SECURITIES AND EXCHANGE COMMISSION
ADMINISTRATIVE PROCEEDING

	)	
In re RANDALL S. GOULDING,	)	File No. 3-19697
	)	
Respondent	)	
	)	

GOULDING'S MEMORANDUM OF LAW IN OPPOSITION
TO THE OGC'S MOTION FOR SUMMARY DISPOSITION

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Respondent Randall S. Goulding respectfully submits this memorandum of law in opposition to the motion by the SEC's Office of General Counsel ("OGC") for a summary disposition in favor of OGC's request that the SEC permanently disqualify Goulding from practicing as an attorney before the agency.

A. INTRODUCTION

This memorandum will show that the SEC's motion for a summary disposition should be denied. The motion seeks a permanent bar against Goulding practicing as attorney before the SEC as a "follow on" remedy. The request is based on Findings of Fact and Conclusions of Law filed by the Hon. Jeffrey T. Gilbert, United States Magistrate Judge, on October 25, 2019 in *Securities and Exchange Commission v. The Nutmeg Group, LLC, et al.*, Case No. 09-cv-1775 (N.D. Ill.), and the resulting judgment in that action. Judge Gilbert's Findings and Conclusions are at Tab 3 in the OGC's Appendix in support of its motion, and the resulting judgment is at Tab 4.

Judge Gilbert held that Goulding violated several sections of the Investment Advisors Act of 1940, 15 U.S.C. §80b-1 *et seq.* Goulding noticed an appeal from Judge Gilbert's ruling, and his brief in support of that appeal is required to by filed with the Seventh Circuit on August 14, 2020. *SEC v. Goulding*, 7th Cir., Dkt. 20-1689, ECF No. 11 (Scheduling Order on May 20, 2020).[1] Goulding requested that OGC consent to stay this disbarment proceeding until the Seventh Circuit appeal is decided. Even though Goulding is already subject to a temporary suspension that will remain in effect pending the resolution of this administrative proceeding, OGC denied that request.

The memorandum of law will show, first, that Judge Gilbert's findings should not be

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[1] https://ecf.ca7.uscourts.gov/docs1/00703616250

given preclusive effect in this disqualification proceeding since they were made according to a preponderance of the evidence standard, while, under the Due Process Clause, a deprivation of livelihood – such as OGC is seeking here – must be based on findings made under the more stringent "clear and convincing evidence" standard. Accordingly, the SEC should hold in this proceeding that Rule of Practice 102(e)(1)(iii) – which automatically accords preclusive effect to prior findings of securities law violations – can only constitutionally apply to prior findings made according to at least a "clear and convincing" evidence standard. (Point I, *infra*.)

Furthermore, Judge Gilbert's findings establish only recklessness. That is insufficient under Rule of Practice 102(e)(1)(iii) which requires a "willful" violation. In quasi-criminal proceedings such as this, willfulness means more than recklessness, instead, it requires at least a "knowing" violation. (Point II, *infra*.)

The obey-the-law injunction entered by Judge Gilbert is insufficient to support Goulding's disbarment from practice before the SEC since it does not track the statutory language and fails to specify what conduct is prohibited. (Point III, *infra.*)

Since neither Judge Gilbert's ruling nor the judgment entered upon that ruling can be given preclusive effect, and since the outcome of the *SEC v. Nutmeg* case does not establish any knowing violation, Goulding is entitled to a hearing *de novo* on the SEC's charges before he can be disbarred from practice before the SEC. At the hearing *de novo* he will show that the SEC's charges are unfounded and, in any event, that he did not knowingly violate any anti-fraud provision within the federal securities statutes and rules. (Point IV, *infra*.)

B. 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 unsuccessful, 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 practicing 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 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" (sometimes, "the Funds") 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. (Each investor pool is a client under the Investment Advisors Act of 1940.) However, by 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.

C. 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 practicing 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 defended himself (*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.

On October 25, 2019, Judge Gilbert filed Findings of Fact and Conclusions of Law. 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.

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. The misappropriation finding is wrong. 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 was not the commingling of the funds of law clients, instead, it involved the commingling of Nutmeg's 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.

Judge Gilbert's Findings and Conclusions (OGC Appendix, Tab 3) never state that the legal violations it attributes to Goulding were intentional as opposed to reckless. *Id.*, 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.")

D. POINTS AND AUTHORITIES

Point I

The Automatic Preclusive Effect that Rule 102(e)(1)(iii) Accords to Prior Judicial Findings of Securities Law Violations Can Only Be Constitutionally Applied to Prior Findings Established Under a Clear and Convincing (or More Stringent) Standard

Under Rule 102(e)(1)(iii), a previously established securities law violation may result in an automatic disqualification from practicing before the SEC, without further character or fitness review. The rule is thus a regulatory codification of issue preclusion (or "collateral estoppel").

However, issue preclusion comports with due process only where the prior findings are made according to a standard that is at least as stringent as that governing the subsequent proceeding. *In re St. Laurent*, 991 F.2d 672, 677 (11th Cir. 1993) ("issue preclusion . . . requires the standard of proof in the earlier litigation to be at least as stringent as that employed in the

later litigation"); *Azalea Drive-In Theatre, Inc. v. Hanft*, 540 F.2d 713, 717 (4th Cir. 1976) (". . . [I]n federal court Azalea had to prove by no more than a preponderance of the evidence that Kornfeld had threatened a group boycott. * * * Therefore, on the single element common to both cases, namely, the existence of Kornfeld's threat, the difference in the burden of proof between state and federal actions militates against holding that Azalea was collaterally estopped from asserting its antitrust claim."); *see generally:* 18 Charles Alan Wright & Arthur R. Miller, *Federal Practice & Procedure* §4422 (3d ed. 1998) ("[A] party who has carried the burden of establishing an issue by a preponderance of the evidence is not entitled to assert preclusion in a later action that requires proof of the same issue by a higher standard.")

The rule that only prior findings made according to a standard of proof at least as stringent as that applicable in the subsequent proceeding applies in attorney disbarment matters. *In re Gygi*, 541 P.2d 1392, 1395 (Ore. 2000) (". . . [T]here is a higher standard of proof in disciplinary actions than that which obtained in the federal securities case. Collateral estoppel is not applicable when the standard of proof in the second proceeding is greater than that which applied in the first."). As stated in *Attorney Grievance Commission of Maryland v. Robert Harley Bear*, 763 A.2d 175 (Md. 2000):

> Jurisdictions that have dealt with the precise issue presented by this case almost uniformly refuse to give preclusive effect to issues decided in a civil case under a preponderance of the evidence standard in a subsequent attorney discipline proceeding. Stated otherwise, the other jurisdictions which have encountered this issue have refused to apply offensive collateral estoppel in an attorney discipline proceeding unless the burden of proof in the prior proceeding equaled or exceeded the clear and convincing burden which governs disciplinary proceedings.

763 A.2d at 181 (summarizing cases). *Cf. In re Owens*, 1532 N.E.2d 248, 252 (Ill. 1988) (according only findings made in criminal cases collateral estoppel effect in attorney disciplinary

proceedings).

Undoubtedly, "an attorney is entitled to procedural due process . . . in disbarment or suspension proceedings." *Dailey v. Vought Aircraft Co.*, 141 F.3d 224, 229 (5th Cir. 1998). The rule that findings made in a prior proceeding are not preclusive in a later one governed by a more stringent burden of proof is based on the Due Process Clause. *Wilson v. City of Chicago*, 707 F.Supp. 379, 386 (N.D. Ill. 1989) (due process required that police officer defendants not be precluded from contesting a coerced confession claim under 42 U.S.C. §1983 by reason of a prior ruling in a criminal case that excluded the confession, since the arrestee's burden of proof was higher in the §1983 action than it had been on his exclusionary motion); *Pragovich v. I.R.S.*, 2008 WL 5082267 (D.Ariz., Nov. 26, 2008) ("full and fair opportunity" requires compliance with the "procedural requirements of the Due Process Clause" and protects a party from issue preclusion in a subsequent proceedings where "a different burden of proof applies").

Automatic issue preclusion pursuant to Rule 102(e)(1)(iii) is thus constitutionally impermissible in this proceeding since the SEC may not disbar attorneys based upon securities law violations established by only a preponderance of the evidence. Admittedly, *In re William R. Carter*, 47 S.E.C. 471, *1 n.3 (1981), held that a preponderance of evidence was sufficient to impose attorney discipline and, in subsequent rulings, OGC has relied upon *Carter*. However, *Carter* was incorrectly decided, is contrary to the view of most jurisdictions, and constitutionally incorrect because it overlooks the quasi-criminal nature of disbarment proceedings. The SEC should overrule *Carter* in favor of clear and convincing standard.

First, the *majority* approach is that attorney discipline can only be based upon violations shown by clear and convincing evidence. After surveying the law, *In re Auerhahn*, 2011 WL

4352350 (D. Mass., Sept. 15, 2011), concluded:

> *Most jurisdictions require clear and convincing evidence in attorney discipline proceedings. The majority of states and many federal districts apply this higher standard.* Of the eleven districts where local rules articulate a standard of proof, eight require clear and convincing evidence. Even where local rules are silent, federal courts have nonetheless recognized clear and convincing evidence as the applicable standard. * * * The American Bar Association, whose Model Rules and Model Code have provided the basis for the Massachusetts ethical rules, also supports the use of the clear and convincing evidence standard in discipline proceedings.

Id., *4 (emphasis added, footnotes and internal citations omitted). *See also*, *e.g.*, U.S.D.C., District of Columbia, Local Civil Rule 83.16(d)(8) ("If the charges are sustained by clear and convincing evidence, the Disciplinary Panel may . . . discipline the respondent by entering an appropriate order."); *In re Barrett*, 966 A.2d 862, 863 n.2 (D.C. 2009) (in disciplinary matters, the District of Columbia Bar "use[s] the more stringent 'clear and convincing' standard"); *In re Karavidas*, 999 N.E.2d 296, 314 (Ill. 2013) (". . .. [W]e hold that professional discipline may be imposed [by the Illinois' Attorney Disciplinary Commission] only upon a showing by clear and convincing evidence that the respondent attorney has violated one or more of the Rules of Professional Conduct."); ABA, *Model Rules for Disciplinary Enforcement*, Rule 18(C) ("Formal charges of misconduct . . . shall be established by clear and convincing evidence.")

The clear and convincing standard is constitutionally required. The Supreme Court has held that: "[d]isbarment . . . is a punishment or penalty imposed on the lawyer" and that disbarment "proceedings are of a quasi-criminal nature." *In re Ruffalo*, 390 U.S. 544, 551, 88 S.Ct. 1222, 1226 (1968). Citing *Ruffalo*, in *Nguyen v. Department of Health Medical Quality Assurance Commission*, 29 P.3d 689 (Wash. 2001), the Washington Supreme Court held that medical de-licensure proceedings, like attorney disbarment, was quasi-criminal in nature,

"involving a stigma more substantial than mere loss of money," and that due process therefore required "clear and convincing proof." *Id.* at 695, 697. As *Nguyen* recognized, that outcome was necessitated under *Santosky v. Kramer,* 455 U.S. 745, 756, 102 S.Ct. 1388 (1982), which held that "clear and convincing evidence" is required when the individual interests at stake in the proceeding are both "particularly important" and "more substantial than mere loss of money." 455 U.S. at 756, 102 S.Ct. at 1396.

As stated in Jayne W. Barnard, "Rule 10b-5 and the 'Unfitness' Question," 47 *Arizona L. Rev.* 9 (2005):

> The use of a clear and convincing standard is not merely prudential. It is constitutionally-mandated. The appropriate standard of proof is determined by the Due Process Clause, taking into account the magnitude of what is at stake for the defendant. For example, a preponderance of the evidence standard may suffice to support the entry of a simple damage award. A beyond a reasonable doubt standard is required when the interest at stake is the defendant's freedom. In between these extremes is an intermediate standard of proof—clear and convincing. This is the standard that courts must apply when something more than money (or even a job) is at stake.

Id. at 45.

William R. Carter, *supra*, the SEC's authority supporting a preponderance of evidence standard, held:

> Shortly before this opinion was issued, the Supreme Court decided, in *Steadman v. SEC*[, 450 U.S. 91 (1981)] that the standard of proof applicable in administrative proceedings of this nature is the "preponderance-of-the evidence," rather than the "clear and convincing evidence" standard, and we have therefore applied such standard in our review of these proceedings. While the Administrative Law Judge, citing *Collins Securities Corp. v. S.E.C.*, 562 F.2d 820 (C.A.D.C. 1977), made his findings and conclusions on the basis of the higher "clear and convincing" standard, we have carefully considered the operation of the two different standards and conclude that our findings herein would remain the same under either standard.

47 S.E.C. 471, *1 n.3. The *Carter* decision does not describe what the SEC's "careful

consideration" of the issue involved, or provide any reasoning for adopting the preponderance of evidence standard, beyond its assumption that *Steadman* was persuasive authority.

However, *Steadman* did not involve a professional bar, but instead an industry bar. In extending the *Steadman* precedent to professional bars, *Carter* overlooked the fact that professional licenses are a unique form of property and entitled to greater protections that business licenses. *Nguyen v. State*, supra, 29 P.3d at 697 ("[Revocation of a medical license involves] much more than the loss of a specific job. It involves the professional's substantial interest to practice within his profession, his reputation, his livelihood, and his financial and emotional future. [That is why] the constitutional minimum standard of proof in a professional disciplinary proceeding for a medical doctor must be something more than a mere preponderance [of the evidence]."); *U.S. v. Shotts*, 145 F.3d 1289, 1296 n.9 (11th Cir. 1999) (right to practice law and medicine are protected property interests, while bail bond licenses are not); *In re Isaacson*, 478 B.R. 763, 778 (Bankr., E.D. Va. 2012) (" . . . [T]he Business License cannot be conflated with a professional license, which implies by its issuance a certain level of competence to perform duties in a regulated profession, such as law, medicine, architecture, engineering or general contracting."); *see also: Auerhahn*, *supra*, 2011 WL 4352350, *4 (holding, following its comprehensive survey of the law, "Requiring a higher quantum of proof, like clear and convincing evidence, recognizes the gravity of limiting an individual's right to practice in his or her chosen profession, while balancing the need to protect the public from unfit practitioners."); *see generally:* Barnard, "Unfitness Question," *supra*, 47 *Arizona L. Rev.* at 46 (concerning securities industry (non-professional) bars under Sarbanes-Oxley, "There may even be an equal protection claim for a defendant subjected to a preponderance of the evidence standard when

other professionals (like doctors and lawyers) are protected by a clear and convincing standard.")

Since due process requires that a clear and convincing standard apply in this proceeding, Goulding cannot be disbarred from practice before the SEC based upon Judge Gilbert's findings made under a preponderance of evidence standard.

Also, as the Sixth Circuit recognized in *Jones Brothers, Inc. v. Secretary of Labor*, 898 F.3d 669 (6th Cir. 2018):

> It may be true that an administrative agency is a creature of statute and derives its existence and all of its power from Congress. And it may be true that, without a statute conferring authority, a federal agency has no ability to act, let alone bind private actors. But it does not follow that administrative agencies may look the other way when it comes to as-applied constitutional challenges and constitutional-avoidance arguments. Agency actors must continually interpret and apply their statutory duties in light of constitutional boundaries.

Id. at 674. The Commission should therefore further hold that automatic issue preclusion under Rule 102 (e)(1)(iii) is permitted only when the prior finding of a securities law violation was made in a prior proceeding (such as a criminal case) in which the burden of proof was at least as stringent as the clear and convincing standard that should properly apply here.

Point II

The Willful Violation Requirement under Rule 102(e)(1)(iii) is Either Void for Vagueness as A Penal Remedy or Must Be Construed as Requiring a Knowing Violation

As shown in Point I, professional discipline is penal in nature. *Cf. Saad v. SEC*, 873 F.3d 297, 306 (D.C. Cir. 2017) (Kavanaugh, J., concurring) (opining that "the SEC must justify expulsions or suspensions as punitive").

Rule 102(e)(1)(iii) provides that the SEC may bar a professional from practicing before it if he has been previously been found "to have to have willfully violated, or willfully

aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder." All that is required is a "willful" violation; no further character or fitness review is required. In other words, Rule 102(e)(1)(iii) means that a securities law violation may result in an *automatic* disbarment or suspension of the privilege of practicing before the Commission.

Because Judge Gilbert held only that Goulding's securities law violation were either "intentional or reckless" (OGC Appendix, Tab 3, p. 49, at ¶¶31 and 32), his ruling does not establish an intentional violation. *In re Baylis*, 222 B.R. 1, 7 (Bankr., D. Mass. 1998) (prior judgment "based upon its alternative findings of negligence and bad faith" not given preclusive effect on issue of *mens rea*); *Restatement (Second) of Judgments*, §27 comment i (1982) ("If a judgment of a court of first instance is based on determinations of two issues, either of which standing independently would be sufficient to support the result, the judgment is not conclusive with respect to either issue standing alone.")

While Judge Gilbert necessarily found that Goulding's violations were at least reckless, it is uncertain whether recklessness suffices to justify a disbarment under Rule 102(e)(1)(iii), which requires that the attorney have "willfully violated" the federal securities laws.

Rule 102(e)(1)(iii)'s regulatory codification of a "willful" *mens rea* requirement is constitutionally vague. The vagueness problem lies in the Rule's use of the term "willfully" to define the *mens rea* that must be shown before a violation may result in disbarment.[2] "Willful"

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[2]Goulding is aware that *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) held, in this context of industry (rather than practice bars) that "willfulness" in this context means intentionally or recklessly committing an act that constitutes a violation of the securities laws. However, as shown in Point I, practice bars are clearly penal in nature, while industry bars are not.

is regarded as having an uncertain meaning, and, for a very long time, has been the subject of competing interpretations. *United States v. Zeeze*, 2020 WL 554803, *5 (D.D.C., Feb. 4, 2020) ("'Willfully,' . . . 'is sometimes said to be a word of many meanings whose construction is *often dependent on the context in which it appears*'" (emphasis added, quoting *Bryan v. United States*, 524 U.S. 184, 191, 118 S.Ct. 1939, 1944-1945 (1988)).

For civil securities law violations, "willfulness" has been interpreted to include reckless disregard of the law. *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1039-1040 (7th Cir.), *cert. denied*, 434 U.S. 875, 98 S.Ct. 224 (1977) (equating recklessness and "willful fraud").

However, the Supreme Court recognizes that, while the meaning of "willful," in a purely civil case includes "reckless disregard of the law":

> It is different in the criminal law. 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.

Safeco Ins. Co. of America v. Burr, 551 U.S. 47, 57 & n.9, 127 S.Ct. 2201, 2208 & n.9 (2007).

There is no clarity as to whether the term "willfully," as used in Rule 102(e), includes the reckless violations of the law that Goulding was found to have committed. In fact, the District of Columbia Circuit has repeatedly sustained "challenges" to "Rule 102(e)(1) sanctions" based on the Commission's "failure to provide standards or notice as to the possibility that negligent or reckless conduct could fall within [its] ambit." *Altman v. S.E.C.*, 666 F.3d 1322, 1328 (D.C. Cir. 2011) (citing *Marrie v. SEC*, 374 F.3d 1196, 1202 (D.C. Cir. 2003); *accord: Checkosky v. SEC*, 139 F.3d 221 (D.C. Cir.1998). *See also: Checkosky v. SEC*, 23 F.3d 452, 458 (D.C. Cir.1994)) (Silberberg, J.. plurality opinion) ("The Commission . . . does not specify the state of mind both necessary and sufficient to constitute a violation in light of its past

precedents.")

In the first *Checkosky* case, Judge Silberberg's opinion stated:

> I think the Commission must choose its standard and forthrightly apply it to this case. Given the enormous impact on accountants—and lawyers—that the Rule has, and in fairness to petitioners, the Commission must be precise in declaring the standard against which petitioners' conduct is measured and exactly why that conduct violated the standard.

Id., 23 F.3d at 462.

Nevertheless, following the *Checkofsky* rulings, the SEC clarified that reckless conduct was sufficient to sustain a bar or suspension, but *only* in the case of accountants charged with "improper professional conduct" under Rule 102(e) (1)(ii). Amendments to Rule 102(e) of the Commission's Rules of Practice, Fed. Sec. L. Rep. (CCH) ¶ 86,052, at 80,844 (Oct. 19, 1998). In other types of Rule 102 proceedings – such as those involving attorneys or allegations of securities law violations – the Commission did not clarify whether reckless disregard of the law is a sufficient *mens rea* to justify disbarment or suspension, and the vagueness defect identified in the *Checkosky* decisions still exists.

The vagueness doctrine is an aspect of procedural due process. As shown in Point I, Goulding's right to practice law before the SEC is a protected property interest. Under the due process clause, "[A] statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application, violates the first essential of due process of law." *Connally v. General Constr. Co.*, 269 U.S. 385, 391, 46 S.Ct. 126, 127 (1926).

The vagueness doctrine imposes a "requirement of clarity in regulation [that] is essential to the protections provided by the Due Process Clause of the Fifth Amendment." *F.C.C. v. Fox*

Television Stations, Inc., 567 U.S. 239, 253, 132 S.Ct. 2307, 2317 (2012).

Given the quasi-criminal nature of this proceeding, any ambiguity should be resolved in favor of requiring a knowing violation. As the Washington Supreme Court summarized the law, in holding an attorney disciplinary rule unconstitutionally vague:

> Courts have long recognized that disbarment is "penal in its nature" and subject to the rule of lenity. *Moutray v. People*, 162 Ill. 194, 198, 44 N.E. 496 (1896) (holding statutes authorizing disbarment must be "strictly construed, and not extended by implication to things not expressly within their terms"). *See also Ruffalo*, 390 U.S. at 550–51, 88 S.Ct. 1222 ("Disbarment ... is a punishment or penalty imposed on the lawyer" involving "adversary proceedings of a quasi-criminal nature."); *Charlton v. Fed. Trade Comm'n*, 177 U.S.App. D.C. 418, 543 F.2d 903, 906 (1976)); *In re McBride*, 602 A.2d 626, 640–41 (D.C.1992) (applying rule of lenity to statute governing disbarment). The same holds for all other sanctions. "Because attorney suspension is a quasi-criminal punishment in character, any disciplinary rules used to impose this sanction on attorneys must be strictly construed resolving ambiguities in favor of the person charged." *United States v. Brown*, 72 F.3d 25, 29 (5th Cir.1995); *In re Thalheim*, 853 F.2d 383, 388 (5th Cir.1988).

In re Disciplinary Proceeding v. Haley, 156 Wash.2d 324, 349, 126 P.3d 1262, 1274 (2006). *See generally: Manning v. Caldwell*, 930 F.3d 264, 272 (4th Cir. 2019) ("laws that nominally impose only civil consequences warrant a 'relatively strict test' for vagueness if the law is 'quasi-criminal' and has a stigmatizing effect").

Thus, in a penal or quasi-criminal proceeding, under the rule of lenity, the ambiguity inherent in the term "willing" should be revolved in favor of the higher degree of *scienter*, *i.e.*, "knowing," rather than "reckless."[3] That is, an intentional or knowing violation of the law should be required before a disbarment or suspension is ordered, rather than merely deliberate conduct and reckless disregard of the law.

---

[3]The rule of lenity *requires the court to resolve any statutory ambiguity in favor of a criminal defendant. See Leocal v. Ashcroft*, 543 U.S. 1, 11 n.8 (2004)

According, the Commission should dismiss the allegation that Goulding should be disbarred based upon reckless securities law violations, since Rule 102(e)(1)(iii) is either unconstitutionally vague as to whether reckless conduct is sufficient, or ambiguous, in which case the rule of lenity mandates that it be interpreting as requiring a knowing, rather than reckless, violation.

Point III

The Obey-the-Law Injunction Entered By the District Court Is Invalid and Does Not Justify Any Discipline

As noted, the District Court entered an obey the law injunction. However, it contained no guidance as to what particular conduct is prohibited. OGC Appendix, Tab 3, 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.") 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. *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 IV

Upon a Hearing *De Novo*, Goulding Will Show that He Did Not Overstate or Misappropriate the Funds' Assets

Upon a hearing *de novo*, none of the SEC's allegations will be sustained.

(a) There Were No Improper Transfers to Affiliated Entities

Judge Gilbert's findings that Goulding improperly transferred Fund assets to Nutmeg's

affiliates is wrong. Upon a hearing *de novo,* Goulding will show that the transfer to affiliates was a legal use of special purpose vehicles, and consistent with the SEC's own rules and guidance.

In particular, Goulding arranged for certain Funds to make investments through affiliated entities, or for assets to be titled in the name of such affiliates, for the benefit of the Funds. It was Goulding's intention that these affiliates function as special purpose vehicles ("SPVs"). SPVs are legal devices, and assets "titled" in the name of SPVs were properly attributable to the Funds. The SEC has commented on SPVs in the following fashion:

> Investment advisers to pooled investment vehicles may from time to time use special purpose vehicles (SPVS) to facilitate investments in certain securities by one or more pooled investment vehicles that the advisers manage. These SPVS are typically established or controlled by the investment adviser or its related persons who often serve as general partners of limited partnerships (or managing members of limited liability companies, or persons who hold comparable positions for another type of pooled investment vehicle).

SEC Release No. Release No. IA-2968, File No. S7-09-09, 6p. 41 (December 30, 2009).

This release specifically provides that: "To comply with the [custody] rule, as amended, the investment adviser could either treat the SPV as a separate client, in which case the adviser will have custody of the SPV's assets, or treat the SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly." *Id.*

It was entirely proper – indeed, it was required – that the account statements show the assets held by the investor special purpose vehicles *(i.e.*, Nutmeg's affiliates) as belonging to the respective Funds. *Id.* See also: SEC, Guidance Update No. 2014-07 7, pp. 2-3, at Scenarios 1 & 3 (where the pooled investment vehicle invests a portion of its capital in either single purpose or multi-purpose special purpose vehicle, which in turn invests in either one or more investments,

and the special purpose vehicle has no owners other than the adviser's related person(s), the adviser may choose to treat the assets of the single purpose vehicle as assets of the pooled investment vehicle client).

Since it was Goulding's intention that these affiliates function as SPVs, since the SEC approves of such use of the "SPVs," and since assets "titled" in the name of SPVs were properly attributable to the Funds, neither the use of the SPVs nor dissemination of the account statements attributing the assets they held to the Funds was either an intentional or a reckless violation of any law or rule.

At a hearing, Goulding will show that, following the SEC's examination of Nutmeg in 2007, the use of these nominees ceased and that the assets were reassigned to the various funds, a fact never disputed by the SEC and well-known to the Division of Enforcement. Accordingly, the allegation in OGC's motion that these transfers resulted in a $4 million misappropriation is misleading and inflammatory, since labeling the transfers as misappropriations wrongly suggests that the assignment of assets to the SPVs as the Funds' nominees was not reversed.

(b) The Evidence Will Confirm that Goulding Did Not Receive any Ill-Gotten Gains

An issuer (or promoter) of a securities offering may be liable under misappropriation type theories if they either caused or participated in an fraudulent securities offering, or received an allocation of the offering proceeds in excess of his or her contractual entitlements. Goulding did neither.

In fact, none of Judge Gilbert's findings establish that Goulding or Nutmeg committed any fraud in the securities offerings in which capital contributions were solicited and received. "To meet the 'in connection with' requirement, the fraud practiced must have been prior

to or contemporaneous with the sale of securities." *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) ("For Section 10(b) purposes the only investment decision made by Freschi occurred on December 29, 1977. Hence, defendants are correct in their assertion that Freschi can only recover for conduct committed before that date; subsequent conduct would lack the requisite 'in connection with the sale or purchase of any security.'")

Also, Judge Gilbert's findings did not even attempt to compare the compensation Goulding received with his contractual entitlements, and in fact the entirety of the compensation he received was within those entitlements. *S.E.C. v. Resnick*, 604 F.Supp.2d 773, 783 (E.D.N.Y. 2009) (". . . [I]t is reasonable to assume that Mr. Kaiser performed various functions of value to the company other than the fraudulent activities which inflated earnings. Accordingly, I cannot conclude, based purely on Mr. Lee's testimony, that Mr. Kaiser's salary was causally linked to his unlawful conduct, and will not order disgorgement.")

(c) Goulding Cannot Be Disciplined Based on the Valuations Reflected in the Account Statements

The SEC's claim at trial was that Nutmeg used an incorrect valuation methodology, not that valuations were mis-stated by any particular amount. At trial, SEC expert evaluation witness Peter Hickey testified that he focused on valuation "methodologies," and "ha[d] not formed an opinion as to what correct valuation numbers would be" and that his opinion "didn't put an actual number on it." Trial Transcript (Ex. A hereto), at 695:8-11.

The SEC's inability to quantify the alleged overvaluation means that it cannot prove a claim that the values reflected in the account statement was incorrect. In *SEC v. Mannion*, 2013

WL 1291621, *12, *14 (N.D. Ga., Mar. 25, 2013) the SEC contended that hedge fund assets, including convertible debentures, had been overvalued, but did not demonstrate "the amount" of the overvaluation. The defendant obtained summary judgment dismissing the overvaluation claims because, as the Court stated, "[a]bsent evidence of the extent of these over-valuations," the "trier of fact cannot conclude that the over-valuations . . . were material[.]" *See also: Fulton Cty. Emps. Ret. Sys. v. MGIC Inv*., 2010 WL 5095294, *7 (E.D. Wis. 2010), *aff'd* 675 F.3d 1047 (7th Cir. 2012) ("[T]he relevant question is not whether C-BASS's assets declined in value, but by how much. That three inputs into C-BASS's fair-value determination pointed downward does not tell me anything about the magnitude of the write-offs C-BASS should have taken."); *see generally:* Salvatore Massa, "Outside a Black Box: Court and Regulatory Review of Investment Valuations of Hard-to-Value Securities, 8 *Wm. & Mary Bus. L. Rev.* 1, 43-44 (2016) (where "applicable accounting guidance provides wide latitude," the plaintiff must show not only variance from how the asset should be valued but also "the dollar impact of the variance").

At Hickey, the SEC's expert, opined that Nutmeg should not have valued convertible debentures according to the market value of the underlying common stock; that was improper to value restricted securities based on the market value of otherwise identical unrestricted stock; and that blockage and illiquidity discounts should be applied. That view, as Hickey acknowledged was based upon Accounting Standard Release ("ASR") 113.

Under ASR 113, the convertible debentures were to be valued based on a hypothesized "current sale" which is understood to be a distress price. ASR 113 is considered "fundamentally a liquidation value principle." Janet K. Smith, Ph.D, "The SEC's 'Fair Value' Standard," 6

Fordham J.C.&F.L 421, 423 (2001). 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 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 fact, at trial, Hickey repeatedly asserted that Nutmeg had not adhered to ASR 113 (the prior standard), and referred to ASR 113 nine times in his direct testimony. Trial Transcript (excerpted at Ex. A), at 602-603, 606, 607, 609, 612, 622, 682.

However, in 2007, ASR 113 was superceded by Financial Accounting Standard 157 (and re-codified as ASC 820). 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. Relying on FAS 157/ASC 820, Goulding and Nutmeg valued the convertible debts based largely on the prevailing market value of the common stock into which they could be converted. That approach is mandatory under FASB Guidance currently in place, and in place at the time of the valuations that the SEC is challenging.

Goulding was adhering to the applicable FASB guidance, and shouldn't be disciplined for following guidance that the SEC has itself stated 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.

Even if wrong (though it was not), Goulding's view he was required to follow the approach adopted in FAS 157/ASC 820 is not an appropriate basis for disciplinary action. *NY Eth. Op. 635*, 1992 WL 348747 (N.Y. St. Bar. Assn. Comm. Prof. Eth., Sept. 23, 1992) (" . . .

[J]ust as matters of opinion, judgment or strategy upon which competent lawyers could disagree do not necessarily give rise to civil liability for malpractice, such matters would not ordinarily form the basis for attorney discipline, and thus do not involve the kind of conduct the reporting of which is required under DR 1-103(A)."); *See generally:* ABA Comm. on Professional Ethics, Informal Opinions, No. 1273 (1973) ("error of judgment made in good faith" does not justify a finding that the attorney violated professional diligence or competence requirements).

E. <u>CONCLUSION</u>

For the foregoing reasons, the motion for a summary disposition should be denied in its entirety.

Dated: New York, New York
June 30, 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 June 30, 2020, I caused the annexed Memorandum of Law to be served by email upon:

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Dated: New York, New York
June 30, 2020

/s/ Eric W. Berry
Eric W. Berry

EXHIBIT A

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

3 SECURITIES AND EXCHANGE COMMISSION,) No. 09 CV 1775
)
4 Plaintiff,)
vs.) Chicago, Illinois
5)
THE NUTMEG GROUP, LLC, et al.,)
6)
Defendants.)
7)
DAVID GOULDING, et al.,) January 16, 2018
8)
Relief Defendants.) 9:00 o'clock a.m.
9

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

12

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24

25

1 From time to time there are different accounting standards that
2 come into play overall for businesses, but this valuation
3 standard from FAS 157 to ASC 820, there's no real changes to
4 it.
09:36:45 5 THE COURT: Okay.
6 BY MR. MOYE:
7 Q. All right. We don't need to look up the dates.
8 So what other source or standard did you consult
9 besides FAS 157?
09:36:55 10 A. Well, the Investment Company Act.
11 Q. Okay. So to clarify, you're not an attorney. Why did you
12 consult the Investment Company Act as part of this analysis?
13 A. Because the Investment Company Act provides guidance on
14 valuation.
09:37:10 15 Q. Okay. Besides the Investment Company Act, what else did
16 you consult?
17 A. The SEC has also issued guidance on the valuation of
18 restricted securities through what is call ASR 113 and ASR 118,
19 they're accounting series releases, and they're actually quite
09:37:27 20 old. ASR 113 dates back to 1969 and ASR 118 dates to 1971, but
21 they're very well-known in the industry and they are extremely
22 helpful in terms of providing guidance on the valuation of
23 restricted securities.
24 Q. Okay. What about anything more recent.
09:37:48 25 A. The SEC has offered some, as they do from time to time,

1 some letters that reaffirm the guidance as provided by ASR's
2 113 and 118.
3 Q. Are these private letters or are they publicly available?
4 A. They're publicly available.
09:38:06 5 Q. All right. So let's talk about one of the definitions that
6 you've offered in your report and that you're opining on. Can
7 you tell us what you mean by the term fair value or what do you
8 understand by the term fair value?
9 A. Well, fair value is as defined by FAS 157 and is pretty
09:38:24 10 well-known, it's a price that you receive to sell an asset or
11 that you pay to transfer a liability in an orderly transaction
12 between market participants at the current date.
13 Q. Okay. Can now give us, in brief, your own understanding
14 what means.
09:38:41 15 A. Well, it's assuming an exit value. If the principle of it
16 is you're to get at what price you would receive for the
17 security you're selling today if you were to sell it today.
18 Q. Question, is FAS limited or is FAS 157 limited or directed
19 to securities only or does it cover other things?
09:39:03 20 A. It covers other things. It covers assets and liabilities,
21 really anything that a company would have to value for purposes
22 of its financial reporting.
23 Q. Okay. But in your opinion, it certainly does cover
24 securities?
09:39:14 25 A. It does.

1 Q. Does FAS 157 offer any guidance or establish any standards
2 for the valuation of restricted securities?
3 A. Yes, it does.
4 Q. Can you tell us what those are?
09:39:32 5 A. Well, for restricted securities FAS 157 expressly says you
6 can't simply value a restricted security at an unrestricted
7 price.
8 Q. Just to clarify, what do you mean by an unrestricted price
9 of a security.
09:39:46 10 A. So if there was a security like a common stock that had
11 been issued by a company that freely tradeable, that was
12 unrestricted, yet you owned a restricted security form that
13 same company you can't just apply the common stock price to the
14 restricted security that you own.
09:40:03 15 Q. So what's the relevance, what should someone do in valuing
16 restricted securities?
17 A. Well, again, you have to use what's referred to by -- we'll
18 get to that with the Investment Company Act, but you need to
19 take into account the effects of the restriction. So someone
09:40:22 20 who's going to buy that security from you, if they're going to
21 consider the effects of the restriction on pricing that
22 security, you have to also take into account those restrictions
23 and your ongoing pricing or valuation of that security.
24 Q. What about access to public markets, is that relevant?
09:40:42 25 A. Well, for restricted security you have an inability to

1 access public markets for a period of time, and so the
2 valuation has to account for that.
3 Q. Do restricted securities have a single or common length of
4 time for restriction?
09:41:02 5 A. No, they vary. And the nature and the duration of
6 restrictions can vary security to security. And your valuation
7 as FAS directs has to take into account the variance of those
8 restrictions.
9 Q. Anything else on FAS guidance on restricted securities that
09:41:27 10 you think is relevant for now?
11 A. No.
12 Q. All right. Let's talk briefly about the Investment Company
13 Act. How does this help and form your analysis or the
14 standards you think are applicable here?
09:41:37 15 A. Well, the Investment Company Act says a lot of things, but
16 for valuation it really says two things that are applied: For
17 investment funds that have securities for which market prices
18 are readily available, so it's like Microsoft stock or some
19 stock that was trading in active market, you use market
09:41:58 20 quotations to value those securities, but then the Investment
21 Company Act says for securities that don't have a readily
22 available market price, you have to use what's called
23 good-faith efforts to arrive at the fair value of those
24 securities.
09:42:14 25 Q. So what's your understanding of what might be required for

1 the second thing, for -- if there's no readily available market
2 quote for the price of an asset, what might be required for the
3 use of good faith in valuing that asset?
4 A. Well, again, you're trying to -- you're trying to come up
09:42:42 5 with a valuation for a security that you own. And as the FAS
6 157 says, and the Investment Company Act is clear too, you're
7 looking for an exit value, you're looking for a value that you
8 could receive upon the current sale of that security.
9 So you have to take into account all relevant
09:43:02 10 information, information from the company that issued that
11 security, and the size of that security, the financial
12 condition of the company. So, really, any information that's
13 available to you have to, you know, use good-faith efforts to
14 use that information to come up with a valuation of the
09:43:21 15 security. You know, the SEC guidance provides a lot more
16 detail for that that's pretty helpful that is directed to the
17 Investment Company Act's principles.
18 Q. All right. So let's look at the SEC 113 -- or ASR 113.
19 A. So -- sorry. Sorry.
09:43:41 20 Q. Yeah. Tell us what your understanding is of what sort of
21 guidance is provided by 113.
22 A. Well, as I said just previously, what ASR 113 says, and
23 this is dating back to the '60s, it really clearly says that
24 there's no set formula you should use in order to value a
09:44:00 25 restricted security. You have to consider all pertinent

1 factors: The business condition of the company that's issued
2 the security, general market conditions, and any change in the
3 inherent value of the security.
4 So if something has happened with the company or
09:44:17 5 within, you know, the capital structure of the company, you
6 have to consider all of those factors in order to come up with
7 fair value.
8 Q. Well, that seems pretty broad. Is there anything that
9 ASR 113 says you should not consider or not incorporate in an
09:44:33 10 analysis?
11 A. Yes; expressly, ASR 113 rejects four methods of valuations
12 for restricted securities.
13 Q. So we've got them on the slide here. Which of these four
14 methods of valuation do you think are loss applicable to your
09:44:51 15 engagement in this case?
16 A. Well, probably number three, which is valuing restricted
17 security at the unrestricted market price, but all four of
18 these are important from the perspective of the SEC and the
19 industry, that you can't, you know, value a restricted security
09:45:10 20 continuously at the cost of which you bought the security, when
21 conditions have actually changed for the company that's issued
22 the security.
23 You can't use constant percentages or dollar
24 discounts. You can't simply, and this is the most applicable
09:45:27 25 in this case, you can't value restricted security at the

1 unrestricted market price.
2 Q. Okay.
3 A. And then this is also applicable in this case, especially
4 with the Stealth Fund, you can't value the restricted security
09:45:39 5 using an amortization of the discount over time. So, in other
6 words, if you have a restricted security that is restricted for
7 24 months or two years, you can't just have a formula that
8 says, okay, in 23 months it's going to be worth a little bit
9 more because it's less restricted, and then it's going to be
09:45:56 10 less restricted in 20 months so it should be worth more. The
11 SEC has expressly said you can't use an amortization schedule
12 to discount the security.
13 Q. Let's talk about 118. Before we do, can you just explain
14 in your own words what you think the issue is. Why -- your
09:46:21 15 understanding of the standard, why shouldn't you value a
16 restricted security at an unrestricted price?
17 A. Well, because --
18 Q. You said it's the guidance of the rule.
19 A. Yeah, it's the guidance of the rule, but it's really kind
09:46:36 20 of -- I don't want to say it's common sense, but it is, in a
21 way, because you don't own the common stock. So if you don't
22 own the common stock, you can't value what you own at the
23 common stock price.
24 And you also took a restricted valuation or SDOUVENTS
09:46:52 25 when you purchase the security. So the company that issued the

1 security did so at a discount, and so your valuation should
2 continue to take into account that discount unless things have
3 changed that, you know, cause you to, you know, not apply the
4 discount anymore.
09:47:10 5 Q. Right. I've heard the term liquidity used, is that what's
6 meant by not have immediate ability to sell?
7 A. Correct.
8 Q. Lack of liquidity?
9 A. Correct.
09:47:19 10 Q. And you --
11 A. Well, the restrictions that are placed on the restricted
12 stock, but then one of the factors which we'll talk about in a
13 minute, I think, is the liquidity of the common stock is one of
14 the factors you would use in order to arrive at your good faith
09:47:34 15 valuation for a restricted security.
16 Q. All right. So let's look at ASR 118. What did ASR 118 do?
17 A. So this was, again, two years later, I believe, than ASR
18 113, and the SEC in this accounting series release provided
19 additional guidance for the valuation of restricted securities.
09:47:57 20 Q. Did it stick with the factor approach?
21 A. Yes; it talked about the factors that you need to consider
22 in valuing restricted securities, including fundamental and
23 analytical data. So fundamental will be, you know, business
24 information about the company that's issued the security,
09:48:11 25 analytical data could be stock price in volume data for the

1 company that's issued the security.
2 Q. What about restrictions?
3 A. The length and the nature of the restrictions are something
4 that you have to consider. And the analysis of a market, if
09:48:28 5 there's a market in which the restricted security can be bought
6 or sold, you have to analyze that as well.
7 Q. So am I correct ASR 118 gives sort of a longer list of
8 things that have to be considered?
9 A. It does. It does.
09:48:43 10 Q. All right.
11 A. Which is helpful because it really, you know, lays out some
12 specific things that you should be looking at in order to value
13 restricted securities.
14 Q. All right. So let's look at the first thing on that list.
09:48:58 15 If you could go through it quickly and then we may circle back.
16 A. So there's ten factor that ASR 118 clearly lays out: The
17 type of security, the financial statements of the company
18 that's issued the security, these are factors to consider, the
19 cost of security at purchase, the size of the fund's holding of
09:49:18 20 the security --
21 Q. Let me interrupt you there. What does that mean?
22 A. Well, the actual size of the restricted security that's
23 owned by a Fund. So if the fund owns 150 million shares versus
24 5 million shares, that's a pertinent factor.
09:49:34 25 Q. Okay. What about --

1 MR. BERRY: Your Honor, could I interrupt for one
2 second?
3 THE COURT: Yes.
4 MR. BERRY: My apologies. Can the witness view his
09:49:47 5 PowerPoint presentation?
6 THE COURT: He's got a screen that has it up there.
7 MR. BERRY: Isn't that somewhat identical as having
8 the witness testify from notes?
9 THE COURT: I don't think so. I mean, my view is that
09:50:01 10 this is a demonstrative aid to his testimony and he's listed --
11 I mean, at least at this point. Now, I don't think he's -- I
12 mean, first of all, the witness can testify from notes but we'd
13 mark them as an exhibit, but, I mean, this is a demonstrative
14 aid. I don't think we need to do that with this. What's your
09:50:22 15 problem with it?
16 MR. BERRY: I don't know if it actually qualifies as
17 demonstrative because it's not summarizing large quantities of
18 data. It's simply -- it is simply -- simply notes that
19 correspond to the order of presentation of his narrative
09:50:41 20 testimony.
21 THE COURT: So what's your problem with it?
22 MR. BERRY: I believe that it does not qualify as
23 demonstrative data. I don't think it would be appropriate to
24 use this as a -- as a jury exhibit -- or as a display to the
09:51:00 25 jury, because it's not summarizing information that is fast or

1 needs to be quantified or needs to be summarized or displayed
2 in a chart-like form. So I think says simply testifying from
3 notes and I object to it.
4 THE COURT: Well, I'm going to overrule that
09:51:19 5 objection. We don't have a jury, number one. Number two, your
6 objection really is kind of like Federal Rule of Evidence 1009
7 objection in terms of presenting fast amounts of data in a
8 summary form. I don't think that's what we're doing at all. I
9 want to confirmed, that my memory is serving me right in terms
09:51:41 10 of the Federal Rule of Evidence.
11 MR. MOYE: Yeah, the summary exhibit rule is 1006.
12 We're not offering this PowerPoint as an exhibit.
13 THE COURT: Right. And, you know, I'm assuming that
14 this PowerPoint accurately, for purposes of a demonstrative and
09:51:55 15 not in an -- you're right 1006, 9 upside down.
16 I'm assuming that this is a fair and accurate
17 portrayal of ASR 113, ASR 118, the FAS 157 factors. If you
18 want to give an objection that says it's not, I'll listen to
19 that, but that's not your objection, so I'll overrule --
09:52:24 20 MR. BERRY: These projections -- these projections
21 are -- this is not ASR 118. ASR 118 is far lengthier than
22 this.
23 MR. MOYE: But there's summaries. The witness said he
24 put this together to summarize his understanding.
09:52:43 25 MR. BERRY: I understand that, but 1006, summaries to

1 This was something I know that was addressed in your report.
2 We're not introducing the slide into evidence, it was already
3 talked about, what has the Commission said more recently about
4 valuation of restricted securities?
10:14:17 5 A. As I said previously, the Commission offered some letters
6 to the ICI, which is the Investment Company Institute public
7 letters, that reaffirmed some their guidance from ASRs 113 and
8 118.
9 Q. In your own words, what do you understand their more recent
10:14:34 10 guidance in 1999 to be saying?
11 A. Well, really it's getting back to what I spoke about
12 earlier, which is fair value assumes an exit value or at the
13 price that you would receive if you currently sold a security,
14 the price that you might reasonably expect to receive if you
10:14:51 15 try to sell your restricted security today.
16 Q. What can't it based on?
17 A. It can't be based on what you think it's worth at some
18 point in the future or what you think someone may purchase it
19 for in -- when the restrictions are lifted at some point in the
10:15:08 20 future when the true value of the security, as you see it,
21 could be realized. It really has to be today, exit value
22 today.
23 Q. Okay. Let's look at another recent pronouncement by the
24 SEC, this time in 2001. Again, in your own words, what did the
10:15:26 25 SEC say in offering guidance on the issue of fair value -- I'm

1 A. It was over $1 million.
2 Q. Did you draw any conclusions, whether general or specific,
3 about whether these overvaluations led to investors actually
4 paying more money than they should have?
11:38:32 5 A. Yeah, they did pay more money than they should have because
6 the funds were overvalued.
7 Q. Let me ask you just briefly about Stealth. We're not going
8 to go through Stealth and we don't have slides prepared in any
9 sort of detail in Stealth, but what, if anything, can you tell
11:38:45 10 me about how Mercury approached valuations of the Stealth Fund?
11 A. Very similar, as I said before, to the Nutmeg Group's
12 valuation were very similar in Stealth Fund as they were to the
13 valuations in the Mercury Fund, but there was a time
14 coefficient that they applied for some of their valuations for
11:39:05 15 the Stealth Fund and that gets to what the SEC says ASR 113,
16 you can't use -- you shouldn't use a time coefficient to, you
17 know, kind of gage your liquidity.
18 THE COURT: Can I interrupt here.
19 MR. MOYE: Yeah.
11:39:20 20 THE COURT: I just want to know, it's about 11:35, I
21 want to know how we're doing.
22 Blanca, do you need a break here? Would a break be
23 helpful here?
24 THE COURT REPORTER: Judge, it's up to you. I'm fine.
11:39:26 25 THE COURT: No, it's really up to you here.

1 A. Looking at the document, it was negative $1,901,011.
2 Q. Did you calculate Randall Goulding's capital account
3 balance in Nutmeg for year-end 2007?
4 A. Yes.
5 Q. What did you calculate as Randall Goulding's capital
6 account balance in Nutmeg as of year-end 2007?
7 A. Negative $2,318,275.
8 Q. Did you calculate Randall Goulding's capital account
9 balance for the year-ending of 2008?
10 A. Yes.
11 Q. What was, if you remember, Randall Goulding's capital
12 account balance as of December 31st, 2008?
13 A. Negative $2,596,048.
14 Q. Did you also look at Randall Goulding's capital account
15 balance in Nutmeg for year-end 2009?
16 A. Yes.
17 Q. What did you calculate, if you remember, Randall
18 Goulding's capital account balance for year-end 2009?
19 A. Negative -- it's for as of July 31st, 2009. And looking
20 at 296, the number is negative $2,648,426.
21 Q. Why did your analysis stop in July of 2009?
22 A. Post July 2009, a receiver was appointed to Nutmeg.
23 Q. So overall, could you summarize for the Court whether or
24 not Randall Goulding had a positive capital account balance or
25 a negative capital account balance.

1 we discussed how the number of units declined when they were
2 at liquidations.
3 In Exhibit 25, I see no liquidations during the time
4 period that the statements cover, but there were changes in
5 the number of units held by that investor.
6 Q. Well, you see that there is a liquidation in -- that's
7 correct. Okay.
8 In MiniFund, in Exhibit 25, there is a liquidation on
9 October 31, 2007; isn't that correct?
10 A. Yes.
11 Q. And that's the third quarter of 2007; isn't that right?
12 A. It would be the fourth quarter of 2007.
13 Q. The beginning of the fourth quarter, end of the third
14 quarter; isn't that correct?
15 A. It would have occurred in the fourth quarter of 2007.
16 Q. Thank you.
17 Now, on this summary schedule, you show that there
18 was a total -- the summary schedule that's been admitted as
19 PX43, you see that you show a total benefit of $2.5 million
20 and change to Randall Goulding; isn't that correct?
21 A. Yes.
22 Q. Okay. Now, did you ever yourself conduct any analysis of
23 what Mercury was entitled to receive under its agreements with
24 the various investment funds?
25 A. No.

1 Q. Okay. So you yourself -- you don't have any view one way
2 or another as to whether the amount that Nutmeg was entitled
3 to receive under its agreements with the investment funds was
4 more or less than $2.5 million?
5 A. I do not have an opinion.
6 Q. Okay. Now, did you -- do you know who owned Mercury? I'm
7 sorry.
8 Do you know who owned Nutmeg?
9 A. I believe Randall Goulding owned Nutmeg.
10 Q. Okay. And was it your assumption that Randall Goulding
11 owned the entirety of Nutmeg?
12 A. Yes. I'm trying to recall from his deposition if there
13 was maybe one unit held by his wife, but it was at least
14 99 percent owned by Mr. Goulding.
15 Q. Okay. But, in any event, it's correct that Mr. Goulding
16 would be entitled to distributions equivalent to the -- most
17 of the profit earned by Nutmeg; isn't that right?
18 A. It would go back to the capital account.
19 Q. I'm not talking about capital account.
20 A. But that is part of the capital account because you would
21 have to take into account his contributions and withdrawals
22 and then any net income or loss, and then you come with an
23 ending number. That ending number, he could take a hundred
24 percent of that every year, he could take zero. That's his
25 capital balance, but it also includes any contributions or

1 it has nothing to do with *pro rata* ownership of any particular
2 company, it has to do with the net or adjusted capital account
3 balance; isn't that right?
4 A. That's how I was using it.
5 Q. Thank you. And I apologize for the interjection, but I
6 was totally lost.
7 Now -- so in summary, your work showed that
8 Mr. Goulding's capital withdrawals exceeded his capital
9 contributions by a significant amount of money; is that right?
10 A. Yes.
11 Q. Okay. Now, just in the abstract, there are a lot of
12 different circumstances that could justify -- that could
13 explain why capital account withdrawals are in excess of --
14 oh, maybe not.
15 Let me ask you a question. If there were profit, if
16 there was significant profit in a company and all the profit
17 was taken out, would that -- would that change the capital
18 account balance in and of itself?
19 A. Yes, you would attribute to the capital account balance
20 any profits, any net income of the company.
21 Q. Any profit what?
22 A. Any profits of the company.
23 Q. Would --
24 A. To the member's equity account.
25 Q. Okay. Well, just as -- okay. So let's just say

1 hypothetically that if there's profit -- if there is a
2 significant profit allocated to a partner or an owner, is --
3 does that change his capital account balance?
4 A. Yes.
5 Q. Okay. So if it stays in the company, it changes the
6 capital account balance, right? If the -- if there's profit,
7 instead of having a distribution, it's maintained in the
8 company, that changes the capital account balance, right?
9 A. Yes.
10 Q. Okay. Now, if that profit were to be disbursed or
11 distributed to the owner or the owners, would that -- the
12 entirety of it, would that change the capital account balance?
13 A. Yes.
14 Q. How so?
15 A. If the owner takes the remaining -- let's say there's a
16 million dollars in profit and after you calculate, you know,
17 the -- after you have taken into account the contributions and
18 withdrawals, that the remaining capital account balance is
19 950,000 and the owner decides to take 950,000, their capital
20 account balance would be zero.
21 Q. Okay. But -- so let's just say there's a -- the owner
22 makes a capital contribution of a million dollars that stays
23 there, okay, in their operations for a year. And the
24 operations generate -- the operations generate $500,000. The
25 owner would request and obtain the distribution of that

1 $500,000 in profits to him, right? The capital account
2 balance still is a million dollars, right?
3 A. Yes.
4 Q. Okay. Fine. So we're talking about the same thing.
5 All right. Now, isn't it -- isn't it correct that an
6 owner's withdrawal cannot change the capital balance --
7 withdrawn.
8 So it's correct, isn't it, that the owner's
9 withdrawal might not change the capital balance if all the
10 owner is withdrawing is profit? Isn't that right?
11 A. If you look at two different points in time, it could
12 change it if you keep a constant accounting of it, like a
13 daily accounting. The ownership balance or your owner's
14 equity account will change if there's accounting.
15 But if you look at it as of the end of a year, then
16 it could stay the same if you look at it like the last day of
17 the year and profits have been distributed.
18 Q. So a distribution might, hypothetically, be based on the
19 earning of profit as opposed to a reduction in the capital
20 account balance; isn't that correct?
21 A. It would be accounted for as a distribution. So it would
22 be a withdrawal from the capital account balance, but the
23 other side of it would be net income, which would be in
24 addition to the capital account balance.
25 Q. Well, when you prepared -- when you prepared the summary

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

1 account balance, would it, if the distribution was identical
2 to the amount of the profit earned?
3 A. His capital account balance would remain the same.
4 Q. As it was prior to -- prior to the separate investment and
5 prior to the profits being earned?
6 A. Right.
7 Q. Did you ever see any reference to the Morgan Wilbur deals?
8 THE COURT REPORTER: To the what? I'm sorry?
9 THE COURT: Morgan --
10 BY MR. BERRY:
11 Q. The Morgan Wilbur deals in any of the work you did in
12 connection with this case for the SEC's investigation?
13 THE COURT: Is that W-i-l-b-u-r?
14 MR. BERRY: Yeah, Morgan like Captain Morgan, and
15 Wilbur like -- I think it was a cartoon character, but
16 W-i-l-b-u-r.
17 BY MR. BERRY:
18 Q. Did you see any reference to any Morgan Wilbur deals in
19 any of the work you did for the SEC in this case?
20 A. I have heard about --
21 Q. Okay.
22 A. -- Morgan Wilbur deals.
23 Q. Can you describe them?
24 A. I believe they are investments made early on in Nutmeg's
25 history.