

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

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AUG 20 2007

MICHAEL W. DOBBINS
CLERK, U.S. DISTRICT COURT

JUDGE KOCORAS
MAGISTRATE JUDGE MASON

07C 4684
CASE NO.

JURY DEMANDED

UNITED STATES SECURITIES
AND EXCHANGE COMMISSION,

Plaintiff,

v.

SENTINEL MANAGEMENT GROUP, INC.

Defendant.

**DECLARATION OF LOU GRACIA IN SUPPORT OF
PLAINTIFF'S EMERGENCY MOTION FOR A
TEMPORARY RESTRAINING ORDER AND OTHER ANCILLARY RELIEF**

I, Lou Gracia, pursuant to 28 U.S.C. 1746, declare as follows:

1. I am an Assistant Regional Director of the United States Securities and Exchange Commission (the "Commission" or "SEC") in its Chicago Regional Office. One of my duties is to conduct and supervise SEC examinations of investment advisers registered under the Investment Advisers Act of 1940 ("Advisers Act"). In such examinations, the SEC obtains and reviews various kinds of information obtained from investment advisers to monitor compliance with the federal securities laws. Such information includes brokerage account statements, bank statements, custodial account statements, investment advisory customer statements reflecting the securities transactions, assets and liabilities in their accounts, client account reconciliations, and client advisory agreements. I submit this declaration in support of Plaintiff's Emergency Motion for a Temporary Restraining Order and Other Ancillary Relief. The facts set

forth herein are based upon my personal knowledge or upon information contained in the files of the Commission.

2. Sentinel Management Group, Inc. ("Sentinel") is an investment advisor registered with the Commission and a futures commission merchant ("FCM") registered with the Commodities Futures Trading Commission ("CFTC"), located in Northbrook, Illinois. Sentinel's business is to provide investment advisory and discretionary money management services for various advisory clients, including financial institutions, private investment firms, pension funds, and individuals. Sentinel is regulated by the Commission and the CFTC. Sentinel is also a member of the National Futures Association ("NFA"), a self-regulatory organization. As of August 13, 2007, Sentinel claimed to have \$1.2 billion of client interests in assets under management.

3. On August 13, 2007, Sentinel issued a letter to clients announcing that it was requesting authority from the CFTC to cease redemptions ("August 13 letter"). Attached as **Exhibit A** to this declaration is a copy of that letter. Although the CFTC did not grant that authority, Sentinel told clients that they would not be allowed to redeem their investments.

4. On August 14, 2007, Sentinel's refusal to allow redemptions was reported in the press.

5. On August 15, 2007, the Commission began an examination of Sentinel at its Northbrook offices under my supervision. My staff conducted interviews of Eric Bloom, Sentinel's President, Theresa Arana, Sentinel's Chief Financial Officer, and J. Matthew Keel, Sentinel's Chief Compliance Officer, and collected documents from Sentinel.

6. In its August 13 letter, Sentinel told clients that the reason for the redemption freeze was because if clients requested significant redemptions due to the downturn in the credit markets, Sentinel would be forced to sell securities at deep discounts to their fair value; and this could cause losses to clients. This explanation is false and misleading. As described below, the clients' exposure to loss was exacerbated by the undisclosed use of leverage and apparent commingling and misappropriation of clients' securities.

7. At the time the August 13 letter was sent to clients, the securities reported on account statements provided to clients bore no relation to the actual securities held for clients as reflected in their custodial account records.

The Programs

8. According to Sentinel's Form ADV, Part II, Sentinel offered clients the opportunity to participate in a variety of investment programs, each of which had its own investment policy designed to meet the requirements and preferences of different types of clients.

9. Regardless of which investment program a particular client chose, Sentinel pooled the client's assets with those of similar types of clients in one of three segregated accounts, Seg 1, Seg 2 and Seg 3:

- Seg 1 contained assets of FCMs with only domestic customer deposits. FCMs are futures brokers that are members of the NFA and investments are subject to the rules of the CFTC;
- Seg 2 contained assets of FCMs with domestic customer deposits trading in foreign markets; and

- Seg 3 contained assets of all other types of clients, including hedge funds, trust accounts, endowments and individuals.

10. Under Rule 206(4)-2 under the Advisers Act, these accounts were required to be segregated by client. In other words, client funds and securities could not be commingled with Sentinel's funds and securities, nor could client funds be commingled among the different segregated client accounts. Sentinel representatives informed the examination staff that Sentinel did not adhere to this requirement, but instead commingled and transferred client securities among the segregated accounts and a "house" account, which also contained securities owned by Sentinel.

Sentinel's Representations to Clients

11. Sentinel made written representations to its clients through at least four means: an advisory agreement with clients; client account statements provided daily to clients; its investment policies on Sentinel's website; and Part II of Sentinel's Form ADV filed with the Commission.

12. From at least July 2005, in its standard investment advisory agreement with clients (see example agreement attached as **Exhibit B**) ("the Agreement"), Sentinel represented that the clients in each segregated portfolio owned an indirect, pro rata interest in their particular segregated investment portfolio.

13. The Agreement also provided discretionary authority to Sentinel to buy and sell securities without requesting authority from clients before executing the trades.

(Ex. B ¶ 3)

14. The Agreement often had an Addendum specifying the investment policy that was to be used to invest the client's funds. (Ex. B) For example, the Addendum for one client in Seg 3 stated that its funds would be invested consistent with the limitations

of CFTC Rule 1.25. This rule restricted investment to highly rated debt instruments and other highly rated and relatively liquid investments.

15. The version of the Agreement provided to clients prior to 2005 did not state that any form of leverage would be utilized by Sentinel in managing the clients' accounts. At some point in late 2004 or early 2005, Sentinel typically added to the Agreement a provision allowing the use of leverage, but did not disclose to what extent it would be used.

16. Sentinel represented on its Website that "Sentinel clients receive a daily account statement (by email or fax), which shows, down to the penny, precisely what securities they own." This was on Sentinel's website as late as August 14, 2007 (see **Exhibit C**). Sentinel did send account statements to its clients but they were materially false and misleading, as detailed below.

Undisclosed Misappropriation and Commingling of Client Assets

17. On August 13, 2007, Sentinel e-mailed customer account statements to clients in Seg 3. One client received a statement purporting to reflect a \$360 million interest in securities held by that client in Seg 3 (see **Exhibit D**). A representative of that client told me that he asked Sentinel to transfer the securities held in the client account to his firm, but Sentinel refused.

18. Sentinel provided the SEC examination staff with customer statements reflecting that the total value of securities interests reported to all Seg 3 clients was approximately \$674 million (see **Exhibit E**).

19. However, the Bank of New York custodial statement for the Seg 3 account showed only approximately \$94 million of securities held by all Seg 3 clients (see **Exhibit F**).

20. When the SEC examination staff asked about the discrepancy between the customer statements and the custodial statement, Sentinel's representatives admitted that the customer accounts would not "tie out" because Sentinel had moved securities among the Seg accounts and its own "house" account.

21. Based on our review of custodial account records and oral representations from Sentinel's representatives, it appears that before August 13, 2007, Sentinel commingled and transferred at least \$460 million of clients' securities from the segregated customer accounts to Sentinel's "house" account (see **Exhibit G**). This "house" account was owned by Sentinel, not the clients. The "house" account also contained securities owned by Sentinel. The transfers of these clients' securities were never disclosed to clients on the client account statements.

22. When the SEC examination staff asked Sentinel to identify which securities in the "house" account were owned by clients or Seg accounts, Sentinel representatives responded that it could not determine who owned those securities.

23. The Bank of New York has informed Sentinel that it intends to begin selling the securities in the "house" account to satisfy Sentinel's outstanding debt on a line of credit on August 22, 2007 (see **Exhibit H**). The Bank of New York has a lien on the assets of the "house" account due to its line of credit, described below.

24. Sentinel's records concerning clients' securities holdings are unreliable, at least in part, due to the commingling and misappropriation of those securities. Sentinel purported to reconcile the securities inventory to what was in client accounts, but the starting inventory balance on the reconciliation bore no relation to the actual securities balance reflected on the custodial brokerage records. A reconciliation dated August 13, 2007 and signed by Theresa Arana, Sentinel's CFO, shows an opening inventory balance

of approximately \$700 million for Seg 3, while custodial brokerage records show only \$94 million (see **Exhibit I**).

Undisclosed Leveraging of Clients Assets

25. Sentinel pledged securities owned by the clients as collateral in order to obtain a \$321 million line of credit from the Bank of New York for its own benefit. The client account statements, which should have accurately reflected the portfolio holdings, the value of the portfolio and all transactions in the portfolio, did not reflect the fact that the securities had been encumbered in this manner. In other words, the clients had no way of knowing that their assets had been used by Sentinel to obtaining financing.

26. Among other things, Sentinel stated that it used money obtained through the line of credit to purchase additional securities and in some cases to cash out clients from the different Seg accounts.

27. Sentinel also used client assets to obtain additional leveraged financing. A representative of Sentinel told a member of my examination staff that since 2004 Sentinel had used \$1.5 billion in securities owned by the clients to obtain financing totaling three times the value of those securities. Sentinel told us that the financing was used to purchase additional securities.

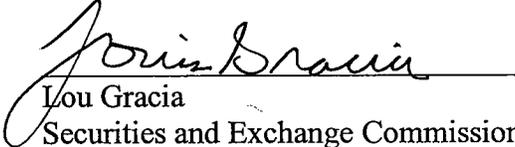
28. The client account statements prepared and distributed by Sentinel never reflected any of this activity.

Other Indications of Misconduct

29. On August 16, 2007, Sentinel fired Charles Moseley, its sole portfolio manager/head trader. The termination letter stated that he had engaged in misconduct (see **Exhibit J**).

30. The SEC has been informed by Sentinel that it has sold \$312 million of securities to Citadel (see **Exhibit K**). Despite the unreliability of Sentinel's records, its inability to verify the ownership of particular securities by its particular clients, its commingling of client securities, its failure to disclose its significant leveraging of clients' assets to its clients, and its allegations of "misconduct" by its trader, Sentinel has informed the SEC staff that it intends to distribute the proceeds of its securities sale to Citadel to meet redemption demands of selected clients.

I, Lou Gracia, declare under penalty of perjury that the foregoing is true and correct. Executed on the 20th day of August, 2007.


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