prejudicial error, and the Initial Decision contains exercises of discretion or decisions of law or policy that are important and that the Commission should review. For these reasons, summary

affirmance is inappropriate, and the Commission should deny Respondents' motion in its entirety.

Dated: November 21, 2018

Respectfully submitted:



Benjamin J. Hanauer
David F. Benson
Division of Enforcement
U.S. Securities and Exchange Commission
175 West Jackson Blvd, Suite 1450
Chicago, IL 60604
Phone: 312-353-8642
Fax: 312-353-7398

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CERTIFICATE OF SERVICE

Benjamin Hanauer, an attorney, certifies that on November 21, 2018, he caused a true and correct copy of the foregoing The Division of Enforcement's Response in Opposition to Respondents' Motion for Summary Affirmance to be served on the following:

Brent J. Fields, Secretary
Office of the Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-2557
(via facsimile and overnight delivery)

James A. Winkelmann
23 Glen Abbey Drive
St. Louis, MO 63131
jim@blueoceanportfolios.com
(via email and overnight delivery)

Dated: November 21, 2018

Benjamin Hanauer
Division of Enforcement
U.S. Securities and Exchange Commission
175 West Jackson Blvd, Suite 1450
Chicago, IL 60604
Phone: 312-353-8642
Fax: 312-353-7398
Email: hanauerb@sec.gov