

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 2849 / March 2, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13387

In the Matter of

M.A.G. CAPITAL, LLC AND
DAVID F. FIRESTONE

Respondents.

**ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS
PURSUANT TO SECTIONS 203(e), 203(f),
AND 203(k) OF THE INVESTMENT
ADVISERS ACT OF 1940, MAKING
FINDINGS, AND IMPOSING REMEDIAL
SANCTIONS AND A CEASE-AND-DESIST
ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”) against M.A.G. Capital, LLC and David F. Firestone. (“Respondents”).

II.

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondents' Offer, the Commission finds that:

A. SUMMARY

This case concerns violations of Section 206(2) of the Advisers Act by M.A.G. Capital, LLC ("M.A.G."), a registered investment adviser, and its principal, David F. Firestone ("Firestone"). On forty-four separate occasions between May 2003 and September 2006, M.A.G. took warrants from three hedge funds that it advises (the "Funds") without compensating the Funds for them. The Funds had purchased the warrants and other securities in PIPEs transactions (private investment in public equity). As part of these transactions, M.A.G. took, as compensation for itself, warrants that were being paid for by its clients, the Funds. M.A.G. did not adequately disclose that the warrants that M.A.G. took were being paid for by the Funds and that M.A.G. was not compensating the Funds for these warrants. The net value of the warrants retained by M.A.G. was approximately \$18.9 million.

In May 2006, the Los Angeles Regional Office's ("LARO") examination staff examined M.A.G. and cited various deficiencies, including warrant-taking in PIPEs transactions. The warrant-taking issue was raised with M.A.G. in the examination staff's May 25, 2006 exit interview and again in a September 20, 2006 deficiency letter. Although M.A.G. tried to improve its disclosure of the warrant-taking after the exit interview, M.A.G. continued to take warrants from the Funds until it received the September 20 deficiency letter and halted the practice.

B. RESPONDENTS

1. **M.A.G. Capital, LLC**, based in Los Angeles, California, has been in business since 2002, and has been registered with the Commission as an investment adviser since January 13, 2006 (File No. 801-65139). M.A.G. has five employees, and, as of March 31, 2008, it had approximately \$33.6 million in assets under management. M.A.G. has no disciplinary history.

2. **David F. Firestone**, age 42, lives in Laguna Niguel, California. He is the president and sole owner of M.A.G. Firestone held NASD Series 7, 63, and 65 licenses, but allowed them to expire in or around 2003. Firestone has no disciplinary history.

C. FACTS

1. Background: M.A.G.'s Operations and the Funds

M.A.G. specializes in short-term investments in privately placed convertible debt and equity securities, as well as derivative instruments such as warrants and options. It serves fifty-four high-net-worth individuals through two domestic hedge funds, Mercator Momentum Fund, L.P. ("MMF I") and Mercator Momentum Fund III ("MMF III") (there is no MMF II). In addition, it serves eighteen institutional clients through an off-shore hedge fund domiciled in the British Virgin Islands, the Monarch Pointe Fund ("Monarch") (collectively, the "Funds"). As of March 31, 2008,

MMF I and MMF III had assets of \$4.1 million and \$3.8 million, respectively, and Monarch had assets of \$25.7 million.

2. M.A.G. Took Warrants from the Funds

Between May 2003 and September 2006, M.A.G. took warrants from the Funds in forty-four separate PIPEs transactions that involved investments by one or more of the Funds. In seven of the forty-four transactions, M.A.G. exercised the warrants for the underlying common stock, and in three of those seven transactions, M.A.G. sold the underlying stock for total proceeds of \$7,477,292. The number of warrants that M.A.G. took varied with each transaction. As of December 31, 2006, the warrants (including exercised) that MAG had taken represented approximately 37% of MMF I's, 28% of MMF III's, and 19% of Monarch's respective net asset values (pre-remediation).

The PIPEs transactions generally involved the Funds' purchase of bundles, or units, of convertible preferred securities and warrants. The Funds paid for the warrants as part of the bundle of securities sold by the issuers in the transactions. Pursuant to subscription agreements between M.A.G., the Funds, and the PIPEs issuers, M.A.G. took a portion of the warrants in each transaction. Firestone and other officers of M.A.G. signed these subscription agreements on behalf of the Funds. M.A.G. did not compensate the Funds for the warrants that it took.

An example of a typical PIPEs transaction in which M.A.G. took warrants is an August 2004 \$5.5 million investment, comprised of a private offering of 55,000 shares of convertible preferred stock and 330,000 warrants. MMF I paid \$1,292,500 to the PIPES issuer and received 12,925 shares and 62,040 warrants. MMF III paid \$1,485,000 and received 14,850 shares and 71,280 warrants. Monarch paid \$2,722,500 and received 27,225 shares and 130,680 warrants. M.A.G. paid nothing and yet received the remaining 66,000 warrants, or 20% of the warrants issued in the offering.

Beginning in October 2004 and January 2005, respectively, MMF I's and MMF III's PPMs disclosed that "in connection with financing a Portfolio Company, the Partnership and the General Partner may receive warrants to purchase common stock of the Portfolio Company." This disclosure, however, was inadequate because it did not convey the nature of M.A.G.'s self-interest. Specifically, M.A.G. did not disclose that the warrants that M.A.G. took were being paid for by the Funds and that M.A.G. was not compensating the Funds for these warrants. Monarch's PPMs never disclosed the warrant-taking.

3. The LARO Exam Staff Puts M.A.G. On Notice Regarding Warrant-Taking

In January 2006, M.A.G. registered with the Commission as an investment adviser. In May 2006, the LARO's examination staff conducted a routine examination of M.A.G. and found a number of deficiencies. The most egregious deficiency was M.A.G.'s warrant-taking and failure to adequately disclose this activity.

a. The May 25, 2006 Exit Interview

On May 25, 2006, the examiners met with Firestone to provide him with a summary overview of the deficiencies they found during the examination. The examiners told Firestone that, among other deficiencies, they were concerned about M.A.G.'s warrant-taking in the PIPEs transactions and lack of adequate disclosure to the Funds' investors.

During and after the interview, Firestone and others at M.A.G. discussed the warrant-taking issue and how best to address it. M.A.G. tried to address the issue by revising the disclosure distributed to investors in the MMF I and MMF III funds. M.A.G. sent out a revised PPM in July 2006 to all MMF I and MMF III investors, as well as a cover letter to MMF I and MMF III investors highlighting the changes. The revised disclosure stated, in bold, that with respect to due diligence fees, "[t]he amount of the due diligence fee may be payable in the form of cash, warrants to purchase common stock of the Portfolio Company or other securities," and with respect to fees for possible post-investment activity, that:

[M.A.G.] may receive a fee, typically payable in the form of cash, or warrants to purchase shares of Portfolio Company stock or other securities, for the possible provision of the [post-investment] activities described above. Such fee, if any, may be charged either concurrent with an investment in a Portfolio Company or subsequent to such investment, at [M.A.G.'s] discretion. Such fee, if received in the form of warrants, is designed to incentivize [M.A.G.] to maximize the value of the underlying stock in the Portfolio Company. The exercise price of warrants typically will be greater than the fair market value of the underlying stock at the time of receipt of such warrants.

This revised July 2006 disclosure, however, still failed to alert the Funds that the warrants that M.A.G. took were being paid for by the Funds and that M.A.G. was not compensating the Funds for these warrants. M.A.G. did not add warrant disclosure to the Monarch PPM because Firestone believed that Monarch's investors knew that M.A.G. received warrants.

b. The September 20, 2006 Deficiency Letter

On September 20, 2006, the examiners sent a deficiency letter to M.A.G. The first concern raised in the deficiency letter was M.A.G.'s warrant-taking and failure to adequately disclose the warrant-taking. M.A.G. responded by immediately halting the practice of warrant-taking in PIPEs transactions. Between the May 25 exit interview and M.A.G.'s receipt of the September 20 deficiency letter, M.A.G. had continued to take warrants in four PIPEs transactions.

D. LEGAL DISCUSSION

1. Violations of Section 206(2) of the Advisers Act

Section 206(2) of the Advisers Act makes it unlawful for an investment adviser "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any

client or prospective client.” An investment adviser has a fiduciary duty to act in good faith in all dealings with its clients. See Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979).

Scienter is not a required element of Section 206(2); negligence suffices for liability. See Capital Gains Research Bureau, Inc., 375 U.S. at 195; Steadman v. SEC, 603 F.2d 1126, 1134 (5th Cir. 1979), aff’d, 450 U.S. 91 (1981). An investment adviser is accountable for the actions of its principals. See SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1089 n.3, 1096-97 nn.16-18 (2d Cir. 1972) (company’s scienter imputed from individuals who control it).

2. M.A.G.’s Primary Violation

M.A.G. willfully violated Section 206(2) of the Advisers Act by fraudulently taking warrants from bundles of securities the Funds had purchased in forty-four PIPEs transactions. Specifically, M.A.G. took, as compensation for itself, warrants that were being paid for by the Funds. In doing so, M.A.G. breached its fiduciary duty to the Funds. M.A.G.’s eventual disclosure of the warrant-taking practice in MMF I’s and MMF III’s PPMs is not a defense to the violation because M.A.G. never adequately disclosed that the warrants that M.A.G. took were being paid for by the Funds and that M.A.G. was not compensating the Funds for these warrants. In addition, M.A.G. never included any disclosure in Monarch’s PPMs. Accordingly, M.A.G. violated Section 206(2) of the Advisers Act.

3. Firestone’s Aiding and Abetting and Causing M.A.G.’s Violation

Firestone, as a person associated with an investment adviser, may be charged as an aider and abettor under Section 203(e) of the Advisers Act and as a cause of the violation under Section 203(k) of the Advisers Act. Aiding and abetting liability requires a showing that there was a primary violation; the respondent substantially assisted in the primary violation; and the respondent had a general awareness, or reckless disregard, of the wrongdoing and of his role in furthering it. See In re Clarke T. Blizzard and Rudolph Abel, Advisers Act Rel. No. 2253, 2004 SEC LEXIS 1298, at *16 & n.10 (June 23, 2004). A finding that a respondent willfully aided and abetted violations of the securities laws necessarily makes that respondent a “cause” of those violations. Id. at *16 n.10. The willfulness requirement does not require an intent to violate the law but merely an intent to do the act that constitutes the violation. Wonsover v. SEC, 205 F.3d 408, 413-15 (D.C. Cir. 2000).

Firestone willfully aided and abetted and caused M.A.G.’s primary violation of Section 206(2) of the Advisers Act. First, Firestone substantially assisted in the violation by directing that M.A.G. take the warrants in the PIPEs transactions. Second, Firestone had a general awareness, or at a minimum a reckless disregard, of the wrongdoing and of his role in it because he instituted the warrant-taking practice and knew that M.A.G. did not compensate the Funds for the warrants that it took.

E. RESPONDENTS' REMEDIAL EFFORTS

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondents and cooperation afforded the Commission staff.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offer.

Accordingly, pursuant to Sections 203(e), 203(f), and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondents cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act;

B. Respondents are censured.

C. Respondents M.A.G. Capital, LLC and David F. Firestone shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of \$100,000 and \$50,000, respectively, to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies M.A.G. Capital LLC and David F. Firestone as the Respondents in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Andrew Petillon, Associate Director, Securities and Exchange Commission, 5670 Wilshire Blvd., 11th Floor, Los Angeles, CA 90036.

By the Commission.

Elizabeth M. Murphy
Secretary