No. ________

In The
Supreme Court of the United States

PENTAGON CAPITAL MANAGEMENT PLC
AND LEWIS CHESTER,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

**On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Second Circuit**

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

This is an SEC enforcement action against foreign investment advisers that advised and placed trades for an independent foreign investment fund through U.S.-regulated stockbrokers. Petitioners were held primarily liable under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), based on implied misrepresentations made by their stockbrokers and on a "scheme liability" theory. After the district court concluded that the SEC had failed to prove Petitioners' own gain, it held Petitioners jointly and severally liable to "disgorge" approximately $38 million in gain earned by the third party investment fund that they advised.

The questions presented are:

Whether investment fund advisers that made no affirmative representation to a mutual fund, who had no duty to make any representation, and who engaged in no inherently deceptive acts separate from their broker's implied misrepresentation, can be held primarily liable for securities fraud as the "maker" of the implied misrepresentation and as scheme participants.

Whether, under the district court's authority to grant equitable relief in Section 21(d)(5) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(d)(5), an investment fund adviser and its director can be held jointly and severally liable to "disgorge" gains that they never received, possessed, or transferred, and which were instead received by an independent third party that they did not control.

PARTIES TO THE PROCEEDING BELOW

Petitioner Pentagon Capital Management PLC ("PCM"), a United Kingdom public limited company, was an appellant in the court below and a defendant in the district court.

Petitioner Lewis Chester, a natural person, was an appellant in the court below and a defendant in the district court.

The United States Securities and Exchange Commission was the appellee in the court below and the plaintiff in the district court.

Pentagon Special Purpose Fund, Ltd. ("PSPF"), a United Kingdom limited company, was named as a relief defendant in the complaint in the district court but did not participate in the district court or the court below.

CORPORATE DISCLOSURE

There are no parent corporations or publicly held companies that own more than 10% of Petitioner PCM's stock.

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PETITION FOR CERTIORARI

This case presents an important question of federal securities law that the court below decided in direct contravention of the Court's opinion in *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. ___, 131 S. Ct. 2296 (2011), and in conflict with rulings of the United States Courts of Appeals for the Seventh, Eighth, and Ninth Circuits.

The decision of the court below conflicts with *Janus* because Petitioners did not "make" any misrepresentation, express or implied. In *Janus*, the Court held that only the "maker" of a misrepresentation may be held primarily liable for securities fraud under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (the "Exchange Act"), and SEC Rule 10b-5(b), 17 C.F.R. § 240.10b-5(b). The court below concluded that Petitioners were "*as much the 'maker'*" of an implied misrepresentation as was the stockbroker that had ultimate authority and responsibility for the misrepresentation, and which was the only party to whom it was attributed. Because Petitioners lacked ultimate authority over any misrepresentation implied by late trading, and because there is no finding or any evidence that any such representation was attributed to Petitioners, they cannot be held primarily liable under *Janus*.

The misrepresentation implied by late trading arose because the brokers failed to disclose the actual time they received Petitioners' trade orders, thus implying that the brokers received the orders before

4:00 p.m. This resulted in the mutual funds giving Petitioners the same day's price for their mutual fund trades, rather than the following day's price, as they were required to do under SEC Rule 22c-1(a), 17 C.F.R. § 270.22c-1(a), which applies only to regulated market professionals, not customers. To the extent that the court below held Petitioners primarily liable based on this implied misrepresentation, the decision is in direct conflict with *Chiarella v. United States*, 445 U.S. 222 (1980), and the recent decision of the United States Court of Appeals for the Seventh Circuit in *Fulton County Employees Retirement System v. MGIC Investment Corp.*, 675 F.3d 1047 (7th Cir. 2012), because Petitioners made no implied misrepresentation and had no duty to make any representation to anyone regarding the time that they submitted their trade orders to their broker.

Furthermore, holding Petitioners alternatively liable on a "scheme liability" theory under SEC Rules 10b-5(a) and (c), 17 C.F.R. § 240.10b-5(a) & (c), is in direct conflict with the rulings of the United States Courts of Appeals for the Eighth and Ninth Circuits. This is because Petitioners engaged in no inherently deceptive conduct separate from the implied misrepresentation. By concluding that the same conduct that resulted in the implied misrepresentation constituted a deceptive scheme under Rules 10b-5(a) and (c), the court below conflated misrepresentation liability and scheme liability, essentially nullifying *Janus*'s express limitation on primary liability. This decision, allowing a misrepresentation to be restyled as a scheme, conflicts with rulings of the Eighth and Ninth Circuits holding that a misrepresentation case is different from a scheme case in that scheme liability requires inherently deceptive acts by the defendant separate and independent from a misrepresentation.

After erroneously holding Petitioners primarily liable for securities fraud, the court below affirmed the district court's imposition of joint and several liability to "disgorge" $38 million in gain earned, not by Petitioners, but by a third party relief defendant that Petitioners did not control, despite the district court's express finding that the SEC had failed to prove the amount of Petitioners' own gain at trial. This was not only inconsistent with settled law holding that disgorgement is properly limited to a defendant's own gain, but also exceeded the boundaries of the court's statutory authority to grant equitable relief.

Under Section 21(d)(5) of the Exchange Act, 15 U.S.C. § 78u(d)(5), federal courts have the power to order securities law violators to disgorge their ill-gotten gains as a form of equitable relief. But a disgorgement order that bears no relation to any ill-gotten gain actually received by the defendant is not equitable: it is punitive. Moreover, joint and several liability cannot be imposed consistent with equity without a showing that defendants actually received proceeds, controlled the third party that did, or transferred money to it. The decision of the court below affirming joint and several liability places it in direct conflict, not only with its own precedent, but with settled law from other circuits, holding that the court's equitable power to order disgorgement extends only to the amount by which the defendant profited from wrongdoing.

The disgorgement order affirmed here presents as clear-cut an example as this Court is likely to see of a disgorgement award that is utterly divorced from any proven ill-gotten gain. Allowing it to stand would significantly increase the risk profile for investment advisers, foreign or domestic, who would have to bear the additional risk (and cost) of potential liability to pay "back" millions of dollars they never earned, which were in fact earned by the fund they advised. This case presents an opportunity for the Court to establish much-needed limitations on the disgorgement remedy and to prevent further abuse of the disgorgement remedy, by requiring that disgorgement bear a direct relationship to the defendant's – and not an independent third party's – unjust enrichment.

OPINIONS BELOW

The opinion of the court of appeals is reported at 725 F.3d 279 (2d Cir. 2013) and reproduced beginning at page 1 of the appendix. The court's order denying rehearing en banc is reproduced beginning at page 183. The relevant opinions of the district court are reported at 2012 U.S. Dist. LEXIS 43046 (S.D.N.Y. Mar. 28, 2012) and 844 F. Supp. 2d 377 (S.D.N.Y.

2012). They are reproduced beginning at pages 23 and 62, respectively. The relevant final order of the district court is reproduced beginning at page 53.

JURISDICTION

The judgment of the court of appeals was entered on August 8, 2013. Petitioners' timely petition for rehearing en banc was denied on December 19, 2013. App. 183. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –
>
> * * *
>
> To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations

> as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

SEC Rule 10b-5, "Employment of Manipulative & Deceptive Devices," promulgated under Section 10(b) of the Exchange Act, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> a. To employ any device, scheme, or artifice to defraud,
>
> b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

SEC Rule 22c-1, "Pricing of redeemable securities for distribution, redemption and purchase," provides in relevant part:

> (a) No registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in, any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security. . . .

17 C.F.R. § 270.22c-1.

Section 21(d)(5), which was added to the Exchange Act by the enactment of Section 305(b) of the Sarbanes-Oxley Act of 2002, provides:

> In any action or proceeding brought or instituted by the [SEC] under any provision of the securities laws, the SEC may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.

15 U.S.C. § 78u(d)(5).

STATEMENT OF THE CASE

This is an enforcement action in which the Securities and Exchange Commission ("SEC") sued Petitioners for violations of Section 10(b) of the Exchange Act and SEC Rules 10b-5(a), (b), and (c). After a bench trial, the district court found that Petitioners' trading of mutual funds was unlawful and therefore gave rise to both misrepresentation liability under Rule 10b-5(b) and "scheme" liability under Rules 10b-5(a) and (c). The court below affirmed the district court's determination with regard to liability and disgorgement but reversed and remanded for reconsideration of the $38 million civil monetary penalty imposed by the district court.

A. The Context of Petitioners' Late Trading

The investment strategy at issue here is called "late trading," which is a particular form of "market timing." Market timing seeks to generate profits by timing the buying and selling of mutual funds as markets move up and down: investing in equity mutual funds as markets move up, and investing in cash as markets move down. Late trading is a form of market timing in which trading decisions are made after trading has closed for the day, but where the customer receives that day's, rather than the next day's, price for the securities traded.

Petitioners' late trading involved multiple parties. Lewis Chester was a director of Pentagon Capital Management PLC ("PCM"), which acted as the investment adviser to Pentagon Special Purpose Fund Ltd. ("PSPF"), an independent investment fund named as a relief defendant in the district court. Chester was merely a salaried director of PCM; he was not an investor in PCM. Neither PCM nor Chester were owners, investors, or directors of PSPF, which had a board of directors completely independent of PCM and Chester.

Importantly, as the actual investor (as opposed to the adviser), PSPF and its investors received the gain from the late trading at issue here. Petitioners placed PSPF's late trade orders with introducing broker Trautman Wasserman & Co. ("TWC"), an SEC-registered broker-dealer. TWC, in turn, cleared those orders through an electronic trading system provided by Banc of America Securities LLC ("BofA"), also an SEC-registered broker-dealer. All of Petitioners' late trade orders that are the subject of this action were placed with TWC after 4:00 p.m., entered by TWC brokers into BofA's electronic trading system, cleared by BofA, and involved trades in U.S. mutual funds.

Late trading was widespread in the United States and abroad before 2003. The SEC was aware of this but took no enforcement action to stop it. In September 2003, New York Attorney General Elliot Spitzer sued hedge fund Canary Capital for illegal market timing and late trading, sending shockwaves through the financial industry. Shortly after Spitzer's lawsuit, the SEC began to take enforcement action against market timers and late traders, alleging that late trading and market timing constituted securities fraud.

On March 15, 2004, the SEC announced a landmark settlement with BofA in connection with the late trading/market timing scandal. Under the terms of that settlement, BofA agreed to pay $375 million to the SEC for all of the trades it had cleared, including all Petitioners' late trades that are the subject of this action. *See* Press Release, SEC Reaches Agreement in Principle to Settle Charges Against Bank of America for Market Timing and Late Trading, No. 2004-33 (Mar. 15, 2004), http://www.sec.gov/news/press/2004-33.htm.

Introducing brokers also found themselves targeted in the SEC's enforcement efforts. One such broker was Gregory Trautman, CEO of TWC, Petitioners' stockbroker. On February 14, 2008, the Commission issued its opinion in the SEC administrative proceedings against Trautman, finding him primarily liable for securities fraud in connection with late trading. *In the Matter of Gregory O. Trautman*, Securities Act Rel. No. 9088A, Exchange Act Rel. No. 61167A, 2009 SEC LEXIS 4173 (Dec. 15, 2009). The SEC ordered Trautman to pay disgorgement of $534,160 and a civil money penalty of $120,000 for *all* of the late trades placed through TWC, which included all of Petitioners' late trades that are the subject of this action.

Notably, in prosecuting late trading against introducing brokers like TWC and clearing firms like

BofA, the SEC's division of enforcement decided not to prosecute late trading as a mere violation of SEC Rule 22c-1, the directly applicable "forward pricing" rule, which requires mutual fund investment advisers, distributors, and dealers to ensure that the investor gets the price "next determined" after receipt of the order. 17 C.F.R. § 270.22c-1. Instead, the SEC chose to prosecute late trading as fraud, under Exchange Act Section 10(b) and SEC Rule 10b-5. In aid of these efforts, the SEC's enforcement division adopted the theory, based on obligations imposed on regulated entities by contract and by Rule 22c-1, that late trading brokers made an "implied misrepresentation" to the mutual funds.

On November 20, 2009, the Commission formally adopted the enforcement division's implied misrepresentation theory, in its opinion against an introducing broker who had engaged in late trading through BofA. The SEC's opinion in *VanCook* held that late trading *by a broker* constitutes securities fraud because it results in an implied misrepresentation made by the broker to the mutual funds, that the broker had received the trade orders in question *before* 4:00 p.m., even though the broker submitted them *after* 4:00 p.m. *In the Matter of John Joseph VanCook*, Exchange Act Rel. No. 61039A, 2009 SEC LEXIS 3872, *33-34 (Nov. 20, 2009). On August 8, 2011, the Second Circuit denied VanCook's appeal for review of the Commission's decision, affirming the SEC's determination that VanCook made an implied misrepresentation (under SEC Rule 10b-5(b)), and concluding that his conduct constituted a scheme to defraud, for which he was liable under SEC Rules 10b-5(a) and (c). *VanCook v. SEC*, 653 F.3d 130 (2d Cir. 2011).

Released shortly before the Second Circuit's *VanCook* ruling, this Court's June 13, 2011, decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. ___, 131 S. Ct. 2296 (2011), significantly narrowed the scope of primary liability for misrepresentation under SEC Rule 10b-5(b). Under *Janus*, only the "maker" of a misrepresentation may be held primarily liable for securities fraud; those who use or otherwise benefit from the misrepresentation may be held liable only under a secondary liability theory, such as aiding and abetting. *Janus* was not mentioned in *VanCook*.

B. The Proceedings Below

The SEC initiated this enforcement action on April 3, 2008. The trial began on April 4, 2011 and concluded on May 4, 2011, shortly before this Court's decision in *Janus* was released. The district court issued its primary opinion on February 14, 2012, six months after the Second Circuit's decision in *VanCook*. After supplemental briefing regarding civil monetary penalties, the district court issued a supplemental opinion and entered final judgment on March 28, 2012.

Although the SEC had argued at trial that both market timing and late trading violated the securities laws, the district court only found Petitioners' late trading through TWC to be unlawful. It accordingly held Petitioners primarily liable for securities fraud under Section 10(b) of the Exchange Act, largely based on the theory adopted by the Second Circuit in *VanCook*: that late trading by a broker resulted in an implied misrepresentation to the mutual funds. The district court held that this Court's ruling in *Janus* was inapplicable to SEC enforcement actions, but alternatively held that Petitioners were primarily liable as the "makers" of the implied misrepresentation. In addition to the implied misrepresentation theory, the district court held Petitioners primarily liable on a "scheme liability" theory under SEC Rules 10b-5(a) and (c), as in *VanCook*.

The Second Circuit affirmed the district court's conclusions regarding primary liability on both theories, holding that Petitioners were "as much 'makers'" of the implied misrepresentation "as were their brokers at Trautman Wasserman & Co." and that Petitioners' late trading constituted a fraudulent scheme. Neither the district court nor the court of appeals addressed the question of secondary liability.

REASONS FOR GRANTING THE PETITION

Certiorari is warranted for two principal reasons.

First, the decision of the court below, in affirming the district court's finding of primary liability for securities fraud based on implied misrepresentation, fundamentally conflicts with this Court's precedent in

Janus Capital Group, Inc. v. First Derivative Traders, 564 U.S. ___, 131 S. Ct. 2296 (2011). The finding that Petitioners were "as much 'makers'" of the implied misrepresentation "as were their brokers" cannot be squared with the "clean line" drawn by this Court in *Janus* between "makers," who can be held primarily liable, and others, who can only be held secondarily liable. In determining that Petitioners were "as much 'makers'" as were their brokers, the court ignored attribution, an essential element of the test for who is a "maker" of a misrepresentation. And, in affirming liability on a scheme theory without any inherently deceptive conduct separate from the misrepresentation, the court below permitted an end-run around *Janus*. The decision of the court below in this regard conflicts with holdings of the Seventh, Eighth, and Ninth Circuits.

Second, in affirming joint and several liability to disgorge $38 million in gain earned by an independent third party, the court below ignored the equitable principles underlying the disgorgement remedy and exceeded its authority under Section 21(d)(5) of the Exchange Act, 15 U.S.C. § 78u(d)(5). Because the disgorgement order bears no reasonable relationship to any gain earned or controlled by the Petitioners, it must be vacated. A disgorgement order requiring Petitioners to disgorge monies that they neither earned nor controlled cannot be reconciled with the Second Circuit's own precedent or with that of any other circuit, which holds that the court's power to order equitable disgorgement extends only to the amount by which the defendant profited.

A. Petitioners Cannot Be Held Primarily Liable Under Section 10(b) of the Exchange Act

Petitioners were not the "maker" of any misrepresentation and therefore cannot be held primarily liable. And because Petitioners engaged in no deceptive acts separate from a misrepresentation that would give rise to scheme liability, they cannot be held primarily liable under SEC Rules 10b-5(a) and (c).

1. There Is No Basis For Primary Liability Under SEC Rule 10b-5(b)

In holding that Petitioners were "as much 'makers'" of the misrepresentation implied by late trading as were their brokers at TWC, the court below disregarded the "clean line" drawn in *Janus* between "makers" of misrepresentations, who can be held primarily liable, and others, who may be held liable only on a secondary liability theory. The appeals court's determination that Petitioners were the "as much the 'makers'" of the implied misrepresentation cannot be reconciled with either the "ultimate authority" or the "attribution" tests in *Janus*. The Court defined "maker" thus:

> For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including

> its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not "make" a statement in its own right. One who prepares or publishes a statement on behalf of another is not its maker. And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by – and only by – the party to whom it is attributed.

Janus, 131 S. Ct. 2296, 2302 (2011).

The district court initially sought to avoid the "maker" question altogether, holding that *Janus* does not apply to SEC enforcement actions. Even if it did apply, the district court stated, Petitioners were still the "maker" of the misrepresentation. The district court considered the ultimate authority element but erroneously failed to consider the attribution question, which this Court held in *Janus* is a necessary element when determining whether a misrepresentation was "made" indirectly. *Id.* at 2305 n. 11.

The court below implicitly rejected the district court's ruling that *Janus* did not apply to an SEC enforcement proceeding. But it affirmed the district court's holding that Petitioners were the makers of the implied misrepresentation, stating that Petitioners were "as much" the makers as were their brokers. This conclusion is clearly erroneous. Applying the attribution test, there is no evidence in the record that the implied misrepresentation was attributed to

Petitioners. Indeed, because the Petitioners had no obligation under the "forward pricing rule" in SEC Rule 22c-1 or by contract with the mutual funds, no one could have attributed any implied representation to them.

2. Late Trading of Mutual Funds Through Regulated Brokers

This action involves late trading on behalf of a foreign investment fund, PSPF, named as a relief defendant in this action. As PSPF's investment adviser, Petitioner PCM and its director Chester determined when to trade on PSPF's behalf (based on a "signal" provided by a computer trading model), but Petitioners exercised no other control of PSPF. Indeed, Petitioners were neither owners, nor investors, nor shareholders of PSPF. PCM merely advised PSPF about trading. There is no finding by the court below that Petitioners exercised any form of control over PSPF or its investors other than the trading decisions, and indeed there is uncontroverted evidence in the record, relied on by the district court, that shows that Petitioners' interactions with PSPF were "limited to computer model signal generation and placement of trades" on PSPF's behalf and that Petitioners did not serve as directors of PSPF or signatories of its bank accounts. App. 188 (PX-554, cited by the district court at App. 174).

Petitioners had no direct contact with the mutual funds or the clearing firm. Instead, Petitioners placed trading orders after 4:00 p.m. with their introducing broker, TWC. The broker then submitted Petitioners' orders electronically through their clearing broker BofA, via BofA's electronic trading system, which permitted brokers to settle and clear trades they received after the 4:00 p.m. market close. Because of duties imposed on the brokers by law and contract, Petitioners' brokers had a responsibility to hold trades they received after 4:00 p.m. until the next business day, or, at the very least, to provide the mutual funds the actual times that Petitioners had submitted the trade orders. Indeed, the order entry screen in BofA's electronic trading system contained a data field in which TWC could have specified the time that TWC received Petitioners' orders. But the field was optional, so trades could be entered with the field left blank. *See In the Matter of Banc of America Capital Management, LLC*, Exchange Act Rel. No. 51167, 2005 SEC LEXIS 291 (Feb. 9, 2005), at ¶¶ 80-86 (describing how the system allowed brokers to enter trades without inputting order receipt time). Thus, when the brokers submitted Petitioners' trades to mutual funds after 4:00 p.m. and omitted the material fact of the actual time of order receipt, the brokers impliedly misrepresented that they had received the orders before 4:00 p.m.

3. The Misrepresentation Implied By Late Trading

Any analysis of liability for misrepresentation must begin with a determination of what was actually misrepresented. The district court was vague in its description of the implied misrepresentation, moving from active to passive voice, thus obfuscating the representation, how it arose, and who made it:

> Here, Defendants' submission of late-trade orders constituted a fraudulent device and an implied misrepresentation in violation of Rule 10b-5(b) because it suggested that *final orders were received before the funds' 4:00 p.m. pricing time*, as reflected in the applicable prospectus language, *when, in fact, the trading decisions were made after 4:00 p.m.* Defendants were aware that *TW&Co. took steps to make it appear to any outside observer* that their buy and sell orders had been finalized by 4:00 p.m., when the critical decisions were not made until well after the close of market. The mutual funds *were thus deceived* into believing that the trades were made before 4:00 p.m. and thus into giving the trades that day's NAV.

App. 160 (emphasis added). So, according to the district court, the implied misrepresentation that resulted from Petitioners' orders and "steps taken" by the stockbrokers at TWC was either that "final orders were received before the funds' 4:00 p.m. pricing time" or "the trades were made before 4:00 p.m."

If these were the representations implied by late trading, then Petitioners could not have been the "makers." Petitioners had no authority – let alone "ultimate authority" – to make *any* representation to the mutual funds as to the time the orders were *received* *by TWC*. The duty to monitor the time of order receipt to insure correct pricing is assigned to the broker-dealers and other regulated market professionals under SEC Rule 22c-1, which has no application to customers such as Petitioners.

4. Petitioners Lacked "Ultimate Authority" Over Any Implied Misrepresentation

Under SEC Rule 22c-1, Petitioners' brokers, not Petitioners, had the ultimate authority over any implied misrepresentation regarding order or trade timing. This is because the rule required the brokers to monitor the time they received trade orders to ensure that the customers were given the correct price. Neither the district court nor the court of appeals has ever held that Rule 22c-1 imposed any obligations on customers like Petitioner. The only obligations resulting from Rule 22c-1 in the context of this case fell squarely on the brokers as "dealers in" fund shares, who had not only the obligation but also the authority to monitor and communicate order and trade timing information to the mutual funds.

In addition to the *legal duty* to monitor time of order receipt, the brokers at TWC also had the *practical ability* to make an accurate representation regarding the time of order receipt as to *every trade they entered into BofA's electronic trading system*. As a matter of common sense, the brokers at TWC were the only ones who could represent when they received Petitioners' orders. But they chose not to provide that information, and BofA's electronic trading system did not require it. *Banc of America*, *supra,* 2005 SEC LEXIS 291, at ¶¶ 80-86. TWC's omission directly resulted in the implied misrepresentation that the district court found. TWC therefore is the only entity that can fairly be said to have had "ultimate authority" over the implied misrepresentation regarding the time it received Petitioners' trade orders, because TWC was the only entity that had control over such information and "whether and how to communicate it." *Janus*, 131 S. Ct. at 2302.

While Petitioners had authority over the *decision to trade* in the first instance, they had no authority over the content of the misrepresentation found by the district court and whether and how to communicate it. How to communicate the trade information and whether to advise the mutual funds of the time that the orders were received was within the exclusive control of the broker. To follow the Court's analogy in *Janus*, a speechwriter who authors a false representation does not have the ultimate authority over whether that false representation will be communicated to anyone. *Janus*, 131 S. Ct. at 2302. That authority lies with the speechmaker – here, the broker.

5. No Misrepresentation Was Attributed to Petitioners

The Court's majority opinion in *Janus* states that, in the ordinary case, attribution is strong evidence of who is the "maker" of a statement:

> attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by – and only by – the party to whom it is attributed.

131 S. Ct. 2296, 2302. Later in the opinion, the Court emphasized that attribution is a "*necessary*" element of the test for primary liability. When determining whether a statement was made indirectly (as here), the Court wrote, "[m]ore may be required, but attribution is necessary." *Id.* at 2305 n. 11.

Neither the district court nor the court below conducted any analysis of attribution. The court below not only failed to consider attribution, it also omitted all of the attribution language from the portions of the *Janus* majority opinion that it quoted. App. 166, 169. There is accordingly no finding by either the district court or the court below that any misrepresentation was ever attributed to Petitioners.

Focusing on the implied misrepresentation at issue here, namely, that the broker received Petitioners' late trade orders before 4:00 p.m. (when in fact the broker received the orders after 4:00 p.m.), it is clear that it could not have been – and was not – attributed to Petitioners. Petitioners had no contact at all with the mutual funds, so there is no likelihood that the mutual funds would have attributed any representation regarding late trade order timing to Petitioners. But TWC and BofA *did* have contact with the mutual funds through the electronic trading system. And under the "forward pricing rule" in SEC Rule 22c-1, the burden was squarely on the broker-dealers and other regulated market professionals to monitor the time of order receipt to ensure that Petitioners' trades were priced correctly. So the brokers are the only ones to whom the misrepresentation could have been attributed.

6. Petitioners Cannot Be Held Liable For An Omission

Petitioners cannot be liable for an implied misrepresentation, because they had no duty to make any representation, express or implied. The implied representation here arose from the broker-dealers' failure to advise the mutual funds of the time that the broker actually received Petitioners' trade orders. But the brokers, not Petitioners, were the ones who were under a legal and contractual obligation to provide this information.

In *Fulton County Employees Retirement System v. MGIC Investment Corp.*, 675 F.3d 1047 (7th Cir. 2012), the Seventh Circuit had before it an analogous case. There, the plaintiffs alleged that the defendant "made" misstatements about the prospects of a joint venture that the defendant operated with separate third parties. The alleged misstatements were made during one of the defendant's quarterly earnings calls, not by the defendant, but by one of the third parties. Like the SEC here, the plaintiffs alleged that the defendants effectively "made" the misstatements by inviting the third party to speak. *Id.* at 1051. But the Seventh Circuit rejected this argument, holding that *Janus* precludes liability where the defendant was essentially alleged to have "kept silent" when a third party joint venturer with an affirmative duty to speak truthfully made a misrepresentation. *Id.* at 1051-52.

The decision of the court below conflicts with the decision of the Seventh Circuit in *Fulton County*, because the party with the duty to speak to the mutual funds regarding the time Petitioners' trade orders were actually received was Petitioners' broker, *not* Petitioners. No court has found that Petitioners had any duty to provide this information to the mutual funds, so they cannot be liable for having "kept silent" while the broker failed to speak.

7. There Is No Basis For Scheme Liability Under Rules 10b-5(a) and (c)

In alternatively holding Petitioners primarily liable on a "scheme liability" theory under SEC Rules 10b-5(a) and (c) for the very same conduct that resulted in the implied misrepresentation under Rule 10b-5(b), the court below conflated implied misrepresentation with a deceptive scheme. In this regard, the decision of the court below is in conflict with decisions of the Eighth and Ninth Circuits, holding that scheme liability requires inherently fraudulent conduct that is separate from a misrepresentation. The court below identified no inherently deceptive conduct by Petitioners separate from the implied misrepresentation. The only acts identified were directly related to Petitioners' placing of orders after 4:00 p.m. But placing a mutual fund order after 4:00 p.m. is not an inherently deceptive act. As the SEC conceded at trial, there is no statute, law, or regulation that prohibits a customer from placing a mutual fund order at any time of the day or night. And there is no other act identified by the district court that justifies imposition of scheme liability in addition to misrepresentation liability.

It is settled law in the Eighth and Ninth Circuits that scheme liability requires inherently deceptive conduct that is separate from a misrepresentation. *See, e.g., Public Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d 972, 987 (8th Cir. 2012) ("We join the Second and the Ninth Circuits in recognizing a scheme liability claim must be based on conduct beyond misrepresentations or omissions actionable under Rule 10b-5(b)."); *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057-58 (9th Cir. 2011), *cert. denied*, 132 S. Ct. 2713 (2012) (limiting scheme liability to cases where scheme encompasses conduct beyond misrepresentations and omissions). As observed by the Ninth Circuit in *Public Pension Fund Group*, the Second Circuit's own prior rulings in other cases support this position. *See, e.g.*, *Lentell v.*

Merrill Lynch & Co., 396 F.3d 161, 177 (2d Cir. 2005) (refusing to allow misrepresentations and omissions in a market manipulation case to be recast as a scheme under Rules 10b-5(a) and (c)).

Indeed, as explained previously by the district court in another recent case, the requirement that plaintiffs attempting to prove scheme liability under Rules 10b-5(a) and (c) show inherently deceptive acts separate and distinct from a misrepresentation is intended to shut the "back door into liability for those who help others to make a false statement or omission in violation of subsection (b) of Rule 10(b)(5)." *SEC v. Kelly*, 817 F. Supp. 2d 340, 343-44 (S.D.N.Y. 2011). And yet this is precisely what the district court did here, perhaps concerned that *Janus* would not support primary liability for misrepresentation. As the district court warned in *Kelly*:

> To permit scheme liability "to attach to individuals who did no more than facilitate preparation of material misrepresentations or omissions actually communicated by others . . . would swallow" the bright-line test between primary and secondary liability.
>
> * * *
>
> Where the SEC is attempting to impose primary liability under subsections (a) and (c) of Rule 10b-5 for a scheme based upon an alleged false statement, permitting primary scheme liability when the defendant did not "make" the misstatement would render the rule announced in *Janus* meaningless. It

> would allow the SEC to allege that the conduct *Janus* held insufficient to establish primary liability under subsection (b) of Rule 10b-5 is scheme-related conduct that supports primary liability under subsections (a) and (c), notwithstanding that the alleged misstatements represent the basis of that claim.

817 F. Supp. 2d at 343, 344 (quoting *SEC v. PIMCO Advisors Fund Mgmt., LLC*, 341 F. Supp. 2d 454, 467 (S.D.N.Y. 2004)).

Several other courts have considered attempts by the SEC to impose primary liability based on a scheme theory on secondary actors in misrepresentation cases and have decided that scheme liability must be centered on acts that are separate from those leading up to and including the misrepresentation. *See, e.g., SEC v. Lucent Techs., Inc.*, 610 F. Supp. 2d 342, 358-61 (D.N.J. 2009); *SEC v. Collins & Aikman Corp.*, 524 F. Supp. 2d 477, 486-87 (S.D.N.Y. 2007); *SEC v. KPMG LLP*, 412 F. Supp. 2d 349, 377-78 (S.D.N.Y. 2006); *PIMCO Advisors Fund Mgmt.*, 341 F. Supp. 2d at 467.

In its haste to impose primary liability regardless of *Janus*, the district court failed to identify any acts *by Petitioners* that were both inherently deceptive and sufficiently unrelated to the implied misrepresentation to provide an independent basis for primary liability on a scheme theory under SEC Rules 10b-5(a) and (c). If this restyling of a misrepresentation case were sufficient to invoke scheme liability, then the "clean line" between primary and secondary liability drawn by this Court in *Janus* would be made utterly irrelevant.

B. The Disgorgement Order Exceeds the Equitable Relief Authorized by Congress and Conflicts With Rulings of Other Circuits

Section 21(d)(5) of the Exchange Act provides federal courts the power to order any *equitable* relief necessary for the protection of investors. 15 U.S.C. § 78u(d)(5). Disgorgement is an equitable remedy that deprives a wrongdoer of ill-gotten gains by requiring the return of proceeds of illegal activity. In light of the district court's admission that the SEC failed to prove Petitioners' gain at trial, and the fact that the gain resulting from late trading was earned by PSPF, the investment fund, and not by Petitioners, who were merely PSPF's investment advisers, the disgorgement affirmed by the court below is inequitable. As such, it exceeds the scope of the court's statutory authority to impose equitable relief, for at least five reasons.

First, to require a party to "disgorge" (or pay back) funds that it never received is at odds with the primary purpose of disgorgement, which is to "correct unjust enrichment" by depriving a violator of ill-gotten gains. *SEC v. AbsoluteFuture.com*, 393 F.3d 94, 96 (2d Cir. 2004); *SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978). Purporting to require the Petitioners to "return" money that they never obtained is not disgorgement: it is punishment. That was the ruling of the court below in an earlier SEC enforcement case, *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1104 (2d Cir. 1972), where the Second Circuit held that a district court's award of disgorgement in excess of the defendant's ill-gotten gain was an abuse of discretion. In *Manor Nursing*, the appeals court held that a disgorgement award constituted an improper penalty assessment to the extent that it exceeded the defendant's gain. The court accordingly required that the award be reduced to the amount that the defendant was proven to have received as a result of the defendant's unlawful conduct. *Id.*

In this case, the district court itself held that the SEC had failed at trial to establish Petitioners' individual pecuniary gain. App. 44 ("Thus, the record does not establish with sufficient certainty either Defendant's individual pecuniary gain."). The $38 million that the district court ordered Petitioners to "disgorge" was actually earned by PSPF, the independent investment fund that Petitioners advised, not by Petitioners. So there is every indication that the award at issue here is entirely punitive.

In ordering disgorgement that exceeded Petitioners' gain, the court below ignored settled law that disgorgement is limited to the return of unjust enrichment. *See, e.g., Zacharias v. SEC*, 569 F.3d 458, 473 (D.C. Cir. 2009), *reh'g denied*, 584 F.3d 1073 (D.C. Cir. 2009) (explaining precedent holding that "disgorgement may not be used punitively" and that its purpose is to restore defendants to the status quo ante); *SEC v. ETS Payphones, Inc.*, 408 F.3d 727, 735 (11th Cir. 2005) (holding that disgorgement extends only to amount by which defendant profited, and stating that any further sum would constitute a penalty assessment); *Hateley v. SEC*, 8 F.3d 653, 656 (9th Cir. 1993) (limiting disgorgement to gain); *Blatt*, 583 F.2d 1325, 1335 (stating that the court's power to order disgorgement extends only to the amount with interest that the defendant profited from wrongdoing); *Rowe v. Maremont Corp.*, 850 F.2d 1226, 1241 (7th Cir. 1988) (stating that equity requires only that a defendant give up its unjust enrichment). From the Second Circuit's recent decision in *SEC v. Contorinis*, No. 12-1723-cv, ___ F.3d ___, 2014 WL 593484 (2d Cir. Feb. 18, 2014), upholding an order imposing more than $7 million in "disgorgement" against a defendant who personally earned only slightly more than $427,000, it now appears that the Second Circuit has definitively split from other circuits in ignoring this key equitable limitation.

Second, there was no basis for imposing joint and several liability for disgorgement here, under the law of the Second Circuit or any other circuit. Joint and several liability for disgorgement is itself at odds with the equitable foundations of disgorgement, which is to prevent unjust enrichment. Ordering a violator to "pay back" money that is in the hands of another is facially inconsistent with equity. Perhaps this is why joint and several liability has only generally been imposed in exceptional cases, such as where courts conclude that the party held jointly liable had the ability to recoup the ill-gotten gain from the third party, or where the third party had the funds only because they were transferred to the third party by the jointly liable defendant. *E.g., SEC v. Calvo*, 378 F.3d 1211, 1217-18 (11th Cir. 2004) (permitting joint liability for sole managing member who owned 50% of stock and received ill-gotten gain); *SEC v. First Pac. Bancorp*, 142 F.3d 1186, 1192 (9th Cir. 1998) (allowing joint and several liability for majority owner who transferred funds); *SEC v. First Jersey Securities, Inc.*, 101 F.3d 1450, 1476 (2d Cir. 1996) (noting that principal might not have been jointly liable if he had not been 100% owner).

Joint and several liability has generally been allowed only in cases where it would not offend equity to hold a party jointly liable to disgorge the ill-gotten gain. For example, in *SEC v. AbsoluteFuture.com*, 393 F.3d 94 (2d Cir. 2004), a case cited by the court below apparently in support of its determination to affirm the district court's order making Petitioners jointly and severally liable for $38 million in gain earned by PSPF, the Second Circuit in fact found abuse of discretion where the district court had held individual defendants jointly and severally liable for the entire amount of the defendants' total gain. 393 F.3d at 95-96. In that case, the court below actually *reduced* the disgorgement awarded against the individual defendants so that it would not exceed that portion of the illegal gain that the defendants had combined and transferred among themselves. *Id.*

In this case, there was not even an allegation (and certainly no proof) that the Petitioners controlled PSPF and combined and transferred the proceeds of late trading among themselves. So there is no basis under *AbsoluteFuture.com* or any Second Circuit precedent for holding the Petitioners jointly and severally liable to disgorge the $38 million in gain that went to PSPF and its investors. Indeed, *AbsoluteFuture.com* may stand for the proposition that joint and several liability for disgorgement is appropriate in cases where defendants have combined and transferred ill-gotten gain among themselves. Even then, however, joint and several liability is appropriate under *AbsoluteFuture.com* only *to the extent* that defendants combined and transferred profits among themselves.

The decision in *AbsoluteFuture.com,* limiting disgorgement to gains combined and transferred, is consistent with the equitable underpinnings of the disgorgement remedy, because defendants who had the ability to transfer funds among themselves would presumably be able to get the funds back to pay the disgorgement. But in this case, there was not even an allegation of any such transfer or ability. And, as explained below, Petitioners lacked the ability to make any such transfer. The disgorgement awarded here – $38 million imposed jointly and severally against an investment adviser and its director who were not proven to have earned, controlled, or transferred it – is in direct conflict with the equitable principles underlying the disgorgement remedy, as applied in the very case relied upon by the court below.

Third, Petitioners' mere "closeness and collaboration" in a misrepresentation or a fraudulent scheme is insufficient to support joint and several liability to disgorge a third party's gain. If that were the rule, then joint and several liability would be imposed in nearly every multi-party securities fraud case, especially those involving investment fund advisers, who are required to "closely collaborate" with the funds they advise. In *Janus*, the plaintiffs argued that a fund and its adviser had a "well-recognized and uniquely close relationship" and that the adviser exerted significant influence over the fund. *Janus*, 131 S. Ct. at 2304. The Court nevertheless held that the fund and the adviser were separate legal entities with independent boards and observed corporate formalities. The Court concluded:

> Any reapportionment of liability in the securities industry in light of the close relationship between investment advisers and mutual funds is properly the responsibility of Congress and not the courts.

Id. Similarly, it would be inappropriate to impose joint and several liability on an independent investment adviser for gain obtained by the fund it advised, simply on the basis of a "close collaboration" between the two entities. As the Court noted in *Janus*, Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), imposes liability for influence resembling control. *Id.* To impose joint and several liability here would thus read into Rule 10b-5 a theory of liability broader than that created by Congress in Section 20.

Indeed, the joint and several liability has never been imposed based merely on "close collaboration." The court below relied on a Second Circuit case, *SEC v. First Jersey Securities, Inc.*, 101 F.3d 1450 (2d Cir. 1996), as support for its determination that joint and several liability was appropriate based merely on Petitioners' "closeness and collaboration" in late trading. But *First Jersey Securities* does not support joint and several liability here. The defendant in that case was held jointly and severally liable because he had *complete control* over the broker-dealer entity with which he was held jointly liable. The defendant in *First Jersey Securities* so completely controlled the broker-dealer – as its 100% owner, president, and CEO – that he not only had unfettered ability to transfer and withdraw ill-gotten gains from the broker but also was held liable as a "controlling person" of the broker under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a). 101 F.3d at 1461, 1476. The court noted that he "possessed control over every aspect of" the broker's operations. *Id.* The defendant's control over the broker was so complete that the court rejected the defendant's contention that he should be required to disgorge only the amounts he withdrew from the broker, noting that the argument "might be more persuasive" if he had been less than a 100% owner and had lacked the ability to withdraw money directly from the broker. *Id.* at 1476.

First Jersey Securities is inapposite because Petitioners have almost nothing in common with the defendant in that case. Apart from advising PSPF with regard to trading, Petitioners had no ownership, direction, or control of PSPF. They were never alleged to be "controlling persons" of PSPF, and there is no evidence that would support such an allegation. To the contrary, PSPF had a board of directors that was wholly independent of the Petitioners, who owned 0% of PSPF's stock. Petitioners were not owners, officers, or directors of PSPF. And Petitioners had no ability to transfer or withdraw funds from PSPF, as they had no signatory authority for PSPF or its bank accounts. App. 188.

SEC v. Calvo, 378 F.3d 1211 (11th Cir. 2004), an Eleventh Circuit case relied on by the district court for the notion that "close collaboration" alone justifies joint and several liability, similarly does not support the court's conclusion here. In *Calvo*, the defendant maintained a 50% ownership interest in the company throughout the entire course of sale of unregistered stock, and the defendant served as the company's sole managing member. 378 F.3d at 1217-18. Indeed, the court rejected Calvo's claim that he received less than the full proceeds of the illegal activity as "irrational at best," and it found that the amount of the defendant's illicit gains had been "obscured" by his own "record-keeping or lack thereof." *Id.* There are no similar facts here. Petitioners had no ownership interest in or management of PSPF, and there is an express finding by the district court that the SEC failed to prove Petitioners' gain.

None of the cases relied on by the court below or the district court support making Petitioners jointly and severally liable for *$38 million* in gain earned by PSPF and its investors. Here, there is no finding that Petitioners ever combined and transferred gains from PSPF to themselves (as in *AbsoluteFuture.com*). There is no finding that Petitioners owned or managed PSPF or earned the bulk of the gain (as in *Calvo*). And there is certainly no finding that Petitioners were 100% owners and Section 20(a) "control persons" who had the ability to transfer money from PSPF (as in *First Jersey Securities*). Indeed, even if there had been a suggestion that the Petitioners had control over PSPF such that they could transfer its gains to themselves, it would have been plainly contradicted by evidence specifically cited by the district court, which makes clear that Petitioners lacked such control:

> PCM or its principals [i.e., Chester] do not act in the capacity of director(s) of PSPF, nor as signatories of the Master Fund or its bank accounts.

App. 188 (trial exhibit PX-554, quoted by the district court (App. 174), but with the above language omitted). Petitioners are unaware of any authority under which they can be held jointly and severally liable to disgorge gains of a third party where they neither controlled the third party nor obtained ill-gotten gains from the third party.

Fourth, because Petitioners never possessed, controlled, or transferred the gains that flowed from the securities law violation, imposition of joint and several liability here would be akin to making Petitioners liable to pay a substitutionary sum of money approximating another's gain. But this would be a *legal* remedy, derived from the common law writ of assumpsit, rather than an *equitable* remedy, such as disgorgement. As this Court explained in *Great-West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204, 213-14 (2002), the right to possession or ownership is central to whether a remedy falls within the boundaries of law or equity. The disgorgement order here, imposing joint and several liability to "disgorge" property over which Petitioners lacked possession or control, is a legal remedy that does not fit within the boundaries of equity and therefore exceeds the scope of the court's power to order equitable relief under Section 21(d)(5) of the Exchange Act.

Finally, the disgorgement awarded here cannot be reconciled with the statutory provision established by Congress for civil monetary penalties in SEC enforcement actions. 15 U.S.C. §§ 77t(d); 78u(d)(3). Indeed, the district court imposed a civil money penalty, which was reversed and remanded by the court below. To the extent that the district court's disgorgement award exceeds the Petitioners' proven gain, it is a de facto penalty (or an impermissible enhancement of the penalty erroneously imposed by the district court). The disgorgement award should accordingly be reversed and remanded for reconsideration of the appropriate disgorgement amount

C. The Questions Presented Are Exceptionally Important

This case presents a key opportunity for this Court to provide guidance regarding the proper application of *Janus*'s "clean line" defining the scope of primary liability for securities fraud and its relationship to scheme liability under SEC Rules 10b-5(a) and (c). Simply put, if conduct that gives rise to a misrepresentation can alternatively be labeled a "scheme," without any showing of inherently deceptive acts separate and apart from the misrepresentation, then the limitation of primary liability in *Janus* to "makers" of misrepresentations will be rendered meaningless. This Court's guidance is needed to prevent courts from attempting to circumvent *Janus* by labeling a misrepresentation as a "scheme." *See SEC v. Kelly*, 817 F. Supp. 2d 340, 343-44 (S.D.N.Y. 2011) (warning that this would "swallow whole" the bright-line test between primary and secondary liability); *see also Public Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d 972, 987 (8th Cir. 2012); *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057-58 (9th Cir. 2011); *SEC v. PIMCO Advisors Fund Mgmt., LLC*, 341 F. Supp. 2d 454, 467 (S.D.N.Y. 2004).

This case also presents a critical opportunity to remind the circuit courts of the equitable boundaries of disgorgement. There is already strong indication that the court below is continuing to ignore its own precedent and that of other circuits holding that the disgorgement remedy should be limited to the return of ill-gotten gain. The Second Circuit's recent decision in *SEC v. Contorinis*, No. 12-1723-cv, ___ F.3d ___, 2014 WL 593484 (2d Cir. Feb. 18, 2014), should eliminate any debate whether the court below has abandoned the equitable underpinnings of disgorgement in seeking to fashion penalties in the guise of disgorgement. Indeed, the dissent in *Contorinis* highlights this, arguing that the Second Circuit has affirmatively split with its own precedent and that of other circuits requiring that disgorgement be limited to unjust enrichment and not be imposed punitively. *Id.*, 2014 WL 593484, at *10.

Joint and several liability is a limited exception to the rule requiring that disgorgement be limited to return of individual gain. As such, joint and several liability is only properly imposed where it would not offend equity, such as alter ego situations or those where defendants have controlled and transferred funds to a third party. Those circumstances are not present here. The assertion that mere "close collaboration" of the parties is the touchstone for joint and several liability cannot be correct. If the ruling of the court below were allowed to stand, then nearly every defendant who collaborated with another in a securities fraud case would potentially face joint and several liability for the total gain, equity notwithstanding. This would have grave implications for the investment advisory industry, as all investment advisers would be potentially at risk to "disgorge" third party profits going forward. This case accordingly presents a critical opportunity to restore the disgorgement remedy to its equitable and statutory underpinnings by limiting joint and several liability to cases where its application is actually consistent with equity.

CONCLUSION

The Court should grant the petition.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
August Term 2012
(Argued: April 9, 2013 Decided: August 8, 2013)
Docket No. 12-1680-cv

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SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

-- v. --

PENTAGON CAPITAL MANAGEMENT PLC,
LEWIS CHESTER,

Defendants-Appellants,

PENTAGON SPECIAL PURPOSE FUND, LTD.,

Relief Defendant.

--x

Before: WALKER and CHIN, *Circuit Judges*, and RESTANI, *Judge*.*

Defendants-Appellants Pentagon Capital Management and Lewis Chester appeal from the 2012 judgment of liability of the United States District Court for the Southern District of New York (Sweet, *Judge*). After a bench trial, Defendants-Appellants were found liable for securities fraud under Section 17(a) of the Securities Act of 1933, Section 10(b) of the

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* The Honorable Jane A. Restani, of the United States Court of International Trade, sitting by designation.

Securities Exchange Act of 1934, and Rule 10b-5. The district court ordered disgorgement and imposed a civil penalty. Both monetary awards were imposed jointly and severally in the amount of $38,416,500. We find no error in the district court's determination of liability, its disgorgement award, or its decision to impose joint and several liability for the disgorgement amount, but we reverse the district court's imposition of joint and several liability for the civil penalty, vacate that penalty, and remand for reconsideration of the amount of the civil penalty in light of the Supreme Court's decision in *Gabelli v. SEC*, 133 S. Ct. 1216 (2013). AFFIRMED in part, VACATED in part, and REMANDED in part.

BENJAMIN L. SCHIFFRIN (Michael A. Conley, John W. Avery, Susan S. McDonald, David Lisitza, *on the brief*), Securities and Exchange Commission, Washington, DC, *for* Appellee.

FRANK C. RAZZANO (Ivan B. Knauer, Matthew D. Foster, John C. Snodgrass, *on the brief*), Pepper Hamilton LLP, Washington, DC, *for* Defendants-Appellants.

JOHN M. WALKER, JR., *Circuit Judge*:

Defendants-Appellants Pentagon Capital Management and Lewis Chester appeal from a judgment of the United States District Court for the Southern District of New York (Sweet, *Judge*). After a bench trial, the district court found the defendants liable for securities fraud under Section 17(a) of the Securities Act of 1933 (the "Securities Act"), Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), and Rule 10b-5; ordered disgorgement; and imposed a civil penalty. Each monetary award was imposed jointly and severally in the amount of $38,416,500. We find no error in the district court's determination of liability, the amount of its disgorgement award, and its decision to impose that award jointly and severally. But we reverse the district court's imposition of joint and several liability for the civil penalty, vacate that penalty, and remand for reconsideration of its amount in light of the Supreme Court's decision in *Gabelli v. SEC,* 133 S. Ct. 1216 (2013).

BACKGROUND

We assume the parties' familiarity with the background of this case and recite only those facts relevant on appeal. For additional detail, we refer the parties to the district court's thorough opinion. *See SEC v. Pentagon Capital Mgmt. PLC,* 844 F. Supp. 2d 377 (S.D.N.Y. 2012). The basis for the district court's imposition of fraud liability was the defendant's practice of late trading in the mutual fund market. Late trading occurs when, after the price of a mutual fund becomes fixed each day, an order is placed and executed as though it occurred at or before the time the price was determined, thereby allowing the purchaser to take advantage of information released after the price becomes fixed but before it can be adjusted the following day.

I. Mutual Funds and Late Trading

Mutual fund shares are priced according to the fund's "net asset value," or NAV. SEC Rule 22c-1, promulgated under the Investment Company Act of 1940, requires that a mutual fund calculate its NAV at least once per day, Monday through Friday. 17 C.F.R. § 270.22c-1(b)(1) (2013). A mutual fund's NAV is generally calculated "by using the closing prices of portfolio securities on the exchange or market on which the securities principally trade." Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 68 Fed. Reg. 70,402-01, 70,403 (proposed Dec. 17, 2003) (to be codified at 17 C.F.R. pts. 239, 274) (final rule adopted in 69 Fed. Reg. 22,300). However, if the closing price of a security held in a mutual fund's portfolio does not reflect its current market value at the time of the fund's NAV calculation, a mutual fund must calculate its NAV "by using the fair value of that security, as determined in good faith by the fund's board." *Id.* This could occur, for example, when some price-affecting event occurs after the closing price is established but before the fund's NAV calculation. If a mutual fund's shares are mispriced, "an investor may take advantage of the disparity between the portfolio securities' last quoted prices and their fair value." *Id.*

Rule 22c-1 also requires that mutual funds "sell and redeem their shares at a price based on the NAV *next computed* after receipt of an order," a practice called "forward pricing." *Id.* (emphasis added); *see also* 17 C.F.R. § 270.22c-1(a). Forward pricing prevents dilution of mutual fund shares by keeping traders from profiting off of a stale share price. Some mutual fund investors, however, engage in late trading, "the practice of placing orders to buy or redeem mutual fund shares after 4 p.m., Eastern time, as of which most funds calculate their [NAV], but receiving the price based on the 4 p.m. NAV," instead of the next day's NAV, as required by Rule 22c-1. Disclosure, 68 Fed. Reg. at *70,402. In *VanCook v. SEC,* 653 F.3d 130 (2d Cir. 2011), we held that such late trading violated Rule 22c-1.

II. Pentagon Capital Management

Chester formed Pentagon Capital Management ("Pentagon") in 1998 to facilitate mutual fund trading in the European markets with a market timing strategy.[1] In 1999, Chester and Pentagon explored the possibility of market timing and late trading in the

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[1] If a mutual fund misprices its shares, such as by failing to appropriately use fair value pricing, "short – term traders have an arbitrage opportunity that they can use to exploit the fund and disadvantage the fund's long-term investors by extracting value from the fund without assuming any significant investment risk." This practice is known as "market timing." Disclosure, 68 Fed. Reg. at 70,403. Because market timing can dilute the value of long-term shareholders' interests in a mutual fund, many funds have imposed trading restrictions to minimize the practice, including "identifying market timers and restricting their trading privileges or expelling them from the fund." *Id.* at 70,404.

United States mutual fund market.[2] To facilitate its trading in the United States, Pentagon formed Pentagon Special Purpose Fund ("PSPF"), the relief defendant in this case. PSPF was the sole member and manager of three Delaware limited liability companies that were established solely for Pentagon's use in trading mutual funds in the United States. At all times relevant to this case, Pentagon was PSPF's investment advisor and made all of its trading decisions.

In the United States, unlike in Europe, Pentagon was required to trade through a broker. As relevant here, Pentagon primarily used two individual brokers, James Wilson and Scott Christian, first at other brokerage firms, and finally at Trautman, Wasserman & Company ("Trautman"). Pentagon began trading through Trautman on February 15, 2001.

Based on Pentagon's instructions, Wilson and Christian executed Pentagon's trades through Bank

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[2] International market timers can have an additional advantage because they

> profit from purchasing or redeeming fund shares based on events occurring after foreign market closing prices are established, but before the events have been reflected in the fund's NAV. In order to turn a quick profit, market timers then reverse their positions by either redeeming or purchasing the fund's shares the next day when the events are reflected in the NAV.

SEC v. Gabelli, 653 F.3d 49, 53 (2d Cir. 2011), *rev'd on other grounds*, 133 S. Ct. 1216 (2013).

of America, Trautman's clearing broker. Notwithstanding that the NAV was normally fixed at 4:00 p.m., Bank of America used a processing system for mutual fund orders that allowed brokers to change an order until 5:15 p.m. or 5:30 p.m. and later, until 6:30 p.m.

The parties do not dispute that Pentagon utilized Bank of America's permissive clearing system to engage in late trading with the assistance of Trautman's brokers. Pentagon opened 67 different accounts with Trautman, each of which could trade separately without a mutual fund knowing they were related. Wilson and Christian registered the accounts with different broker numbers with the effect that if a mutual fund detected late trading or market timing and blocked one account from trading, other accounts could remain active. Pentagon knew that various of its accounts had been expelled from at least thirteen funds, but it continued to trade in those funds using different accounts.

In April 2001, Chester sent an email to Wilson and Christian detailing Pentagon's "After Hours Trading Instructions." Chester instructed that Wilson and Christian would receive a target figure on the Standard & Poors ("S&P") future[3] near the close of

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[3] Black's Law Dictionary defines futures as "standardized assets (such as commodities, stocks, or foreign currencies) bought or sold for future acceptance or delivery." Black's Law Dictionary 746 (9th ed. 2009). Whether an index future (like the S&P future) rises or falls depends on whether other investors

(Continued on following page)

the markets from a Pentagon employee; then, if the future exceeded or fell below the target, the brokers were to contact Pentagon to ask them what to do. Chester then emailed other executives at Pentagon about the potential for late trading through Trautman:

> For this week only, [Trautman] can place or cancel any trades up to 5:00pm (10pm UK time). From next week – [Trautman] to confirm – the time will be 6:30pm (11:30 pm UK time).
>
> The significance of this is great.
>
> For instance, last night, the S & P future shot up at around 9:45pm [UK time]. Even though we hadn't placed any trades before 9pm [UK time], we STILL COULD HAVE PLACED THE TRADE after the bell, which we should have done given the marked rise in the future.
>
> I have been in Jimmy [Wilson's] office. Every day, whether we do a trade or not, they timestamp our trade sheets before 4pm, and then sit on them until they leave the office, at which point they will process them or not. Hence, the ability to place a buy order after the bell, even if we haven't done so before the bell.
>
> . . .

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believe the stocks comprising that index will rise or fall on a specified date in the future.

> This facility is VERY VALUABLE and we should utilize it accordingly.
>
> . . .
>
> It doesn't matter whether we place trades or not before the bell, we can do so afterwards, up to Trautman's time limits.

Pentagon, 844 F. Supp. 2d at 400-01 (alterations omitted).

Thereafter, Christian would create potential trade sheets for Pentagon each day and time-stamp them before 4:00 p.m., notwithstanding that the actual decision to place the order or not would be made after 4:00 p.m. Then, sometime after 4:00 p.m., a Pentagon employee would email Christian the instructions for Pentagon's late trades for that day. The district court found that Pentagon realized profits of "approximately $38,416,500 from the U.S. mutual fund [late] trades they executed through [Trautman]" between February 15, 2001 and September 3, 2003. *Id.* at 427.

Pentagon tried to conceal its late trading activities. For example, on July 30, 2002, Chester sent an email to a broker that instructed him not to use the words "market timing" (which, viewed broadly, includes late trading) on any correspondence, telling him "'to label what we do . . . "dynamic asset allocation," but never market timing!'" *Id.* at 396. In August 2002, Chester instructed another Pentagon employee to "phone around First Union" to see if late trading was available because "late trading is key," adding "[I] don't know how you find out about this [late trading] without actually saying it. No doubt you'll work it out!" *Id.* at 408.

In September 2003, the New York Attorney General announced that it had settled an enforcement action with Canary Capital Partners for violations of the New York State securities laws, including late trading. Shortly thereafter, Chester received a request from an investor for a letter stating that Pentagon had not engaged in late trading or any other illegal activity. Chester provided the letter, stating that Pentagon had "'never entered into arrangements with any U.S. onshore Mutual Fund in order to trade post-4:00pm EST for same-day NAV,'" and that all of Pentagon's trading arrangements were "'in accordance with the relevant rules, regulations, investment prospectus, and/or any other such relevant documentation relating to the investment(s) concerned.'" *Id.* at 410.

On April 3, 2008, the SEC brought this enforcement action against Pentagon. The complaint alleged that Pentagon's market timing and late trading activities violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5. After a seventeen-day bench trial, the district court found Chester and Pentagon primarily liable for late trading.[4] The district court found that appellants "did

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[4] The district court found that because market timing is not illegal *per se* and because the SEC "did not establish the funds'

(Continued on following page)

not act merely in reliance on their broker-dealers . . . [but] directed, indeed micromanaged, the late trading that [Trautman] performed on their behalf."[5] *Id.* at 421. The district court entered an injunction prohibiting Pentagon from late trading in the future. It also held Pentagon, Chester, and PSPF jointly and severally liable for a $38,416,500 disgorgement award and $38,416,500 in civil penalties. The amount of $38,416,500 was based on the district court's valuation of the profit Pentagon, Chester, and PSPF realized in late trading through Trautman between February 15, 2001 and September 3, 2003. This appeal followed.

DISCUSSION

On appeal, Pentagon and Chester argue that they cannot be held liable because their actions involved no fraud or deceit and that as investment advisors (as opposed to brokers), they cannot be held primarily liable for securities fraud. They further

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particular market timing rules . . . or that Defendants in fact took actions that would have operated a fraud with respect to those rules," that the defendants were not liable under the securities laws for their market timing activities not involving late trading. *SEC v. Pentagon Capital Mgmt. PLC,* 844 F. Supp. 2d 377, 416 (S.D.N.Y. 2012).

[5] With respect to late trading, because the district court made a finding of primary liability, it did not reach the question of whether defendants had aided and abetted Trautman in the late trading scheme. *See id.* at 423. Hence, the question of aider-and-abettor liability is not presented on this appeal.

argue that the district court made various errors related to the monetary awards. Following a bench trial, we review the district court's findings of fact for clear error and its legal conclusions *de novo*. *SEC v. Mayhew,* 121 F.3d 44, 50 (2d Cir. 1997).

I. Primary Liability for Securities Fraud

Section 17(a) of the Securities Act makes it

> unlawful for any person in the offer or sale of any securities . . .
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (2012). Section 10(b) of the Exchange Act, in relevant part, makes it unlawful for any person to "use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may

prescribe." 15 U.S.C. § 78j(b) (2012). Finally, Rule 10b-5, implementing Section 10(b), includes three subsections:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2013).

We have held that to violate Section 10(b) and Rule 10b-5, a party must have "(1) made a material misrepresentation or a material omission as to which he had a duty to speak, or used a fraudulent device; (2) with scienter; (3) in connection with the purchase or sale of securities." *SEC v. Monarch Funding Corp.,* 192 F.3d 295, 308 (2d Cir. 1999). The requirements for a violation of Section 17(a) apply only to a sale of securities but in other respects are the same as Section 10(b) and Rule 10b-5, except that "no showing of scienter is required for the SEC to obtain an injunction under [Section 17] (a)(2) or (a)(3)." *Id.*

Pentagon and Chester do not deny that they engaged in late trading. The defendants argue, however, that there was no fraud or deceit in their actions. The defendants also argue that an investment advisor – as opposed to a broker – may not be held liable for securities fraud because the advisor is not responsible for communicating the direction to late trade to the clearing broker. We reject both arguments.

First, the defendants' argument that their lack of fraudulent or deceitful intent bars a finding of liability fails because deceitful intent is inherent in the act of late trading. The late trader places an order after the daily mutual fund price is set, but receives the benefit of additional information that the earlier price does not reflect. For this reason, we have held that late trading violates all three subsections of Rule 10b-5 because, as discussed above, it violates Rule 22c-1, the forward-pricing rule. *See VanCook,* 653 F.3d at 138. In *VanCook,* an individual broker sought out a clearing broker that would allow him to clear late trades, used time-stamped trade sheets as evidence that orders were placed before 4 p.m. when they were not, and assured his employer that he had not facilitated late trading. In short, "he was [the scheme's] architect." *Id.* at 139. We found that VanCook went beyond making misrepresentations, taking "a series of actions over several years to implement a scheme that he devised." *Id.* On these grounds, we held that VanCook's late trading violated all three subsections of Rule 10b-5. Although Section 17(a) was not at issue in *VanCook,* the requirements for a violation of Section 17(a), as relevant here, are identical to the requirements for a violation of Section 10(b). Thus, we have no trouble concluding that Section 17(a) is also implicated by late trading activity (so long as some of the late trading involves the sale of securities).

Pentagon and Chester engaged in similarly deceitful behavior. They sought out brokers who would engage in late trading. As evidenced by Chester's email, they knew that the trade sheets were time-stamped before 4 p.m., even though they had no intention of trading before that time. Finally, they issued a false and deceitful letter of assurance that they were not engaging in late trading, similar to VanCook's false assurances to his employer.

The defendants are not identically situated to VanCook, however. VanCook was a broker, directly bound by the language of Rule 22c-1, which applies to issuers of securities, persons "authorized to consummate transactions in any such securit[ies]," principal underwriters, and dealers in securities. 17 C.F.R. § 270.22c-1(a). Investment advisors are not explicitly mentioned in Rule 22c-1, but that is of no moment when the claims are brought under Sections 17 and 10 and Rule 10b-5. Pentagon and Chester were as much the "architects" of this scheme as VanCook was, and they orchestrated the late trading program carried out by their brokers. They are liable under Section 17(a), Section 10(b), and Rule 10b-5 because their actions caused the misrepresentations as to the time of the trades and led to their concomitant deception.[6] Pentagon's role as an investment advisor therefore does not shield it from liability under the securities laws.

We also reject the defendants' corollary argument that they may not be held liable because they did not communicate directly with the mutual funds. In *Janus Capital Group, Inc. v. First Derivative Traders,* 131 S. Ct. 2296 (2011), shareholders of Janus Capital Group sued Janus Capital Group and Janus Capital Management for making false statements in mutual fund prospectuses filed by Janus Investment Fund.

[6] We endorse the reasoning of the district court in *SEC v. Simpson Capital Management, Inc.,* 586 F. Supp. 2d 196 (S.D.N.Y. 2008), which dealt with the late trading activities of an investment advisor and the relevance of Rule 22c-1 in the context of a motion to dismiss. In *Simpson,* the SEC alleged that the investment advisor "was responsible for all investment decisions[,] . . . carefully identified individuals . . . who agreed to participate in the late trading scheme[, and] . . . orchestrated late-trading schemes." *Id.* at 208. We endorse the district court's finding in *Simpson* that these allegations were sufficient to state a claim for primary 10b-5 liability against an investment advisor. Specifically, the district court reasoned that "the existence of [Rule 22c-1] . . . provides the background for why the defendants . . . engaged in a scheme where they could obtain the prices that were set as of 4:00 p.m. ET, even though their transactions actually occurred at a later time." *Id.* at 203.

Because Janus Investment Fund retained ultimate control over the content of the prospectuses, the Supreme Court held that Janus Capital Management could not be liable as a "maker" of the statement under Rule 10b-5:

> For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not "make" a statement in its own right. One who prepares or publishes a statement on behalf of another is not its maker.

Id. at 2302. To illustrate its point, the Supreme Court used the analogy of "the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it." *Id.* Pentagon and Chester argue that because they never communicated directly with the mutual funds, they cannot be held liable as "makers" of any false statements.

To the extent that late trading requires a "statement" in the form of a transmission to a clearing broker, we find that in this case, Pentagon and Chester were as much "makers" of those statements as were the brokers at Trautman. The brokers may have been responsible for the act of communication, but Pentagon and Chester retained ultimate control over both the content of the communication and the decision to late trade.

Moreover, we reaffirm our holding in *VanCook* and find that the defendants' activities violated all three subsections of Rule 10b-5, not just subsection (b), which was the only subsection at issue in *Janus.* Pentagon's late trading activity, beyond the communication of the trades themselves, included finding brokers and a clearing system that would allow late trades, as well as the specific coordination – on a daily basis – of the transmission of instructions to buy or sell or refrain from doing so based on NAVs and after-hours information. In short, Pentagon's fraudulent activities independently satisfy the requirements of scheme liability under Rule 10b-5(a) and (c) and Section 17(a).

We have considered the remainder of Pentagon's arguments and find them to be unpersuasive. The district court's determination of liability is affirmed.

II. Monetary Awards

The district court imposed joint and several liability for a disgorgement award and a civil penalty, each in the amount of $38,416,500. The district court first determined that both monetary awards would be imposed jointly and severally because the defendants (including the relief defendant) "collaborated on the mutual fund trading scheme, and [Chester and Pentagon] exercised complete control over PSPF's trading." 844 F. Supp. 2d at 425. The district court then determined that a disgorgement award of $38,416,500 was appropriate because it was a reasonable approximation of the profit made through defendants' late trades with Trautman beginning in February 2001. Turning to the amount of the civil penalty, the district court applied Section 20(d) of the Securities Act and Section 21(d)(3) of the Exchange Act. Because the violation involved "'fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement' and 'directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons,'" the district court awarded the maximum penalty, in this case, the gross amount of the pecuniary gain. *Id.* at 427 (quoting 15 U.S.C. §§ 77t(d), 78u(d)(3)). On appeal, Pentagon argues that the district court erred in setting the amounts and in imposing joint and several liability.

A. Civil Penalty

We review the district court's imposition of the civil penalty for abuse of discretion. *See SEC v. Kern,* 425 F.3d 143, 153 (2d Cir. 2005) ("The tier determines the maximum [civil] penalty, with the actual amount of the penalty left up to the discretion of the district court.").

In light of the Supreme Court's recent decision in *Gabelli,* 133 S. Ct. 1216, rendered after the district court's decision, we must vacate the district court's civil penalty award and remand it for reconsideration.

In *Gabelli,* the Supreme Court held that the so-called "discovery rule," which tolls a statute of limitations for crimes that are difficult to detect, does not apply to toll the five-year statute of limitations for fraud cases in SEC enforcement actions. *See id.* at 1221-24. Thus, any profit earned through late trading earlier than five years before the SEC instituted its suit against the defendants may not be included as part of the civil penalty. All parties agree that remand on this issue is required.

We also must reverse the district court's decision to impose joint and several liability for the amount of the civil penalty as an error of law. *See Johnson v. Univ. of Rochester Med. Ctr.,* 642 F.3d 121, 125 (2d Cir. 2011) ("A court abuses its discretion when . . . its decision rests on an error of law. . . .") (per curiam). The statutory language allowing a court to impose a civil penalty plainly requires that such awards be based on the "gross amount of pecuniary gain *to such defendant.*" 15 U.S.C. § 77t(d)(2) (emphasis added). This language does not provide room for the district court's interpretation that the civil penalty be imposed jointly and severally.[7]

[7] Although we vacate the civil penalty award, we find no error in the district court's methodology for calculating the maximum penalty by counting each late trade as a separate violation. *See* 15 U.S.C. § 77t(d)(2)(C) ("[T]he amount of penalty for *each such violation* shall not exceed the greater of (i) $100,000 for a natural person or $500,000 for any other person, or (ii) the gross amount of pecuniary gain to such defendant as a result of the violation." (emphasis added)).

B. Disgorgement Award

The district court's disgorgement award is also reviewed for abuse of discretion. *See SEC v. Warde,* 151 F.3d 42, 49 (2d Cir. 1998).

We find no abuse of discretion in the amount of the disgorgement award, which reflected a "reasonable approximation of profits causally connected to the [late trading] violation." *SEC v. First Jersey Sec., Inc.,* 101 F.3d 1450, 1475 (2d Cir. 1996) (quotation marks omitted).[8] It was reasonable for the district court to consider the profit to PSPF as well as Chester and Pentagon in light of the fact that PSPF existed only to enable Pentagon's trading in the United States. *See SEC v. AbsoluteFuture.com,* 393 F.3d 94, 96 (2d Cir. 2004) ("It is only logical that the total disgorgement of multiple defendants be determined by the total amount of profit realized by those defendants.") (per curiam).

We also affirm the district court's decision to impose the disgorgement award jointly and severally on all defendants. Unlike the civil penalty, there is no statutory requirement that a disgorgement award be measured as to each individual defendant. The district court found that relief defendant PSPF opened

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[8] Aside from appellants' assertion that the disgorgement award should be considered a penalty because it incorporated profits earned by PSPF, an argument we reject, we do not understand the appellants to argue that a disgorgement award would be subject to the statute of limitations provided by 28 U.S.C. § 2642.

accounts at Pentagon's direction and that defendants late-traded on PSPF's behalf. Hence, the district court found that defendants and PSPF had "collaborated" on the late trading scheme, and concluded that joint and several liability with respect to disgorgement was warranted. *See id.* at 97 (in reviewing disgorgement award, holding that "joitn and several liability for combined profits on collaborating . . . parties" is "appropriate"). We agree with the district court that, in light of their collaboration, Pentagon, Chester, and PSPF should be held liable for the disgorgement award on a joint and several basis. *See First Jersey,* 101 F.3d at 1475-76 (affirming district court's decision to impose joint and several liability of disgorgement award).

CONCLUSION

For the foregoing reasons, the district court's rulings are AFFIRMED in part, VACATED in part, and REMANDED in part for further proceedings in accordance with this opinion.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

– against –

PENTAGON CAPITAL MANAGEMENT PLC and LEWIS CHESTER,

Defendants,

– and –

PENTAGON SPECIAL PURPOSE FUND, LTD.,

Relief Defendant.

-- X

08 Civ. 3324(RWS)

OPINION

(Filed Mar. 28, 2012)

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Sweet, D.J.

On April 3, 2008, the Securities and Exchange Commission ("Plaintiff" or "SEC") commenced the instant enforcement action against defendants Pentagon Capital Management PLC ("PCM"), Lewis Chester ("Chester") (collectively, the "Defendants"), alleging that Defendants had orchestrated a scheme to defraud mutual funds in the United States through late trading and deceptive market timing in violation of Section 17(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77q(a), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, thereunder. In the alternative, the SEC asserted that Defendants aided and abetted violations of Section 10(b) and Rule 10b-5.

Following a seventeen-day bench trial, by opinion of February 14, 2012 (Dkt. No. 205) (the "Merits Opinion"), the Court granted in part and denied in part the relief sought by the SEC. The Court determined that Defendants engaged in a broad ranging fraudulent scheme of late trading U.S. mutual funds but that the rules surrounding market timing of mutual funds during the period in question were not sufficiently clear to permit liability as to Defendants' market timing activities.

Due to the level of scienter, the extensive nature of the fraud, and the likelihood of future violations, the Court determined that injunctive relief was appropriate as to PCM and Chester. (Op. 114-16). In addition, the Court found that Defendants engaged in over 10,000 fraudulent late trades executed through formerly registered broker-dealer Trautman, Wasserman & Company ("TW&Co.") and that the profits and losses avoided due to the late trading scheme through TW&Co. was approximately $38,416,500. (*Id.* at 124.) The Court found Defendants and Relief Defendant Pentagon Special Purpose Fund, Ltd. ("PSPF") joint and severally liable for disgorgement in that sum plus pre-judgment interest. (*Id.*) The Court further held that civil penalties of an equal sum, $38,416,500, would be imposed, without stating under which of the two prongs of the relevant statutory provisions, 15 U.S.C. § 77t(d) and 15 U.S.C. § 78u(d)(3), authority to do so existed or explicitly stating whether such penalty was to be imposed on each Defendant or joint and severally. The Court instructed the parties to submit proposed forms of final judgment on notice in conformity with the Merits Opinion.

On February 17, 2012, the SEC submitted a proposed final judgment to be entered pursuant to the Merits Opinion. The SEC's proposed final judgment reflected separate $38,416,500 civil penalties as to each of PCM and Chester, for a total of $76,833,000.

On February 21, 2012, Defendants requested, and the SEC consented to, an extension until March 2, 2012 to submit a counter-proposed final judgment to permit Defendants to retain additional counsel. (Dkt. No. 206.) On February 29, 2012, Defendants wrote to the Court to contest the imposition of roughly $38 million in civil penalties on the Defendants on the grounds that Relief Defendant "PSPF directly received all proceeds from the trading at Trautman Wasserman" and requesting the civil penalty issue be further briefed.

Following briefing on the scope of the final judgment and submission of a proposed final judgment by Defendants, argument was heard on March 21, 2012.

In short, the parties disagree as to the maximum civil penalty permissible by statute and the appropriate penalty to be assessed thereunder. The SEC contends that pursuant to the Merits Opinion, civil penalties of $38,416,500 should be imposed individually on both PCM and Chester and that the statutory maximum is far greater. Defendants assert that the maximum penalty permissible by statute is $1.62 million for PCM and $372,000 for Chester.

I. CIVIL PENALITES

A. Legal Standard

Under Section 20(d) of the Securities Act, 15 U.S.C. § 77t(d), and Section 21(d)(3) of the Exchange Act, 15 U.S.C. § 78u(d)(3), courts must determine the civil penalty to be imposed "in light of the facts and circumstances" of the case. Civil penalties are designed to punish wrongdoers and deter future violations of the securities laws. *SEC v. Haligiannis,* 470 F. Supp. 2d 373, 386 (S.D.N.Y. 2007).

In weighing the appropriate civil penalty, courts consider a number of factors including:

> (1) the egregiousness of the defendant's conduct; (2) the degree of the defendant's scienter; (3) whether the defendant's conduct created substantial losses or the risk of substantial losses to other persons; (4) whether the defendant's conduct was isolated or recurrent; and (5) whether the penalty should be reduced due to the defendant's demonstrated current and future financial condition.

Id.

The statutes provide that "the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation." 15 U.S.C. §§ 77t(d)(1), 78u(d)(3)(A). The statutes provide that the maximum penalty is the greater of the figure reached under either the statutes' per-violation or gross pecuniary gain prongs. Under the per-violation prong, the penalty is calculated by multiplying the number of violations by a dollar amount provided by statute; under the other, second prong, the figure is the gross amount of pecuniary gain. *See, id.*; *SEC v. Credit Bancorp,* No. 99 Civ. 11395, 2002 WL 31422602, at *2 (S.D.N.Y. Oct. 29, 2002).

The statutory maximum for the per-violation approach is determined by a three-tiered system. Tier one, for which no showing of scienter is required; tier two, for violations involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement"; tier three, for violations involving such factors plus direct or indirect substantial loss or significant risk of loss to other persons. 15 U.S.C. §§ 77t(d), 78U(d)(3).

As previously found, third tier penalties are appropriate in this case because the Defendants' violations involved "fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement" and "directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons." 15 U.S.C. §§ 77t(d), 78u(d)(3); *see* Op. 124-25.

With regard to third tier penalties, the statutes provide that:

> the amount of penalty for each such violation shall not exceed the greater of
>
> (i) $100,000 for a natural person or $500,000 for any other person, or
>
> (ii) the gross amount of pecuniary gain to such defendant as a result of the violation, if –
>
> (I) the violation described in paragraph (1) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and

(II) such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons.

15 U.S.C. §§ 77t(d), 78u(d)(3). Pursuant to the Debt Collection Improvement Act of 1996, the SEC has adopted rules that adjust the maximum penalty pursuant to these provisions for inflation. *See* 17 C.F.R. § 201.1002. For 2001 through 2003, the relevant time period, the maximum civil penalty under prong one is $120,000 for natural persons and $600,000 for any other persons per violation. *Id.*

B. Civil Penalties of $38,416,500 Are Assessed Jointly and Severally on PCM and Chester

As applicable here, Section 20(d) of the Securities Act, 15 U.S.C. § 77t(d), and Section 21(d)(3) of the Exchange Act, 15 U.S.C. § 78u(d)(3), authorize a maximum civil penalty of $120,000 for natural persons and $600,000 for all other persons per fraudulent late trade, as each late trade violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 by fraudulently representing to the mutual funds that such trades were made prior to the 4 p.m. closing of the markets when, in fact, the operative trading decisions occurred after 4 p.m. (Op. 98-112.) As this Court previously found, Defendants engaged in 10,052 late trades through TW&Co. (Op.

123-24.)[1] Accordingly, the maximum civil penalty that may be imposed on each Defendant under the per-violation prong of the statutes, 15 U.S.C. §§ 77t(d)(2)(C)(i) & 78u(d)(3)(B)(iii)(I), are $1.206 billion for Chester (10,052 late trades x $120,000) and $6.03 billion for PCM (10,052 late trades x $600,000).

Numerous other courts have interpreted the statutes to permit a maximum penalty under the per-violation prong in this way, based upon the number of acts taken that violate the securities laws. *See, e.g., SEC v. Pattison,* No. C-08-4238, 2011 WL 723600, at *5 (N.D. Cal. Feb. 23, 2011) (holding that "[t]he Court may assess a penalty for each distinct violation, *e.g.,* each time Defendant falsified a record" (citations omitted) but exercising discretion to impose a lesser penalty); *SEC v. Amerifirst Funding, Inc.,* No. 07-CV-1188, 2008 WL 1959843, at *9 (N.D. Tex. May 5, 2008) (determining that each investment defendants received from defrauded investors constituted a violation of the securities laws, and assessing a $2,000 penalty for each of 589 investments for a total civil penalty of $1.178 million); *SEC v. Johnson,* No. 03 Civ. 177, 2006 WL 2053379, at *10 (S.D.N.Y. July 24, 2006) (assessing separate penalties against a research analyst for each fraudulent report); *SEC v. Coates,* 137 F. Supp. 2d 413, 428-30 (S.D.N.Y. 2001) (assessing a $10,000 penalty for each of four separate, misleading statements to investors); *SEC v. Kenton*

[1] Defendants additionally executed a limited number of late trades through broker-dealer Concord. (Op. 73.)

Capital Ltd., 69 F. Supp. 2d 1, 17 & n.15 (D.D.C. 1998) (assessing a $1.2 million penalty calculated by "multiplying the maximum third tier penalty for natural persons ($100,000) by the number of investors who actually sent money to [defendant] (12)"); *cf. SEC v. Invest Better 2001,* No. 01 Civ. 11427, 2005 WL 2385452, at *5 (S.D.N.Y. May 4, 2005) (noting that defendant "violated Sections 5(a) and 5(c) of the Securities Act, through IB2001 offerings which were purchased by at least 5,000 investors" and "committed numerous violations of the antifraud provisions of Section 17(a) of the Securities Act and Rule 10(b) of the Exchange Act" and imposing a penalty in the gross amount of pecuniary gain as a result of the total violations because "[t]he exact number of violations committed by the Defendants is nearly impossible to determine.") While imposition of civil penalties on the basis of the number of statutory provisions violated may be appropriate in some cases, the plain language of the statute does not call for such a result. To limit the maximum penalty authorized under the per-violation prong other than by the number of violative acts would also produce the result that a defendant who engaged in thousands of repeated violations could be penalized under this provision no more than one who committed a handful of violations.

Defendants argue that to calculate the maximum authorized penalty based upon the Court's finding that Defendants executed 10,052 illegal late trades would violate due process because Defendants were only on notice that the SEC had charged them with two violations of the securities laws (Defs. Mem. 10).[2] This argument is unpersuasive. The amended complaint alleges in detail that Defendants engaged in an extensive, multi-year late trading scheme involving "thousands of trades through TW&Co." (Am. Compl. 19; *see also id.* at 2-3, 6-10, 14-22, 31-35 (Dkt. No. 15)). As found in the Merits Opinion, Defendants understood that late trading was illegal and acted with marked scienter, going to great lengths to seek out, structure, and maintain the ability to deceive the funds into accepting their late trades (Op. 45-76, 98-112) and attempting to cover up their late trading after the fact (Op. 104-0). As such, calculation of the maximum statutory penalty based upon the number of Defendants' late trades poses no such due process concern.

Defendants further argue that calculating the maximum civil penalty by this approach is not permissible because it would permit civil penalties of $1.206 billion as to Chester and $6.03 billion as to PCM. That the statute might permit such large fines does not render the imposition of a fine many times below such maximum unjust or impermissible. Moreover, that the statutes might permit severe penalties

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[2] The Court notes that the amended complaint alleges that Defendants violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder or in the alternative aided and abetted violations of Sections 10(b) and Rule 10b-5. (Am. Compl. 33-35.) Defendants were found to have violated three securities fraud provisions, Section 17(a), Section 10b, and Rule 10b-5.

does not mean that such a fine, in this case or any other, would be appropriate or constitutionally permissible. The statutory maximum is not the only limiting factor on the imposition of civil penalties.

Within those limits, the Court must determine, "in light of the facts and circumstances," 15 U.S.C. §§ 77t(d)(2)(A), 78u(d)(3)(B)(i), the precise amount of civil penalty warranted to be paid by the persons who committed such violations. *See, e.g., SEC v. Universal Express, Inc.,* 646 F. Supp. 2d 552, 567 (S.D.N.Y. 2009) (assessing third tier civil penalties of $1 million and $500,000 and noting that "[a]lthough each tier established a maximum penalty per violation, the amount of any civil penalty rests squarely in the discretion of the court").

For the reasons set forth below, a sum equivalent to the amount of profits gained and loss avoided due to Defendants' thousands of violations of the securities laws is imposed, which is below the maximum authorized by statute and is proportionate to the pecuniary gain from Defendants' repeated violations as well as the harm caused by them.

(1) The egregiousness of the defendant's conduct

As found in the Merits Opinion:

> the Defendants intentionally, and egregiously, violated the federal securities laws through a scheme of late trading. This scheme was broad ranging over the course

> of several years and in no sense isolated. Following the filing of the action by the [New York Attorney General] against Edward Stern and Canary Capital, as found above, Defendants attempted to cover up their conduct. While Defendants have since admitted to late trading, as on this evidence they must, neither Chester nor PCM have accepted blame for their conduct.

(Op. 115-16 (citations omitted).)

(2) The degree of the defendant's scienter

As found in the Merits Opinion, Defendants acted with extreme scienter in carrying out what was an egregious scheme to defraud. Describing this, the Court found in part:

> The evidence establishes that Defendants knew that late trading was impermissible and that they were obtaining an advantage over other investors contrary to the mutual funds' rules and SEC regulation. Defendants were repeatedly made aware, and acknowledged, that the cut-off for trading in U.S. mutual funds in order to receive the same-day NAV was 4:00 p.m. ET.
>
> Late trading capacity was valuable to Defendants. Indeed, Defendants paid more for late trading capacity through TW&Co. As found above, Defendants sought late trading through other broker-dealers but were repeatedly denied. PCM discussed late trading with at least four of these broker-dealers who

refused to them that capacity, while at least three others informed Defendants that their orders had to be placed by 4:00 p.m. ET.

Defendants further received and reviewed multiple academic articles that stated that U.S. mutual fund trades must be submitted prior to 4:00 p.m. ET in order to receive the same day NAV. The Sassano voicemail in 2001 telling Chester that late trading through TW&Co. was "crap" and that Chester should not "pressure anybody to do something stupid" was an additional red flag that late trading was illegal, and Chester's testimony that he "couldn't really understand what [Sassano] was referring to" was not credible. That Chester cautioned Tran to be discreet when inquiring regarding late trading capacity and advised him that "[o]bviously late trading is key . . . don't know how you find out about this without actually saying it" further establishes Chester's knowledge that late trading was impermissible.

Chester was also aware that TW&Co. falsely stamped timesheets as if orders were placed before 4 p.m. and recognized that this gave Defendants "the ability to place a buy order after the bell, even if we haven't done so before the bell." Given Chester's intelligence, training, and experience both as a hedge fund manager whose business model was premised on the timing of trades and as an attorney, the evidence establishes he knew that false stamps were fraudulent and misleading.

> Following the announcement of the Canary enforcement action, Chester responded to a request for a letter stating that "Pentagon has not engaged in late trading or any other illegal activity," to which he responded "not a problem." That same day, Chester provided a letter stating that PCM has "never entered into arrangements with any U.S. onshore Mutual Fund in order to trade post-4:00pm EST for same-day NAV." At that time, Chester knew that he could not confirm that Pentagon had not late traded and that the comfort letter was deliberately misleading or false. Those statements and the fact that Defendants did not turn over the Sassano voicemail or SEC Ex. 2 (the "smoking gun" email) to the [Financial Services Authority of the United Kingdom] when prompted by document requests that should have produced them further establish that Defendants knew that their late trading was illegal.

(Op. 101-04 (citations omitted).)

(3) Whether the defendant's conduct created substantial losses or the risk of substantial losses to other persons

SEC expert Professor Harris demonstrated that Defendants' fraudulent late trading created losses and the risk of substantial losses to other investors in the mutual funds traded at least in the tens of millions of dollars through dilution to their shares. (Op. 121-22; SEC Ex. 420.)

(4) Whether the defendant's conduct was isolated or recurrent

Far from isolated, Defendant's late trading scheme persisted over approximately two and a half years, through thousands of repeated and knowing violations.

(5) Whether the penalty should be reduced due to the defendant's demonstrated current and future financial condition

Defendants seek to raise an issue regarding their ability to pay the civil penalties anticipated by the Merits Opinion. As an initial matter, such a claim should have been raised at trial, not post-judgment. The evidence does not contain documentation or estimates of their current or future financial condition, nor do they contend that they are in fact unable to pay the civil penalty imposed. Defendants argue that a civil penalty of $38 million should not be imposed because Relief Defendant PSPF received much of this gain. However, this does not demonstrate that the penalty should be reduced due to Defendants' financial condition. Further, to the degree that Defendants' argument relies on Defendants' decision to wind down PCM, PCM's status is self-inflicted, and Defendants have long been aware of this action, their late trading, and their potential liability.

Moreover, in imposing monetary sanctions, the Court is not required to assess Defendants' current ability to pay or the collectability of any judgment. As Judge Lynch has aptly observed:

> [Defendant's] claims of poverty cannot defeat the imposition of a disgorgement order or civil penalty. Perhaps, if [the defendant] is indeed impecunious, the SEC will eventually prove unable to collect on any judgment. But to withhold the remedy of disgorgement or penalty simply because a swindler claims that she has already spent all the loot and cannot pay would not serve the purposes of the securities laws. An order of disgorgement and civil penalty are both proper remedies in this case; the future will tell whether the SEC can find assets to levy upon.

SEC v. Inorganic Recycling Corp., No. 99 Civ. 10159, 2002 WL 1968341, at *4 (S.D.N.Y. Aug. 23, 2002); *see also SEC v. Kane,* No. 97 Civ. 2931, 2003 WL 1741293, at *4 (S.D.N.Y. Apr. 1, 2003) ("[A] defendant's claims of poverty cannot defeat the imposition of a civil penalty by a court. If the defendant is indeed impecunious, the SEC will ultimately not be able to collect on the judgment. . . . In addition, the court agrees with the Commission that it should not ignore the possibility that a defendant's fortunes will improve, and that one day the SEC will be able to collect on even a severe judgment.").

Defendants argue that the civil penalties sought by the SEC and those anticipated by the Merits Opinion are unjust because they are significantly larger than those imposed on TW&Co. and Gregory Trautman ("Trautman") in the SEC proceedings against them. The Commission ordered TW&Co. to disgorge $9,040,000 and assessed a $500,000 civil penalty on TW&Co., *In* *re Trautman Wasserman & Co.,* SEC Release No. 340, 92 SEC Docket 1156, 2008 WL 149120 (Jan. 14 2008), and the $500,000 civil penalty initially imposed on Trautman was later reduced by administrative appeal to $120,000, *In re Gregory O. Trautman,* Admin. Proc. File No. 3-12559 (Commission Opinion Dec. 15, 2009) *available at* http://sec.gov/litigation/opinions/2009/33-9088a.pdf.

First, Defendants argue that imposition of significantly greater penalties here would be unjust because TW&Co. was "the primary malfeasor in the present case." (Defs. Mem. 12.) This contention is directly contrary to the Court's finding that "as the facts establish, Defendants did not act merely in reliance on their broker-dealers, as they have asserted. Defendants directed, indeed micromanaged, the late trading that TW&Co. performed on their behalf." (Op. 105.) "Defendants sought out late trading through TW&Co., directed TW&Co.'s personnel to place late trades on their behalf in awareness of TW&Co.'s false time stamps, and indeed provided TW&Co. with detailed instructions for how and when to do so, according to Defendants' precise specifications, metrics, and authorization. . . . Defendants[had] ultimate authority over both the content of and the decision to make late trades as if they had been placed before 4 p.m. ET . . . As detailed above, the evidence as a whole demonstrates that Defendants were the creators, directors, and chief beneficiaries of the fraudulent scheme. . . ." (Op. 111-12 (citations omitted).)

In addition, Defendants argue that the Commission concluded on review of Trautman's case that through, among other things, his extensive late trading, Trautman had committed but a single "violation" for purposes of the calculation of civil penalties and that such a determination is entitled to deference. (Defs. Mem. 13; Defs. Reply 2.) However, the Commission did not address the issue, analogous to that here, of what the maximum civil penalty was that could be imposed on Trautman, only the appropriate penalty to impose. *In re Gregory O. Trautman,* Admin. Proc. File No. 3-12559, at 41-42.[3] The Commission held in relevant part: "We have decided to impose civil penalties based on the totality of Trautman's fraudulent misconduct. . . . We consider a total penalty of $120,000, along with the other sanctions imposed, to be sufficient to deter future violations of the securities laws." *Id.* at 42. Additionally, the

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[3] The ALJ conducted a similar inquiry, though recognizing the authority to impose a greater penalty:

> The Division recommends third-tier penalties against TWCO in the amount of $500,000, against Trautman in the amount of $1,373,799, and against Wasserman in the amount of $511,000. The Division notes that a per-occurrence calculation would result in an astronomical result, and that TWCO "is defunct and has negligible assets." The conduct of TWCO and Trautman merits a third-tier penalty, however, given their financial condition I find it appropriate to assess a $500,000 civil penalty against TWCO and the same amount against Trautman.

In re Trautman Wasserman & Co., 2008 WL 149120, at *25-*26.

Commission had before it, and considered, Trautman's financial information supporting his request for reduced penalties. *Id.* at 42-45 ("Trautman argues that he is 'destitute' and cannot pay disgorgement, interest, or civil penalties. . . . We have reviewed the financial statements submitted by Trautman. Even accepting those statements at face value, we find that the egregiousness of Trautman's conduct outweighs discretionary waiver of disgorgement, prejudgment interest, and/or penalties. Ordering Trautman to pay disgorgement of $608,886, plus prejudgment interest, and a single third-tier penalty of $120,000 is necessary to deter others from defrauding mutual funds and their shareholders through illegal and deceptive trading practices." (citations omitted)). As the Commission faced a different question, with different defendants, and upon a different record than that before this Court, the deference Defendants seek is inappropriate. This is particularly the case in light of the record here, which establishes Defendant's leadership and indeed "micromanage[ment]" of the late trading scheme. (Op. 105.)

Defendants additionally argue that civil penalties of $38 million are inconsistent with those recently imposed in this District. Defendants contend that in the majority of cases in which courts in this District have awarded a third tier civil penalty, the penalty assessed was less than the disgorgement amount. (Defs. Mem. 12.) The caselaw demonstrates that far from uncommon, courts routinely impose civil penalties equal to disgorgement. *See, e.g., SEC v.*

Becker, No. 09 Civ. 5707, 2010 U.S. Dist. LEXIS 52623 (S.D.N.Y. May 28, 2010) (imposing third tier penalty equal to defendants' pecuniary gain and disgorgement ordered); *SEC v. Great Am. Techs., Inc.,* No. 07 Civ. 10694, 2010 U.S. Dist. LEXIS 34830 (S.D.N.Y. Apr. 8, 2010) (same); *SEC v. Aimsi Technologies, Inc.,* 650 F. Supp. 2d 296 (S.D.N.Y. 2009) (same); *SEC v. World Info. Tech., Inc.,* 590 F. Supp. 2d 574 (S.D.N.Y. 2008) (same); *SEC v. Solow,* 554 F. Supp. 2d 1356, 1368 (S.D. Fla. 2008) (same); *SEC v. Haligiannis,* 470 F. Supp. 2d 373 (same); *SEC v. Invest Better 2001,* 2005 WL 2385452 (same); *SEC v. Bocchino,* No. 98 Civ. 7525, 2002 U.S. Dist. LEXIS 22047 (S.D.N.Y. Nov. 8, 2002) (same); *SEC v. Rosenfeld,* No. 97 Civ. 1467, 2001 WL 118612 (S.D.N.Y. Jan 9, 2001) (same); *cf. SEC v. Koenig,* 557 F.3d 736, 744-45 (7th Cir. 2009) (affirming imposition of penalty equal to disgorgement plus prejudgment interest, holding "the district court was entitled to treat the disgorged bonuses, plus prejudgment interest, as [defendant's] 'pecuniary gain' and to impose an equal penalty in 2009 dollars"); *SEC v. Razmilovic,* ___ F. Supp. 2d ___, No. 04 Civ. 2276, 2011 WL 4629022, at *35 (E.D.N.Y. Sept. 30, 2011) (finding defendant liable for disgorgement of more than $41 million and imposing a civil penalty of approximately $20.8 million equal to one-half of the gross pecuniary gain). Defendants' actions here were extensive, as evidenced by the fact that the amount of illegal gains in this case is larger than those involved in nearly all the cases Defendants cite, some by many orders of magnitude.

Defendants contend that $38 million in civil penalties should not be imposed because "the bulk of the $38 million in gain went to PSPF, and not to Chester or PCM." (Defs. Mem. 14) Defendants argue that they should only be penalized to the extent of their individual gain as currently established by the record. With regard to Chester, Defendants urge that "the evidence in the record indicates that Chester's gains did not exceed the amount of his salary of approximately £150,000 per annum, plus car allowance." (*Id.* (citing Chester Dep. 222-24 (Jan. 17, 2011)).) Defendants argue that, based on this salary, the amount of Chester's gain attributable to late trades through TW&Co. during the period in question is $372,000. Defendants do not contend that such a contextually small sum was in fact Chester's pecuniary gain for his illegal conduct, simply that the evidence in the record does not demonstrate that Chester received more than this figure. (*Id.*) The record does not establish that Chester's gain due to the late trading scheme was limited to $372,000, only that he received at least as much as the salary to which he testified by deposition. SEC expert Professor Harris did not estimate the amount of Chester's individual gain (SEC Ex. 420). The record does not establish the pecuniary gain Chester received from the scheme. As to PCM, while Professor Harris estimated the fees PCM received from both late trading and market timing at approximately $14 million, this figure was based not on knowledge of PCM's fee rates, as they were not established, but instead assumed rates of a 2% management fee and a 20% performance fee. (*Id.*) The evidence is silent as to whether PCM's fees were higher or lower than these estimates during the period in question. Defendants point to the testimony of Jafar Omid for the proposition that PCM earned only $4.2 in fees from 1999 to 2003. (Tr.2031-34.) However, Omid testified as to net, not gross, fees (*id.*), while the statutes specifically call for "gross pecuniary gain." 15 U.S.C. §§ 77t(d), 78u(d)(3). Omid's estimates are therefore not sufficient to establish PCM's pecuniary gain for civil penalty purposes. Additionally, Omid's testimony does not address PCM's gain specifically due to Defendants' late trades. Defendants have not sought to provide any additional financial information to establish Chester's individual gain or that of PCM nor have they agreed to open their finances to determine such figures.

Thus, the record does not establish with sufficient reliability either Defendant's individual pecuniary gain. What is established, however, is the amount gained, and losses avoided, due to the over 10,000 fraudulent late trades Defendants executed through TW&Co. – $38,416,500 – and the resulting loss and risk of loss of tens of millions of dollars thereby imposed upon other investors. *Cf. SEC v. Invest Better 2001,* 2005 WL 2385452, at *5 (assessing a penalty equal to the gross amount of the pecuniary gain because "[t]he exact number of violations committed by the Defendants is nearly impossible to determine.")

Defendants cannot wash their hands of this fact on the grounds that "the bulk of the $38 million in gain went to PSPF, and not to Chester or PCM."

(Defs. Mem. 14.) As hedge fund advisors, Defendants are directly responsible for the fund's illegal gains, which were acquired through Defendants' fraudulent acts, as well as for the significant harm thereby caused to other investors. Defendants cannot isolate themselves from the ill-gotten gains they created on the grounds that they took illegal acts not only for their own benefit but also for the fund's. Civil penalties in securities fraud cases are intended not only to punish the individual violator for past violations but also deter future violations of the securities laws. *See, e.g., SEC v. Razmilovic,* 2011 WL 4629022, at *34; *SEC v. Universal Express, Inc.,* 646 F. Supp. at 561. By deterring future violations, civil penalties further the goals of "encouraging investor confidence, increasing the efficiency of financial markets, and promoting the stability of the securities industry." *SEC v. Palmisano,* 135 F.3d 860, 866 (2d Cir. 1998). Congress enacted the civil penalties because disgorgement alone did not provide an adequate "financial disincentives to securities law violations." H.R.Rep. No. 101-616 (1990), *reprinted in,* 1990 U.S.C.C.A.N. 1379, 1384 (the "authority to seek or impose substantial money penalties, in addition to the disgorgement of profits, is necessary for the deterrence of securities law violations") Were disgorgement alone imposed jointly and severally on Defendants and the Relief Defendant fund, and the advisors to bear no penalty in relation to the illegal gains their acts produced, little incentive would exist for advisors like Defendants not to violate the securities laws. This is particularly the case for sophisticated securities traders such Defendants, who are highly skilled in statistical analysis of risk and gain, as no doubt all violators are not caught and the potential gains to illegal trading, as this case amply demonstrates, are staggeringly large. On the record established, a penalty of $372,000 for Chester and $1.62 million for PCM is plainly insufficient to deter or punish Defendants or deter those similarly situated. As fund advisors, Defendants are responsible for the gains achieved through their illegal conduct, and their penalty should reflect this fact.

For the reasons set forth above, and pursuant to the findings of fact and conclusions of law reached in the Merits Opinion, a civil penalty of $38,416,500 joint and several as to PCM and Chester is warranted.

Finally, joint and several liability is appropriate here. The SEC argues that the $38 million penalty should be imposed separately on each Defendant in order to ensure the punishment and deterrent purposes of the penalties are accomplished. For support, the SEC points to two cases in which courts assessed civil penalties individually. (SEC Mem. 6 (citing *SEC v. Forest Res. Mgmt. Corp.,* 09 Civ. 903, 2010 WL 2077202, at *2 (S.D.N.Y. May 18, 2010); *SEC v. One Wall Street, Inc.,* No. 06 Civ. 4217, 2008 WL 5082294, at *9-10 (E.D.N.Y. Nov. 26, 2008).) Defendants argue that joint and several liability for civil penalties is impermissible on the ground that the SEC has argued that civil penalties cannot be assessed joint and severally. (Defs. Mem. 3-4.) However, neither party cites any authority for the proposition that joint and several liability for civil penalties is impermissible, particularly where, as here, the penalty is imposed pursuant to the per violation prong, and the Court is aware of none.

As detailed in the Merits Opinion, and evidenced in particular through the record of extensive email communications, PCM and Chester jointly created, led, and executed the late trading scheme. (Op. 45-76, 98-112.) PCM and Chester intimately collaborated in leading and carrying out the late trades, to the finest details of their metrics, timing, and procedures, thereby jointly violating the securities laws. Joint and several liability is therefore appropriate. *See SEC v. Haligiannis,* 470 F. Supp. 2d 373, 386 n.13 (imposing $15 million in civil penalties jointly and severally, a sum roughly equivalent to that disgorged, holding "[a]s with disgorgement and prejudgment interest, the Court holds all four defendants to be joint and severally liable for civil penalties, as there is no meaningful difference in their culpability."); *see also SEC v. Elliot,* No. 09 Civ. 7594, 2011 WL 3586454, at *19-*20 (S.D.N.Y. Aug. 11, 2011) (holding two sets of defendants jointly and severally liable for civil penalties in sums equal to disgorgement).

In light of the seriousness of Defendants' repeated and knowing violations of the securities laws and the substantial losses those violations created for the funds' shareholders, pursuant to 15 U.S.C. § 77t(d) and 15 U.S.C. § 78u(d)(3), civil penalties in the amount equal to the pecuniary gain for late trades through TW&Co., a sum of $38,416,500, are imposed jointly and severally on Defendants PCM and Chester.

C. The Civil Penalties Imposed Do Not Violate the Excessive Fines Clause

Defendants contend that a civil penalty of $38 million as to either or both Defendants would violate the Eighth Amendment's prohibition on excessive fines under the Supreme Court's decision in *United States v. Bajakajian,* 524 U.S. 321 (1998). The Eighth Amendment provides: "Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted." U.S. Const., Amdt. 8. In *Bajakajian,* the Court determined that forfeiture of $357,144, with which Bajakajian attempted to leave the United States without reporting, as required by 31 U.S.C. § 5316(a)(1)(A), that he was transporting more than $10,000 in currency, violated the Excessive Fines Clause. *Bajakajian* does not stand for the proposition that Defendants assert, that "civil fines be strictly proportional to any gain realized by unlawful conduct." (Defs. Mem. 14.) Instead, *Baljakajian* held that "[t]he touchstone of the constitutional inquiry under the Excessive Fines Clause is the principle of proportionality: The amount of the forfeiture must bear some relationship to the gravity of the offense that it is designed to punish." 524 U.S. at 334. Thus, the inquiry under *Bajakajian* is thus not whether a fine is "strictly proportional to any gain realized" but instead whether it is disproportionate to the "gravity of a defendant's offense." *Id.* at 335. Second, the Court rejected a requirement of "strict proportionality between the amount of a punitive forfeiture and the gravity of a criminal offense," instead "adopt[ing] the standard of gross disproportionality." *Id.* at 336. In assessing whether the forfeiture in *Bajakajian* was grossly disproportionate, the Court noted that the Bajakajian's violation was unrelated to any other illegal activities, that he was "not a money launderer, a drug trafficker, or a tax evader," the class of persons for whom the statute was principally designed, but instead deemed him to have "a minimal level of culpability." *Id.* at 337-39; *see also id.* at 339 n.13 ("Respondent owed no customs duties to the Government, and it was perfectly legal for him to possess the $357,144 in cash and remove it from the United States. His crime was simply failing to report the wholly legal act of transporting his currency.") As the Court found, "[t]he harm that respondent caused was also minimal." *Id.* at 339. The Court reasoned:

> Failure to report his currency affected only one party, the Government, and in a relatively minor way. There was no fraud on the United States, and respondent caused no loss to the public fist. Had his crime gone undetected the Government would have been deprived only of the information that $357,144 had left the country. The Government and the dissent contend that there is a correlation between the amount forfeited and the harm that the Government would have suffered had the crime gone undetected. We

> disagree. There is no inherent proportionality in such a forfeiture. It is impossible to conclude, for example, that the harm responded caused is anywhere near 30 times greater than that caused by a hypothetical drug dealer who willfully fails to report taking $12,000 out of the country in order to purchase drugs.

Id.; *see also Cooper Ind., Inc. v. Leatherman Tool Group, Inc.,* 532 U.S. 424, 434-35 ("We have recognized that the relevant constitutional line is 'inherently imprecise,' rather than one 'marked by a simple mathematical formula.' But in deciding whether that line has been crossed, we have focused on the same general criteria: the degree of the defendant's reprehensibility or culpability; the relationship between the penalty and the harm to the victim caused by the defendant's actions; and the sanctions imposed in other cases for comparable misconduct." (citations omitted)).

Here, by contrast to *Bajakajian,* Defendants' fraudulent conduct was far from minimal or harmless. The record establishes the extensive nature of the fraud on the mutual funds, Defendants' high degree of scienter, and the substantial loss and risk of loss of tens of millions of dollars that Defendants' illegal trades imposed on the funds' many investors. Defendants quite clearly fall into the class of persons for whom the securities fraud statutes were principally designed, and civil penalties equivalent to the disgorgement ordered are routinely imposed. The civil penalty assessed here is proportionate to the harm Defendants caused, and, as key to the constitutional inquiry, not grossly disproportionate to the gravity of their offenses.

Moreover, as the Second Circuit has recently held, "because the factors for 'proportionality' under the Eighth Amendment are substantially similar to those that" courts must consider when imposing civil penalties pursuant to the federal securities fraud statutes, where a court properly considers such factors, "no constitutional violation" exists. *SEC v. Rosenthal,* 426 Fed. Appx. 1, 4-5 (2d Cir. 2011) (citing *United States v. Sabhnani,* 599 F.3d 215, 262 (2d Cir. 2010), and affirming award of two times the illegal profits generated from the violations).

For the reasons set forth above, and pursuant to the findings of fact and conclusions of law reached in the Merits Opinion, a civil penalty of $38,416,500 is well-supported by the evidence of record and constitutionally permissible.

II. CONCLUSION

The evidence presented at trial established that Defendants engaged in an intentional and egregious fraudulent late trading scheme over the course of several years, involving thousands of transactions violative of the federal securities laws. In light of the facts and circumstances of this case, civil penalties of $38,416,500 are assessed jointly and severally on Defendants PCM and Chester.

It is so ordered.

New York, NY
March 28, 2012

/s/ Sweet
ROBERT W. SWEET
U.S.D.J.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

-- X
SECURITIES AND
EXCHANGE COMMISSION,

Plaintiff, 08 Civ. 3324(RWS)

– against –

PENTAGON CAPITAL
MANAGEMENT PLC
and LEWIS CHESTER,

Defendants,

– and –

PENTAGON SPECIAL
PURPOSE FUND, LTD.,

Relief Defendant.
-- X

FINAL JUDGEMENT

(Filed Mar. 28, 2012)

WHEREAS on April 3, 2008, Plaintiff Securities and Exchange Commission ("SEC") commenced this action by filing a Complaint (Dkt. No. 1) against Defendants Pentagon Capital Management PLC ("PCM") and Lewis Chester ("Chester"), and Relief Defendant Pentagon Special Purpose Fund, Ltd. ("PSPF"), alleging that PCM and Chester orchestrated a scheme to defraud mutual funds in the United States through late trading and deceptive market timing in violation of Section 17(a) of the Securities

Act of 1933 ("Securities Act"), 15 U.C.S. § 77q(a), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, thereunder. In the alternative, the SEC asserted a claim for aiding and abetting violations of Section 10(b) of the Exchange Act and Rule 10b-5.

WHEREAS on August 1, 2008, Defendants and Relief Defendant filed a motion to dismiss the Complaint. (Dkt. No. 11.)

WHEREAS on September 9, 2008, the SEC filed an Amended Complaint (Dkt. No. 15), and on October 8, 2008 Defendants and Relief Defendant moved to dismiss the Amended Complaint (Dkt. No. 23). That motion was heard on December 3, 2008, and by an opinion of February 9, 2009 it was denied (Dkt. No. 30). *SEC v. Pentagon Capital Management PLC,* 612 F. Supp. 2d 241 (S.D.N.Y. 2009).

WHEREAS on March 16, 2011, the SEC moved for partial summary judgment. (Dkt. No. 92.) That motion was heard on April 5, 2011 and denied in open court and then by memo endorsement on April 22, 2011 (Dkt. No. 141).

WHEREAS beginning on April 12, 2011, the bench trial was conducted over seventeen days, ending May 4, 2011, during which the Court heard testimony from eighteen witnesses and received in evidence many hundreds of exhibits.

WHEREAS final argument was heard on September 27, 2011.

WHEREAS this Court entered its Opinion in this action on February 14, 2012 (Dkt. No. 205) in which the Court, *inter alia*: found that the entire record establishes that the Defendants did not violate the securities law by pursuing a strategy of market timing, but did violate the securities laws by engaging in late trading, thereby entitling the SEC to judgment; found that Defendants intentionally and egregiously violated the federal securities laws through a broad ranging fraudulent late trading scheme through broker-dealer Trautman Wasserman & Company, Inc. ("TW&Co.") from February 2001 to September 2003; found Defendants and Relief Defendant jointly and severally liable for disgorgement of $38,416,500 of profits from the U.S. mutual fund trades executed through TW&Co. plus prejudgment interest; and imposed civil penalties in the amount equal to the profits accrued through Defendants' late trades through TW&Co., a sum of $38,416,500.

NOW THEREFORE

I.

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that Defendants and Defendants' agents, servants, employees, attorneys, and all persons in active concert or participation with them who receive actual notice of this Final Judgment by personal service or otherwise are permanently restrained and enjoined from violating, directly or indirectly, Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, by using any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, in connection with the purchase or sale of any security:

(a) to employ any device, scheme, or artifice to defraud;

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading;

or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

II.

IT IS HEREBY FURTHER ORDERED, ADJUDGED, AND DECREED that Defendants and Defendants' agents, servants, employees, attorneys, and all persons in active concert or participation with them who receive actual notice of this Final Judgment by personal service or otherwise are permanently restrained and enjoined from violating Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a), in the offer or sale of any security by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly:

(a) to employ any device, scheme, or artifice to defraud;

(b) to obtain money or property by means of any untrue statement of a material fact or any omission of a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading;

or

(c) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

III.

IT IS HEREBY FURTHER ORDERED, ADJUDGED, AND DECREED that Defendants and Relief Defendant are liable, on a joint and several basis, for disgorgement of $38,416,500, representing profits gained as a result of the fraudulent late trading through TW&Co., together with prejudgment interest thereon in the amount of $21,787,923.20, for a total of $60,204,423.20. Defendants and Relief Defendant shall satisfy this obligation by paying $60,204,423.20 within 14 days after entry of this Final Judgment to the Clerk of this Court, together with a cover letter identifying PCM, Chester, and PSPF as Defendants and Relief Defendant in this action; setting forth the title and civil action number of this action and the name of this Court; and specifying that payment is made pursuant to this Final Judgment. Defendants and Relief Defendant shall simultaneously transmit photocopies of such payment and letter to the Commission's counsel in this action. By making this payment, Defendants and Relief Defendant relinquish all legal and equitable right, title, and interest in such funds, and no part of the funds shall be returned to Defendants or Relief Defendant. Defendants and Relief Defendant shall pay postjudgment interest on any delinquent amounts pursuant to 28 U.S.C. § 1961.

If Defendants and Relief Defendant fail to pay any of this amount within 14 days following entry of this Final Judgment, the Commission may enforce the Court's judgment for disgorgement and prejudgment interest by moving for civil contempt (and/or through other collection procedures authorized by law) at any time after 14 days following entry of this Final Judgment. In response to any such civil contempt motion by the Commission, Defendants and Relief Defendant may assert any legally permissible defense.

The Clerk shall deposit the funds into an interest bearing account with the Court Registry Investment System ("CRIS") or any other type of interest bearing account that is utilized by the Court. These funds, together with any interest and income earned thereon and any payments made pursuant to the civil penalties imposed in Paragraph IV of this Final Judgment (collectively, the "Fund"), shall be held in the interest bearing account until further order of the Court. In accordance with 28 U.S.C. § 1914 and the guidelines set by the Director of the Administrative Office of the United States Courts, the Clerk is directed, without further order of this Court, to deduct from the income earned on the money in the Fund a fee equal to ten percent of the income earned on the Fund. Such fee shall not exceed that authorized by the Judicial Conference of the United States.

The Commission may by motion propose a plan to distribute the Fund subject to the Court's approval. Such a plan may provide that the Fund shall be distributed pursuant to the Fair Fund provisions of Section 308(a) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7246, for the benefit of victims of the violations of the federal securities laws found in this action. Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil penalties pursuant to this Final Judgment shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Defendants shall not, after offset or reduction of any award of compensatory damages in any Related Investor Action based on Defendants' payment of disgorgement in this action, argue that they are entitled to, nor shall they further benefit by, offset or reduction of such compensatory damages award by the amount of any part of Defendants' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Defendants shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this Final Judgment. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Defendants by or on behalf of one or more investors based on substantially the same facts as alleged in the Complaint in this action.

IV.

IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that Defendants Chester and PCM shall pay civil penalties, on a joint and several basis, in the amount of $38,416,500 pursuant to Section 20(d) of the Securities Act, 15 U.S.C. § 77t(d), and Section 21(d)(3) of the Exchange Act, 15 U.S.C. § 78u(d)(3). Defendants Chester and PCM shall pay $38,416,500 within 14 days after entry of this Final Judgment to the Clerk of this Court, together with a cover letter identifying Chester and PCM as Defendants in this action; setting forth the title and civil action number of this action and the name of this Court; and specifying that payment is made pursuant to this Final Judgment.

Defendants shall simultaneously transmit photocopies of such payment and letter to the Commission's counsel in this action. Defendants shall pay post-judgment interest on any delinquent amounts pursuant to 28 U.S.C. § 1961. The Clerk shall deposit the funds into an interest bearing account with the CRIS or any other type of interest bearing account that is utilized by the Court as provided for in Paragraph III of this Final Judgment.

V.

IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that this Court shall retain jurisdiction of this matter for the purposes of enforcing the terms of this Final Judgment.

New York, NY
March 28, 2012

/s/ Sweet
ROBERT W. SWEET
U.S.D.J.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

-- X

SECURITIES AND
EXCHANGE COMMISSION,

Plaintiff,

– against –

PENTAGON CAPITAL
MANAGEMENT PLC
and LEWIS CHESTER,

Defendants,

– and –

PENTAGON SPECIAL
PURPOSE FUND, LTD.,

Relief Defendant.

-- X

08 Civ. 3324

OPINION

(Filed Feb. 14, 2012)

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[1] **Sweet, D.J.**

On April 3, 2008, the Securities and Exchange Commission ("Plaintiff" or "SEC") commenced the instant enforcement action against defendants Pentagon Capital Management PLC ("PCM" or "Pentagon"), Lewis Chester ("Chester") and relief defendant Pentagon Special Purpose Fund, Ltd. ("PSPF") (colectively, the "Defendants"), alleging that PCM and Chester had orchestrated a scheme to defraud mutual funds in the United States through late trading and deceptive market timing in violation of Section 17(a) of the Securities Act of 1933 ("Securities Act"), 15

U.S.C. § 77q(a), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, thereunder. In the alternative, the SEC asserted a claim of aiding and abetting violations of Section 10(b) and Rule 10b-5. The following findings of fact and conclusions of law result from the evidence presented at the bench trial and all the prior proceedings. Based on the findings and conclusions, the Court grants in part and denies in part the relief sought by the SEC and will enter judgment providing injunctive relief, disgorgement of $38,416,500 and civil penalties of $38,416,500.

[2] PCM, a British hedge fund, traded the shares of mutual funds from 1999 through September 2003 on the New York Stock Exchange. This trading included two practices challenged by the SEC in this action as securities violations, namely, market timing and late trading. The issues surrounding these practices are complicated and controversial as evidenced by the eighteen witnesses and the many hundreds of exhibits presented by the able and skilled counsel. The entire record establishes that the Defendants did not violate the securities law by pursuing a strategy of market timing, but did violate the securities laws by engaging in late trading, thereby entitling the SEC to judgment.

I. PRIOR PROCEEDINGS

This case was initiated by the SEC on April 3, 2008. (Dkt. No. 1.) On August 1, 2008, Defendants filed a motion to dismiss. (Dkt. No. 11.) On September 9, 2008, the SEC filed an amended complaint (Dkt. No. 15), and on October 8, 2008, Defendants again moved to dismiss (Dkt. No. 23). That motion was heard on December 3, 2008, and by an opinion of Febuary 9, 2009 it was denied. *SEC v. Pentagon Capital Management PLC,* 612 F. Supp. 2d 241 (S.D.N.Y. 2009).

[3] On March 16, 2011, the SEC moved for partial summary judgment. (Dkt. No. 92.) That motion was heard on April 5, 2011 and denied in open court and then by memo endorsement on April 22, 2011 (Dkt. No. 141).

Beginning on April 12, 2011, the bench trial was conducted over seventeen days, ending May 4, 2011. The eighteen witnesses included: Professor Lawrence Harris, Samuel Engelson, Scott Christian, Lewis Chester, Carl Heppenstall, Seth Gersch, Thomas Feretic, Philip Hetzel, Said Haidar, Matthew Perrone, Justin Ficken, Dino Coppola, Gregory Trautman, Professor Jonathan Macey, Dr. Anthony Profit, Edward Stern, Conrad Ciccotello, and Jafar Omid.

Final argument was heard on September 27, 2011.

II. FINDINGS OF FACT

A. The Parties

1. The Plaintiff

[4] The SEC is the federal agency, established following the stock market crash of 1929, that is charged with enforcing federal securities laws and regulating the national securities markets.

2. The Defendants

In the 1980's Jafar Omid ("Omid") and David Chester, defendant Chester's father ("Chester, Sr."), were partners in an accounting firm in the United Kingdom and formed a wealth management advisory firm, Booth Anderson Investment Services, which traded European mutual funds using a dynamic asset allocation strategy. The term "dynamic asset allocation" is a British or European term for what Americans called "market timing."

The strategy sought to generate profits based on buying and selling mutual funds as markets moved up or down, Chester, Sr. believed that as markets were moving up, investors should be invested in equity mutual funds, and when markets were moving down, they should be invested in cash. To assist in this determination, Chester, Sr. developed a basic statistical analysis.

[5] In 1998, Chester joined the firm and Chester, Sr. retired for health reasons. Until 2003, Chester served as PCM's Chief Executive Officer. Chester is a

graduate of the University of Oxford in England, the College of Law in London, and the Harvard Business School. He is also qualified as a solicitor in England and Wales and, prior to joining PCM, Chester summered at the law firm White & Case in the United States and worked for three years as an international corporate attorney at the London law firm Linklaters & Paines.

Following Chester Sr.'s departure, the business continued under the name Pentagon Capital Management. Chester and Omid soon thereafter hired a team of mathematicians to computerize Chester, Sr.'s original methodology. Using these computer models, PCM traded unitized collective investment trusts, *i.e.,* European mutual funds, in the European markets.

The models were developed by performing a regression analysis which compared European mutual funds to various indices such as the Nikkei and FTSE 100. When the model found that a fund tracked an index or indices, the fund would become a candidate for trading, since a correlationship between the [6] performance of the fund and the performance of an index provided a predictive value as to the fund's future price movement.

As each fund was analyzed and found to track a particular index or indices, it would be added to a basket of similar funds. At the end of each day, the computer model would provide a signal indicating whether the funds in each basket should be bought, sold or held depending on how it tracked against the correlated index or indices. That signal – buy, sell or hold – was then communicated to PCM's brokers.

3. The Relief Defendant

PSPF is an international business company incorporated in the British Virgin Islands. In connection with trading U.S. mutual funds, PCM formed three Delaware limited liability companies (Pentagon Investment Partners, LLC, Pentagon Management Partners, LLC, and Pentagon Performance Partners, LLC), of which the PSPF was the sole member and manager. From 1999 to 2003, PCM was PSPF's investment advisor responsible for making its trading decisions.

B. The Operation of Mutual Funds

[7] Mutual funds consist of a basket of underlying equity holdings, and, as such, their value fluctuates as a function of the change in the value of the underlying shares. Professor Lawrence Harris, an SEC expert ("Professor Harris"), accurately described mutual funds and their operation. Portions of his report (SEC Ex. 420) follow:

> Mutual funds are investment companies whose sole purpose is to invest in securities on behalf of their shareholders. The directors of investment companies hire investment managers, who are paid out of the assets of the fund, to manage the company. The investment managers choose the securities

held by the mutual fund. The securities typically are publicly traded stocks or bonds issued by corporations or governmental agencies. The shareholders of a mutual fund are its investors. Mutual funds are called pooled investments because mutual fund investors pool their money together for management by a professional manager.

* * *

When investors want to buy fund shares, the fund issues new shares in exchange for cash deposited by the investors. When existing investors want to sell their shares, the fund redeems (repurchases) those shares by paying the investors cash in exchange for their shares. The directors of open-end mutual funds hire distribution agents to help arrange and settle their trades. The distribution agent is generally a company affiliated with the investment manager.

The managers of an open-end fund, or agents hired by the fund, set the prices at which the deposit and redemption transactions occur.

* * *

[8] The managers (or their agents) generally set the deposit and redemption price at their best estimate of the value of a share in the mutual fund, which is called the fund's net asset value (NAV), The aggregate net asset value of the fund is the total value of the fund's assets, less any liabilities that the fund may have. Funds compute their NAV by dividing the aggregate net asset value by the

total number of mutual fund shares outstanding.

For example, suppose that Mutual Fund ABC owns 100 shares of Stock A and 200 shares of Stock B. If Stocks A and B were respectively valued at $20 and $40 per share, the total net asset value of the fund would be 100 x $20 + 200 x $40 = $10,000. If the mutual fund had 400 shares outstanding, the NAV of the fund would be $10,000 ÷ 400 = $25 per share.

Suppose a new investor buys 200 shares of Fund ABC at $25 per share. After the transaction, the total net asset value of the Fund will increase by $5,000 to $15,000 and the total shares outstanding will increase to 600 shares. However, the NAV of the fund will remain at $25 = $15,000 ÷ 600 dollars per share. The NAV of a fund following a deposit or redemption transaction does not change if the transaction price takes place at the NAV.

* * *

Deposit (investor purchase) and redemption (investor sale) transactions in open-end mutual funds are always executed after the normal closing time of the stock and bond markets. In general, traders must place their orders before 4:00 PM Eastern Time.

The fund's NAV is generally computed from last trade prices recorded as of 4:00 PM Eastern Time. If the fund managers believe that the last observed price of a security held by the fund does not fairly represent its current value, the managers may specify a different price. This process is called fair valuation.

* * *

[9] Managers who fair value their portfolios risk choosing the wrong prices for their securities. For example, although the best estimate of the 4:00 PM value of Stock B in the example above, made on the basis of movement of similar stocks, may be $40.40, Stock B might actually be worth $40 because some negative news specific to Stock B counteracted the market-wide price rise. If so, the use of a $40.40 estimate of the value of Stock B would cause the NAV of the fund be too high. Any purchasers of the fund would receive too few shares and any sellers would receive too much cash.

When computing NAVs, managers rarely specify prices different from last observed prices for their portfolio securities because they are afraid of the mistakes, and thus the associated liability, that may result from fair valuation. They prefer to use last observed prices because the computation of NAVs based on such prices does not require any judgment. Although the failure to fair value a portfolio commonly creates NAVs that inaccurately value their funds, managers generally have not been concerned about the liability associated which such mistakes because the principle of valuation based on last observed prices is objective and well accepted.

* * *

Fund managers must set the price at which they allow investors to transact at their best estimate of the NAV to ensure that they treat all shareholders fairly. These shareholders include purchasers, sellers, and the vast majority of shareholders who on any given day merely retain their shares. If purchasers could buy shares for less than they are worth, the purchasers would profit and the retaining shareholders would lose. The purchasers would profit and the retaining shareholders would lose because the proportionate increase in the number of shares in the mutual fund would be greater than the proportionate increase in the total value of the fund's assets. The retaining shareholders suffer dilution because the purchasing shareholders contribute less to the fund than their proportionate share of ownership.

[10] * * *

As noted, when setting NAVs, fund managers also must be mindful of sellers as well as purchasers and retaining shareholders. If investors could sell shares for more than their worth, they would gain at the expense of the retaining shareholders. The selling investors would gain by avoiding a loss, because the shares that they tendered would be less valuable than the cash that they would receive in exchange. The retaining shareholders would lose because the proportionate decrease in the number of shares in the mutual fund would be less than the proportionate decrease in the aggregate value of the fund's assets. The retaining shareholders would suffer dilution because the selling shareholders would have taken out more than their proportionate share of the value of the fund.

C. Market Timing

As the Second Circuit has described:

"Market timing" refers, *inter alia,* to buying and selling mutual fund shares in a manner designed to exploit short-term pricing inefficiencies. A mutual fund sells and redeems its shares based on the fund's net asset value ("NAV") for that day, which is usually calculated at the close of the U.S. markets at 4:00 P.M. Eastern Time. Prior to 4:00 P.M., market timers either buy or redeem a fund's shares if they believe that the fund's last NAV is "stale," *i.e.,* that it lags behind the current value of a fund's portfolio of securities as priced earlier in the day. The market timers can then reverse the transaction at the start of the next day and make a quick profit with relatively little risk.

Mutual funds . . . that invest in overseas securities are especially vulnerable to a kind of market timing known as "time zone arbitrage," whereby market timers take advantage of the fact that the foreign markets on

> [11] which such funds' portfolios of securities trade have already closed (thereby setting the closing prices for the underlying securities) before the close of U.S. markets. Market timers profit from purchasing or redeeming fund shares based on events occurring after foreign market closing prices are established, but before the events have been reflected in the fund's NAV. In order to turn a quick profit, market timers then reverse their positions by either redeeming or purchasing the fund's shares the next day when the events are reflected in the NAV.

SEC v. Gabelli, 653 F.3d 49, 53 (2d Cir. 2011) (citations omitted).

Professor Harris accurately described the practice of market timing. Portions of his report follow:

> Market Timing Strategies
>
> Some traders can occasionally estimate a fund's NAV more accurately than can the fund managers. When such traders expect that a fund's computed NAV likely will be less than its actual NAV, they will buy the fund. If they are correct, they will profit when the NAV of the fund eventually rises to its correct value. This strategy is called market timing, and such traders are called market timers. The market timing strategy can also work in reverse. If market timers own fund shares that they believe will be overvalued by the fund, they will sell their shares to avoid losses that they would otherwise

incur when the NAV eventually drops to its correct value.

Market timing causes the retaining shareholders to experience dilution. The profits that market timers earn when buying, and the losses they avoid when selling, reduce the returns that the other shareholders obtain from their fund investments.

[12] Market times generally are short-term traders. They usually sell their positions within a week of acquiring them, though some market timers may wait longer for an opportunity to profitably exit the fund. While invested in a fund, market timers may hedge their positions in the futures markets to reduce the risks of fund ownership. For example, a market timer may sell S & P 500 Index futures contracts while invested in a large cap equity index fund. If prices fall, the profits on the short futures contract position will offset losses from the mutual fund investment. If prices rise, the profits from the mutual fund investment will offset the losses from the short futures contract position.

To protect their shareholders from market timers, many funds have adopted various policies designed to prevent market timing. These policies may restrict the number of trades that investors may make in a fund, or they may impose minimum holding periods for investors. These policies do not harm long term investors that the funds seek to serve, but they discourage or prevent short-term trading by market-timers.

* * *

Identifying Market Timing

Mutual funds most often misvalue their portfolios when prices are changing rapidly. The uncertainty associated with large price changes makes their valuation problems difficult.

For example, mutual funds that hold portfolios of international stocks must value these portfolios as of 4:00 PM Eastern Time. At that time, the home markets in which these stocks trade generally have been closed for 5 to 16 hours, depending on their locations. Accordingly, the prices last observed in these market often are quite stale. If significant events occur after these markets close, the last closing prices in these home markets will not reflect the effects of these events on security values until the markets next open. Many such events also affect U.S. securities [13] markets. Market timers therefore often buy international mutual funds (U.S.-domiciled mutual funds that invest in international securities) when the U.S. markets rise substantially more than the foreign markets that closed earlier. Market timers may also buy when the U.S. markets rise in response to news that was disseminated after the foreign markets closed. Although international mutual funds sometimes fair value-adjust their NAVs to avoid this

> problem, the adjustments often are not large enough. Accordingly, market timers often buy international funds on days when their NAVs rise with the expectation that NAV will rise again on the next day.
>
> The international mutual funds generally correct these misvaluations on the next day, after they have observed new prices in the foreign markets. Accordingly, market timing trades in such funds often show profits by the next trading day.
>
> These comments suggest that three characteristics identify market timing:
>
> a. High frequency, short-term trading;
>
> b. Purchases on days when market indices and reported NAVs rise and sales on days when market indices and reported NAVs fall;
>
> c. Extraordinary profits on purchases and extraordinary avoided-losses on sales that, on average, accrue the next day but which cease to accrue after that day.
>
> Any of these characteristics is indicative of market timing. When all are found together, they strongly indicate market timing.

(SEC Ex. 420.)

[14] As Professor Harris accurately described at trial, market timing harms long-term fund investors by diluting the value of their shares:

Q. Can market timing and late trading have an effect on the value of other investors' shares of the mutual funds in which such trading takes place?

A. Yes. This is called dilution. . . . [S]uppose that the mutual fund has decided that its shares are worth $10 a share, and it is willing to allow investors to buy those shares for $10 a share. But for whatever reason suppose in fact that those shares are actually worth . . . $11 a share. So anybody who can buy those shares at $10 is receiving $11 in value. So if no transactions take place . . . the existing shareholders will eventually get the full value of their shares, which is to say that tomorrow prices will rise to $11 if the information becomes revealed and the existing shareholders will profit to the full extent of that rise. If, however, the fund allows new shareholders to buy . . . at $10 a share, those new shares will participate in the increase in the value of the fund . . . [which] means that the existing shareholders will have to share their gains with the new shareholders. That process is called dilution because there are now more shares that will share in the gain to the fund as the funds' value rises from 10 to 11. Note though that the new shareholders, they will be buying at $10 a share, something that is worth 11. So they will make a profit from this transaction. The profit comes from the other shareholders, and

. . . their profit is exactly equal to the losses from the existing shareholders. . . . So that is dilution on a purchase.

On the sale, let's set up that situation as a similar circumstance. So once again, let's assume that the fund believes its shares are worth $10 a share but in fact . . . the actual value of the fund is now $9. So anybody who can sell their shares on that information will be able to make a dollar a share of losses [15] avoided. So they will avoid losing a dollar when the fund drops from $10 to, presumably, $9 the next day. So if nobody sells their shares, then those losses will be distributed evenly over all the existing shareholders. But if some of the shareholders are able to sell, they will receive $10 of something that is actually only worth $9, which it means that all of the other shareholders will have to share the losses – they will share the total amount of the losses, but now there are fewer of them and so their loss per share will be greater than it otherwise would be. The losses that the exiting shareholders avoid will be losses that the remaining shareholders will incur and that, again, is called dilution although in this case it seems to work backwards. But, again, it is a loss to the existing shareholders. So the ability to do a market timing strategy . . . in which you can buy shares at a price less than their actual value or sell shares at a price above their actual

> value, that process causes dilution and losses to the other shareholders. . . .

(Tr. 99-102.)

In addition, as the Court of Appeals has recognized:

> [M]arket timing can harm long-term investors in the fund by raising transaction costs for a fund, disrupting the fund's stated portfolio management strategy, requiring a fund to maintain an elevated cash position to satisfy redemption requests, . . . resulting in lost opportunity costs and forced liquidations . . . unwanted taxable capital gains for fund shareholders and a reduction of the fund's long term performance.

Gabelli, 653 F.3d at 53 (citations and internal quotations and [16] alterations omitted); *see also Janus Capital Group, Inc. v. First Derivative Traders,* ___ U.S. ___, 131 S. Ct. 2296 (2011) (finding that market timing "harms other investors in the mutual fund."); *SEC v. PIMCO Advisors Fund Mgmt. LLC,* 341 F. Supp. 2d 454, 458 (S.D.N.Y. 2004) ("[M]arket timing . . . can also harm investors . . . by increasing trading and brokerage costs, as well as tax liabilities, incurred by a fund and spread across all fund investors . . . [and] market timing may also hinder the ability of mutual fund managers to act in the best interest of fund investors who seek to maximize their long-term investment gains."); *First Lincoln Holdings, Inc. v. Equitable Life Assurance Soc'y,* 164 F. Supp. 2d 383, 390-94 (S.D.N.Y. 2001) (discussing the detrimental effects of market timing on long-term mutual fund investors).

As testified by Professor Jonathan Macey ("Professor Macey"), one of the Defendants' experts, market timing was ubiquitous during the 1999 through 2003 time period. (Tr. 1466.) Professor Conrad Ciccotello ("Professor Ciccotello"), one of the Defendants' experts, testified that mutual fund complexes knew of market timing, and that 40 of the 80 largest mutual fund families had at some point entered into capacity agreements, whereby they permitted market timing by certain [17] investors. (Tr. 1869-72.) *See also PIMCO Advisors Fund Mgmt.,* 341 F. Supp. 2d at 460-61 ("According to the SEC investigations, press reports, allegations in complaints, and expert commentary, many mutual fund companies engaged in huge volumes of undisclosed transactions with Canary and other market timers during the period at issue.")

Mutual funds sought to uncover and reject trades by market timers. The industry termed this effort "kick outs." Three mutual fund witnesses testified at trial and four by deposition about the steps taken to restrict market timers and to bar their trading. (Carl Heppenstall (American Century) Tr. 874-91; Philip Hetzel (Federated) Tr. 1036-42; Matthew Perrone (Dryfus) Tr. 1166-71; Barbara Sleiman (Evergreen) Dep. Tr. 30-33, 60-64; Ellen Bradley (MFS) Dep. Tr. 6-7, 10, 40-60, 78, 91-92, 190-91, 196-8, 213-17; John Mari (Janus) Dep. Tr. 122-23; Henry Brennan

(Alliance Capital) Dep. Tr. 27-8, 33-35, 63-4, 73, 95, 115-9, 124.)

The prospectuses of many of the funds traded by the Defendants contained provisions granting the funds the right to reject trades considered by the funds to be market timing trades. (SEC Ex. 420A-499.)

[18] **D. Late Trading**

Professor Harris accurately described the practice of late trading. Portions of his report follow:

> The Late Trading Strategy
>
> Traders must submit orders to trade open-end mutual funds before 4:00 PM if they want the orders filled on that day. Orders submitted after 4:00 PM are late orders. Brokers are supposed to hold late orders for execution on the next trading day. Late trading results when brokers allow late orders to execute on the same day instead of the next day.
>
> * * *
>
> Late trading is an extreme form of market timing. It can be very profitable when traders know that their late orders will be executed on the same day. Funds compute the NAVs that they use to price deposit and redemption orders from security prices last observed as of 4:00 PM. If values subsequently change, these NAVs would no longer reflect

the actual value of the funds. Late traders who submit buy orders when values rise after 4:00 PM tend to profit from buying undervalued funds because the NAVs of those funds tend to rise on the next day. Those who submit sell orders when values fall after 4:00 PM tend to avoid losses from holding overvalued funds because the NAVs of those funds tend to fall on the next day. In both cases, their profits and losses-avoided result in dilution to the other shareholders, for the same reasons described above in the discussion of market timing.

Events that convey material information about security values often occur after 4:00 PM. For example, many corporations and governmental agencies deliberately [19] wait until after the 4:00 PM close of the normal trading session to release significant news. Traders who observe these announcements sometimes can infer that prices will change substantially on the next day. Late traders thus pay close attention to these news events to determine whether, and how, they will affect values.

Trading in equity index futures contracts and in some securities continues after the 4:00 PM close of the regular trading sessions at U.S. equity markets. The futures markets continue to trade until 4:15 PM. Many equity index futures contracts resume trading at 4:30 PM and continue to trade throughout the night. Many equity markets have extended trading sessions in which traders can

> continue to trade stocks in electronic trading sessions from 4:00 PM until 5:30 PM or later.
>
> Trading after 4:00 PM in these contracts and securities can be quite active when traders respond to significant news first released after 4:00 PM. Late traders thus do not need to interpret news events to trade successfully. They simply follow price changes in these after-hours markets. When those prices rise, the value of mutual funds that hold similar assets will also rise. Late traders thus tend to buy mutual funds when the prices of securities and contracts have risen significantly after 4:00 PM. They tend to sell funds when prices have fallen significantly after 4:00 PM.

(SEC Ex. 420.)

Almost all mutual funds require that trades be placed by 4:00 p.m. ET in order to receive that day's NAV. The SEC submitted 82 mutual fund prospectuses from the relevant time period, covering 116 mutual funds late traded by Defendants, which required that trades be placed by 4:00 p.m. ET in order to [20] receive that day's NAV. (SEC Exs. 419A, 420A, 421-499.) Additionally, three witnesses from mutual funds testified at trial that 4:00 p.m. ET was the order deadline (Carl Heppenstall (American Century) Tr. 870, 873, 892-893; Philip Hetzel (Federated) Tr. 1046-7, 1050-3; Matthew Perrone (Dryfus) Tr. 1173-6, 1203), as did five witnesses by deposition submitted at trial. (Barbara Sleiman (Evergreen) Dep. Tr. 84-85; Ellen Bradley (MFS) Dep. Tr. 24-29, 209-10, 218-9;

John Mari (Janus) Dep. Tr. 35-36, 69-70; Henry Brennan (Alliance Capital) Dep. Tr. 70, 119, 120; Ira Cohen (AIM) Dep. Tr. 89-90; Stephen Adamsky (Ivy) Dep. Tr. 94-99.)

E. Market Regulation

On October 16, 1968, the SEC announced the adoption of Rule 22c-1 under the Investment Company Act, 17 C.F.R. § 270.22c-1. Rule 22c-1 provides that "[n]o registered investment company issuing any redeemable security . . . shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security." 17 C.F.R. § 270.22c-1. "The rule is commonly referred to as the [21] 'forward pricing rule' because the price assigned to mutual fund shares is not assigned until after the time an order is placed by an investor. The rule creates a requirement that the price of mutual fund shares be set at the NAV 'next computed' by the mutual fund company after the receipt of the order to buy or sell the shares in question." *SEC v. Simpson Capital Mgmt., Inc.,* 586 F. Supp. 2d 196, 202 (S.D.N.Y. 2008).

At the same time it adopted Rule 22c-1, the SEC issued a release entitled "Adoption of Rule 22c-1 Under the Investment Company Act of 1940 Prescribing the Time of Pricing Redeemable Securities for Distribution, Redemption, and Repurchase, and

Amendment of Rule 17a-3(a)(7) Under the Securities Exchange Act of 1934 Requiring Dealers to Time-Stamp Orders" (the "Adopting Release"). *See* Release No. 5519, 1968 WL 87057 (Oct. 16, 1968). (SEC Ex. 72.) The Adopting Release provides in part as follows:

> One purpose of Rule 22c-1 is to eliminate or reduce so far as reasonably practicable any dilution of the value of outstanding redeemable securities of registered investment companies through (i) the sale of such securities at a price below their net asset value or (ii) the redemption or repurchase of such securities at a price above their net asset value. Dilution through the sale of redeemable securities at a price below their net asset value may occur, for example, through the practice of selling securities for a certain period of time at a price based upon a previously established net asset value. This practice [22] permits a potential investor to take advantage of an upswing in the market and an accompanying increase in the net asset value of investment company shares by purchasing such shares at a price which does not reflect the increase. . . .
>
> Another purpose of Rule 22c-1 is to eliminate or reduce so far as reasonably practicable other results, aside from dilution, which arise from the sale, redemption, or repurchase of securities of registered investment companies and which are unfair to the holders of such outstanding securities. The Commission believes that the practice of selling

> securities for a certain period of time, at a price based upon a previously established net asset value, encourages speculative trading practices which so compromise registered investment companies as to be unfair to the holders of their outstanding securities. This pricing practice allows speculators to buy large blocks of such securities under circumstances where the net asset value of the securities has increased but where the increase in value is not reflected in the price. The speculators hold such securities until the next net asset value is determined and then redeem them at large profits. These speculative trading practices can seriously interfere with the management of registered investment companies to the extent that (i) management may hesitate to invest what it believes to be speculators' money and (ii) management may have to effect untimely liquidations when speculators redeem their securities. . . .

1968 WL 87057, at *1-*2.

In addition to announcing the adoption of Rule 22c-1, the Adopting Release also announced that, as a companion measure, the SEC was amending Rule 17a-3(a) under the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.,* which sets forth the types of records that broker-dealers must make and keep, to [23] require all broker-dealers to maintain records of orders from customers showing, *inter alia,* the time the orders are received. 17 C.F.R. § 240.17a-3(a). The Adopting Release provided as follows:

> In order to implement Rule 22c-1 under the Investment Company Act, the Commission, as a companion measure, has determined to adopt an amendment of Rule 17a-3(a)(7) under the Securities Exchange Act to require dealers, when selling securities to, or buying securities from, a customer, other than a broker or dealer, to stamp on the memorandum of order the time of receipt. Brokers are already subject to such requirement under subparagraph (a)(6) of Rule 17a-3.

1968 WL 87057, at *3.

On December 27, 1968, and again on January 9, 1969, the SEC staff issued a Staff Interpretive Position (the latter updating the former) regarding the adoption of Rule 22c-1 and the Commission's October 16, 1968 Release discussed above. *See Staff Interpretive Positions Relating to Rule 22c-1,* Release No. 5569, 1968 WL 87104 (Dec. 27, 1968) (SEC Ex. 73); *Staff Interpretive Positions Relating to Rule 22c-1,* Release No. 5569, 1969 WL 96373 (Jan. 9, 1969) (SEC Ex. 74). Both versions of the Staff Interpretive Position contain a hypothetical to the effect that orders to trade U.S. mutual funds at the current day's NAVs have to be received before the funds' pricing times.

[24] The January 9, 1969 Interpretive Position, issued at a time when the New York Stock Exchange closed at 3:30 p.m. ET, provided as follows:

> The following examples are intended to illustrate how the pricing provisions apply:

The fund prices at 1:00 p.m. and 3:30 p.m.

> (a) A dealer receives a customer's order before 1:00 p.m. The 1:00 p.m. price would be applicable and the dealer should assure that the order is received by the underwriter prior to 3:30 p.m.
>
> (b) A dealer receives a customer's order after 1:00 p.m. but before 3:30 p.m. The 3:30 p.m. price would be applicable and the dealer should assure that the order is received by the underwriter prior to the close of the underwriter's business day.
>
> (c) A dealer receives a customer's order at 4:00 p.m. ET. The 1:00 p.m. price on the next business day would be applicable and the dealer should assure that the underwriter receives the order prior to 3:30 p.m. on such next day.

1969 WL 96373, at *2 (SEC Ex. 74).

In an April 2001 letter, the SEC's Associate Director and Chief Counsel of Investment Management, Douglas Scheidt, noted the prevalence of market timing strategies designed to capitalize on mispricing. *See* Letter from Douglas Scheidt, Assoc. Dir. and Chief Counsel, Div. of Inv. Mgmt., U.S. Sec. and [25] Exch. Comm'n, to Craig S. Tyle, Gen. Counsel, Inv. Co. Inst., 2001 SEC No-Act. LEXIS 543 (Apr. 30, 2001) *available at* http://www.sec.gov/divisions/investment/guidance/tyle043001.htm. The letter emphasized that mutual funds have a fiduciary duty to protect investors from any loss of value due to these strategies and evidenced that the Commission knew of these timing strategies. The letter gave no indication that the SEC intended to prohibit such strategies and proposed no regulatory action to prevent or deter market timing.

On September 3, 2003, the New York Attorney General ("NYAG") announced a settled enforcement action against hedge fund Canary Capital Partners, LLC ("Canary Capital") for violations of the New York State Martin Act through, among other things, late trading of U.S. mutual funds. Chester and other PCM employees were aware of the Canary Capital settlement the day it was announced. (SEC Exs. 61, 62, 103; *see also,* SEC Ex. 522 (August 21, 2003 email from Matthew Embler, PCM employee, to Frank Bristow, head of trading at PCM, Omid, Anthony Profit ("Profit"), head of research and development for PCM, and PCM's Capacity Team, saying "Talked about Spitzer, and Stern giving up capacity following the subpoena. Sounds like a main focus of the investigation is the unfair advantage from late-trading [26] (maybe Scott at TWC was being straight with us after all?). Stern's plight is letting [competitor Goodwin Trading] pick up a lot of capacity, because for obvious reasons (Goodwin is an ex-Stern guy) they're already well connected with the same broker networks!").)

Stephen M. Cutler, then director of the SEC's Division of Enforcement, testified in 2003 before the Senate Subcommittee on Financial Management that a written examination of 88 of the largest mutual fund complexes in the country revealed that more than 50% of the mutual fund groups had "one or more arrangements with certain shareholders that allow[ed] these shareholders to engage in market timing." *Mutual Funds: Trading Practices and Abuses that Harm Investors: Hearing Before S. Subcomm. on Fin. Mgmt., the Budget and Int'l Sec., Comm. on Gov't'l Affairs,* 108th Cong. 11-12 (Nov. 20, 2003) (statement of Stephen M. Cutler, Dir., Div. of Enforcement, U.S. Sec. and Exch. Comm'n) ("Cutler Testimony").

Prior to 2003, the SEC had never commenced an enforcement proceeding against any mutual fund, market timer, or securities firm for market timing.

[27] In April of 2004, following the announcement of the Canary enforcement action, the SEC adopted a market timing rule that requires mutual funds to describe in their prospectuses the risks, if any, that frequent purchases and redemptions may present to other shareholders; to state whether or not the fund's board has adopted policies and procedures with respect to frequent purchases and redemptions, and, if not, to provide a statement of the specific basis for the view of the board that it is appropriate not to have such policies and procedures. *See* Final Market Timing Rule, 69 Fed.Reg. at 22,300. In addition, under the 2004 rule, U.S. mutual funds must describe their market timing policies with particularity as a requirement of registration. *See* SEC Form N-1A, *available at* http://www.sec.gov/about/forms/formn-1a.pdf.

F. Market Timing by PCM

In 1999 Chester was introduced to an American at Chronos Asset Management, from whom he learned that market-timing techniques were employed in the United States. (Tr. 479-80.) After this conversation, Chester began trading in mutual funds, using market timing techniques as described above, through CIBC, a U.S. broker-dealer. The broker utilized by PCM [28] at CIBC was Michael Sassano ("Sassano"). Sassano had an assistant, James Wilson ("Wilson"). (Tr. 483-84.)

In 2000, Wilson left CIBC and obtained employment at Paine Webber. At Paine Webber, he acquired an assistant named Scott Christian ("Christian"). (Tr. 490.)

At Paine Webber, Wilson and Christian facilitated their customers' market timing strategies in a number of ways, including making a series of purchases with small ticket amounts, such as $150,000 or $300,000, with the intention of not drawing too much attention to the size of the overall purchase. (Tr. 212-13.) Wilson and Christian also kept PCM's names off its accounts. (SEC Ex. 15 (memorandum written by Chester following a May 5, 2000 meeting between Chester, Wilson and Christian stating that Wilson "agreed to code the names of our accounts, so that the Pentagon name does not appear on any of the accounts"); Tr. 495). Additionally, Wilson and Christian facilitated their customers' market timing strategies by using multiple accounts. If Wilson and

Christian were purchasing a small position and a customer was sending them millions of dollars, there were only so many mutual funds that could be purchased. Purchasing the same mutual funds by way of multiple [29] accounts enabled them to break down their ticket amounts such as to avoid detection but nonetheless in aggregate make large purchases. (Tr. 214.)

While at Pane Webber, Pentagon's accounts were restricted from trading. In response, Pentagon continued to trade the same fund families that had restricted their trading by journaling money to other accounts to be purchased into the same fund family. Pentagon was aware that Wilson and Christian were trading the same group of mutual funds among different accounts. (Tr. 215-16.)

Wilson and Christian were terminated from Paine Webber in August or September of 2000. (Tr. 224.) Wilson was accused by a Paine Webber back office employee of attempting to bribe her in exchange for information about what other brokers at Paine Webber with market timing clients were doing. (*Id.*) Chester testified that he had a different understanding as to why Wilson and Christian were terminated and that he believed that Wilson, "in a drunken stupor," made inappropriate comments to a female employee at Paine Webber. (Tr. 502-03.)

[30] On September 25, 2000, Chester sent an email to Michael Sapourn ("Sapourn"), a U.S. trader, saying: "Just wanted to know how the various managers

coped with last week. I assume some/all got caught on one day at least. Also, I'm sure you saw the article in WSJ on timers. Interested to hear your views as to whether there might be some repercussions as a result of this." (SEC. Ex. 223.) Sapourn responded that he had noticed that "many" U.S. international fund families (*i.e.,* U.S.-based funds holding international securities) were "trying to stamp out timer activity" and that he was being coached by his brokers "as to when to 'suspend' our activity in order to stay off the radar screens of many of our Fund families. The strong will survive . . . " (*Id.* (ellipsis in original)).

After Wilson and Christian were terminated, a different broker, Scott Shedden ("Shedden"), and his assistant, Dino Coppola ("Coppola") took over PCM's accounts at Paine Webber. (SEC Ex. 18.)

In November or December of 2000, Wilson and Christian obtained employment with Trautman Wasserman & Co., Inc., a small New York broker-dealer ("TW&Co."). (Tr. 225.) Christian testified that in searching for a position following his [31] termination from Paine Webber, he and Wilson were "looking for another company to facilitate market timing" and that they found that in TW&Co. (*Id.*)

On February 15, 2001, PCM began trading through TW&Co. (SEC Ex. 126.)

Defendants' market timing involved the utilization of multiple broker-dealers, the use of multiple accounts at broker-dealers, keeping trades in small amounts that would avoid detection by mutual funds, and the use of multiple registered representative numbers by PCM's brokers. This practice was referred to in the marketplace and in this litigation as "under the radar" trading. As described by Justin Ficken, PCM's broker at Prudential, "'under the radar' is a term that we used as market timers, the phrase was to facilitate trades, to execute trades, to place trades with mutual funds without generating a block or a kick-out by the fund family." (Tr. 1209.) Under the radar trading was designed to elude detection by "market timing police," internal employees of investment advisers to mutual funds whose job it was to detect market timers and enforce the policies that the funds had in place. (Tr. 1211.)

[32] On PCM's account opening documents at TW&Co., in response to the question "[d]oes customer object to disclosing his/her name, address and security position to requesting companies in which he/she is a shareholder," a box is checked "yes." (SEC Ex. 235.)

In an email on February 27, 2002, Quang Tran ("Tran"), a principal trader on the PCM trading desk, wrote to Matthew Heerwagen, a broker at Brown Brothers Harriman, as follows:

> When you do enquire with the Fund Families please do not mention our name. Anonymity is very important in Market Timing, the Fund Families should never know who is the underlying client. . . . With regards to the execution I need to be able to place trades as

> late as possible or close to the cut off point as possible. I'm looking to invest into a few funds in Europe to begin with, not just one fund family. In case they decide to terminate the agreement we wouldn't be reliant on one fund family.

(Ex. 133; Quang Tran Dep. Tr. 127-128.)

In an undated email from Lewis Chester to Christopher Glassman, a broker at Morgan Stanley, Chester stated "[l]ooking at my notes from our meeting, I note that we can put our accounts through Morgan Stanley's trust company, to ensure anonymity. Can you please do this for us on these new accounts." (SEC Ex. 208.)

[33] Wilson and Christian used multiple registered representative numbers, or broker numbers, at TW&Co. YKA was Wilson's registered representative number, and YKB was Christian's registered representative number. Wilson and Christian also used registered representative numbers YKC, YKD, YKF, YKG, YKN, YKO, YLR, YLS, YLT, YLU, YLV, YLW, YLX, YL1, YL2, and YL3 to trade mutual funds at TW&Co. Christian prepared account opening forms for PCM to trade mutual funds using the registered representative numbers. (Tr. 275-80; SEC Ex. 901, 235.) Wilson and Christian used different registered representative numbers on accounts to shield the unitary nature of the accounts. Mutual funds would

only see the name "Bank of America"[1] on PCM's accounts at TW&Co., and not Pentagon's name. (Tr. 284-285; SEC Ex. 235, 237.)

PCM opened accounts at U.S. broker-dealers in order to facilitate market timing as follows:

- Brown Brothers Harriman – 2 accounts
- Charles Schwab – 2 accounts
- [34] Concord – 39 accounts
- Investex – 13 accounts
- JP Morgan – 4 accounts
- Morgan Stanley – 16 accounts
- Murjen – 2 accounts
- CIBC/Oppenheimer – 11 accounts
- Paine Webber – 21 accounts
- Prudential – 30 accounts
- Solomon Smith Barney – 10 accounts
- Trautman Wasserman – 67 accounts
- Wall Street Discount – 12 accounts.

(SEC Dem. Ex. 1.)

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[1] Various Bank of America entities are referred to by the parties, including but not limited to Banc of America Securities LLC. For ease, all are denoted as "Bank of America" here.

Chester was aware that mutual funds blocked PCM's trading. On one occasion at TW&Co., PCM wanted to purchase a significant amount of international equity mutual funds. The following morning a good portion of the positions did not get invested because of the market timing police. Christian spoke directly with Chester about this because it was a significant portion of Pentagon's portfolio, and instead of being invested, they had to sell out of the fund families. Chester was [35] disappointed because the market was up on that particular day. (Tr. 216-17.)

TW&Co. negotiated timing capacity primarily with the Janus mutual fund complex. Gregory Trautman ("Trautman"), President and CEO of TW&Co., knew Warren Lammert, one of the earliest portfolio managers at Janus. (Tr. 272-73.) As Christian testified when asked to describe the negotiated capacity:

> Well, it was – we didn't have to deal with the market timing police. We were not dealing with kick-outs. The fund was allowing us to trade their funds. They acknowledged who we were and they were allowing us to trade within certain parameters, meaning we couldn't just trade every day but our traders weren't typically doing that anyway, so they were openly allowing us to trade, to mark time their funds, despite what a prospectus might state.

(Tr. 273.)

In a May 3, 2001 email Chester also inquired about using annuities because several other brokers were using annuities and were having success trading mutual funds through annuities because they were not being kicked out of the funds. (SEC Ex. 868; Tr. 298.)

[36] On August 30, 2001, Chester sent an email to Trevor Rose ("Rose"), the head of PCM's Trading & Dealing Desk, and Omid, the Chief Operating Officer of PCM, suggesting that "we start swapping stuff around as we get chucked from funds," (SEC Ex. 207.)

On November 6, 2001 and March 1, 2002, Putnam Investments sent kick out letters to Christian that referenced accounts at TW&Co. that held Putnam mutual funds. (Tr. 285-288; SEC Ex. 243, 236.)

On November 28, 2001, Christian sent an email to PCM to advise that the First American mutual fund complex had "hard rejected" trades in seven PCM accounts, meaning that the trades were blocked and the accounts frozen from any further exchanges. (SEC Ex. 233; Tr. 298-301.) Christian sent a similar email on October 26, 2001 concerning different mutual fund complexes, including AIM and Sun America. (Defs. Ex. 159.)

Barbara Donegan ("Donegan") worked at Olympia Capital, the fund administrator for PSPF. Donegan opened accounts for PCM at U.S. broker-dealers only when directed to do so. Donegan took instructions from personnel at PCM to open accounts, not [37] from U.S. broker-dealers. Donegan testified that she was in daily contact with individuals at PCM. Documents that Donegan sent to U.S. broker-dealers indicated that the various LLCs that were on the names of PCM's accounts were composed of a single member, PSPF. (Barbara Donegan Dep. Tr. 13-14, 19-22, 24-29, 32-111, 131-33; SEC Ex. 680-718.)

Christian sent Chester an email on July 1, 2002 indicating that PCM should not trade mutual funds on July 3 or July 5 because the those are low volume days and "on low volume days, it is easier for the funds to track us." (SEC Ex. 249; Tr. 288-90.)

In May 2002, Chester proposed using PSPF share classes C and D interchangeably to trade Janus midcap fund pursuant to TW&Co.'s capacity agreement. (Tr. 291-94; SEC Ex. 686.)

On June 7, 2002, Christian sent Chester an email with the subject line "thought you might be interested." Christian copied a story from a website, entitled "Market Timing Costs Funds $4 billion a Year," into the body of the email. The story indicated that "the NAVs that international funds (mutual funds holding international equities) calculate at 4:00 p.m. EST are [38] based on securities prices that are half a day old," and that "[t]imers take advantage of that because they can predict whether the funds' underlying securities will rise or fall the following day. International markets usually perform the same way U.S. markets did the day before." (SEC Ex. 624.)

On July 30, 2002, Chester sent instructions to at least one broker that "I NEVER want to see the words 'Market Timing' on any correspondence, e-mail, telephone call etc. If you want to label what we do with something, call it 'dynamic asset allocation', but never market timing!" (SEC Ex. 231.)

In one email dated July 30, 2002, Chester wrote that "[w]e can assume a certain level of kickouts, but nevertheless tough to be close to exact." (SEC Ex. 226.) Similarly, Dr. Profit, head of PCM's Research and Development Department, ran a trading analysis assuming that PCM suffered from a 25-50% kick out rate. (SEC Ex. 407; Tr. 1708-10.) While Profit testified that he did not conduct a study to reach this rate, his assumption, as PCM's head of Research and Development, was an educated and knowledgeable estimate.

[39] In August 2002 Christian sent fifteen Bank of America account agreements to Donegan for her to open five new accounts for each of PSPF's classes A, B and C.

On August 20, 2002, Chester sent an email to Profit, CC'ing Omid, that states:

> For our strategy, the following can be said: . . . Our return and our models are NOT based on us taking market views, they are based on us taking advantage of mispriced securities (in our case, mutual funds). To pretend any different is stupid. Even Jafar has admitted that the value of us trying to predict positive momentum is a lot less valuable than capturing our edge.

(SEC Ex. 59.)

On October 4, 2002, Chester had an email exchange with Christian in which Christian indicated that Invesco had "captured," or frozen, all of Pentagon's accounts that were trading the Invesco technology fund. (Defs. Ex. 59; Tr. 301-303.)

On October 31, 2002, Chester wrote an email about a hedge fund known as "Spire/Tower." Chester stated that "[h]is ticket sizes have decreased and therefore his number of trades have also increased substantially in recent years – as we would [40] expect for someone trading under the radar screen. And he uses various sub-entities to place the deals – *i.e.,* like our LLCs." (SEC Ex. 209.)

On December 27, 2002 Chester sent Christian an email inquiring whether a mutual fund complex had kicked Pentagon out, which Christian understood to be asking whether "we were no longer allowed to trade the fund because we got kicked out by the mutual fund timing police." (SEC Ex. 250, Tr. 290-91.)

On January 15, 2003, Rose asked Donegan to complete a document for CIBC World Markets that provided that all transactions pursuant to the agreement shall be subject to the regulations of all applicable federal, state and self-regulatory agencies, including but not limited to the SEC. (SEC Ex. 698.)

On March 19, 2003, Tran sent an email to Donegan asking that when she received paperwork to open Pentagon accounts at Prudential Securities in New York, she "play around with the name" on the accounts "so instead of Pentagon Management

Partners can you call it Management Partners and on the second line write C/o PSP I've found out by change the [41] format this confuses the Fund Company and they're unable to detect who we are for a good few months." (SEC Ex. 703.)

Tran also wrote in a March 19, 2003 email that he had forwarded to Donegan account opening forms to open five accounts with Wall Street Discount, and that Donegan should "mark the first line c/o Olympia, and then the second line as normal." (SEC Ex. 703.)

Two PCM internal emails refer to under the radar trading as "Stealth Trading" in the context of PCM's research into the practices of other market timers.

On July 9, 2003, Matthew Ember ("Ember"), a trader at PCM, sent an email to Chester, Anthony Profit ("Profit"), head of the PCM Research and Development Department, and Omid describing a conversation he had with a hedge fund known as "Axiom." Under the heading "Stealth/distribution," Ember wrote:

> Use many small tickets (a couple of hundred k) Understand 'hot spots' for fund companies, often by explicitly asking them(!) – result is low kickout rate of 2-3% (same as before)
>
> Have about 12 clearers/platforms – same as before – nothing has tightened/no problems in this area.

(SEC Ex. 210.)

[42] On July 31, 2003, Ember sent an email to Directors and Research & Development entitled "Quick summary: US 'bottom feeders' doing pure long-only International under the radar," which described a hedge fund known as "Blackpoint," to which Chester directed investments on behalf of the fund-of-funds, Talisman. (SEC Ex. 217.) Under the heading "Stealth," Ember described Blackpoint's trading as "[j]ust small ticket sizes, trial and error, etc. (didn't mention anything original that we've heard elsewhere, like phoning up the fund companies and asking them)." (*Id.*) The same day, Chester replied to Embler's email, saying "obviously, after each of these, put them on the file." (*Id.*)

On August 5, 2003, Chester received a memorandum discussing market timing hedge funds from a European banker. Chester's response was "[n]ote: no mention of Pentagon anywhere. This means either one of two things: i) we really are well below the radar screen, which is good news (!) or ii) he's not as knowledgeable about the sector as he professes(!!)." (SEC Ex. 203).

[43] On August 22, 2003, Ember sent an email to Chester, Omid, and Research & Development describing a conversation with the hedge fund NettFund. Ember wrote "Entirely international, small tickets, under the radar (average $250k tickets, means about 250 trades on a full go in day), lots of different entities, etc." (SEC Ex. 199.)

The Defendants were aware that their trades had been rejected or that they were kicked out of the Oppenheimer Funds, Ivy Funds, Goldman Sachs Funds, Sentinel Funds, Federated Funds, Van Kampen Funds, First American Funds, Pilgrim Funds, ING Funds, Putnam Asia Pacific Growth Funds, Putnam Europe Equity Funds, Evergreen Funds, Seligman Funds and Defendants continued trading in these funds after these "kick outs." (SEC Ex. 256, SEC Dem. Ex. 11 (Oppenheimer); SEC Exs. 642-46, Tr. 1252, SEC Dem. Ex. 28(Ivy); SEC Exs. 858 & 867, SEC Dem. Ex. 30 (Goldman); SEC Ex. 282, SEC Dem. Ex. 15 (Sentinel); SEC Ex. 373, SEC Dem Ex. 26 & 27 (Federated); SEC 233, SEC Dem. Ex. 9 (First American); SEC Ex. 108, SEC Dem. Ex. 5 (Pilgrim); SEC 748, SEC Dem. Ex. 18(ING); SEC Ex. 291, SEC Dem. Ex. 20 (Putnam); SEC Ex. 343 & 748, SEC Dem. Ex. 22 (Evergreen); SEC Ex. 345, SEC Dem. Ex. 23 (Seligman).) Defendants were further aware that [44] they were kicked out of the AIM funds for market timing. (SEC Ex. 234, 677, 678, 679, 839, 840, 841, 842.)

SEC witness Samuel Engelson ("Engelson") reviewed TW&Co.'s files and assembled various documents demonstrating both PCM's cloning of accounts to continue trading U.S. mutual funds following kick outs. (Tr. 181-205, 1136-1156, 1755-1760; SEC Ex. 839, 840, 841, 842, 858, 859, 860, 861, 863, 864, 865, 866, 867.)

Between 1999 and 2003, PCM placed a total of 44,488 mutual fund transactions through thirteen

U.S. broker-dealers. (SEC Ex. 420, App. 3.) These transactions totaled over $14 billion. (*Id.,* Ex. 4.) PCM had an average holding period of three days, and a median holding period of two days. (*Id.* Ex. 5). Of these transactions, 22,448 were buys totaling over $7,128,391,744 (over $7.1 billion) and 22,038 were sells/redemption totaling $7,178,636,179 (nearly $7.2 billion). (*Id.,* Ex. 4).

The Defendants participated in market timing under the radar with knowledge that certain of the mutual funds sought to eliminate the practice.

[45] **G. Late Trading By PCM**

On March 30, 1999, Chester emailed three PCM employees as follows:

> On the assumption that we will be investing an initial $2m with Morgan Stanley for onward investment in Templeton, the following dealing arrangements have been agreed: –
>
> You will need to contact Graves Kieley by phone (follow up fax) 5 mins before Templeton's dealing cutoff time (which I believe is 9pm[2]). Graves will then place the deal.
>
> Best thing to do is contact Graves directly and talk through the exact procedure with him to ensure no cock-ups. . . . Make sure you have 2 other people to contact and 2 fax

---

[2] This is equivalent to 4 p.m. ET.

> numbers, and discuss with Graves worse case scenario – i.e. can't get hold of anyone . . . what do you do?

(SEC Ex. 52).

As found above, in early 2001 PCM began trading through TW&Co. after Wilson and Christian joined the firm.

Wilson and Trautman, the president and CEO of TW&Co., met with Chester to greet him shortly after Wilson joined TW&Co. [46] There was reference at that meeting to legal advice relating to mutual fund trading. Trautman credibly testified that during that meeting Chester and Wilson discussed that the mutual fund trading business that they were engaged in had been vetted through some sort of legal review. (Tr. 1397-1404.)

PCM first started late trading through TW&Co. on February 15, 2001. Initially, PCM sent its orders to TW&Co. before 4:00 p.m. ET, but was allowed to cancel trades after 4:00 p.m. ET. (Tr. 225-28, 461.) Wilson and Christian sent PCM's late trades to Bank of America via the Mutual Fund Order Entry Processing system ("MFRS"), which was created by the software company Automatic Data Processing ("ADP") to process mutual fund trades (Tr. 225-30). This system was open until 5:15 or 5:30 p.m. ET. (SEC Ex. 10, 11; Tr. 225-26.) TW&Co. soon switched to a system called RJE, which shut down at 6:30 p.m. ET. (Tr. 230; SEC Ex. 6.)

On February 15, 2001, the day PCM began trading through TW&CO., Chester emailed Jack Governale, Esq., ("Governale") of Wolf, Block, Schorr, & Solis-Cohen LLP, PCM's U.S. counsel. The subject of the email concerned PCM's attempt to sell shares of three Federated mutual funds through Wall St. [47] Discount Corp. ("WSDC"), an effort which was frustrated by WSDC's failure to honor a redemption request. The email contains the following:

> Please note that I have instructed Wolf Block Schorr Solis-Cohen to liase with Justin Morcom at Wall Street Discount Corp. in respect of positions we have with Federated mutual funds.
>
> In brief, we put in a redemption request to withdraw our funds from Federated on Tuesday afternoon *before the fund's cutoff dealing point*. . . . Wall Street Discount have informed us that Federated ignored our redemption request and kept us invested in the funds, without giving good reason.
>
> On Wednesday afternoon, *before the fund's cutoff dealing point,* another redemption request was placed by Wall Discount Corp. Once again, this was ignored by Federated and they kept us invested in the funds, without giving good reason. . . .
>
> I have asked Justin Morcom to put Federated on notice of our intention to take legal action against them, and to elicit * * address/person to write to in respect of this matter. I have also asked Justin to write a statement for

> Wolf Block outlining the facts of this matter. I have also instructed them to continue placing redemption requests with Federated so as to mitigate our losses.
>
> Jack Governale, on behalf of Wolf Block, will project manage the proceedings.
>
> Regards,
> Lewis

(Defs. Ex. 92 (emphasis added).)

[48] Chester testified that that he did not recall anything about the February 15, 2001 email, sending this document, or the circumstances surrounding the dispute between PCM and the Federated Funds, (Tr. 485-7; Chester Dep. Tr. 237.)

Likewise, Governale testified that that he did not recall this February 15, 2001 email or the circumstances surrounding it. (Governale Dep. Tr. 75-7.) When asked what the phrase "fund's cutoff dealing point" referred to, however, Governale testified as follows: "The trading deadline for mutual funds generally is the close of the trading day 4 o'clock." (*Id.* at 76.)

Wilson and Christian had Excel spreadsheets on their computer that captured all the positions that PCM owned. The spreadsheets were set up with a "from" symbol, indicating the mutual fund, the account number, and a "to" column with the symbol that they were trading into with the share amount or quantity listed. Wilson and Christian printed the spreadsheets every day on behalf of PCM to be prepared for their orders. (Tr. 230.)

[49] On April 5, 2001, Chester sent an email to Wilson and Christian at 7:31 a.m. GMT (*i.e.,* 2:31 a.m. ET), with the subject header "After Hours Trading." It states as follows:

> **AFTER HOURS TRADING INSTRUCTIONS**
>
> I have spoken to my R & D people regarding a procedure for going IN, OUT or cancelling an IN or OUT on any given night, as per our telephone conversation last night.
>
> Lets [sic] us know what the current cutoff time is (5:30pm N.Y. time?) and when you'll have the 6:30pm facility – I think you told me it will be available from Monday???
>
> The procedure we are thinking of putting in place is as follows (subject to speaking this through to Trevor):
>
> – Trevor's team will give you a single figure on the S & P future (e.g. 1320), at or around the close
>
> – If the future exceeds (for an IN) or falls below (for an OUT) – see examples below – after hours, then try to get hold of one of us by telephone
>
> – If you can't get hold of us, then do the corresponding trade

– Send Trevor an e-mail letting him know what you've done

Example 1

Before the close, we go IN/stay IN on all/some baskets.

Trevor calls at 4pm and tells you that if the S & P future falls below 1420 before 6:30pm N.Y. time, to call us.

The future falls to 1418.50.

You try to call us.

[50] You can't get hold of anybody.

You CANCEL all our trades, and send Trevor an e-mail telling him what you've done.

Example 2

Before the close, we go OUT/stay OUT on all/some baskets.

Trevor calls at 4pm and tells you that if the S & P future rises above 1420 before 6:30pm N.Y. time, to call us.

The future rises to 1421.

You try to call us.

You can't get hold of anybody.

You go IN on all baskets, and send Trevor an e-mail telling him what you've done.

My R & D team is building an application for Trevor's team to spew out the requisite S & P future figure each night for you. We should

> be able to be up and running on this within a day or two.

(SEC Ex. 1.)

At 10:25 a.m. GMT, approximately three hours after sending SEC Ex. 1 with the late trading instructions to TW&Co., Chester circulated an email to Omid, the other principal of PCM and PCM's Chief Operating Officer, as well as to PCM's Trading & Dealing and Research & Development Departments. The SEC has characterized this email as the "smoking gun" email, which states as follows:

> For this week only, TW can place or cancel any trades up to 5:00pm (10pm UK time). From next week – TR [PCM [51] employee Trevor Rose] to confirm – the time will be 6:30pm (11:30pm UK time).
>
> The significance of this is great.
>
> For instance, last night, the S & P future shot up at around 9:45pm [4:45 p.m. ET]. Even though we hadn't placed any trades before 9pm [4 p.m. ET], we STILL COULD HAVE PLACED THE TRADE after the bell, which we should have done given the marked rise in the future.
>
> I have been in Jimmy's office. Every day, whether we do a trade or not, they timestamp our trade sheets before 4pm, and then sit on them until they leave the office, at which point they will process them or not. Hence, the ability to place a buy order after

the bell, even if we haven't done so before the bell.

I spoke with Jimmy late last night – too late to trade I'm afraid! We agreed that I would send him some parameters for switching In or Out of the market after the bell, in the event that he can't reach any of us.

AP [PCM employee Anthony Profit]/CK [PCM employee Christian Koehl], can you come up with some simple parameters for this, without giving the game away to Jimmy re: our models. Please bear in mind we trade D, E and F baskets with them currently, and that they might not be able to understand or obtain FV information.

This facility is VERY VALUABLE and we should utilize it accordingly.

We missed a big opportunity to trade last night because nobody was watching the S & P future – Trevor and I were at the game and I only got home at 10:45pm [5:45 p.m. ET]. Equally, I never received a text message saying that the S & P future had gone up considerably.

Conclusion

1. We fucked up last night.

2. It doesn't matter whether we place trades or not before the bell, we can do so afterwards, up to Trautman's time limits

[52] 3. TR – check with Jimmy when they are extending to 6:30pm[ET].

> 4. AP/CK – come up with parameters for Jimmy to trade on our behalf if he can't reach any of us. I will then send him a fax with the instructions.

(SEC Ex. 2.)

Chester testified that "the bell" in the email quoted above referred to the closing bell of the New York Stock Exchange at 4 p.m. ET. (Tr. 521.)

On April 9, 2001, Chester sent an email to Wilson and Christian stating:

> Guys,
>
> 1. Did you find out that question re: BofA margin if we get kicked out of a fund?
>
> 2. Are you know [sic] able to do trades up to 6:30 p.m. N.Y. time? Please confirm.

(SEC Ex. 3.)

Wilson responded in an email to Chester on April 10, 2001 that states, in part, as follows:

> scott [Christian] and i feel that if you are going to use our late trading – "it" (you said) adds a certain [53] percentage of value – we would then like some kind of system or proposal on how we can make money on this . . . [because] if we are going to trade later then we need parameters so we can establish guidelines – im not staying here everynight without cause – i feel things are tight allover and there are only so many places to do this . . so lets be partners or such . . . cheers

(SEC Ex. 4.)

On April 11, 2001, Chester replied via an email that states, in part, as follows:

> Re: Late Trading
>
> 1. We are partners. I have always gone out of my way to support you. When you went to Paine Webber, we gave you assets asap, and then when you went to [TW&Co.], you [sic] gave you assets asap. (When you left PW, you left me in the shit . . . but I accepted it and got on with it.)
>
> 2. Your facility for late trading is not the only one we have. In all the other cases, we pay 1% [per annum].
>
> 3. We pay 2% [per annum] to you and Mike, because that's what you both wanted and we went along with it, even though it's double what we pay elsewhere. . . .
>
> 4. All our other brokers are suffering a bit at the moment. A number of timers have been having a bad time of it, and have been forced to withdraw money from brokers accounts to cover redemptions in their funds. Hence, I am getting calls daily from other brokers asking me "to fill the void" left by other clients taking money out. In other words, I have been giving you money ahead of other brokers who have been asking for it. And that's because I want to be your [54] biggest client, as we had talked about when you left PW.

> 5. You currently earn 2% [per annum]. This is double what Pentagon earns as a management fee. (Our performance fee reflects the strength or otherwise of our modeling decisions, and hence is as variable as our decisions.) We work all the hours of the day to ensure we do our best for the client. To ask you or Scott, or someone else at [TW&Co.] to cover until 6:30pm each night, really is no big deal. And you know it. Remember, the more money we make, the more fees you earn – 2% of a larger figure. Hence, it's in everyone's interests to ensure we get the later trading times.
>
> I really EXPECT you guys to go out of your way to make sure I get late trading – you're earning double what everyone else takes home on this business – although it's unlikely that we'll need 6:30pm trading every night. . . .
>
> I really want to be your biggest client. I want to be first to try your new products. And I want you to have the best facilities/trading. And that's why I am happy to pay you double what I pay any one [sic] else.

(SEC Ex. 4.)

At trial Chester characterized the email as "negotiating" and stated that he had no other late trading facility and that the 1% statement may or may not have been true. (Tr. 540-41.)

On April 11, 2001, Wilson replied to Chester stating, in part, as follows:

> [55] [y]ou guys limit your funds choices and thus restrict the business. You do one type of business . . .
>
> we are the only place to trade late past 530- in the [U.S.] with any brokers. – fact.;^)
>
> thus you have to pay more . . .

(SEC Ex. 5.)

On May 1, 2001, Chester sent an email to Wilson and Christian, stating as follows:

> We're sending you some leverage money – hopefully [CIBC] and your lawyer will get off their backside and complete the bloody leverage documentation! – for domestic funds. Trevor will call you later to discuss.
>
> Hopefully this should stop your endless, pathetic, pittiful [sic] moaning that I've been subjected to for years.
>
> It does mean you might have to work a little harder . . . poor souls, working past cookie and milk time . . . for once in your lives, you can work like real men and do a proper day's work. (You really are a bunch of women of the first order).
>
> Trevor will run through the procedures of how the trading is going to work.
>
> In essence, most of it will be done by you within certain parameters that we will give

> you each day. In the majority of cases, your decision point will be 5:30 pm N.Y. time. In a few cases, your decision point will be 6:30 pm – I know, slave labor . . . whatever will you do working that late!
>
> When there are close decisions, you'll have a list of home/cell numbers for me, Trevor, Jafar [PCM's Chief [56] Operating Officer] and Anthony [another PCM employee] (priority in that order) . . . and we'll make the call. If you can't get through to us, then on a close decision, you'll need to act like men and make the call. (Not too difficult really, as it's not your money!)

(SEC Ex. 6.)

On May 3, 2001, Chester sent an email to Wilson, Christian, and Rose, which stated in part as follows:

> I think Scott [Christian] will need to amend the fee letter to 2.25%, so that Anne [Harrington] at Olympia [Olympia Capital, PSPF's administrator] can accrue properly for the fees. Can you arrange for this to happen.

(Tr. 297-98, SEC Ex. 868.)

These exchanges establish the importance of the late trading facility to PCM.

On May 9, 2001, Profit sent an email to Christian at TW&Co. attaching a document entitled "Notes on Trading Domestic Technology Funds" that provided more detailed instructions on how PCM wanted TW&Co. to execute late trades on behalf of PSPF.

Specifically, the document indicated that PCM's trading model [57] "outputs a couple of lines of text at about 16:10 (New York time)," that is, 4:10 p.m. ET. (SEC Ex. 8.) The document then provided the following trading instructions for trading U.S. mutual funds holding technology companies' securities:

> [T]he procedure for trading these funds is as follows (all times are New York):
>
> 1. At or around 16:10 [4:10 p.m. ET], the dealing team at Pentagon phone Trautman Wasserman to tell them the output of the model.
>
> 2. At 17:30 [5:30 p.m. ET], if the condition on the futures is met and the futures are outside the "warning" band, Trautman Wasserman execute the trades – no need to phone Pentagon.
>
> 3. At 17:30, if the condition on the futures is not met and the futures are outside the "warning" band, no trades executed – TW can go home!
>
> 4. At 17:30, the futures are in the warning band, Trautman phones Lewis [Chester] at Pentagon, or the list of phone numbers that Trevor [Rose] will supply for further instructions, which might include waiting for another hour.

(SEC Ex. 8.)

On June 8, 2001, Rose sent an email to Christian attaching a "revised list of instructions for TW." The new instructions modified the prior "Notes on Trading Domestic Technology Fund" as follows:

> If Pentagon is unreachable and the futures are in the warning band at 18:30 [6:30 p.m. ET], then Trautman should take a half position. So if we're going in to [58] the market, put half the funds in. If we're coming out, take half out.

(SEC Ex. 9).

Sometime in late 2001, likely after August (Tr. 337-39), Sassano left a voicemail for Chester stating the following:[3]

> Hey Louis, it's Sassano. Uhm, Listen, here's the scenario. Uhm. I don't care what Trevor or what Jimmy's touting you as his time for cut off or whatever it is, Bank of America is closing off their deal with the guy. Alright? You wanna tell him that I said so, go right ahead, but I would prefer you not.
>
> You know, we'll take care of your trades the way you want. If you guys don't want to trade with us, that's okay too. But uhm, you know, I don't need those, your guys busting my guys balls. Alright? So uhm, come on down here. Let me explain to you the way this thing works these days. I'll, I'll make it nice n' cheap for you. I mean there's no big deal, and there's no rush, and there's no

[3] There is some conflict over whether any part of the tape containing the voicemail was deleted. (Tr. 2169-73.)

> hurry and there's no problem. But uhm, trust me, this 8:30 trading crap that he's got going on . . . He's, I'll explain the scenario later. Just stand clear and don't try to pressure anybody to do something stupid, cause pressuring us is the wrong move.

(SEC Ex. 19.) Chester received this voicemail (Tr. 558-63) and Christian testified that Chester played it for him (Tr. 338-39, 428-32).

[59] Between May 14, 2001 and June 16, 2002, Tran at PCM typically sent one-sentence emails to Christian at TW&CO., usually shortly after 4:00 p.m. ET, describing what the parameters for PCM's late trades that evening would be. (SEC Ex. 12 (compiling such emails).)

Prior to receipt of these emails, Christian would time-stamp potential trade sheets based on PCM's existing position. PCM's trades were either from an equity mutual fund to a predetermined bond or cash fund (in the case of sells), or from a bond or cash fund to a predetermined equity fund (in the case of a buy). Thus, Christian was able to create trade sheets reflecting PCM's potential trades before 4:00 p.m. ET. (Tr. 231.)

Both SEC and Defense witnesses explained that one of the advantages to late trading is that PCM could see what various companies' post-4:00 p.m. ET corporate announcements were released and the resulting movements in the futures markets. (Tr. 97, 247, 1336, 1680; SEC Ex. 60.)

[60] Chester's calendar contains a March 11, 2002 entry with the following: "Gigi re: getting Haidar's Prospectuses." (SEC Ex. 39.) Chester's calendar contains an April 2, 2002 entry with the following: "Haidar Conference Call." (SEC Ex. 40.) Haidar refers to Said N. Haidar, the principal of two investment adviser entities, Haidar Capital Advisors, LLC (collectively, "Haidar"). A PowerPoint presentation sent by Haidar to PCM provided examples of Haidar's trading strategy, noting that trades in U.S. mutual funds must be made by 4:00 p.m. ET. (SEC Ex. 41 at 7-8.)

Chester and other PCM employees, acting through a fund-of-funds investment vehicle named "Talisman," directed investments into three Haidar hedge funds, including the Haidar Jupiter Shorty Equity Fund. The prospectus for the Haidar Jupiter Short Equity Fund contained in Defendants' files contains the following concerning late trading:

> Mis-pricings arise for a variety of reasons. For example, open-ended mutual funds, which allow purchase by 4PM Eastern Time for same-day Net Asset Value, value their portfolios at the last traded price on a major stock exchange.

(SEC Ex. 44 at 4-5.)

[61] PCM, via Talisman, invested in another hedge fund, NetFund Offshore Fund, managed by NetFund, Inc., which stated in its offering memorandum contained in Defendants' files that trades in U.S.

mutual funds had to be made by 4:00 p.m. ET to receive that day's NAV. (SEC Ex. 45.). On July 12, 2002, Omid sent an email to Chester forwarding that offering memorandum. (SEC Ex. 45.)

On March 21, 2002, Chester sent an email to a number of PCM personnel, analyzing an academic article entitled "The Wildcard Option in Transaction Mutual Fund Shares," Draft 00-03, published by the Wharton School at the University of Pennsylvania, by Professor Roger M. Edelen of the Wharton School, Professor John M.R. Chalmers of the Lundquist College of Business at the University of Oregon, and Professor Gregory B. Kedlec of the Pamplin College of Business at the University of Virginia Tech (the "Wharton Article") which stated that most funds accept trade up to the 4 p.m. close of the market. (SEC Ex. 31.)

On April 10, 2002, Chester received an email from Professor Andre Perold, a former professor of his at Harvard Business School, attaching an academic article by three [62] professors at the Yale School of Management, William Goetzmann, Zoran Ivkovich, and K. Geert Rouwenhorst, entitled "Day Trading International Mutual Funds: Evidence and Policy Solutions." (SEC Ex. 38.) The article states, in part, as follows:

> [T]ime-zone differences create a special dilemma for U.S. mutual funds that invest in foreign securities. Consider a U.S. mutual fund invests in Japanese equities, most of which are not cross-listed in the U.S.

> Suppose the fund wants to determine the NAV in dollars (U.S.D.) of its shares as of 4PM Eastern Standard Time (EST) to settle the buy and sell orders it receives during the day.[FN1]
>
> > FN1. Among other reasons, 4PM EST is desirable because it allows fund companies to transfer investor wealth among its funds on the same day.
>
> Which prices should the fund use to compute the value of its Japanese holdings? One option is to take the Yen closing prices from the Tokyo Stock Exchange (TSE) and use the Yen/U.S.D. exchange rate that prevails at 4PM EST to compute the dollar value of the portfolio. The TSE closes at 1 AM EST, about nine hours before the opening New York Stock Exchange (NYSE). Therefore, this pricing rule effectively allows U.S. investors to purchase or sell shares in the fund during NYSE trading hours at prices determined at least fifteen hours earlier.

(SEC Ex. 38.) Chester wrote an eight point, two-page email analyzing this article and forwarded it to Profit. (Defs. Ex. 32.) Chester's analysis of this article did not address the fact that the article states that investors can purchase or sell shares during NYSE trading hours.

[63] On April 30, 2002, an entry in Chester's personal calendar from Profit reflects an entry entitled "Zitzewitz Discussion." (SEC Ex. 34). "Zitzewitz" refers to Prof. Eric Zitzewitz, a professor at the

Stanford Graduate School of Business, who wrote multiple articles between 1999-2004 regarding market timing of U.S. mutual funds. (*See* SEC Exs. 36 & 37.)

On May 10, 2002, Profit created a 10-page analysis memorandum entitled "Mid-Cap models" that specifically attempts to replicate the results from the Zitzewitz 2000 and 2002 Articles for the purpose, among others, of back testing actual models and investigating hedging strategies. (SEC Ex. 35.) The references to Zitzewitz 2000 and 2002 Articles refer to articles entitled "Daily Mutual Fund New Asset Value Predictability and the Associated Trading Profit Opportunity" (Zitzewitz, February 2000) and "Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds" (Zitzewitz, March 2002). (SEC Ex. 36, 37.)

The March 2002 Zitzewitz Article states:

> Almost all U.S.-based mutual funds calculate daily net asset values (NAVs) using the most recent price data [64] as of 4 PM Eastern Time (ET) and allow investors to make trades at the current day's NAV up until 4 PM.

(SEC Ex. 37 at 1.) The February 2000 Zitzewitz Article states

> A trading strategy designed to take advantage of the predictability of fund returns would involve buying when expected future returns are high and selling when they are

> low. In practice this would involve checking the market at 3:55PM each day and switching between the fund and cash depending on whether expected next-day returns are high or low.[FN 18]
>
> > FN.18 Almost all fund families allow transactions up to 4:00 p.m. ET; a few even allow one to cancel transactions after 4:00 p.m. ET but before NAVs are reported at 5:30 PM.

(SEC Ex. 36 at 12 & n.18.)

On June 19, 2002, Ember memorialized a conversation he had with Tran about how late trading through TW&Co. worked. The email, entitled "Notes on conversion [sic] with QT concerning evening models etc.," states, in part:

> TWC allow late switches until around 23:30 [6:30 p.m. ET], priced at the close – these domestic and international trades are useful for catching news releases just after the close. (Historically, we have found returns from these to be volatile.) The thresholds to go in are emailed to Scott & Jimmy (brokers at TWCo) although JO [Jafar Omid]/LC [Lewis Chester] makes the final decision around 23:00 [6:00 p.m. ET].

[65] (SEC Ex. 14.)

On July 18, 2002 at 4:27 p.m., Christian sent an email to Tran with the subject line "Earnings Tonight" that listed companies that would be reporting earnings after the time of Christian's email (Allstate, Delta Air, International Paper, Eli Lilly, Philip Morris, Microsoft, Nokia, Nortel, Sprint PCS, Sun Microsystems) because of the effect on the futures markets and PCM's trading decisions. (SEC Ex. 60; Tr. 307-09.)

On April 17, 2002, Chester and Profit participated in a conference call with personnel from The RAM Group, including a former broker from WSDC who had started a market timing fund. PCM's notes of the conference call include the following:

> After-hours trading
>
> - There is an SEC letter that "legally allows us to trade until the time that the NAV is actually calculated"
> - They've come to direct agreements with fund families to secure late trading.
> - Using after-hours trading moves his proportion of profitable trades from 55% to 68%.
> - They pulled 3 trades in Jan 2002, saving in the region of 6%.

(SEC Ex. 57.)

[66] At his deposition, Chester testified about this subject matter as follows:

> Q: Did you ever look for an SEC "no action" letter or other SEC publication regarding late trading?

A: No.

* * *

Q: Did Pentagon ever seek a legal opinion regarding the legality of late trading?

A: No.

Q: Did Pentagon ever make any attempts to find an SEC "no action" letter –

A: No.

Q: – regarding late trading?

A: No, but we – I relayed the information to Jimmy Wilson, because I was in the habit of giving Jimmy information that I learnt in the marketplace and what Eddy [Stern] was doing seemed very much akin to what Jimmy was doing, which was acting as an introducing broker or someone who was inputting trades through a banking system, so I thought it was relevant information for Jimmy. It wasn't necessarily relevant information for Pentagon, because we weren't carrying out what Eddy Stern purported to tell me he was doing.

Q: What did Jimmy Wilson say when you told him what Eddy Stern had told you?

A: Umm . . . I don't recall if he said anything in particular but I do recall that Scott Christian called me some time shortly thereafter and had said that a friend of his had found the legal opinion and thanking me for bringing it to his attention. Sorry, not the legal opinion, the SEC "no action" letter.

Q: Did he send you the SEC "no action" letter?

A: No.

[67] (Chester Dep. Tr. 211-13.) At trial, Chester testified that that PCM never sought legal counsel regarding late trading or talked to TW&CO.'s compliance department, and never looked for a no-action letter, nor contacted a mutual fund regarding late trading. (Tr. 513, 637, 646.)

At trial, Christian recalled a conversation with Chester in which Chester recounted a conversation with Stern, who managed Canary Capital, a U.S. market timing hedge fund. According to Christian, Chester was told that there was a legal opinion from a white shoe law firm and that in addition there was a SEC no-action letter that supported late trading that PCM's own attorney had. (Tr. 345, 463-64.) Chester testified that Stern had informed him of a legal opinion and an SEC no-action letter that justified late trading. (Tr. 651.)

Following this conversation, on or about February 24, 2003, Christian asked a friend who was an attorney to do a Lexis-Nexis search for the no-action letter and the letter was sent to Christian. According to Christian, he by himself or with Wilson came up with the search terms to find the no-action letter after speaking with Chester. Christian provided copies of the letter to Wilson, and Wilson gave copies to Trautman and, [68] TW&Co. principal, Sam Wasserman, (Tr. 345-48, 352-53; SEC Ex. 784.)

Stern testified that he sought legal advice about late trading between 2000 and 2001 from Rosenman & Colin and that he never waived the privilege as to the advice. (Tr. 1851.) He testified that he did not recall discussing the advice with Chester or that he discussed late trading with anyone outside of Canary Capital, including Chester. (Tr. 1854.)

The totality of the evidence establishes that Stern and Chester did have a conversation relating to late trading and the advice of counsel. Based on the timing of Chester's relationship with Stern, PCM had commenced late trading prior to this conversation. (*See* Tr. 648-52.)

PCM traded U.S. mutual funds through thirteen U.S. broker-dealers. (SEC Ex. 75.) Of these, eleven required that PCM place their trades by 4:00 p.m. ET in order to receive that day's NAV. (SEC Ex. 20, 909.) PCM discussed late trading with at least five of these broker-dealers (Paine Webber (SEC Exs. 15, 18); CIBC (SEC Exs. 19, 20, 909); Wall Street Discount (SEC Exs. 20, 27, 909, Quang Tran Dep. Tr. 200); Investex (SEC Exs. [69] 20, 21, 22, 909); Millennium (SEC Exs. 153, 154) but was not granted it. Others (Prudential (SEC Ex. 17), Solomon Smith Barney/ Citigroup (SEC Ex. 20, 909; Quang Tran Dep. Tr. 98), Brown Brothers Harriman (SEC Ex. 20, 28, 909)) told

PCM that orders had to be placed prior to 4:00 p.m. ET.

Chester requested late trading from Justin Ficken ("Ficken"), a Prudential broker-dealer, who testified that Chester told him that PCM was late trading with TW&Co. and CIBC/Oppenheimer and that he would give Prudential more assets to manage if Prudential would give PCM late trading. (Tr. 1239-43, 1288.) Ficken additionally discussed these issues with Tran. (Tr. 1243, 1245.)

On August 22, 2002, Chester instructed Tran via email as follows:

> Do you want to phone around First Union and see if you can – discreetly – find out who's dealing with Najjy's account there. Then see if you can set up with them too. They might have late trading?

(SEC Ex. 55.) "Najjy" refers the Najy N. Nasser, the head of another U.K.-based hedge fund known as Headstart [70] Advisers Ltd. ("Headstart"), which engaged in late trading and market timing of U.S. mutual funds according to an enforcement action against Nasser and Headstart on April 10, 2008, brought shortly after the filing of this action. *See* Complaint (Dkt. No. 1), *SEC v. Headstart Advisers Ltd.,* 08 Civ. 05484 (S.D.N.Y.) *available at* http://www.sec.gov/litigation/complaints/2008/comp20524.pd; *see also Gabelli,* 653 F.3d 49 at 54.

Tran responded to Chester's August 22, 2002 email the same day as follows:

> I've been in touch with First Union aka Wachovia, I spoke to a mutual funds broker there, it seems they are an outfit like pru [Prudential], solly [Salomon Smith Barney] where you have more than 1 broker at that place.
>
> However this guy does have other timers (I didn't use that word with him) and he is keen on wanting to further discuss. He is on holiday and will get back next week to continue this discussion.

(SEC Ex. 56.)

On August 23, 2002, Chester responded as follows:

> good . . . see if you can find out who Headstart are using. Obviously late trading is key . . . don't know [71] how you find out about this without actually saying it. No doubt you'll work it out!

(SEC Ex. 56.)

On August 27, 2002, Dr. Christian Koehl ("Koehl"), an employee in PCM's Research & Development Department, wrote an email analyzing an article dated July/August 2002 by four professors at the Stern School of Business at New York University entitled "Stale Prices and Strategies for Trading Mutual Funds" (the "Boudoukh Article"). The Boudoukh Article states the following:

> The buying or selling of mutual funds in the United States occurs at the close of trade (i.e., 4:00 p.m.), but the reported prices of the underlying assets in the fund reflect their last traded priced.

(SEC Ex. 33.) The Boudoukh Article goes on to state:

> In general, three implementation methods are possible. First and foremost, an investor can trade directly through the mutual fund complex online (if available) or via automated telephone service. The speed of this transaction can be as quick as 30 seconds; thus, it can be implemented close to the 4:00 p.m. ET transaction deadline. Second, an investor can put in a trade through a broker. Brokers can also trade close to the 4:00 p.m. deadline, but this mechanism has the disadvantage of introducing an intermediary into the process. Third, a number of online trading firms (e.g., Charles Schwab & Company, E*TRADE Group, and Ameritrade) allow mutual fund trading. Transactions [72] through these firms are relatively quick and allow trading across mutual fund families (i.e., the monies invested are through the online account); however, the transactions usually involve a fee (between $9.95 and $29.95) and execution times are sometimes limited. For example, a number of online trading firms require notice by 3:00 p.m.

(SEC Ex. 33.) Koehl's August 27, 2002 email analyzing the Boudoukh Article made nine points, including the following:

> (Tragically) Interesting paper, reads like what could be a blue print to what we are doing, coming from the public domain. . . .
>
> The authors state that all trading has to be done by 4pm U.S. time latest. I suppose it is a little consolation that they haven't heard about late trading . . . yet!

(SEC Ex. 33.)

On October 3, 2002 Tran sent an email to an Australian broker-dealer. In the email, Tran stated the following:

> Thank you for your email, I'm getting my R & D team to look at the fund list. In the mean time can you confirm the cut off time for the funds on the platform and do I get the same day NAV or the next day NAV. Typically with a UK Fund Platform we invest at 12 GMT, with European platforms this varies throughout the day and the U.S. we have to place orders just before the U.S. Close at 4pm EST. On all platforms we receive same day NAV. I assume for Australia we have to place orders before Market Close.

[73] (SEC Ex. 50.)

At the end of 2002, Coppola left Paine Webber and joined a small broker-dealer in New Jersey, Concord Equity. (Tr. 1328.) Shortly after Coppola joined Concord, Pentagon opened accounts and began trading U.S. mutual funds through Concord. Defendants engaged in a limited number of late trades through Concord. (Tr. 1332-33.) On April 30, 2003 Tran emailed Chester, Omid, and Bristow regarding a lunch he had with Coppola. That email states "Dino informs me we are the only people that have late trading and they only stay late for us (I think you mentioned this to me before Lewis)". (SEC Ex. 543; *see also* SEC Ex. 92.) Evidence presented demonstrated that Coppola permitted PCM to trade up to 4:20 p.m. ET. (SEC Exs. 20, 909.)

On May 14, 2003, Chester sent an email to Ron Basu, at Lehmann Brothers. In discussing non-U.S. mutual funds, Chester wrote the following:

> Ron, these work just like the U.S. funds, except dealing time is 3pm London time. If we were able to convince them to allow us to trade at 9pm London time, they would be exactly the same as any U.S. mutual fund.

(SEC Ex. 51.)

[74] At his September 23, 2010 deposition, when questioned about academic articles reviewed by PCM, Chester testified as follows:

> Q: So an academic who is publishing a paper on the market timing of United States mutual funds states that all trades have to be placed by 4 p.m. Eastern Time and doesn't appear to know or even understand the concept of late trading, did that raise any red flags to you?
>
> A: I understand the concept is not what . . .

Q: OK. Did point number five raise any red flags for you?

A: No.

Q: Why not?

A: I wouldn't expect an academic to necessarily know every feature of a particular marketplace.

Q: Would you expect an academic to know the structure of the marketplace?

Mr. Razzano: Objection.

A: I would expect an academic to be able to analyse statistical numbers and return streams and come up with a view as to the predictability of those return streams and whether they have alpha or not.

(Chester Dep. Tr. 248-49.) At trial, Chester testified that "I do not expect professors to know the ins and out of a particular marketplace." (Tr. 588.)

[75] Chester and PCM were aware of the 4 p.m. closing time of the NYSE and its significance to the mutual funds and the assignment of NAVs.

Following the announcement of the Canary enforcement action in September of 2003, Chester received a request for a letter stating that "Pentagon has not engaged in late trading or any other illegal activity." (SEC Ex. 63.) Chester responded "not a problem." (SEC Ex. 63.) That same day, September 18, 2003, Chester provided the requested letter, which states that all arrangements PCM has entered into "are in accordance with the relevant rules, regulations, investment prospectus, and/or any other such relevant documentation relating to the investment(s) concerned" and that PCM has "never entered into arrangements with any U.S. onshore Mutual Fund in order to trade post-4:00pm EST for same-day NAV." (SEC Ex. 65.) When prompted by the United Kingdom Financial Services Authority (the "FSA") to produce certain documents and other materials, Defendants did not produce the Sassano voicemail or SEC Ex. 2 (the "smoking gun" email) (SEC Ex. 637; Tr. 2142-43, 2164-66, 2174-77.)

[76] Between February 15, 2001, and September 3, 2003, PCM placed approximately 10,052 purchases of open-end U.S. mutual funds through TW&Co., totaling a principal investment of over $3.1 billion. (SEC Ex. 420.) PCM had an average holding period of two days on the purchases. (*Id.*) PCM realized profits of approximately $38,416,500.00 (approximately $38.4 million) from the U.S. mutual fund trades executed through TW&Co. (SEC Dem. Ex. 31.)

III. CONCLUSIONS OF LAW

A. The Applicable Standard

This action is brought pursuant to Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a), Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. Those sections are among the federal securities laws' antifraud provisions that "prohibit the use of fraudulently misleading representations in the purchase or sale of securities." *SEC v. Parklane Hosiery Co. Inc.,* 558 F.2d 1083, 1085 n.1 (2d Cir. 1977).

[77] Section 17(a) of the Securities Act makes it unlawful in the offer or sale of any security, using the mails or an instrumentality of interstate commerce, directly or indirectly

(1) to employ any device, scheme or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a).

Section 10(b) of the Exchange Act prohibits any person, using the mails or any instrumentality of interstate commerce or the facility of a national securities exchange, from employing, in connection with the purchase or sale of any security, "any manipulative or deceptive device or contrivance in contravention of [SEC] rules and regulations." 15 U.S.C. § 78j(b). Rule 10b-5 thereunder makes it unlawful for any person, directly or indirectly, by the use of any means or [78] instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange:

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

> To establish a violation of Section 10(b) and Rule 10b-5, the SEC must "prove that in connection with the purchase or sale of a security the defendant, acting with scienter, made a material misrepresentation (or a material omission if the defendant had a duty to speak) or used a fraudulent device."

VanCook v. SEC, 653 F.3d 130, 138 (2d Cir. 2011) (quoting *SEC v. First Jersey Sec., Inc.,* 101 F.3d 1450, 1467 (2d Cir. 1996)); *see also SEC v. Monarch Funding Corp.,* 192 F.3d 295, 308 (2d Cir. 1999); *Pentagon Capital Mgmt.,* 612 F. Supp. 2d at 258; *In re Alstom*

S.A. Sec. Litig., 406 F. Supp. 2d 433, 474 (S.D.N.Y. 2005); *In re Global Crossing, Ltd., Sec. Litig.,* 322 F. Supp. 2d [79] 319, 336-37 (S.D.N.Y. 2004). Thus, "'[c]onduct itself can be deceptive, and so liability under § 10(b) or Rule 10b-5 does not require a specific oral or written statement. Broad as the concept of deception may be, it irreducibly entails some act that gives the victim false impression.'" *Pentagon Capital Mgmt.,* 612 F. Supp. 2d at 261 (quoting *United States v. Finnerty,* 533 F.3d 143, 148 (2d Cir. 2008)).

In the context of the securities fraud statutes, scienter means the "'intent to deceive, manipulate, or defraud; or at least knowing misconduct.'" *VanCook,* 653 F.3d at 138 (quoting *First Jersey Sec.,* 101 F.3d at 1467); *see also Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n.12 (1976). Scienter may also be "established through a showing of reckless disregard for the truth, that is, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care." *SEC v. McNulty,* 137 F.3d 732, 741 (2d Cir. 1998) (citations and internal quotation marks omitted); *see also SEC v. Stanard,* 06 Civ. 7736, 2009 WL 196023, at *27 (S.D.N.Y. Jan. 27, 2009) ("An egregious refusal to see the obvious, or to investigate the doubtful, may also give rise to an inference of recklessness. Accordingly, a defendant cannot plead ignorance of facts where there are warning signs or information that [80] should have put him on notice of either misrepresented or undisclosed facts," (citations omitted)). Whether or not such intent existed is a question of fact. *First Jersey Sec.,* 101 F.3d at 1467 (citation omitted).

"Essentially the same elements are required under Section 17(a)(1)-(3) in connection with the offer or sale of a security, though no showing of scienter is required for the SEC to obtain an injunction under subsections (a)(2) or (a)(3)." *Monarch Funding Corp.,* 192 F.3d at 308; *see also Aaron v. SEC,* 446 U.S. 680, 701-02 (1980) (SEC need not establish scienter as an element of an action to enjoin violations of Section 17(a)(2), 15 U.S.C. § 77q(a)(2), or Section 17(a)(3), 15 U.S.C. § 77q(a)(3), of the Securities Act). Thus, Section 17(a) applies only to "offers and sales" and only one of Section 17(a)'s three subsections, prohibiting individuals from "employ[ing] any device, scheme or artifice to defraud," 15 U.S.C. § 77q(a)(1), requires proof of scienter. *Id.*

The Supreme Court has directed lower courts to interpret the Exchange Act "flexibly" and broadly, rather than "technically [or] restrictively." *SEC v. Zandford,* 535 U.S. 813, 819 (2002) (internal quotation marks and citation omitted). [81] "Section 10(b) was designed as a catch-all clause to prevent fraudulent practices," *Chiarella v. United States,* 445 U.S. 222, 226 (1980) (citation omitted), including not just "garden type variet[ies] of fraud" but also "unique form[s] of deception" involving "[n]ovel or atypical methods," *Superintendent of Ins. v. Bankers Life & Cas. Co.,* 404 U.S. 6, 11 n.7 (1971) (internal quotation marks omitted).

To sustain a claim of aiding and abetting liability pursuant to Section 20(e) of the Exchange Act, 15 U.S.C. § 78t(e), the Commission must prove "(1) the existence of a securities law violation by the primary wrongdoer; (2) knowledge of the violation by the aider and abettor; and (3) proof that the aider and abettor substantially assisted in the primary violation." *PIMCO Advisors Fund Mgmt.,* 341 F. Supp. 2d at 467-68 (internal quotation marks and citation omitted). The Commission need only prove extreme recklessness to establish aiding and abetting liability. *See Graham v. SEC,* 222 F.3d 994, 1004-05 (D.C. Cir. 2000).

B. The SEC Has Not Established Liability for Defendants' Market Timing

[82] Market timing alone is neither illegal nor necessarily fraudulent. The SEC to date has not prohibited market timing, and timing a mutual fund may be executed in a myriad of different forms. At core, market timing is the attempt to more effectively predict a fund's NAV than the fund's managers themselves, and as a result reap returns against the fund's long term investors. This is not to say, however, that market timing strategies may not be carried out though the use of unlawful fraudulent devices, and/or material misstatements, and thus violate the securities laws. *See Gabelli,* 653 F.3d 49.

Certain mutual funds under certain circumstances seek, and sought during the period in question, to prevent timing. In civil enforcement actions such as these, as the Fifth Circuit has described:

> The SEC is essentially enforcing corporate regulations on behalf of the various mutual funds. Because market timing itself is not illegal, the SEC had to prove an intent to deceive to fit [the defendant's] behavior within Section 10(b) and Rule 10b-5. This creates a dilemma for the courts, which are asked to determine whether the defendant's *legal* acts are made *illegal* by his compliance or noncompliance with corporate regulations that companies sometimes suspend or ignore, either tacitly or expressly, depending on the circumstances of that particular trade.

[83] *SEC v. Gann,* 565 F.3d 932, 939 (5th Cir. 2009). (emphasis in original). Thus, the inquiry here must be whether the Defendants, in their efforts to market time, engaged in actions or misstatements or omissions that defrauded the mutual funds or aided and abetted their defrauding. Squarely presented, then, is the often blurry line between outwitting another in the marketplace and defrauding him.

This inquiry is further complicated by the fact that while it is the funds that a market timer might seek to and in fact deceive, it is the long term investors of that fund who bear the brunt of the losses caused by market timing through dilution. At the same time, the funds' long term investors may have different and conflicting interests than the funds' advisors, who are incentivized to seek large investors such as market timing hedge funds and the fees and cash flow they bring. (*See* Tr. 1925-26 (Professor Ciccotello stating "there weren't too few timing police, but the timing police were insufficiently independent of the advisor. So the timing police would see the trades . . . and would be unable to stop it because of the business plan of the advisor.").)

[84] In addressing this dilemma, the courts have identified a number of actions as fraudulent when taken in deliberate attempts to avoid the funds' efforts to prevent market timing.

The Fifth Circuit has recognized that both breaking up trades to remain under a fund's radar, continuing to trade a mutual fund after receiving block notices, and the use of multiple registered representative numbers and account numbers demonstrates the intent to mislead mutual funds as to the source of the trades. *Gann,* 565 F.3d 932 at 937-38. In *Gann* the court of appeals affirmed the district court's finding that a stockbroker had committed securities fraud in violation of Section 10(b) and Rule 10b-5 by using multiple registered representative and client account numbers so as to hide his market timing from the funds. Specifically, after receiving block notices, Gann, the broker, would switch the representative or account numbers he was using so as to enable his ability to keep trading. As here, there was no question that the defendant engaged in market timing, just a question as to whether the means employed by the broker violated the securities laws. As the Defendants here do, Gann argued that market timing is legal and, as such, his practices were not deceptive. The Fifth Circuit found that while market timing is not necessarily [85] illegal, a broker's switching of registered representative numbers in order to fly under the funds' radar constitutes a "material misstatement" for purposes of Section 10(b) and Rule 10b-5.

In *SEC v. Ficken,* 546 F.3d 45 (1st Cir. 2008), the First Circuit affirmed a similar finding. In that case, involving several brokers, the district court found that Ficken's use of various registered representative and client numbers in order to facilitate his market timing was a material misrepresentation and that there was sufficient evidence of scienter, based on the use of multiple numbers and breaking down trades to fly under the fund's radar, in order to grant summary judgment in favor of the SEC. *See SEC v. Druffner,* 517 F. Supp. 2d 502, 509-10 (D. Mass. 2007).

At the motion to dismiss stage, the court in *In re Mut. Funds Inv. Litig.,* 384 F. Supp. 2d 845 (D. Md. 2005), a multidistrict proceeding involving private class investor and derivative actions brought against (1) investment advisors of several mutual funds, (2) traders, including Canary Capital, a market timing hedge fund, and (3) broker dealers who facilitated those transactions, found that the private plaintiffs stated a [86] claim against the hedge fund trader defendants because they alleged that the trader defendants were involved in the fraudulent scheme from the outset and were at least one of its architects. *Id.* at 852 n.3, 857-58.

Likewise, in *SEC v. O'Meally,* No. 06 Civ. 6483, 2008 WL 4090461 (S.D.N.Y. Sept. 3, 2008), on a motion to dismiss, Judge Swain found that the SEC had adequately pled an action for securities fraud against several former Prudential brokers in connection with the market timing of mutual funds, where the SEC had alleged that the brokers concealed their identities and those of their clients after the mutual funds had directed them to cease and desist from engaging in market timing practices.

Likewise, in *SEC v. JB Oxford Holdings, Inc.,* No. CV 04-7084, 2004 U.S. Dist. LEXIS 29494, at *20 (C.D. Calif. Nov. 9, 2004), the court found that a clearing firm and its principals' cloning of account numbers "to circumvent the mutual funds' efforts to prevent market timing sufficiently allege[d] a deceptive device, scheme, artifice, or practice in violation of Rule 10b-5(a) or (c)."

[87] The D.C. Circuit denied a defendants' petition for review of an SEC decision, *In re Thomas C. Bridge,* 411 Fed. Appx. 337 (D.C. Cir. 2010), which held that registered representatives establishing of multiple ac-counts with different customer names and numbers, transferring assets between accounts, and transferring accounts between branch offices, in an effort to mislead mutual fund companies as to the identity of their market timing clients constituted fraud. *See In re Thomas C. Bridge,* No. 3-12626, 2009 WL 3100582 at *11 (Commission Opinion Sept. 29, 2009).

These cases stand for the principle that while market timing itself is not illegal, the execution of certain practices to effectuate a market timing plan, such as breaking down trades, cloning accounts, and using multiple accounts and registered representative numbers with the intent to deceive a fund into accepting a trade it would otherwise reject may constitute fraud. However, *In re Mut. Funds Inv. Litig.,* 384 F. Supp. 2d 845, *Oxford Holdings,* 2004 U.S. Dist. LEXIS 29494, and *O'Meally,* 2008 WL 4090461, were decided on motions to dismiss, and *Gann,* 565 F.3d 932, and *Ficken,* 546 F.3d 45, involved brokers, not hedge fund traders, as here. In so far as *Gann,* 565 F.3d 932, or *Ficken,* 546 F.3d 45, are read broadly to hold [88] that market timing prior to September, 2003 when the Canary Capital settlement was announced or 2004 when the SEC issued its final market timing rule, was *per se* fraudulent at least with regard to non-broker defendants, the Court declines to follow these decisions.

As found above, Defendants here engaged in similar practices including reentering funds after kick outs and cloning accounts, as well as utilizing numerous and changing accounts and brokers and registered representative numbers in order to ensure their trades were under the funds' radars. In addition, the evidence presented at trial demonstrates that Defendants were aware that if they were determined to be market timing by the market timing police at certain funds they might be kicked out or their trades rejected; they engaged in practices that they knew produced kick outs; and they anticipated certain kick out rates. (SEC Exs. 226, 407; Tr. 1708-14.) Moreover, the evidence established that Defendants acted with the intent to deceive any fund that might have rejected their market timed trades into accepting those trades by "staying below the radar" through the aforementioned practices, thus avoiding kick outs and hard rejected trades.

[89] However, the SEC has not established that market timing rules prior to September, 2003 were sufficiently clear as to permit liability. As Chief Judge Preska has recognized, prior to October 2003, there was "no clear law governing market timing" and "the definition of market timing was still evolving." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Savino,* No. 06 Civ. 868, 2007 WL 895767, at *14. (S.D.N.Y. March 23, 2007). The SEC did not establish that the funds that PCM traded prohibited market timing (however defined), or that Defendants violated an articulated fund rule with any specific trade, such as against the use of a certain number of multiple accounts or brokers, surpassing a number of trades in and out of a fund (termed in the industry as "round-trips") within a given period, or engaging in multiple small trades that would aggregate to a certain sum. Likewise, the SEC itself did not and has not expressly prohibited the market timing of mutual funds. This is perhaps not surprising given the difficulty presented by regulating the amount and timing of investments in a free market.

Defense expert Professor Macey established that during the relevant time period market timing was pervasive (Tr. 1466), and it appears that many funds had capacity agreements [90] permitting certain, but not most, investors to time the funds, a fact that has been extensively litigated. *PIMCO Advisors Fund Mgmt.,* 341 F. Supp. 2d at 460-61 ("According to the SEC investigations, press reports, allegations in complaints, and expert commentary, many mutual fund companies engaged in huge volumes of undisclosed transactions with Canary and other market timers during the period at issue.") (*See also* Tr. 1869-72 (Professor Ciccotello noting that many of the largest mutual fund families had entered into capacity agreements as well as the potentially divergent interests of the mutual funds' advisors and long term investors); Cutler Testimony, 108th Cong. 11-12 (stating that more than 50% of the largest mutual fund groups entered into one or more market timing capacity agreements).)

Defendants' actions thus took place in an atmosphere of uncertainty. There were no definitions or prohibitions from the responsible agency with respect to market timing, and the funds' enforcement of their provisions relating to timing was discretionary, inconsistent, and occasionally conflicted with capacity agreements. The SEC issued no guidelines as to which fund provisions it might seek to enforce and, of course, prior to the Canary enforcement action by the NYAG in September 2003, [91] the SEC had not initiated any proceedings to obtain the relief sought here.

In addition, the SEC failed to establish the particular rubrics utilized by the funds and their market timing police or that those rubrics were either publicly available, known by the Defendants, or should have been known by the Defendants.[4] It appears, for instance, that the transactional limits varied by fund and over time and proved to be moving and unpublished targets. It is accordingly uncertain if the funds would have rejected Defendants' trades had they not engaged in the aforementioned practices. In the absence of regulation, the failure to establish the funds' specific rules or practices is fatal to the SECs

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[4] The SEC established that Defendants were aware of what they believed to be the standards of the timing police of certain funds at certain points. (*See, e.g.,* SEC Ex. 248 (email from broker at Wall Street Discount recommending that PCM break up purchases into $500,000 blocks "to try to get avoid detection"); SEC Ex. 244 (email from Tran to Ficken stating: "On Alliance are you getting a lot of kickouts? I've just heard on the street Alliance are not monitoring any trades over $200k. May be we need to keep them below $200k for a longer stay."); SEC Ex. 703 (Tran email to Donegan to "play around with the name" on the accounts as this "confuses the Fund Company and they are unable to detect who we are for a good few months"); SEC Ex. 866 (email from Rick Marino at Bank of America to Christian informing him that the Van Kampen Funds have a limit of eight exchanges per account per year and will hard reject any exchanges beyond that limit.) In addition, on some occasions certain funds informed Defendants of their limits. (SEC Exs. 839, 840, 842 (AIM Fund letters stating a limit of 10 exchanges per year).)

market timing case, which is, and must be grounded, upon a theory that the agency is enforcing the [92] specific rules of given funds. In the absence of regulation, the SEC's case must rise or fall on the funds' rules and practices, as it is those rules the SEC seeks to enforce. *See Gann,* 565 F.3d at 939 (discussing difficulty presented by SEC enforcement of mutual fund rules). Accordingly, in order to establish securities fraud in connection with market timing, the SEC must forge a link between a given market timed transaction and a given prospectus or standard utilized by the market timing police of a specific fund. While the evidence presented at trial supports the SEC's general contention that the funds forbade timing and sought to deter it to a point, even during the period between 2001 and 2003 and with respect to certain transactions that prompted certain funds to kick out Defendants or hard reject certain of their trades, the lack of clarity by either the funds' prospectuses or their enforcement policies undermines the SEC's case here.

To be sure, PCM and Chester generally sought to outwit the funds and knew that the funds at least in some instances did not permit market timing. However, the SEC did not demonstrate that in any given instant Defendants knew or should have known a given fund's limits and acted such as to fly below that limit in order to defraud a fund into accepting a trade that that fund [93] would not in fact had accepted, had Defendants not engaged in the various practices they did in order to stay "under the radar." Without the clarity of what the funds' rules were, despite Defendants' general intent to deceive, the SEC has failed to establish the requisite scienter required by Section 10(b), Rule 10b-5, and Section 17(a)(1).

Defendants are likewise not liable under Section 17(a)(2) or (3) of the Exchange Act of 1933 with regard to their market timed redemptions or exchanges of mutual fund shares. Section 17(a)(2) prohibits, in the context of the offer or sale of any security, "obtain[ing] money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 15 U.S.C. § 77q(a)(2). Section 17(a)(3) makes it unlawful to "engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser" in the offer or sale of a security. 15 U.S.C. § 77q(a)(3). Neither Section 17(a)(2) nor Section 17(a)(3) requires a showing of scienter. *Aaron,* 446 U.S. at 695-702.

[94] Here, because the SEC did not establish the funds' particular market timing rules, as embodied in their prospectuses, enforcement practices regarding redemptions or otherwise, or that Defendants in fact took actions that would have operated a fraud with respect to those rules in effectuating redemptions or exchanges, there is insufficient proof that Defendants engaged in any transaction, practice, or course of business which operated or would operate a fraud upon the funds under Section 17(a)(3).

With regard to market timing, the SEC did not prove any untrue statement of material fact or omission with respect to Defendants' redemptions or exchanges. The Honorable Laura T. Swain appropriately noted that a duty to disclose the identity of a broker or trader may arise following a kick out letter from a fund, *O'Meally,* 2008 WL 4090461, at *2-*3, at least where such fund articulates a clear rule or reason as the basis of the kick out. However, under Section 17(a)(2) such a duty could only attach to the redemption of fund shares, not the purchase. While the SEC has proven that certain funds did not approve of short term round trip transactions in some instances, the SEC has not established any untrue statement or material omission with respect to Defendants' *redemptions* or that any statements [95] or omissions were material to the funds with regards to their market timing policies, given the uncertain market context.

Moreover, Section 22(e) of the Investment Company Act, 15 U.S.C. § 80a-22(e), specifically prohibits mutual funds from suspending the right of redemption or postponing the date of payment for a redeemable security made "in accordance with its terms" for more than seven days except in certain enumerated circumstances. Those exceptions include "as the Commission may by order permit for the protection of security holders of the company." *Id.* The SEC did not establish any rule or regulation under this provision with respect to market timing applicable during the relevant period. Thus, without a clear statement regarding the funds' terms or SEC regulation, the funds operated under an obligation to permit redemptions. Defendants are accordingly not liable under Section 17(a)(2) or (3).

This is not to say that all acts to effectuate market timing are permissible or that they cannot be fraudulent. The market landscape with regard to market timing is now different than prior to September, 2003. The SEC's discovery of the mutual fund industry's systemic failure to deter market timing led the agency in 2004 to require that the funds to describe in [96] their prospectuses the risks, if any, that frequent purchases and redemptions may present to other shareholders; state whether or not the fund's board has adopted policies and procedures with respect to frequent purchases and redemptions, and, if not, to provide a statement of the specific basis for the view of the board that it is appropriate not to have such policies and procedures. *See* Final Market Timing Rule, 69 Fed.Reg. at 22,300. In addition, under the 2004 rule, U.S. mutual funds must describe their market timing policies with particularity in order to register under the Securities Act of 1933, including:

(i) Whether or not the Fund discourages frequent purchases and redemptions of Fund shares by Fund shareholders;

(ii) Whether or not the Fund accommodates frequent purchases and redemptions of Fund shares by Fund shareholders; and

(iii) Any policies and procedures of the Fund for deterring frequent purchases and redemptions of Fund shares by Fund shareholders, including any restrictions imposed by the Fund to prevent or minimize frequent purchases and redemptions. Describe each of these policies, procedures, and restrictions with specificity. Indicate whether each of these restrictions applies uniformly in all cases or whether the restriction will not be imposed under certain circumstances, including whether each of these restrictions applies to trades that occur through omnibus accounts at intermediaries, such as investment advisers, broker-dealers, transfer agents, third party administrators, and insurance companies. Describe with specificity the circumstances under which any restriction will not be imposed. Include a description of the following restrictions,

[97] (A) Any restrictions on the volume or number of purchases, redemptions, or exchanges that a shareholder may make within a given time period;

(B) Any exchange fee or redemption fee;

(C) Any costs or administrative or other fees or charges that are imposed on shareholders deemed to be engaged in frequent purchases and redemptions of Fund shares, together with a description of the circumstances under which such costs, fees, or charges will be imposed;

(D) Any minimum holding period that is imposed before an investor may make exchanges into another Fund;

(E) Any restrictions imposed on exchange or purchase requests submitted by overnight delivery, electronically, or via facsimile or telephone; and

(F) Any right of the Fund to reject, limit, delay, or impose other conditions on exchanges or purchases or to close or otherwise limit accounts based on a history of frequent purchases and redemptions of Fund shares, including the circumstances under which such right will be exercised.

SEC Form N-1A, *available at* http://www.sec.gov/about/forms/forum-1a.pdf.

These requirements may affect under the radar trading in the future. Perhaps sufficient clarity has been achieved so as to establish that market timing of a fund, in contravention of its now published rules and practices, may violate the federal securities laws. However, the lack of regulation or clear rules or practices regarding market timing during the period in question cannot be remedied by a finding of liability here. Litigation in the absence of clear standards may further [98] raise due process concerns, upsetting the basic notion that individuals have fair notice of the standards under which they may be held liable. *See generally Skilling v. United States,* ___ U.S. ___, 130 S. Ct. 2896 (2010). Prospective regulation by the SEC and clear rules by the funds are preferable to *post hoc* litigation.

Clear rules for trading in U.S. mutual funds benefit not only long-term fund investors who would benefit though a reduction – potentially in many millions of dollars annually (Tr. 1896-97, 1935-36; SEC Ex. 37) – in the dilution of their shares, but also sophisticated market actors such as Defendants, who may seek gain and avoid liability in a less grey market regulatory environment.

C. Defendants Engaged in Fraudulent Late Trading

SEC enforcement actions against those who late traded during the period in question seek to deter the fraud against funds perpetrated in attempts to circumvent not only the funds' rules and practices, as with market timing, but also SEC regulation. *See* Rule 22c-1, 17 C.F.R. § 270.22c-1. Due to both SEC regulation and the uniform industry practice, well known to [99] Defendants here, that mutual fund trades must be placed by the close of the markets at 4 p.m. ET in order to receive the same day's NAV, the line with regard to late trading is and was startlingly bright.

Every court to have considered the issue of late trading has concluded that it constitutes a violation of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. *See VanCook,* 653 F.3d 130; *Simpson Capital Mgmt.,* 586 F. Supp. 2d at 205 ("Thus, the 'false impression' communicated by the defendants' acts was that the trades were submitted before 4 p.m., when they actually were submitted with the benefit of market moving information after 4 p.m. The mutual funds were misled into thinking that the trades were made before 4 p.m."); *In re Mut. Funds Inv. Litig.,* 384 F. Supp. 2d at 856 ("Late trading is itself illegal, and therefore, as alleged by plaintiffs, a scheme, practice, or course of business effectuating late trading is inherently fraudulent"); *SEC v. Treadway,* 04 Civ. 3464, 2005 WL 713826, at *1 (S.D.N.Y. Mar. 30, 2005) ("In contrast to market timing, late trading is illegal irrespective of whatever representations may have been made to investors."); *see also In re Joseph VanCook,* Exchange Act Release No. 61039, 97 SEC Docket 761, 2009 WL 4005083, at *2 [100] (Nov. 20, 2009) ("'Late trading' refers to the unlawful practice of permitting mutual fund orders received after the 4:00 p.m., pricing time to receive the NAV calculated at or as of 4:00 p.m. that day, instead of 4:00 p.m. the following trading day."). This conclusion reflects the clear and consistent industry practice of calculating NAVs as of the close of the markets at 4:00 p.m. ET.

The Second Circuit has recently recognized that late trading, and actions taken and statements made in order to accomplish it, may constitute fraud in violation of Rule 10b-5(a), (b), & (c). *VanCook,* 653 F.3d 130. Specifically, the Court of Appeals stated:

> We have no trouble concluding that VanCook's late-trading scheme constituted a 'device, scheme, or artifice to defraud,' in violation of subsection (a) of Rule 10b-5; that, by designing and operating his late-trading scheme, and by taking numerous steps to hide it, VanCook made material, untrue statements and omissions, in violation of subsection (b); and that his actions "operate[d] . . . as a fraud or deceit upon any person, in connection with the purchase or sale of any security," in violation of subsection (c).

VanCook, 653 F.3d at 138 (citing 17 C.F.R. § 240.10b-5).

[101] Here, Defendants' submission of late-trade orders constituted a fraudulent device and an implied misrepresentation in violation of Rule l0b-5(b) because it suggested that final orders were received before the funds' 4:00 p.m. pricing time, as reflected in the applicable prospectus language, when, in fact, the trading decisions were made after 4:00 p.m. Defendants were aware that TW&Co. took steps to make it appear to any outside observer that their buy and sell orders had been finalized by 4:00 p.m., when the critical decisions were not made until well after the close of market. The mutual funds were thus deceived into believing that the trades were made before 4:00 p.m. and thus into giving the trades that day's NAV. This is because late trading is by definition a

form of backwards pricing that misleads the recipient fund into believing that the trade was made prior to the close of the markets. As such, unlike market timing, late trading is *per se* fraudulent.

The evidence establishes that Defendants knew that late trading was impermissible and that they were obtaining an advantage over other investors contrary to the mutual funds' rules and SEC regulation. Defendants were repeatedly made aware, and acknowledged, that the cut-off for trading in U.S. [102] mutual funds in order to receive the same-day NAV was 4:00 p.m. ET. (SEC Ex. 50 (email from Tran stating that in order to get the same day's NAV, in "the U.S. we have to place orders just before the U.S. Close at 4pm EST.")); SEC Ex. 51 (email from Chester stating "these work just like the U.S. funds, except dealing time is 3pm London time. If we were able to convince them to allow us to trade at 9pm London time,[5] they would be exactly the same as any U.S. mutual fund.") The funds Defendants late traded specifically required in their prospectuses that trades be placed by 4:00 p.m. ET in order to receive that day's NAV (SEC Exs. 419A, 420A, 421-499) and eight mutual fund witnesses, three at trial, testified that this was the case.

Late trading capacity was valuable to Defendants. (SEC Ex. 2 (Chester stating that "[t]his facility is VERY VALUABLE and we should utilize it accordingly")

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[5] 9 p.m. London time is 4 p.m. ET.

(emphasis in original).) Indeed, Defendants paid more for late trading capacity through TW&Co. (*See, e.g.,* SEC Ex. 4 (email from Chester to Wilson, stating "[r]emember, the more money we make, the more fees you earn – 2% of a larger figure. Hence, it's in everyone's interests to ensure we get the later trading times. I really EXPECT you guys to go out of your way to make sure I get [103] late trading – you're earning double what everyone else takes home on this business – although it's unlikely that we'll need 6:30pm trading every night. . . . And that's why I am happy to pay you double what I pay any one [sic] else."); SEC Exs. 5, 6, 837, 868; Tr. 270, 297-98, 540-41.) As found above, Defendants sought late trading through other broker-dealers but were repeatedly denied. PCM discussed late trading with at least four of these broker-dealers who refused to give them that capacity, while at least three others informed Defendants that their orders had to be placed by 4:00 p.m. ET.

Defendants further received and reviewed multiple academic articles that stated that U.S. mutual fund trades must be submitted prior to 4:00 p.m. ET in order to receive the same-day NAV. The Sassano voicemail in 2001 telling Chester that late trading through TW&Co. was "crap" and that Chester should not "pressure anybody to do something stupid" (SEC Ex. 19) was an additional red flag that late trading was illegal, and Chester's testimony that he "couldn't really understand what [Sassano] was referring to" (Tr. 563) was not credible. That Chester cautioned

Tran to be discreet when inquiring regarding late trading capacity (SEC Ex. 55) and advised him that "[o]bviously late trading is key . . . don't know how you find [104] out about this without actually saying it" (SEC Ex. 56) further establishes Chester's knowledge that late trading was impermissible.

Chester was also aware that TW&Co. falsely stamped timesheets as if orders were placed before 4 p.m. and recognized that this gave Defendants "the ability to place a buy order after the bell, even if we haven't done so before the bell." (SEC Ex. 2.) Given Chester's intelligence, training, and experience both as a hedge fund manager whose business model was premised on the timing of trades and as an attorney, the evidence establishes he knew that false stamps were fraudulent and misleading.

Following the announcement of the Canary enforcement action, Chester responded to a request for a letter stating that "Pentagon has not engaged in late trading or any other illegal activity," to which he responded "not a problem." (SEC Ex. 63.) That same day, Chester provided a letter stating that PCM has "never entered into arrangements with any U.S. onshore Mutual Fund in order to trade post-4:00pm EST for same-day NAV." (SEC Ex. 65.) At that time, Chester knew that he could not confirm that Pentagon had not late traded and that the comfort letter was [105] deliberately misleading or false. Those statements and the fact that Defendants did not turn over the Sassano voicemail or SEC Ex. 2 (the "smoking gun" email) to the FSA when prompted by document requests that should have produced them (SEC Ex. 637; Tr. 2142-43, 2164-66, 2174-77), further establish that Defendants knew that their late trading was illegal.

Given the implied misrepresentation that Defendants made by engaging in late trading as well the evidence that they knew their actions were impermissible, Defendants violated Rule 10b-5, Section 10(b), and Section 17(a). *See VanCook,* 653 F.3d at 138 ("We have no trouble concluding that VanCook's late-trading scheme constituted a 'device, scheme, or artifice to defraud,' in violation of subsection (a) of Rule 10b-5 . . . and that his actions 'operate[d] . . . as a fraud or deceit upon any person, in connection with the purchase or sale of any security,' in violation of subsection (c)." (citation omitted)).

In addition, as the facts establish, Defendants did not act merely in reliance on their broker-dealers, as they have asserted. Defendants directed, indeed micromanaged, the late trading that TW&Co. performed on their behalf. (*See, e.g.,* SEC Ex. 6 (in an email from Chester to Wilson and Christian at [106] TW&Co.: "Trevor [head of PCM's Trading & Dealing Desk] will run through the procedures of how the trading is going to work. In essence, most of it will be done by you within certain parameters that we will give you each day. In the majority of cases, your decision point will be 5:30 pm N.Y. time. In a few cases, your decision point will be 6:30 pm – I know, slave labor . . . whatever will you do working that late! When there are close decisions, you'll have a list of home/cell numbers for me, Trevor, Jafar [PCM's Chief Operating Officer] and Anthony [Profit] (priority in that order) . . . and we'll make the call."); SEC Ex. 8 (email from Profit, PCM's head of Research & Development, to Christian, stating: "the procedure for trading these funds is as follows (all times are New York): 1. At or around 16:10 [4:10 p.m. ET], the dealing team at Pentagon phone Trautman Wasserman to tell them the output of the model. 2. At 17:30 [5:30 p.m. ET], if the condition on the futures is met and the futures are outside the 'warning' band, Trautman Wasserman execute the trades – no need to phone Pentagon. 3. At 17:30, if the condition on the futures is not met and the futures are outside the 'warning' band, no trades executed – TW can go home! 4. At 17:30, the futures are in the warning band, Trautman phones Lewis [Chester] at Pentagon, or the list of phone numbers that Trevor will supply for further instructions, which might include waiting for another hour.")

[107] Defendants argue that regardless they are not primarily liable under Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act because they personally made no false or misleading statement or omitted no material fact in violation of a duty to disclose. As in *Simpson,* Defendants argue that they are not primary violators and that any liability should be solely that of their brokers. *See Simpson Capital Mgmt.,* 586 F. Supp. 2d at 205-06. For this proposition, Defendants rely on *Janus Capital Group,* 131 S. Ct. 2296, in which the Supreme Court limited the scope of liability for the making of

false statements under Section 10(b) and Rule 10b-5(b). In *Janus,* the Court held that liability under Rule 10b-5(b) attaches to those who have ultimate authority over such a false statement, but not to others who do not. The Court concluded that for "purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." *Id.* at 2302.

In Defendants' view, their brokers were the makers of any false statements, and so under *Janus* the SEC's claims of [108] primary violations under Section 10(b) and Rule 10b-5 must fail.[6] Defendants further argue that *Janus'* rationale applies with equal force to Section 17(a) and so, for the same reasons, the SEC's Section 17(a) claim must fail as well.

Defendants' argument is unpersuasive for several reasons. First, *Janus* was a private suit, not an enforcement action brought by the SEC. The Court emphasized this difference, noting that its holding was limited to "accord [ ] with the narrow scope that we must give the implied private right of action" under Rule 10b-5 to private plaintiffs in contrast to the Commission. *Janus,* 131 S. Ct. at 2303 (citation omitted); *id.* at 2302 ("[I]in analyzing whether JCM 'made' the

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[6] TWC and its principals Wasserman and Trautman were found liable for violating the securities laws through late trading and acts to effectuate market timing. *See In re Trautman Wasserman & Co., Inc.,* SEC Release No. 340, 92 SEC Docket 1156, 2008 WL 149120 (Jan. 14, 2008).

statements for purposes of Rule 10b-5, we are mindful that we must give 'narrow dimensions . . . to a [private] right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.'" (quoting *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.,* 552 U.S. 148, 167 (2008)). There is no indication that the [109] Court or Congress intended for actions brought by the SEC to be so limited.

In addition, the private litigant in *Janus* alleged simple false statements claims under Rule 10b-5(b), which prohibits the "mak[ing]" of an untrue statement of material fact in connection with the purchase or sale of a security. The Court's opinion therefore focused on the construction of the operative term "make." In contrast, this enforcement action was brought pursuant to the liability for schemes to defraud, under Rule 10b-5(a) & (c), which utilizes different and broader operative language.[7] *See SEC v.*

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[7] Rule 10b-5(a) provides that it is unlawful "[t]o *employ* any device, scheme, or artifice to defraud." 17 C.F.R. § 240.10b-5(a) (emphasis added). Rule 10b-5(c) makes it unlawful "[t]o *engage in any act, practice, or course of business* which operates or would operate as a fraud or deceit upon any person" 17 C.F.R. § 240.10b-5(c) (emphasis added). Section 10(b) of the Exchange Act, under which Rule 10b-5 was promulgated, provides that, in connection with the purchase or sale of securities, it is unlawful for any person, directly or indirectly "[t]o *use or employ* . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b) (emphasis added).

Lee, 720 F. Supp. 2d 305, 344 (S.D.N.Y. 2010); *see also In re Parmalat Securities Litigation,* 376 F. Supp. 2d 472, 502 (S.D.N.Y. 2005); *In re Salomon Analyst AT&T Litig.,* 350 F. Supp. 2d 455, 472-74 (S.D.N.Y. 2004). That is, the SEC contends that Defendants engaged in wrongdoing by carrying out a scheme to defraud mutual funds through deceptive [110] conduct. Accordingly, while Defendants were certainly aware of the misstatements made at their direction and behest by TW&Co. personnel, the allegations here hinge on Defendants' deceptive conduct.

In sum, Defendants have put forth no persuasive reason why *Janus* should be read to reach enforcement actions brought by the SEC or to claims alleging scheme liability pursuant to Rule 10b-5(a) & (c), and the Court can identify none.

Nor does *Janus* apply to SEC enforcement actions brought pursuant to Section 17(a) of the Securities Act. *See SEC v. Daifotis,* No. C 11-00137, 2011 WL 3295139 at *5-*6 (N.D. Cal. Aug. 1, 2011), (holding that *Janus* does not apply to SEC claims brought pursuant to Section 17(a) of the Securities Act, stating that "[i]mportantly, the word 'make,' which was the very thing the Supreme court was interpreting in *Janus,* is absent from the operative language of Section 17(a). Rather, Section 17(a) makes it unlawful (1) '*to employ* any device, scheme, or artifice to defraud,' (2) '*to obtain* money or property by means of any untrue statement' or omission of a material fact, or (3) '*to engage in'* certain types of transactions.") (emphasis in original).

[111] Notwithstanding, Defendants indisputably had "authority over the content of . . . and whether and how to communicate," *Janus,* 131 S. Ct. at 2303, the late trades here. Defendants sought out late trading through TW&Co., directed TW&Co.'s personnel to place late trades on their behalf in awareness of TW&Co.'s false time stamps,[8] and indeed provided TW&Co. with detailed instructions for how and when to do so, according to Defendants' precise specifications, metrics, and authorization. (SEC Ex. 6, 8.) While this conduct is best described as a fraudulent scheme, the use of a fraudulent device, or an act, practice, or course of business that operates a fraud, Defendants' ultimate authority over both the content of and the decision to make late trades as if they had been placed before 4 p.m. ET is undoubtedly sufficient under even the more stringent standard articulated in *Janus.*

As detailed above, the evidence as a whole demonstrates that Defendants were the creators, directors, and chief beneficiaries of the fraudulent scheme, and as such they [112] are primarily liable. *See SEC v. U.S. Envtl., Inc.,* 155 F.3d 107, 111-12 (2d Cir. 1998) (defendant can be primarily liable for securities fraud

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[8] As previously found, the SEC established that Chester visited the offices of TW&Co. and, according to an email Chester sent on April 5, 2001, was aware that "[e]very day" TW&Co. time-stamped Defendants' trade sheets before 4 p.m. ET but did not process them until after 4 p.m., giving Defendants "the ability to place a buy order after the bell, even if we haven't done so before the bell." (SEC Ex. 2.)

by knowingly or recklessly participating in and furthering a market manipulation scheme regardless of defendant's personal motivation for manipulating the market); *In re Mut. Funds Inv. Litig.,* 384 F. Supp. 2d at 856 ("Late trading is itself illegal, and therefore as alleged by plaintiffs, a scheme, practice, or course of business effectuating late trading is inherently fraudulent.")

D. Aiding and Abetting Liability

As to late trading, having found the Defendants primarily liable for violations of the anti-fraud provisions of the federal securities laws, the Court does not reach the SEC's alternative contention that they aided and abetted the primary anti-fraud violations of their broker-dealers with regard to late trading.

As to the market timing claims, for the same reasons primary liability fails, so too must aiding and abetting liability. To sustain a claim of aiding and abetting liability the SEC must prove (1) the existence of a securities law [113] violation by the primary wrongdoer; (2) knowledge of the violation by the aider and abettor; and (3) that the aider and abettor substantially assisted in the primary violation. *See SEC v. DiBella,* 587 F.3d 553, 566 (2d Cir. 2009) (quotation marks and citation omitted); *PIMCO Advisors Fund Mgmt.,* 341 F. Supp. 2d at 467-68.

Here, prior to September, 2003, the SEC failed to clearly or adequately define, let alone prohibit, market timing and the funds' market timing rules and practices were frequently uncertain. Given this market context, despite the intentional and coordinated attempts of Defendants and their brokers to outwit the funds, Defendants are not liable under an aiding-and-abetting theory because the SEC did not establish that Defendants knew or acted with extreme recklessness with regard to securities violations by their brokers.

IV. Damages and Injunctive Relief

A. The Claims for Relief Are Not Time Barred

At the threshold, Defendants argue that the SEC's claims are time-barred by the five-year statute of limitations [114] in 28 U.S.C. § 2462 to the degree they are based on transactions or conduct that occurred prior to April 3, 2003. In Defendants' view, because the SEC did not file the original complaint until April 3, 2008, all claims for civil penalties based on transactions or conduct that occurred more than five years earlier (April 3, 2003) are time-barred.

There is no merit to this contention. The Second Circuit recently rejected this argument in *Gabelli,* 653 F.3d at 58-61. In *Gabelli,* in the context of an SEC enforcement action bringing market timing allegations, the Court of Appeals held that "since fraud claims by their very nature involve self-concealing conduct, it has been long established that the discovery rule applies where, as here, a claim sounds in fraud." *Id.* at 59. Specifically, the Circuit found that the Commission's claims against Defendants regarding statements made in association with the market timing of mutual funds did not accrue until September, 2003, when the SEC discovered the fraud. *Id.* at 58-61. As Defendants concede, the Commission filed this action within five years of discovery. (Def. Mem. 55.) Accordingly, the claims for relief are not time-barred.

B. Injunctive Relief

[115] In determining whether injunctive relief is appropriate, "[t]he critical question . . . is whether there is a reasonable likelihood that the wrong will be repeated." *SEC v. Manor Nursing Ctrs., Inc.,* 458 F.2d 1082, 1100 (2d Cir. 1972) (citation omitted). Injunctive relief is appropriate where the Commission demonstrates a substantial likelihood of future violations of the securities laws. *SEC v. Cavanagh,* 155 F.3d 129, 135 (2d Cir. 1998); *SEC v. Power,* 525 F. Supp. 2d 415, 427 (S.D.N.Y. 2007). In this regard, courts consider (1) the fact that the defendant has been found liable for illegal conduct; (2) the degree of scienter; (3) whether the violations were isolated or repeated; (4) whether defendant has accepted blame for his conduct; and (5) whether, due to the defendant's professional occupation, he might be in a position where future violations could be anticipated. *Cavanagh,* 155 F.3d at 135 (citations omitted). In addition, "fraudulent past conduct gives rise to an inference of a reasonable expectation of continued violations." *Manor Nursing Ctrs.,* 458 F.2d at 1100.

Defendants have made no meaningful attempt to rebut this inference. As found above, the Defendants intentionally, and egregiously, violated the federal securities laws through a [116] scheme of late trading. This scheme was broad ranging over the course of several years and in no sense isolated. Following the filing of the action by the NYAG against Edward Stern and Canary Capital, as found above, Defendants attempted to cover up their conduct. While Defendants have since admitted to late trading (*see, e.g.,* Tr. 512-13; Defs. FOF 7-8), as on this evidence they must, neither Chester nor PCM have accepted blame for their conduct. Defendants will continue to have the opportunity to engage in similarly illegal conduct in the future. There is plainly a reasonable likelihood of future violations. *See First Jersey Sec.,* 101 F.3d at 1477-78; *see also Power,* 525 F. Supp. 2d at 427.

The SEC's request for the entry of injunctions against future violations of the antifraud provisions of the securities laws as to PCM and Chester is therefore granted.

C. Defendants and Relief Defendant are Joint and Severally Liable

"It is a well settled principle that joint and several liability is appropriate in securities laws cases where two or more individuals or entities have close relationships in engaging in illegal conduct." *SEC v. Calvo,* 378 F.3d 1211, 1215 [117] (11th Cir. 2004) (citations omitted). Here, Defendants and Relief Defendant PSPF collaborated on the mutual fund trading scheme, and Defendants exercised complete control over PSPF's trading. (*See, e.g.,* SEC Ex. 554 (PCM promotional material stating that "[a]ll investments, including hedging transactions are made at a Master Fund level, Pentagon Special Purpose Fund Ltd. (PSPF). . . . PCM is the investment advisor to the Master Fund, and is responsible for all asset allocation decisions . . . PCM's mandate is limited to computer model signal generation and placement of trades on behalf of the Master Fund.").)

As previously found, PSPF opened accounts at PCM's direction, Defendants were responsible for making PSPF's trading decisions, and Defendants late traded on PSPF's behalf, and to its gain, through TW&Co. PSPF received ill-gotten funds and does not have a legitimate claim to those funds. *See, e.g., Cavanagh,* 155 F.3d at 136. The evidence presented renders joint and several liability appropriate. *See, e.g., SEC v. AbsoluteFuture.com,* 393 F.3d 94, 97 (2d Cir. 2004) (trial court retains discretion to impose "joint and several liability for combined profits on collaborating or closely related parties").

[118] **D. Disgorgement**

1. The Standard for Disgorgement

"The primary purpose of disgorgement as a remedy for violation of the securities laws is to deprive violators of their ill-gotten gains, thereby effectuating the deterrence objectives of those laws." *First Jersey Sec.,* 101 F.3d at 1474 (citations omitted). " '[E]ffective enforcement of the federal securities laws requires that the SEC be able to make violations unprofitable. The deterrent effect of an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illicit profits.' " *Id.* (quoting *Manor Nursing Ctrs.,* 458 F.2d at 1104; citing *SEC v. Texas Gulf Sulphur Co.,* 446 F.2d 1301, 1308 (2d Cir. 1971) ("It would severely defeat the purposes of the Act if a violator of Rule 10b-5 were allowed to retain the profits from his violation.")).

The amount of disgorgement "should include all gains flowing from illegal activities, plus prejudgment interest, and 'need only be a reasonable approximation of profits causally connected to the violation.' " *SEC v. Credit Bancorp, Ltd.,* No. 99 Civ. 11395, 2011 WL 666158, at *2 (S.D.N.Y. Feb. 14, 2011) [119] (quoting *First Jersey Sec.,* 101 F.3d at 1475). When calculating disgorgement, however, "separating legal from illegal profits exactly may at times be a near-impossible task." *SEC v. First City Fin. Corp. Ltd.,* 890 F.2d 1215, 1231 (D.C. Cir. 1989) (citation omitted). Therefore, disgorgement "need only be a reasonable approximation of profits causally connected to the violation." *Id.*; *see also First Jersey Sec.,* 101 F.3d at 1475; *SEC v. Drexel Burnham Lambert Inc.,* 837 F. Supp. 587, 612 (S.D.N.Y. 1993). Further, " 'any risk of uncertainty should fall on the wrongdoer whose illegal conduct created that uncertainty.' " *SEC v. Warde,* 151 F.3d

42, 50 (2d Cir. 1998) (quoting *SEC v. Patel,* 61 F.3d 137, 140 (2d Cir. 1995)).

Finally, Defendants object to including losses avoided in the disgorgement calculation. (Defs. Br. at 57.) However, the Second Circuit has long recognized that losses avoided are a proper measure of disgorgement. *See, e.g., Patel,* 61 F.3d at 140.

2. Disgorgement of $38,416,500 is Ordered

Based in part upon the report (Defs. Ex. 132) and testimony of their expert, Professor Ciccotello, Defendants argue that the SEC has not established that the Defendants [120] caused any dilution to the long-term investors in the mutual funds in which they traded and accordingly no damages are appropriate in this case. Professor Ciccotello initially calculated that Defendants' trades caused $50.7 million in dilution. However, he reached his ultimate damages figure of zero by calculating dilution after excluding several classes of trades, encompassing the vast majority of Defendants' trades, including most significantly all trades that Defendants engaged in with a mutual fund or broker that had entered a settlement agreement with the SEC – including TW&Co. Such trades, by Professor Ciccotello's calculation, amounted to roughly 60% of Defendants' transactions. This method is rejected. The fact that a broker or fund has settled with the SEC does not either as a matter of law or for purposes of calculating damages render lawful or not subject to damages any trades Defendants conducted through that broker or with that fund. Moreover, that, according to their expert, 60% of Defendants' trades were in funds or with brokers that have since settled with the SEC supports the conclusion that, as confirmed by the evidence at trial, Defendants sought out brokers who would market time and funds that were susceptible to market timing. Accordingly, the Court places no weight on Professor Ciccotello's dilution estimate.

[121] The SEC seeks $64,139,678 in disgorgement. This figure springs from the testimony and report of SEC expert Professor Harris, who reached this figure by calculating the dilution Defendants' caused long term investors though both their late and market timed trades. (SEC Ex. 420.) Professor Harris reached this figure and identified additional evidence of both market timing and late trading by reverse engineering Defendants' trading data. (*Id.*)

Professor Harris calculated that Defendants' combined first-day net profits from purchases and net losses-avoided from sales at $64,139,678. Professor Harris reasonably used first-day profits as an estimator of the dilution that existing shareholders experienced from Defendants' market timing and late trading, finding that the total first-day net profits earned by Defendants on purchases was $40,248,732 (with 67% of purchases being profitable on the first day) and $23,890,945 net losses avoided for sales (with 56% of sales avoiding losses). Defendants' expert Professor Ciccotello recognized repeatedly that profits from stale price trading strategies, that is market timing strategies, "come at the expense of the non-trading mutual fund shareholders" in the form of dilution. (Tr. 1896-[122]1901.) Defendants offer no serious objection to Professor Harris' calculations. Indeed, Defendants' expert, Professor Ciccotello recognized that he would "not feel comfortable nor do I have the expertise to analyze Professor Harris' model." (Tr. 1911-12.) In sum, were damages to be calculated based upon dilution to mutual fund shareholders due to both Defendants' late and market timed trades, Professor Harris' calculation would be an accurate estimate of damages.

However, Professor Harris' calculation is overly broad based upon the conclusions of liability reached by the Court. First, Defendants are liable only for their late, not market timed, trading. Second, Professor Harris' model accurately calculates dilution to mutual fund shareholders, that is, the additional profits that Defendants' made at the expense of long-term investors, due to stale NAVs. However, it is well established that "[d]isgorgement wrests ill-gotten gains from the hands of the wrongdoer" and "does not seek to compensate the victims of the wrongful acts, as restitution does." *SEC v. Hughes Capital Corp.,* 917 F. Supp. 1080, 1085 (quoting *SEC v. Huffman,* 996 F.2d 800, 802 (5th Cir. 1993)). "'Thus, a disgorgement order might be for an amount more or less than that required to make the victims whole.'" *Id.* The illegal profits [123] Defendants reaped are those they earned from late trading, regardless of whether this figure is the same as that accrued though the dilution to other investors caused by the fact that those late trades were also market timed trades.

In recognition that disgorgement is proper as to the smaller set of Defendants' late trades, not the larger set of Defendants' market-timed trades, $38,416,500, plus pre-judgment interest, is required as disgorgement. As previously found, Defendants late traded through TW&Co. from February 15, 2001 to September 3, 2003. Defendants possessed late trading capacity through TW&Co. from the beginning of their trading there. Thus, PCM made final trading decisions, whether to stick with a previously made trading decision (through inaction or confirmation) or to cancel or actively trade following the 4 p.m. cut-off, for all trades placed through TW&Co. As such, disgorgement of the sum of all profits Defendants accrued through TW&Co. is the appropriate measure of Defendants' illegal profits.

Between February 15, 2001, and September 3, 2003, PCM placed approximately 10,052 purchases of open-end U.S. mutual funds through TW&Co., totaling a principal investment of over [124] $3.1 billion. (SEC Ex. 420.) Defendants realized profits of approximately $38,416,500 from the U.S. mutual fund trades they executed through TW&Co. (SEC Dem. Ex. 31.)

Defendants and Relief Defendant are therefore found joint and severally liable for disgorgement in the sum of $38,416,500 plus pre-judgment interest. This figure is a "reasonable approximation of profits causally connected to the violation." *Patel,* 61 F.3d 139 (citations and quotation marks omitted), with "any risk of uncertainty . . . fall[ing] on the wrongdoer whose illegal conduct created that uncertainty." *Id.* at 140 (citation and internal quotation marks omitted).

E. Civil Penalties of $38,416,500 are Imposed

The SEC seeks maximum third tier civil penalties. Under Section 20(d) of the Securities Act, 15 U.S.C. § 77t(d), and Section 21(d)(3) of the Exchange Act, 15 U.S.C. § 78u(d)(3), the Court determines the civil penalty "in light of the facts and circumstances" of the case. Civil penalties are designed to punish wrongdoers and deter future violations of the securities laws. *SEC v. Haligiannis,* 470 F. Supp. 2d 373, 386 (S.D.N.Y. 2007). Third tier civil penalties are appropriate for [125] violations that involved "fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement" and "directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons." 15 U.S.C. § 77t(d); 15 U.S.C. § 78u(d)(3); *see also SEC v. Credit Bancorp, Ltd.,* No. 99 Civ. 11395, 2002 WL 31422602, at *2 (S.D.N.Y. Oct. 29, 2002).

In light of Defendants' wrongdoing and, as established by SEC expert Professor Harris, the substantial losses those violations created to the funds' long term investors, pursuant to 15 U.S.C. § 77t(d) and 15 U.S.C. § 78u(d)(3), third-tier penalties against PCM and Chester are imposed. The maximum third tier penalty that may be imposed is the greater of the gross amount of the pecuniary gain or, for violations occurring after February 2, 2001, $120,000 for natural persons and $600,000 for any other persons, per violation, pursuant to 17 C.F.R. § 201.1002.

Accordingly, civil penalties in the amount equal to Defendants' pecuniary gain for late trades through TW&Co., a sum of $38,416,500, are imposed.

[126] V. CONCLUSION

The evidence presented at trial established that Defendants engaged in a broad ranging fraudulent late trading scheme through TW&Co. While the SEC established that Defendants intended and took a variety of actions in order to ensure that their market timed trades were accepted by the funds, due to the failure of either the SEC or U.S. mutual funds to issue or enforce clear standards with respect to market timing or actions to carry out market timing strategies during the period in question, the SEC failed to establish that Defendants engaged in securities fraud with respect to their market timing. Defendants and Relief Defendant, PSPF, shall disgorge the total of their pecuniary gain on trades through TW&Co., a sum of $38,416,500 plus pre-judgment interest. Civil penalties of $38,416,500 are additionally imposed and injunctive relief is granted. Submit judgment upon notice.

It is so ordered.

New York, NY
February 14, 2012

/s/ Sweet
ROBERT W. SWEET
U.S.D.J.

**UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT**

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Thurgood Marshall United States Courthouse, 40 Foley Square, in the City of New York, on the 19th day of December, two thousand thirteen,

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Securities and Exchange Commisison, Plaintiff-Appellee, v. Pentagon Capital Management PLC, Lewis Chester, Defendants-Appellants, Pentagon Special Purpose Fund, LTD., Relief Defendant.	**ORDER** Docket No: 12-1680

Appellants Lewis Chester and Pentagon Capital Management PLC, filed a petition for panel rehearing, or, in the alternative, for rehearing *en banc.* The panel that determined the appeal has considered the request for panel rehearing, and the active members of the Court have considered the request for rehearing *en banc.*

IT IS HEREBY ORDERED that the petition is denied.

FOR THE COURT:

Catherine O'Hagan Wolfe, Clerk

[SEAL]

/s/ Catherine O'Hagan Wolfe

AON PROFESSIONAL INDEMNITY QUOTATION REQUESTED INFORMATION

1. Overview

Pentagon Capital Management (PCM) acts as investment advisor to a number of funds which follow a similar strategy. The strategy is best defined as "dynamic asset allocation". PCM's R&D department build dynamic asset allocation models which determine which asset class these funds should be exposed to on any given day. The models are built in order to identify short term trends and counter-trends in world markets. These can include equities, fixed income and cash. Uniquely, the strategy is executed, not by buying and selling stocks and shares, but by switching between different mutual fund families sub-funds on a pre-agreed Net Asset Value basis (i.e. no bid-offer spreads, commissions or other transaction-based costs).

Additionally, PCM's models determine in all instances hedge levels against currency exposure in the funds and place orders on behalf of the funds for the relevant forward currency contracts with Prudential Bache. Further, for some of these funds, their Long mutual fund exposures are hedged by shorting equity index futures in order to provide – to the extent possible – market neutrality. In rare circumstances, net short positions are held on a temporary basis (e.g. on average less than one hour in duration).

2. Directors & Staff

a) *Executive Directors*

Lewis Chester, CEO: Oxford & Harvard Business School; former international corporate attorney with Linklaters & Paines; leverage buy-out experience in the US & UK.

Jafar Omid, COO: Manchester University (Mathematics); Chartered Accountant; Former Managing Partner of mid-sized accountancy practice in the UK; over 10 years of investment management experience.

b) *Non-Executive Directors*

David Chester, Chairman: Founder: Chartered Accountant; Former Senior Partner of mid-sized accountancy practice in the UK: over two decades of investment management experience.

c) *R&D Department*

Dr. Anthony Profit, Department Head: Cambridge University; Phd Mathematics; 3 years of investment management experience.

Dr. Christian Koehl, Analyst: University of London; Phd Numerical Physics; 2.5 years of investment management experience.

Matthew Ember, Analyst: Cambridge University; Msc Mathematics; 3 years of management consulting experience with PwC Consulting.

Daniel Munroe, Programmer: University of London; Msc Operational Research; Delphi programmer.

Mark Thompson, Programmer: University of Strathclyde; Physics & Computer Information Systems; Delphi programmer.

Alex Francis: University of Loughborough; BSc in Computer Science; Delphi Programmer.

Harry Ogata: Head of IT Systems; over 10 years of IT Systems management.

May Loong Lia: IT Systems analyst; MSc in Computer Engineering.

d) Trading Department (Hedging)

Frank Bristow: over 22 years of experience in financial futures, commodities and equity trading; ex-Prudential Bache; Credit Lyonnais, Lloyds Bank, and Sun Life of Canada.

Trevor Rose: over 10 years of banking experience for NatWest Bank Plc; 4 years experience on Pentagon's Dealing desk.

e) Dealing Department

Quang Tran: dealing & back-office experience with Investec Asset Management UK.

Andrew Taylor: over 10 years fund administration & back-office experience with Royal & Sun Alliance.

Andrew Chaplin: over 11 years of banking experience with Barclays Bank Plc.

David Perry: dealing & treasury experience with Halifax Bank (UK).

Lee Mason: financial futures experience on the floor of LIFFE.

f) Administration & Compliance

Vipool Shah: over 15 years of financial advisory experience.

Emma Swords: secretarial function.

3. <u>Fund Structure & Relationships</u>

All investments, including hedging transactions are made at a Master Fund level, Pentagon Special Purpose Fund Ltd. (PSPF). PSPF is an International Business Corporation based in the British Virgin Islands. PCM is the investment advisor to the Master Fund, and is responsible for all asset allocation decisions. PCM or its principals do not act in the capacity of director(s) of PSPF, nor as signatories of the Master Fund or its bank accounts. PCM's mandate is limited to computer model signal generation and placement of trades on behalf of the Master Fund. There are no agreements, warranties, representations or contractual promises regarding fund performance, benchmark tracking or deviation therefrom.

There are a number of funds feeding into the Master Fund. These include a range of Canada Life International (CLI) Pentagon Funds. In these instances, Pentagon acts as the investment manager to these funds, as well as investment advisor to clients purchasing CLI bonds. In carrying out its FSA regulated functions, Pentagon undertakes the usual advisory procedures, including preparing client fact finds, sending letters of recommendation and quotations to the client. In this capacity, Pentagon principally deals with high net worth individuals or their associated undertakings. The signatories in respect of the CLI Pentagon funds are made up of authorised signatories from CLI.

In addition to the CLI Pentagon Funds, three offshore funds – structured as International Business Corporations in the British Virgin Islands – feed into the Master Fund. These funds are administered by Olympia Capital, one of the world's largest third party administrators of offshore funds. Olympia Capital also provide all the directors to these funds. PCM acts only as the investment advisor. As such, PCM has no advisory interaction with investors into these funds. The signatories in respect of these offshore funds – and in respect of the Master Fund – are made up of authorised signatories from Olympia Capital.

Both CLI and Olympia Capital have their own professional indemnity and insurance arrangements in place as it is their ultimate responsibility to ensure that PCM is acting in accordance with the investment mandate of the relevant fund(s).

4. <u>Hedging & Counter-Parties</u>

The principal counter-party on all hedging transactions is Prudential Bache Ltd., a wholly-owned subsidiary of Prudential Inc. of America. Pru Bache also act as the subscription bank for the majority of the non-CLI Pentagon funds.

Frank Bristow, who was our relationship manager at Pru Bache, left to join us in November, 2001. Since his arrival, he has spearheaded the building of a range of proprietary systems, as well as introducing checking systems and procedures to ensure the proper tracking and maintenance of our hedged positions.

Due to our hedging activities and Frank's involvement, we have brought in extra resources – both in terms of personnel and hardware/software – to boost our reporting systems generally. We now believe these to be of a very high standard.

a) Monitoring

All positions are marked to market on a daily basis. In addition, we have a regular intra-day reporting system that follows all new trades – both on the mutual fund and hedging side – reporting each 30 minutes during the trading day. This report is sent to all directors and senior employees.

The Master Fund's administrator, Olympia Capital, also monitors all of the Fund's positions on a weekly basis, as part of their weekly NAV calculation.

Further, Pru Bache monitors all of the Fund's positions, and produces daily reports which are copied to us and the Fund's administrators.

b) Dealing Limits

Frank's team's dealing limits are determined by our proprietary dealing system, which determines the appropriate number of futures contracts required to hedge a particular Long exposure within the portfolio. In addition, Pru Bache set absolute contract limits of 8,000 contracts (including currency forwards). In order to avoid margin calls, all funds keep significant levels of cash liquidity.

Lewis Chester & Jafar Omid, the company's principals, also determine and monitor position limits with Frank's team on a frequent basis, and personally monitor the trade and hedge reports at least twice daily.

c) Sign-Off Procedures

The dealing team is sandwiched between the directors and R&D department, hence providing constant liaison, feedback and interaction.

PCM has instituted a set of sign-off procedures on all mutual fund trades, including the preparation of an automated trade sheet requiring at least 2 authorised signatories.

On the hedging side, PCM directs all trades through Pru Bache (i.e. PCM does not transact directly with the market).