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SECURITIES AND EXCHANGE COMMISSION
ADMINISTRATIVE PROCEEDING

In re RANDALL S. GOULDING, Respondent	)	File No. 3-19617
	)	**Answer and Affirmative Defenses**

Randall Goulding, by his attorneys, Berry Law PLLC, hereby answers in this administrative proceeding and asserts the following affirmative defenses.

ANSWER

1. Responding to paragraph 1, at p. 1, of the Order Instituting Proceedings, Investment Advisors Act of 1940 Release No. 5417, dated December 13, 2019 (hereinafter "OIP"), Goulding **ADMITS**, except to the extent the allegation suggests that The Nutmeg Group, LLC became registered as an investment advisor with the SEC in 2006, as opposed to 2007.

2. Responding to OIP, ¶1, at p. 1, **ADMITS**; and also asserts that the October 25, 2019 Findings and Conclusion entered in *SEC v. Nutmeg*, 09-cv-1557 (N.D. Ill.) ("District Court Findings and Conclusions") did not specify which sections of the Investment Advisor Act Goulding was enjoined from violating, only that he "should be enjoined permanently from violating the provisions of the Advisers Act which are at issue in this case." The District Court Findings and Conclusions also did not enjoin Goulding from violating any SEC Rules.

3. Responding to OIP, ¶3, at p. 2, **DENIES**.

4. Responding to OIP, ¶4, at p. 2, **ADMITS,** except to the extent the allegation suggests that a finding that Goulding transferred millions of dollars of investor funds to himself underlies the District Court judgment.

AFFIRMATIVE DEFENSES

First Affirmative Defense: There is No Likelihood of a Recurrence of A Securities Law Violation by Goulding

5. Paragraphs 1 - 4 are repeated and realleged as if set forth fully herein.

6. Goulding was born in 1950.

7. Goulding has no record of prior securities law violations.

8. Goulding is no longer affiliated with an investment advisory, and has not been actively affiliated with an investment advisor since 2009.

9. No finding of scienter was necessary to the records keeping violations found by the District Court.

10. No finding of scienter was necessary to the commingling allegation found by the District Court.

11. No particularized findings of scienter were made by the District Court.

12. There is no likelihood of a recurrence of a securities law violation by Goulding.

Second Affirmative Defense: The Obey the Law Injunction Entered by the District Court is Legally Defective

13. Paragraphs 1 - 12 are repeated and realleged as if set forth fully herein.

14. The injunctive relief ordered by the District Court is defective because it fails to track the statutory language and fails to inform Goulding of what conduct is prohibited. *E.g.*, *SEC v. Goble*, 682 F.3d 934, 951-952 (11th Cir. 2019).

15. The injunctive relief ordered by the District Court is defective because the Conclusions of Law underlying the judgment do not specify what provision of the Investment

Advisors Act Goulding is enjoined from violating but, instead, only states that he "should be enjoined permanently from violating the provisions of the Advisers Act which are at issue in this case."

16. For the foregoing reasons the injunction issued by the District Court is defective and not a basis for relief under section 203(f) of Investment Advisor Act, 15 U.S.C. §80b-3.

Third Affirmative Defense: No Inference of Scienter Can Be Made in Connection with the Commingling Claims

17. Paragraphs 1 - 16 are repeated and realleged as if set forth fully herein.

18. SEC Rule 206(4)(2)(a) provides that custody requirements are met if cash and certificated securities are held at a qualified institution, such as a bank or brokerage, which Nutmeg did. The rule does not by its terms require separate accounts for each client since it can be satisfied if:

> (1) . . . A qualified custodian maintains those funds and securities –
> (i) In a separate account for each client under that client's name; or
> (ii) In accounts that contain only your clients' funds and securities, under your name as agent or trustee for the clients.

Id. (Emphasis added)

19. A general partner, like the limited partners, makes a capital contribution to the limited partnership, which will be deposited in the same account that holds the limited partners capital contributions. Goulding thus correctly and reasonably believed that, since Nutmeg was a general partner and investor, it was permitted have its own cash holdings in the investment pools (including both its capital contribution and accreted compensation for management services) placed in the same qualified custodian accounts where the limited partners' capital contributions to those entities were deposited. This is not forbidden by the "custody rule." Edward C.

Laurenson, "Frequent Compliance Issues under the SEC's Custody Rule under the Investment Advisers Act," *Practical Compliance & Risk Management for the Securities Industry*, p. 19 (Sept./Oct. 2013).

20. However, because Nutmeg did not have an audit for the year in which it became registered, it was not permitted to rely on Rule 206(4)(2)(a)(1)(ii). Goulding did not realize that an audit was required for the year in which Nutmeg became registered – a partial year – and the failure to obtain the audit was not intentional.

Fourth Affirmative Defense: No Inference of Scienter Can Be Made in Connection with the Misappropriation Finding

21. Paragraphs 1 - 20 are repeated and realleged as if set forth fully herein.

22. The funds transferred from Nutmeg to Goulding were either not traceable to investor funds or, if they were traceable to investor funds, Goulding received only money he was contractually entitled to receive, which either removes or mitigates any inference of scienter. *In re Dixon*, 535 B.R. 450 (Bankr., N.D. Ga. 2015); *SEC v. Onyx Capital*, 2014 WL 354491 (E.D. Mich., Jan. 31, 2014).

23. The management fees Goulding received were both contractually authorized and not causally related to any securities fraud violations since there was no fraud in the securities offerings that generated those fees. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1231 (D.C. Cir.1989); *SEC. v. Patel*, 61 F.3d 137, 139 (2d Cir.1995); *First Fed. Sav. & Loan v. Oppenheim, Appel, Dixon*, 629 F. Supp. 427, 439 (S.D.N.Y. 1986) (citation omitted); *Freschi v. Grand Coal Venture*, 551 F.Supp. 1220, 1230 (S.D.N.Y. 1982); *SEC v. Razmilovic*, 822 F. Supp. 2d 234, 260& n. 22 (S.D.N.Y. 2011).

Fifth Affirmative Defense: No Inference of Intentional Misconduct Can Be Made in Connection with the Use of Special Purpose Vehicles

24. Paragraphs 1 - 23 are repeated and realleged as if set forth fully herein.

25. Nutmeg's use of affiliates special purpose vehicles for certain investments – defined in the District Court Findings and Conclusions and "Relief Defendants" – is expressly authorized by the SEC. SEC Release No. IA-2968, at p. 41, and SEC Guidance Update No. 2014-07, pp. 2-3, at Scenarios 1 & 3, recognize that an Advisor is permitted to treat assets held by its nominees as belonging to the investment pools it advises. Since Nutmeg treated the assets held by the so-called relief defendants as belonging to the investment pools, it properly attributed those assets to the investment pools in its disclosures to the limited partners. SEC Release No. IA-2968, at p. 41, and SEC Guidance Update No. 2014-07, pp. 2-3, at Scenarios 1 & 3 (recognizing that an Advisor is permitted to treat assets held by its nominees as belonging to the investment pools it advises).

26. Since Nutmeg treated the assets held by the so-called relief defendants as belonging to the investment pools, it properly attributed those assets to the investment pools in its disclosures to the limited partners. SEC Release No. 2968, pp. 41-42 (where the advisor treats assets held by an SPV as within the custody of the investment pool, "such assets must be considered within the scope of the pooled investment vehicle's financial statement audit or surprise examination.")

27. However, compliance with the audit requirement is a pre-requisite to the use of such SPVs, and Nutmeg unintentionally failed to comply with the audit requirement, since it did not understand that the audit required applied even for the partial year in which it became registered.

Nevertheless, the failure to obtain the audit – not the inclusion of the assets titled in the names of Nutmeg's nominees in the account statements sent to investors – was the essence of the investigation. *SEC v. Yang*, 2014 WL 2198323, *3 (N.D. Ill.) ("alternative bases for the same wrong doing" were not "separate violations for the purpose of civil penalties"). Likewise, even if the assignment of assets to the Relief Defendants was improper, the resulting inaccuracy in the account statements is not a separate basis for liability. *Id.* ("a fraud theory and a false disclosure theory" were not separate violations).

28. Goulding did not realize that an audit was required for the year in which Nutmeg became registered – a partial year – and the failure to obtain the audit was not intentional. Accordingly, an inference of scienter cannot be sustained.

Sixth Affirmative Defense: No Inference of Scienter Can Be Sustained in Connection with the Over-Valuation Claim

29. Paragraphs 1 - 28 are repeated and realleged as if set forth fully herein.

30. At the *SEC v. Nutmeg* trial, Peter Hickey, the SEC's valuation expert, opined that Nutmeg should not have valued convertible debentures according to the *market value of the underlying common stock*; that it would be improper to value restricted securities based on the market value of otherwise identical unrestricted stock; and that blockage and illiquidity discounts should be applied. This was an approach that would have been proper only prior – but not after – the promulgation of Accounting Standards Codification ("ASC") fka Financial Accounting Standard ("FAS") 157

31. Hickey's approach was based on SEC's Accounting Series Release ("ASR") 113, which the foregoing FASB guidance (hereinafter, "FAS 157/ASC 820") superceded. (FAS 157,

at the Summary Statement.)

32. FAS 157 represented a "shift from rules-based to principles-based hierarchical guidance."[1] It is well recognized that the distinct approaches mandated under ASR 113 and FAS 157/ASC 820 cannot be reconciled. *See, e.g.*, Janet K. Smith, Ph.D, *et al.*, "The SEC's 'Fair Value' Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Securities," 6 *Fordham Journal of Corporate & Financial Law* 421, 422, 443-444 (2001) (criticizing ASR 113 based on subjective criteria, rather than prices in the underlying security, for presuming that restricted securities should be valued essentially based on what could be obtained if liquidated in a current sale and deference to the judgment of the reporting entity's board of directors, so long as certain procedural requirements – such as board minutes – are met).

33. Hickey, repeatedly asserted at trial that Nutmeg had not adhered to ASR 113 (the prior standard).

34. Applying ASR 113, Hickey concluded that a portion of the debentures at issue could not be immediately converted into unrestricted stock. Under ASR 113, those securities should be valued based on a hypothesized "current sale" which is understood to be a distress price. ASR 113 is "fundamentally a liquidation value principle." Smith, "The SEC's 'Fair Value' Standard," *supra*, 6 *Fordham J.C.&F.L* at 423. In determining what could be obtained in a "current sale," ASR 113 states that adjustments from the market price of the otherwise identical unrestricted security are an inherently unreliable measure, a view based on a presumption that

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[1]Michael J. Mard, *et al.*, *Valuation for Financial Reporting, Fair Value, Business Combinations, Intangible Assets, Goodwill, and Impairment Analysis* 19 (2010)

the market might overreact to news regarding the purchase of restricted securities, "thus lead[ing] to a spiraling increase in the valuation of both the restricted and unrestricted securities." ASR 113, at p. 4. ASR 113 thus *distrusts* the market's interpretation of the restriction. ASR 113, p. 4. In total, these considerations mandated excluding from the analysis what could be obtained upon conversion of the securities.

35. Relying on ASR113, Hickey declined to consider the value of the securities into which the convertible debentures could be converted. *E.g.*, SEC v. Nutmeg, Trial Transcript, pp. 731:21 - 732:8. (". . . [T]here is restricted stock [*sic:* convertible debentures] that the Mercury Fund owned that I have talked about at length, and then there's common stock that was being traded for these companies as well, and that's not what Mercury Fund owned.") This means that Hickey, the SEC's expert, valued the convertible debentures according to their debt component – *i.e.*, excluding the value of the feature that permitted them to be converted into common stock which could be sold at prevailing market prices.

36. By contrast, Goulding and Nutmeg valued the convertible debts based largely on the prevailing market value of the common stock into which they could be converted. This is the approach that is mandatory under FASB Guidance that is currently in place, and was also in place at the time of the valuations that the SEC challenged. FAS 157/ASC 820 requires that, where there is an active market for a security related to (or underlying) one for which there is no such market, the value of the latter should reflect that of the former.

37. The securities at issue were "floating convertibles," since they could be could be converted to stock at specified discounts from prevailing market prices. Therefore, a change in the market price of the stock does not change the intrinsic value of the conversion feature. For

example, in *SEC v. Parnes*, 2001 WL 1658275 (S.D.N.Y., Dec. 26, 2001) rejected a claim that a decline in the stock price was "adverse" to the holder as:

> * * * unpersuasive because the value of the debentures at issue here was not tied to the stock price: the terms of the debentures guaranteed a 25% discount upon conversion whether the stock price was high or low, and as the stock price fell, the number of shares obtained upon conversion increased, so the holders' economic interest remained the same.

Id. at *6 (emphasis added).

38. Under FASB guidance, floating convertibles are classified as "stock settled debt."[2] According to that guidance, the relative value of the debt and conversion features of stock settled debt must be considered.[3] "Relative fair value" means: "Estimating the fair value of each

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[2]ASC 480-10-25-14(a) (issuer must classify as a debt an obligation which is "predominantly" a "fixed monetary amount known at inception (for example, a payable settle-able with a variable number of the issuer's equity shares)[.]"); ASC 470-20-25-8 ("If a convertible instrument has a conversion option that continuously resets as the underlying stock price increases or decreases so as to provide a fixed value of common stock to the holder at any conversion date, the convertible instrument shall be considered stock-settled debt[.]"); ASC 470-20-55-19 ("If the conversion price was described as $1 million divided by the market price of the common stock on the date of the conversion, that is, resetting at the date of conversion, the holder is guaranteed to receive $1 million in value upon conversion . . . the convertible instrument would be considered stock-settled debt.") ASC 480-10-55-22 includes an example in which the number of shares to be delivered is based on a fixed dollar amount and a 30-day average trading price rather than the trading price on the settlement date. There, though the fair value of the shares delivered upon settlement is not completely fixed, the FASB concluded that the monetary value is predominantly fixed and therefore the issuer must classify the instrument should be classified as a liability.

[3]Under ASC 470-20-25-8, the conversion feature of "stock settled debt" should be valued according to "the guidance in paragraph 470-20-25-5." ASC 470-20-25-5, in turn, provides, that: "An embedded beneficial conversion feature present in a convertible instrument shall be recognized separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital[,]" and incorporates ASC 470-20-30-4 and ASC 470-20-30-5 by reference. The latter states that an "allocation" of the proceeds received in a financing transaction that includes a convertible instrument to the convertible instrument . . . *on a relative fair value basis*. It also requires the issuer to "calculate an effective conversion

individual component of the hybrid instrument and allocating the basis of the hybrid instrument to the host instrument and the embedded derivative based on the proportion of the fair value of each individual component to the overall fair value of the hybrid." *FASB Statement 133* Implementation Issue No. B6.

39. While an issuer of a convertible debenture may, in certain instances, have the option of repaying the amount borrowed directly (rather than issuing stock to the investor according to the conversion formula), such cash payments are usually not a realistic option because only companies with poor balance sheets will issue floating convertible debentures, since they shift risk to the issuer. In fact, the notes acquired by the Funds managed by Nutmeg gave the investor – that is, the Funds – the option to insist on receiving stock (pursuant to the conversion feature), rather than cash. Accordingly, the conversion feature – the right to convert the instrument to stock which could be sold at prevailing prices – represented the entire value of these debentures at issue in the *SEC v. Nutmeg* case.

40. As Goulding understood it, this meant that both issuers of such securities and investors in them were required to value them "us[ing] [an] effective conversion price to measure the intrinsic value, if any, of the embedded conversion option[.]" ASC 470-20-30-5(c) (applicable to issuers); ASC 820-10-05-1B & 1D (assets and liabilities are valued in the same way, which means that investors must value their assets the same way issuers value their liabilities).

41. What the applicable FASB guidance means is as follows: For floating convertibles,

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price and use that effective conversion price to measure the intrinsic value, if any, of the embedded conversion option." ASC 470-20-30-5(c).

the contractual discount from prevailing stock prices means that the conversion feature (the right to convert to common stock and sell it) is always "in the money," *i.e.*, the market price for the common stock always exceeds the conversion price. Portfolio Advisory Group, *Convertible Debentures – A Primer* 2 (May 12, 2011) (when security is trading above the conversion price it is "commonly referred to as 'in the money'"); *cf.* ASC 470-20, Master Glossary, defining a "Beneficial Conversion Feature" as a "a nondetachable conversion feature that is in the money at the commitment date."). This favors valuing the instrument based on the value of the underlying securities. *Convertible Debentures, supra* ("When a convertible is trading deep in-the-money, it will take on the characteristics of the underlying equity as opposed to a debt obligation."); *see generally:* Small Business Administration, *Appendix 15: Valuation Guidelines for Small Business Investment Companies* 148 (Aug. 3, 1999) ("Accepted methods for valuing convertible debentures" include "consider[ing] the conversion of all convertible securities of the same class into their common stock equivalent, taking into account dilution, and a subsequent valuation of the [owner's] proportionate equity interest.")

42. The SEC has itself stated that reporting values according to FASB guidance is mandatory. *See* SEC, "Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter," Release Nos. 33-8221; 34-47743; IC-26028; FR-70.[4]

43. Goulding's view that the convertible debentures should be valued primarily according to their conversion feature, rather than their debt feature, even if wrong, was at minimum a colorably correct matter of opinion and therefore is not an appropriate basis for

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[4]available at https://www.sec.gov/rules/policy/33-8221.htm

disciplinary action. *In re Carter*, [1981 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶82,847, at 84,167 (SEC App., Feb. 28, 1991) (lawyers who prepared incorrect proxy materials and disclosures that misled investors could not be sanctioned under SEC Rule 102(e)[5] for errors in judgment).

Seventh Affirmative Defense: Prohibiting Goulding from Associating with an Investment Advisor is Punitive in Nature and Penalties Cannot Be Imposed based on the District Court Findings Since they Were Made Pursuant to the Preponderance of Evidence Standard Applicable Only Outside the Penal Context

44. Paragraphs 1 - 43 are repeated and realleged as if set forth fully herein.

45. Securities industry bars and suspensions are penal in nature. *Saad v. SEC*, 873 F.3d 297, 306 (D.C. Cir. 2017) (Kavanaugh, J., concurring) ("SEC must justify expulsions or suspensions as punitive")

46. The District Court's Findings were made pursuant to the preponderance of evidence standard. *S.E.C. v. Seghers*, 298 Fed.Appx. 319, 323 (5th Cir. 2008); *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F.Supp. 1314, 1369 (S.D.N.Y. 1982).

47. Since the allegations in this proceeding must be proven by a standard higher than the preponderance of evidence, the District Court's Findings are not entitled to preclusive effect, and Goulding is entitled to a hearing *de novo*.

WHEREFORE, for the foregoing reasons, the proceeding should be dismissed in its

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[5]SEC Rule 102(e), 17 C.F.R. 201.102(e) permits the SEC to censure, suspend or bar persons who appear or practice before it.

entirety and with prejudice.

Dated: New York, New York
January 13, 2020

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CERTIFICATE OF SERVICE

Eric W. Berry, pursuant to 28 U.S.C. §1746 hereby certifies that the following statement is true and correct:

On January 13, 2020, I caused the annexed Answer to be served upon

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Dated: New York, New York
January 13, 2020

/s/Eric W. Berry
Eric W. Berry