SECURITIES AND EXCHANGE COMMISSION
ADMINISTRATIVE PROCEEDING

In re RANDALL S. GOULDING,	)	File No. 3-19617
Respondent	)	

GOULDING'S OPPOSITION TO THE DIVISION OF ENFORCEMENT'S MOTION FOR SUMMARY DISPOSITION

Respondent Randall S. Goulding respectfully submits the response in opposition to the motion by the SEC's Division of Enforcement for a summary disposition in its favor in this administrative proceeding. The proceeding seeks to suspend Goulding from the securities industry for a period not to exceed 12 months.

A. INTRODUCTION

The Order Instituting Proceedings ("OIP") cites two bases for the relief it seeks:

First, violations of the Investment Advisors Act of 1940. OIP, ¶3. Such violations, if willful, could be a basis for an industry bar in accordance with Investment Advisors Act ("IAA") §203(e)(5) (concerning willful violations of the IAA).

Second, the existence of an obey-the-law injunction against Goulding. OIP, ¶¶2, 4. That injunction, at least if valid, would implicate IAA §203(e)(4) (permanent or temporary injunction).

However, the motion for summary disposition only requests a ruling only on the allegation that an injunction implicating IAA §203(e)(4) exists against Goulding (OIP, ¶¶2, 4), and does *not* rely upon, or cite, the assertion that Goulding engaged in willful violations of IAA (alleged at OIP, ¶3) within the meaning of IAA §203(e)(5).

Therefore, this response will address only paragraphs 2 and 4 of the OIP, and IAA

§203(e)(4), and will not address paragraph 3 of the OIP, or IAA §203(e)(5). Motions for summary disposition in administrative proceedings are governed by the same principles as motions for summary judgment under Fed. R. Civ. P. 56 (*e.g.*, *American Airlines, Inc. v. Herman*, 176 F.3d 283, 288 (5th Cir. 1999). Therefore, the Division of Enforcement should be precluded from invoking paragraph 3 of the OIP or IAA §203(e)(5) in its reply in support of its motion *(see Johannessohn v. Polaris Insdustries, Inc.*, 2020 WL 1536416, *25 n. 20 (D. Minn., March 31, 2020)).[1]

A. INTRODUCTION

As the OIP alleges, Goulding is a defendant in the *SEC v. Nutmeg* case. Nutmeg, a registered investment advisor, was Goulding's company, and it managed and advised several investment pools organized as limited partnerships (sometimes, "the Funds"). Following ten years of litigation and a bench trial that lasted more than two weeks, Goulding was found to have violated several sections of the Investment Advisors Act of 1940, 15 U.S.C. §80b-1 *et seq.* and an obey-the-law injunction was entered against him. As noted, that injunction is the sole basis for a summary disposition cited in the Division of Enforcement's motion.

[1]Were Goulding required to respond to the allegation that a suspension was warranted under IAA §203(e)(5) on the grounds of "willful" violations, as alleged in ¶3 of the OIP, he would argue, *inter alia*, that the ambiguity of the term "willful" in connection with a quasi-criminal or penal proceeding, such as this, renders that section of the statute constitutionally void for vagueness. *Saad v. SEC*, 873 F.3d 297, 306 (D.C. Cir. 2017) (Kavanaugh, J., concurring) ("SEC must justify expulsions or suspensions as punitive."); *Safeco Ins. Co. of America v. Burr*, 551 U.S. 47, 57 & n.9, 127 S.Ct. 2201, 2208 & n.9 (2007) ("When the term 'willful' or 'willfully' has been used in a criminal statute, we have regularly read the modifier as limiting liability to knowing violations."); *F.C.C. v. Fox Television Stations, Inc.*, 567 U.S. 239, 253, 132 S.Ct. 2307, 2317 (2012) (describing the vagueness doctrine).

B. SUMMARY OF GOULDING'S POSITION

First, the obey-the-law injunction imposed by the District is invalid because it fails to track the statutory language and fails to inform Goulding of what conduct is prohibited, and therefore cannot by itself justify the continuation of the temporary suspension order prior to a hearing. (Point I, *infra*.)

Next, application of the so-called *Steadman* factors requires lenity in imposing a penalty. (Point II, *infra*.)

C. BACKGROUND

Randall Goulding graduated from University of DePaul College of Law in 1978 and was admitted to the Illinois bar that year. Following law school he worked for approximately ten years in a small law firms, and then became a solo practitioner. His principal area practice area was tax law.

In 1992 Goulding was convicted of a conspiracy, mail fraud and currency violations based on charges resulting from a federal sting operation. That conviction was upheld on appeal in 1994. *United States v. Goulding*, 26 F.3d 656 (7th Cir. 1994). As a result of the conviction he was suspended from practicing law for four years. The suspension was concluded on June 24, 1998. *In re Randall S. Goulding*, 91CH0208 (June 24, 1998). A *certiorari* petition requesting the United States Supreme Court review the conviction was unsuccesssful, even though it was supported by an *amicus* brief filed by the National Association of Criminal Defense Lawyers, and authored by retired Illinois State Court Judge Robert Mackey and retired U.S. District Court Judge George N. Leighton.

Following his suspension, Goulding resumed the practice of law, working, *inter alia*, for

Paradigm Group, LLC, an investment firm, first as an attorney and then as a financial consultant.

In 2003, Goulding founded The Nutmeg Group, LLC, a company in which he was first a 50 percent, then a 99 percent owner and the managing member.

Following a business model that Goulding had become familiar with at Paradigm, Nutmeg raised money from investors who became limited partners in "investment pools," for which Nutmeg acted as general partner and investment advisor.

The bulk of the assets Nutmeg caused these investment pools to acquire were convertible debentures issued by small, financially distressed companies. Goulding was familiar with these types of securities from his time at Paradigm. The debt evidenced by a floating convertible debenture can be "converted" to stock in the public company according to an agreed formula. Typically, portions of the debt are converted sequentially. The conversion formula can either be fixed or vary with the trading price of the public company's stock during a recent "look-back period." Debentures with variable formulas are called "floating convertible debentures." While floating convertible debentures are labeled as risk-creating transactions, that is a reference to the risk they impose on the issuer, not the investor. That is, they minimize risk on the part of the investor, and shift the risk to the public company issuer and away from the investor. See Susan Chaplinsky and David Haushalter, "Financing under Extreme Uncertainty: Evidence from PIPEs" 31 (working paper), University of Virginia (2003).

The shift of risk to the issuer (and away from the investors) is accomplished by tying the conversion formula to recent trading prices. For example, *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).

Similarly, Hillion and Vermaen, "Death Spiral Convertibles," 71 *Journal of Financial Economics* 381 (2004), recognizes that:

> [B]y converting and selling 100 shares at [the hypothesized] $12.5 [price during the look back period less the contractual 20 percent discount], the investor can earn a risk free rate of return of 25%[.] . . . . [T]his return is independent of the stock prices: if the stock prices had been $1.25, the investor could have sold 1000 shares and obtained the same 25% return on investment. As a result, a very risky mining company can issue a financial security that is risk-free, . . ."

Id. at 82 (emphasis added).

Originally, because of its small size (both in terms of the number of clients and the value of assets under management), Nutmeg was not required, under the Investment Advisers Act, to register with the SEC or create separate accounts for each client – *i.e.*, each investor pool is a client under the Investment Advisors Act of 1940. However, as of 2007, Nutmeg had grown to the point where it was required to – and did – register, and its registration became effective in May of that year. Unfortunately, however, Nutmeg registered before it had properly segregated accounts (for each investment pool) or installed sufficient records-keeping practices. As a result, an examination by an SEC compliance unit resulted in a letter notifying Nutmeg of certain deficiencies in operations, relating to records-keeping, account segregation and internal controls.

D. THE SEC ENFORCEMENT ACTION THAT RESULTED IN THE DISTRICT COURT'S FINDINGS AND CONCLUSIONS

Despite Nutmeg's effort to comply with recommendations in the deficiency letter, the

SEC commenced the enforcement action on March 23, 2009, alleging violations of the 1940 Act. When the case was filed in 2009, District Court Judge William Hibbler entered an injunction prohibiting Goulding from operating Nutmeg or managing the Funds, and eventually a federal equity receiver, Leslie Weiss, Esq., assumed control of Nutmeg and the Funds.

Thereafter Goulding returned to the practice of law, focusing on transactional work, and devoted a substantial amount of time to defending the enforcement action. Eventually, due to an inability to continue to pay lawyers, he acted *pro se* between 2011 and 2017. It was not until shortly before trial that he was able to retain counsel.

In its enforcement action, the SEC brought several statutory negligence claims against Nutmeg and Goulding, such as the failure to properly maintain records and segregate accounts. However, the main point of contention was the SEC's claim that Nutmeg had overvalued the Funds' assets, causing it to disseminate incorrect account statements. Since part of Nutmeg's compensation (a portion of its "carried interest" allocation) was tied to the value of the assets under management, the SEC also charged that this alleged overvaluation allowed Nutmeg and Goulding to receive excessive compensation, which the SEC sought to have them disgorge.

In 2016, the SEC obtained partial summary judgment on the inadequate record-keeping and other statutory negligence claims. *SEC v. Nutmeg* Dkt. No. 795. (Goulding briefed the summary judgment and several motions *in limine* himself, despite having little to no experience in financial litigation.)

The claims relating to the valuation issue – excessive compensation and misleading account statements – were tried before Magistrate Gilbert between January 16 and January 31, 2018. Goulding was principally represented in this action by Eric Berry, a New York-based

securities litigator, who appeared in the case shortly before trial. (He also represents Goulding in the instant administrative proceeding.) Nevertheless, the years Goulding spent acting without the assistance of counsel resulted in various unfair pre-trial rulings which prejudiced his ability to defend the case at trial.

On October 25, 2019, Judge Gilbert filed Findings of Fact and Conclusions of Law (appended as Ex. 1 to the Division of Enforcement motion. (Hereinafter, the exhibits appended to the Division of Enforcement's motion will be cited as "Div. Ex. __".) Paragraph 37 of those findings states:

> 37. Randall's violations of the Advisers Act were material, in that he: (a) overstated the valuation of Fund assets and investments; (b) assessed fees from the Funds payable to Nutmeg based on overstated asset valuations; (c) misappropriated client and investor assets from Nutmeg's commingled bank accounts for his own personal benefit; and (d) failed to disclose to investors the overstatement of investment assets and fees, and the misappropriation of investor assets.

Div. Ex. 1, at p. 50.

Items (a), (c) and (d) in paragraph 37 are based on a finding that Nutmeg (and Goulding) overstated the value of the assets held by two investment pools, Mercury Fund and Stealth Fund. Item (c) finds that he misappropriated assets. Goulding and his counsel believe the misappropriation finding is wrong. Goulding, his counsel, and the expert witness who testified on his behalf also believe that the overvaluation finding, at worst, is a rejection of Goulding's apparently correct (and, at minimum, colorably correct) view about how Financial Accounting Standard Board (FASB) guidance should be applied to convertible debt securities.

The commingling discussed by Judge Gilbert involved depositing Nutmeg's own money with that of the investor pools. 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 of course 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.)

Of course, 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 terms of the "custody rule." See 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). 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 this at the time, and any inference of scienter should be rejected.

The District Court's Findings and Conclusions never state that the legal violations it attributes to Goulding were intentional as opposed to reckless. Div. Ex. 1, p. 49, ¶31 ("intentionally or recklessly); ¶32 ("intentionally or recklessly").

Also, while the District Court's Findings and Conclusions contain an obey-the-law

injunction, that injunction provides no guidance as to what particular conduct is prohibited. *Id.*, p. 51, ¶41 ("Based on the evidentiary record, and an analysis of the relevant factors, it is reasonably likely that Randall will engage in future violations of the law and should be permanently enjoined."); ¶43 ("Accordingly, Randall should be enjoined permanently from violating the provisions of the Advisers Act which are at issue in this case.")

E. POINTS AND AUTHORITIES

Point I

The Obey-the-Law Injunction Entered By the District Court Is Invalid and Does Not Justify Continuing the Temporary Suspension

As noted, the District Court entered an obey the law injunction. However, it contained no guidance as to what particular conduct is prohibited. *Id.*, 51, ¶41 ("Based on the evidentiary record, and an analysis of the relevant factors, it is reasonably likely that Randall will engage in future violations of the law and should be permanently enjoined."); ¶43 ("Accordingly, Randall should be enjoined permanently from violating the provisions of the Advisers Act which are at issue in this case.") 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). Accordingly, it cannot justify the continuance of the temporary suspension prior to a hearing.

Point II

Application of the *Steadman* Factors Militates Against the Imposition of Any Industry Bar or Suspension

Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd*, 450 U.S. 91, 101 S.Ct. 999 (1981) held that in review a request for an industry bar, the SEC may consider: (1) the

egregiousness of the defendant's actions, (2) the isolated or recurrent nature of the infraction, (3) the degree of scienter involved, (4) the sincerity of the defendant's assurances against future violations, (5) the defendant's recognition of the wrongful nature of his conduct, and (6) the likelihood that the defendant's occupation will present opportunities for future violations.

Goulding has worked as a lawyer, not an investment advisor since the SEC injunction that was entered in his case in 2009. *SEC v. Nutmeg*, 09-cv-01775, ECF 14 (Mar. 25, 2009). That injunction, and the existence of the enforcement action, have practically precluded Goulding from acting as an investment advisor for 11 years. This means that the penal purpose of the IAA 203(f) has already been accomplished, and the purpose of protecting investors is not necessary since the extensive time the Goulding has already been out of the industry means it is likely impossible for him to return to it, and if he did he would operating under the obey-the-law injunction in any event.

The SEC's motion points Goulding's failure to acknowledge the wrongful nature of his conduct. In fact, Goulding intends to appeal.

It should be noted that Judge Gilbert and the SEC enforcement attorneys who have pursued Goulding hold some idiosyncratic views, not shared by the world at large, and not likely to be adopted in the Seventh Circuit. For example, the SEC enforcement attorneys and Judge Gilbert believe that in double entry book-keeping a minus-sign (-) signifies a debit balance in a capital account when, in fact, it properly signifies a credit balance. *Compare* Findings and Conclusions, 09-cv-01775, ECF 14, p. 34, ¶270, n. 1 ("Ryan testified that a negative number in Nutmeg's ledger really means that his father's capital account had a positive balance because of the way in which Ryan prepared the ledger. Ryan's testimony on this point, however, was a bit

shaky and more than a little equivocal, and it therefore is viewed with skepticism by the Court.") *with* Kathy Adams, "Are Equity Accounts a Credit Balance Account?" ("An owner's capital account balance increases with a credit entry [and] decreases with a debit entry. . . .")[2] and David Marshall, "So, you want to learn Bookkeeping!" ("+ (Plus Sign) for Debit and - (Minus Sign) for Credit")[3] Judge Gilbert and the SEC attorneys also overlooked the fact that every other entry in the ledger consistently used plus and minus signs correctly and in accordance with standardized double entry bookkeeping.

Similarly, a key document in the case was PX43, prepared by SEC accountant Ann Tushaus, C.P.A. PX43 purported to show that Goulding had a negative capital account balance at Nutmeg. Trial Transcript (excerpted at Ex. A hereto), at 1104:17-20. However, at trial, Tushaus acknowledged that the summary did not reflect Goulding' entitlements from Nutmeg. In particular, while she agreed that an owner's profits had to be accounted for in determining any capital account balance (Ex. A, at 1164:15 - 1166:17; 1167:4-1168), she nevertheless admitted that she didn't consider whether Goulding was entitled to a share of Nutmeg profits or "net income" that would effect his capital account balance. (Ex. A, at 1166:25 - 1167:2.) Any doubt that Goulding has a viable appeal should be satisfied by the following testimony from Tushaus regarding PX43:

> Q . . . [On] PX43, you see that you show a total benefit of $2.5 million and change to Randall Goulding; isn't that correct?
>
> A. Yes.
>
> Q. *Okay. Now, did you ever yourself conduct any analysis of what [Nutmeg] was entitled to receive under its agreements with the various*

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[2]https://bizfluent.com/info-7891158-equity-accounts-credit-balance-account.html

[3]http://www.dwmbeancounter.com/tutorial/lesson03.html

investment funds?

A. No.

Q. Okay. So you yourself -- you don't have any view one way or another as to whether the amount that Nutmeg was entitled to receive under its agreements with the investment funds was more or less than $2.5 million?

A. I do not have an opinion.

Ex. A, at 1144:19-1145:9 (emphasis added).

Judge Gilbert's Findings and Conclusions also overlook that it was Goulding who was relying on the legally required FASB Guidance in valuing the securities at issue (*i.e.*, FAS 157/ASC 820), while the SEC was relying on an out-dated standard (ASR 113). (Ex. A, at 602-603, 606, 607, 609, 612, 622, 682.)

Goulding's belief that he was correct and Judge Gilbert's Findings and Conclusions wrong on many issues is shared by the legal and accounting professionals advising Goulding, all of whom have substantial resumes in the relevant areas.

For this reason it would be perverse to penalize Goulding for failing to acknowledge that he is wrong, when he disagrees, his views are shared by competent and experienced professionals and he intends to promptly pursue vindication on appeal.

Regarding Goulding's scienter, at no point do Judge Gilbert's Findings and Conclusions specify an intentional violation. Instead, the term used is "intentional *or* reckless" violation. Div. Ex. 1, p. 49, ¶31 ("intentionally or recklessly); ¶32 ("intentionally or recklessly").

Finally, the SEC's motion notes that Goulding's law practice includes matters before the SEC. However, it neglects to acknowledge that a separate proceeding under SEC Rule 102(e) (relating to suspension/disbarment) has been commenced under File No. 3-19617. Any relief the SEC is entitled to regarding Goulding's law practice will be implemented in that proceeding, and further penalizing him in this matter based on the nature of that practice would, in effect,

inflict a double jeopardy.

F. CONCLUSION

For the foregoing reasons, the motion should be denied in its entirety.

Dated: New York, New York
April 3, 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 March 20, 2020, I caused the annexed Response to be served by email upon:

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Dated: New York, New York
April 3, 2020

/s/ Eric W. Berry
Eric W. Berry

EXHIBIT A

IN THE UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, vs. THE NUTMEG GROUP, LLC, et al., Defendants.	) No. 09 CV 1775)) Chicago, Illinois))
DAVID GOULDING, et al., Relief Defendants.	) January 16, 2018) 9:00 o'clock a.m.

VOLUME 1 - A
TRANSCRIPT OF PROCEEDINGS
BEFORE THE HONORABLE MAGISTRATE JEFFREY T. GILBERT

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From time to time there are different accounting standards that come into play overall for businesses, but this valuation standard from FAS 157 to ASC 820, there's no real changes to it.

09:36:45 THE COURT: Okay.

BY MR. MOYE:

Q. All right. We don't need to look up the dates.

So what other source or standard did you consult besides FAS 157?

09:36:55 A. Well, the Investment Company Act.

Q. Okay. So to clarify, you're not an attorney. Why did you consult the Investment Company Act as part of this analysis?

A. Because the Investment Company Act provides guidance on valuation.

09:37:10 Q. Okay. Besides the Investment Company Act, what else did you consult?

A. The SEC has also issued guidance on the valuation of restricted securities through what is call ASR 113 and ASR 118, they're accounting series releases, and they're actually quite

09:37:27 old. ASR 113 dates back to 1969 and ASR 118 dates to 1971, but they're very well-known in the industry and they are extremely helpful in terms of providing guidance on the valuation of restricted securities.

Q. Okay. What about anything more recent.

09:37:48 A. The SEC has offered some, as they do from time to time,

some letters that reaffirm the guidance as provided by ASR's 113 and 118.

Q. Are these private letters or are they publicly available?

A. They're publicly available.

09:38:06 Q. All right. So let's talk about one of the definitions that you've offered in your report and that you're opining on. Can you tell us what you mean by the term fair value or what do you understand by the term fair value?

A. Well, fair value is as defined by FAS 157 and is pretty

09:38:24 well-known, it's a price that you receive to sell an asset or that you pay to transfer a liability in an orderly transaction between market participants at the current date.

Q. Okay. Can now give us, in brief, your own understanding what means.

09:38:41 A. Well, it's assuming an exit value. If the principle of it is you're to get at what price you would receive for the security you're selling today if you were to sell it today.

Q. Question, is FAS limited or is FAS 157 limited or directed to securities only or does it cover other things?

09:39:03 A. It covers other things. It covers assets and liabilities, really anything that a company would have to value for purposes of its financial reporting.

Q. Okay. But in your opinion, it certainly does cover securities?

09:39:14 A. It does.

Q. Does FAS 157 offer any guidance or establish any standards for the valuation of restricted securities?
A. Yes, it does.
Q. Can you tell us what those are?
09:39:32 A. Well, for restricted securities FAS 157 expressly says you can't simply value a restricted security at an unrestricted price.
Q. Just to clarify, what do you mean by an unrestricted price of a security.
09:39:46 A. So if there was a security like a common stock that had been issued by a company that freely tradeable, that was unrestricted, yet you owned a restricted security form that same company you can't just apply the common stock price to the restricted security that you own.
09:40:03 Q. So what's the relevance, what should someone do in valuing restricted securities?
A. Well, again, you have to use what's referred to by -- we'll get to that with the Investment Company Act, but you need to take into account the effects of the restriction. So someone
09:40:22 who's going to buy that security from you, if they're going to consider the effects of the restriction on pricing that security, you have to also take into account those restrictions and your ongoing pricing or valuation of that security.
Q. What about access to public markets, is that relevant?
09:40:42 A. Well, for restricted security you have an inability to

access public markets for a period of time, and so the valuation has to account for that.

Q. Do restricted securities have a single or common length of time for restriction?

09:41:02 A. No, they vary. And the nature and the duration of restrictions can vary security to security. And your valuation as FAS directs has to take into account the variance of those restrictions.

Q. Anything else on FAS guidance on restricted securities that

09:41:27 you think is relevant for now?

A. No.

Q. All right. Let's talk briefly about the Investment Company Act. How does this help and form your analysis or the standards you think are applicable here?

09:41:37 A. Well, the Investment Company Act says a lot of things, but for valuation it really says two things that are applied: For investment funds that have securities for which market prices are readily available, so it's like Microsoft stock or some stock that was trading in active market, you use market

09:41:58 quotations to value those securities, but then the Investment Company Act says for securities that don't have a readily available market price, you have to use what's called good-faith efforts to arrive at the fair value of those securities.

09:42:14 Q. So what's your understanding of what might be required for

the second thing, for -- if there's no readily available market quote for the price of an asset, what might be required for the use of good faith in valuing that asset?

A. Well, again, you're trying to -- you're trying to come up with a valuation for a security that you own. And as the FAS 157 says, and the Investment Company Act is clear too, you're looking for an exit value, you're looking for a value that you could receive upon the current sale of that security.

So you have to take into account all relevant information, information from the company that issued that security, and the size of that security, the financial condition of the company. So, really, any information that's available to you have to, you know, use good-faith efforts to use that information to come up with a valuation of the security. You know, the SEC guidance provides a lot more detail for that that's pretty helpful that is directed to the Investment Company Act's principles.

Q. All right. So let's look at the SEC 113 -- or ASR 113.

A. So -- sorry. Sorry.

Q. Yeah. Tell us what your understanding is of what sort of guidance is provided by 113.

A. Well, as I said just previously, what ASR 113 says, and this is dating back to the '60s, it really clearly says that there's no set formula you should use in order to value a restricted security. You have to consider all pertinent

factors: The business condition of the company that's issued the security, general market conditions, and any change in the inherent value of the security.

So if something has happened with the company or within, you know, the capital structure of the company, you have to consider all of those factors in order to come up with fair value.

Q. Well, that seems pretty broad. Is there anything that ASR 113 says you should not consider or not incorporate in an analysis?

A. Yes; expressly, ASR 113 rejects four methods of valuations for restricted securities.

Q. So we've got them on the slide here. Which of these four methods of valuation do you think are loss applicable to your engagement in this case?

A. Well, probably number three, which is valuing restricted security at the unrestricted market price, but all four of these are important from the perspective of the SEC and the industry, that you can't, you know, value a restricted security continuously at the cost of which you bought the security, when conditions have actually changed for the company that's issued the security.

You can't use constant percentages or dollar discounts. You can't simply, and this is the most applicable in this case, you can't value restricted security at the

unrestricted market price.
Q. Okay.
A. And then this is also applicable in this case, especially with the Stealth Fund, you can't value the restricted security
09:45:39 using an amortization of the discount over time. So, in other words, if you have a restricted security that is restricted for 24 months or two years, you can't just have a formula that says, okay, in 23 months it's going to be worth a little bit more because it's less restricted, and then it's going to be
09:45:56 less restricted in 20 months so it should be worth more. The SEC has expressly said you can't use an amortization schedule to discount the security.
Q. Let's talk about 118. Before we do, can you just explain in your own words what you think the issue is. Why -- your
09:46:21 understanding of the standard, why shouldn't you value a restricted security at an unrestricted price?
A. Well, because --
Q. You said it's the guidance of the rule.
A. Yeah, it's the guidance of the rule, but it's really kind
09:46:36 of -- I don't want to say it's common sense, but it is, in a way, because you don't own the common stock. So if you don't own the common stock, you can't value what you own at the common stock price.
And you also took a restricted valuation or SDOUVENTS
09:46:52 when you purchase the security. So the company that issued the

security did so at a discount, and so your valuation should continue to take into account that discount unless things have changed that, you know, cause you to, you know, not apply the discount anymore.

09:47:10 Q. Right. I've heard the term liquidity used, is that what's meant by not have immediate ability to sell?

A. Correct.

Q. Lack of liquidity?

A. Correct.

09:47:19 Q. And you --

A. Well, the restrictions that are placed on the restricted stock, but then one of the factors which we'll talk about in a minute, I think, is the liquidity of the common stock is one of the factors you would use in order to arrive at your good faith

09:47:34 valuation for a restricted security.

Q. All right. So let's look at ASR 118. What did ASR 118 do?

A. So this was, again, two years later, I believe, than ASR 113, and the SEC in this accounting series release provided additional guidance for the valuation of restricted securities.

09:47:57 Q. Did it stick with the factor approach?

A. Yes; it talked about the factors that you need to consider in valuing restricted securities, including fundamental and analytical data. So fundamental will be, you know, business information about the company that's issued the security,

09:48:11 analytical data could be stock price in volume data for the

company that's issued the security.
Q. What about restrictions?
A. The length and the nature of the restrictions are something that you have to consider. And the analysis of a market, if
09:48:28 there's a market in which the restricted security can be bought or sold, you have to analyze that as well.
Q. So am I correct ASR 118 gives sort of a longer list of things that have to be considered?
A. It does. It does.
09:48:43 Q. All right.
A. Which is helpful because it really, you know, lays out some specific things that you should be looking at in order to value restricted securities.
Q. All right. So let's look at the first thing on that list.
09:48:58 If you could go through it quickly and then we may circle back.
A. So there's ten factor that ASR 118 clearly lays out: The type of security, the financial statements of the company that's issued the security, these are factors to consider, the cost of security at purchase, the size of the fund's holding of
09:49:18 the security --
Q. Let me interrupt you there. What does that mean?
A. Well, the actual size of the restricted security that's owned by a Fund. So if the fund owns 150 million shares versus 5 million shares, that's a pertinent factor.
09:49:34 Q. Okay. What about --

MR. BERRY: Your Honor, could I interrupt for one second?

THE COURT: Yes.

MR. BERRY: My apologies. Can the witness view his PowerPoint presentation?

09:49:47

THE COURT: He's got a screen that has it up there.

MR. BERRY: Isn't that somewhat identical as having the witness testify from notes?

THE COURT: I don't think so. I mean, my view is that this is a demonstrative aid to his testimony and he's listed -- I mean, at least at this point. Now, I don't think he's -- I mean, first of all, the witness can testify from notes but we'd mark them as an exhibit, but, I mean, this is a demonstrative aid. I don't think we need to do that with this. What's your problem with it?

09:50:01

09:50:22

MR. BERRY: I don't know if it actually qualifies as demonstrative because it's not summarizing large quantities of data. It's simply -- it is simply -- simply notes that correspond to the order of presentation of his narrative testimony.

09:50:41

THE COURT: So what's your problem with it?

MR. BERRY: I believe that it does not qualify as demonstrative data. I don't think it would be appropriate to use this as a -- as a jury exhibit -- or as a display to the jury, because it's not summarizing information that is fast or

09:51:00

needs to be quantified or needs to be summarized or displayed in a chart-like form. So I think says simply testifying from notes and I object to it.

THE COURT: Well, I'm going to overrule that objection. We don't have a jury, number one. Number two, your objection really is kind of like Federal Rule of Evidence 1009 objection in terms of presenting fast amounts of data in a summary form. I don't think that's what we're doing at all. I want to confirmed, that my memory is serving me right in terms of the Federal Rule of Evidence.

MR. MOYE: Yeah, the summary exhibit rule is 1006. We're not offering this PowerPoint as an exhibit.

THE COURT: Right. And, you know, I'm assuming that this PowerPoint accurately, for purposes of a demonstrative and not in an -- you're right 1006, 9 upside down.

I'm assuming that this is a fair and accurate portrayal of ASR 113, ASR 118, the FAS 157 factors. If you want to give an objection that says it's not, I'll listen to that, but that's not your objection, so I'll overrule --

MR. BERRY: These projections -- these projections are -- this is not ASR 118. ASR 118 is far lengthier than this.

MR. MOYE: But there's summaries. The witness said he put this together to summarize his understanding.

MR. BERRY: I understand that, but 1006, summaries to

This was something I know that was addressed in your report. We're not introducing the slide into evidence, it was already talked about, what has the Commission said more recently about valuation of restricted securities?

10:14:17 A. As I said previously, the Commission offered some letters to the ICI, which is the Investment Company Institute public letters, that reaffirmed some their guidance from ASRs 113 and 118.

Q. In your own words, what do you understand their more recent

10:14:34 guidance in 1999 to be saying?

A. Well, really it's getting back to what I spoke about earlier, which is fair value assumes an exit value or at the price that you would receive if you currently sold a security, the price that you might reasonably expect to receive if you

10:14:51 try to sell your restricted security today.

Q. What can't it based on?

A. It can't be based on what you think it's worth at some point in the future or what you think someone may purchase it for in -- when the restrictions are lifted at some point in the

10:15:08 future when the true value of the security, as you see it, could be realized. It really has to be today, exit value today.

Q. Okay. Let's look at another recent pronouncement by the SEC, this time in 2001. Again, in your own words, what did the

10:15:26 SEC say in offering guidance on the issue of fair value -- I'm

A. It was over $1 million.
Q. Did you draw any conclusions, whether general or specific, about whether these overvaluations led to investors actually paying more money than they should have?
11:38:32 A. Yeah, they did pay more money than they should have because the funds were overvalued.
Q. Let me ask you just briefly about Stealth. We're not going to go through Stealth and we don't have slides prepared in any sort of detail in Stealth, but what, if anything, can you tell
11:38:45 me about how Mercury approached valuations of the Stealth Fund?
A. Very similar, as I said before, to the Nutmeg Group's valuation were very similar in Stealth Fund as they were to the valuations in the Mercury Fund, but there was a time coefficient that they applied for some of their valuations for
11:39:05 the Stealth Fund and that gets to what the SEC says ASR 113, you can't use -- you shouldn't use a time coefficient to, you know, kind of gage your liquidity.
THE COURT: Can I interrupt here.
MR. MOYE: Yeah.
11:39:20 THE COURT: I just want to know, it's about 11:35, I want to know how we're doing.
Blanca, do you need a break here? Would a break be helpful here?
THE COURT REPORTER: Judge, it's up to you. I'm fine.
11:39:26 THE COURT: No, it's really up to you here.

A. Looking at the document, it was negative $1,901,011.
Q. Did you calculate Randall Goulding's capital account balance in Nutmeg for year-end 2007?
A. Yes.
Q. What did you calculate as Randall Goulding's capital account balance in Nutmeg as of year-end 2007?
A. Negative $2,318,275.
Q. Did you calculate Randall Goulding's capital account balance for the year-ending of 2008?
A. Yes.
Q. What was, if you remember, Randall Goulding's capital account balance as of December 31st, 2008?
A. Negative $2,596,048.
Q. Did you also look at Randall Goulding's capital account balance in Nutmeg for year-end 2009?
A. Yes.
Q. What did you calculate, if you remember, Randall Goulding's capital account balance for year-end 2009?
A. Negative -- it's for as of July 31st, 2009. And looking at 296, the number is negative $2,648,426.
Q. Why did your analysis stop in July of 2009?
A. Post July 2009, a receiver was appointed to Nutmeg.
Q. So overall, could you summarize for the Court whether or not Randall Goulding had a positive capital account balance or a negative capital account balance.

we discussed how the number of units declined when they were at liquidations.

In Exhibit 25, I see no liquidations during the time period that the statements cover, but there were changes in the number of units held by that investor.

Q. Well, you see that there is a liquidation in -- that's correct. Okay.

In MiniFund, in Exhibit 25, there is a liquidation on October 31, 2007; isn't that correct?

A. Yes.

Q. And that's the third quarter of 2007; isn't that right?

A. It would be the fourth quarter of 2007.

Q. The beginning of the fourth quarter, end of the third quarter; isn't that correct?

A. It would have occurred in the fourth quarter of 2007.

Q. Thank you.

Now, on this summary schedule, you show that there was a total -- the summary schedule that's been admitted as PX43, you see that you show a total benefit of $2.5 million and change to Randall Goulding; isn't that correct?

A. Yes.

Q. Okay. Now, did you ever yourself conduct any analysis of what Mercury was entitled to receive under its agreements with the various investment funds?

A. No.

Q. Okay. So you yourself -- you don't have any view one way or another as to whether the amount that Nutmeg was entitled to receive under its agreements with the investment funds was more or less than $2.5 million?
A. I do not have an opinion.
Q. Okay. Now, did you -- do you know who owned Mercury? I'm sorry.
Do you know who owned Nutmeg?
A. I believe Randall Goulding owned Nutmeg.
Q. Okay. And was it your assumption that Randall Goulding owned the entirety of Nutmeg?
A. Yes. I'm trying to recall from his deposition if there was maybe one unit held by his wife, but it was at least 99 percent owned by Mr. Goulding.
Q. Okay. But, in any event, it's correct that Mr. Goulding would be entitled to distributions equivalent to the -- most of the profit earned by Nutmeg; isn't that right?
A. It would go back to the capital account.
Q. I'm not talking about capital account.
A. But that is part of the capital account because you would have to take into account his contributions and withdrawals and then any net income or loss, and then you come with an ending number. That ending number, he could take a hundred percent of that every year, he could take zero. That's his capital balance, but it also includes any contributions or

it has nothing to do with *pro rata* ownership of any particular company, it has to do with the net or adjusted capital account balance; isn't that right?

A. That's how I was using it.

Q. Thank you. And I apologize for the interjection, but I was totally lost.

Now -- so in summary, your work showed that Mr. Goulding's capital withdrawals exceeded his capital contributions by a significant amount of money; is that right?

A. Yes.

Q. Okay. Now, just in the abstract, there are a lot of different circumstances that could justify -- that could explain why capital account withdrawals are in excess of -- oh, maybe not.

Let me ask you a question. If there were profit, if there was significant profit in a company and all the profit was taken out, would that -- would that change the capital account balance in and of itself?

A. Yes, you would attribute to the capital account balance any profits, any net income of the company.

Q. Any profit what?

A. Any profits of the company.

Q. Would --

A. To the member's equity account.

Q. Okay. Well, just as -- okay. So let's just say

hypothetically that if there's profit -- if there is a significant profit allocated to a partner or an owner, is -- does that change his capital account balance?
A. Yes.
Q. Okay. So if it stays in the company, it changes the capital account balance, right? If the -- if there's profit, instead of having a distribution, it's maintained in the company, that changes the capital account balance, right?
A. Yes.
Q. Okay. Now, if that profit were to be disbursed or distributed to the owner or the owners, would that -- the entirety of it, would that change the capital account balance?
A. Yes.
Q. How so?
A. If the owner takes the remaining -- let's say there's a million dollars in profit and after you calculate, you know, the -- after you have taken into account the contributions and withdrawals, that the remaining capital account balance is 950,000 and the owner decides to take 950,000, their capital account balance would be zero.
Q. Okay. But -- so let's just say there's a -- the owner makes a capital contribution of a million dollars that stays there, okay, in their operations for a year. And the operations generate -- the operations generate $500,000. The owner would request and obtain the distribution of that

$500,000 in profits to him, right? The capital account balance still is a million dollars, right?

A. Yes.

Q. Okay. Fine. So we're talking about the same thing.

All right. Now, isn't it -- isn't it correct that an owner's withdrawal cannot change the capital balance -- withdrawn.

So it's correct, isn't it, that the owner's withdrawal might not change the capital balance if all the owner is withdrawing is profit? Isn't that right?

A. If you look at two different points in time, it could change it if you keep a constant accounting of it, like a daily accounting. The ownership balance or your owner's equity account will change if there's accounting.

But if you look at it as of the end of a year, then it could stay the same if you look at it like the last day of the year and profits have been distributed.

Q. So a distribution might, hypothetically, be based on the earning of profit as opposed to a reduction in the capital account balance; isn't that correct?

A. It would be accounted for as a distribution. So it would be a withdrawal from the capital account balance, but the other side of it would be net income, which would be in addition to the capital account balance.

Q. Well, when you prepared -- when you prepared the summary

of the capital account balance, were you assuming that any of the withdrawals or distributions reflected profit?
A. No, I have no assumptions on any net income or loss.
Q. So just say hypothetically that in addition to Nutmeg's participation in the benefits of the investor funds at issue in this case Mr. Goulding made a separate capital contribution to Nutmeg, and that -- and Nutmeg took that capital contribution and invested it and made $1.6 million in profit, would that -- could that $1.6 million in profit be taken out without -- without affecting Mr. Goulding's capital account balance?
A. It would affect it in that the $1.6 million would be an addition to his capital account balance and any distribution of the 1.6 million would be accounted for as a distribution. What that ending amount number would be at a particular time, it could remain the same from one point in time to another, to another date.
Q. Thank you.
So using our simplified example, if Mr. Goulding, in addition to using Nutmeg to run the Funds and to receive the fees and carried interest that it earned in the Funds, earned from a totally separate transaction that was taking -- that took place through Nutmeg, earned a $1.6 million profit, and at the end of the year that $1.6 million profit was distributed to Mr. Goulding, that wouldn't change the capital

account balance, would it, if the distribution was identical to the amount of the profit earned?
A. His capital account balance would remain the same.
Q. As it was prior to -- prior to the separate investment and prior to the profits being earned?
A. Right.
Q. Did you ever see any reference to the Morgan Wilbur deals?
THE COURT REPORTER: To the what? I'm sorry?
THE COURT: Morgan --
BY MR. BERRY:
Q. The Morgan Wilbur deals in any of the work you did in connection with this case for the SEC's investigation?
THE COURT: Is that W-i-l-b-u-r?
MR. BERRY: Yeah, Morgan like Captain Morgan, and Wilbur like -- I think it was a cartoon character, but W-i-l-b-u-r.
BY MR. BERRY:
Q. Did you see any reference to any Morgan Wilbur deals in any of the work you did for the SEC in this case?
A. I have heard about --
Q. Okay.
A. -- Morgan Wilbur deals.
Q. Can you describe them?
A. I believe they are investments made early on in Nutmeg's history.