

UNITED STATES COURT OF APPEALS
FOR DISTRICT OF COLUMBIA CIRCUIT
SEP 20 2006
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Case No. 06-1071

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UNITED STATES COURT OF APPEALS
FOR DISTRICT OF COLUMBIA CIRCUIT
SEP 20 2006

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

**FOG CUTTER CAPITAL GROUP INC.,
Petitioner**

v.

**U.S. SECURITIES AND EXCHANGE COMMISSION,
Respondent**

ON A PETITION FOR REVIEW OF AN OPINION AND ORDER
OF THE U.S. SECURITIES AND EXCHANGE COMMISSION

**OPENING BRIEF OF PETITIONER
FOG CUTTER CAPITAL GROUP INC.**

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Dated: September 20, 2006

UNITED STATES COURT OF APPEALS
DISTRICT OF COLUMBIA CIRCUIT

Fog Cutter Capital Group Inc.,

Petitioner,

v.

U. S. Securities & Exchange Commission,

Respondent.

CORPORATE DISCLOSURE STATEMENT

Case No. _____

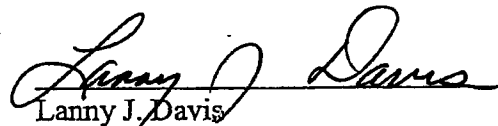
Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure, the undersigned attorneys of record hereby certify that Petitioner Fog Cutter Capital Group Inc. is publicly traded and has no corporate parent, and that there is no publicly held company that owns 10% or more of Fog Cutter Capital Group Inc.'s stock. Fog Cutter Capital Group Inc. operates a restaurant business, conducts commercial mortgage lending and brokerage activities and makes real estate investments; it also seeks to acquire controlling interests in underperforming or undervalued operating businesses in which its management skills and financial structuring can create value.

Dated: February 17, 2006

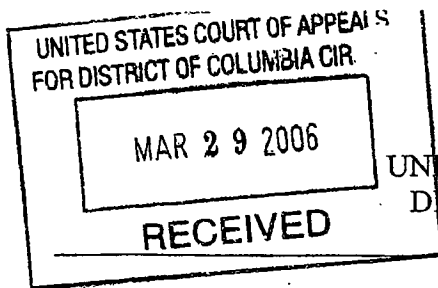
Respectfully submitted,

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UNITED STATES COURT OF APPEALS
DISTRICT OF COLUMBIA CIRCUIT

Fog Cutter Capital Group Inc.,

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U. S. Securities & Exchange Commission,

Respondent.

Case No. 06-1071

September Term, 2005

CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

In accordance with this Court's order of February 27, 2006, and Circuit Rule 28(a)(1), undersigned counsel for petitioner Fog Cutter Capital Group Inc. ("Fog Cutter") submits the following certificate as to parties, rulings and related cases.

(A) Parties and Amici

1. Fog Cutter Capital Group Inc. (petitioner)
2. U.S. Securities & Exchange Commission (respondent)

(B) Ruling Under Review

The order of the U.S. Securities & Exchange Commission Dismissing Review Proceeding appears at *In re Fog Cutter Capital Group Inc*, Exchange Act Rel. No. 34-52993 (Dec. 21, 2005), and is appended to the petition for review.

(C) Related Cases

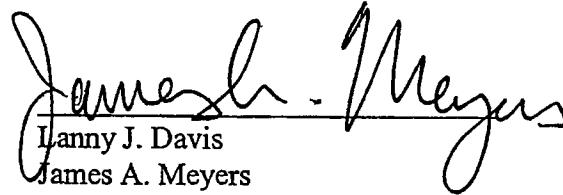
The case on review was not previously before this Court or any other court. No related case is currently pending in this Court or any other court.

Dated: March 29, 2006

Respectfully submitted,

ORRICK, HERRINGTON & SUTCLIFFE LLP

By:

A handwritten signature in black ink that reads "James A. Meyers". The signature is written in a cursive style and is positioned over a horizontal line that serves as a separator between the signature and the printed name below it.

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GLOSSARY

Board	Fog Cutter's Board of Directors
CCI	Capital Consultants, Inc.
Council	Nasdaq Listing and Hearing Review Council
Fatburger	Fatburger Holdings, Inc., an operating segment of Fog Cutter
Fog Cutter or the Company	Fog Cutter Capital Group Inc.
George Elkins	George Elkins Mortgage Banking Company, an operating segment of Fog Cutter
MSLO	Martha Stewart Living Omnimedia Inc.
SRO	Self-Regulatory Organization
WCC	Wilshire Credit Corporation

JURISDICTIONAL STATEMENT

This is a petition for review of a final opinion and order of the U.S. Securities and Exchange Commission (“SEC” or “Commission”) dated December 21, 2005 (“Opinion” or “Order”). *See* Addendum 1. The Order dismissed Fog Cutter Capital Group Inc.’s (“Fog Cutter” or the “Company”) Application for Review of Nasdaq’s decision to delist the Company from Nasdaq National Market. The Commission had jurisdiction to review Nasdaq’s decision pursuant to Section 19(d) of the Securities Exchange Act of 1934 (“Exchange Act”), 15 U.S.C. § 78s(d).

On February 17, 2006, Fog Cutter timely sought review of the Order in this Court. This Court has jurisdiction to hear and decide this petition under Section 25(a)(1) of the Exchange Act, 15 U.S.C. § 78y(a)(1) (“A person aggrieved by a final order of the Commission entered pursuant to this title may obtain review of the order in the United States Court of Appeals ... for the District of Columbia Circuit, by filing in such court, within 60 days after the entry of the order, a written petition requesting that the order be modified or set aside in whole or in part.”).

ISSUES PRESENTED FOR REVIEW

Issue 1: Whether it was in the investing public’s interest for Nasdaq to invoke its ultimate sanction – delisting the Company – and for the Commission to uphold that sanction where (a) neither Nasdaq nor the Commission ever even

accused the Company or any of its officers or directors of any violation of the securities laws; and (b) the Company had previously and promptly disclosed to the investing public every one of the circumstances that Nasdaq relied on to justify its delisting determination, and the investing public continued to trade in the Company's stock at prices and volumes well above Nasdaq-required minimums.

Issue 2: Whether the delisting sanction imposed here was arbitrary in light of the securities regulators' more favorable treatment of other similarly situated issuers, particularly given the Commission's failure to explain how the facts relating to the Company differ from the facts relating to other issuers who have not been delisted.

PERTINENT STATUTES AND REGULATIONS

The pertinent statutes and regulations are set forth in Addendum 2 to this brief.

STATEMENT OF THE CASE

This case is not about any violation of the securities laws. Nasdaq and the Commission have never even accused Fog Cutter or its founder and CEO, Andrew Wiederhorn, of violating the securities laws or any Nasdaq rule or regulation. This case is also not about shareholders, prospective investors, or regulators who were kept in the dark. Fog Cutter's record of disclosure to its shareholders is exceptional and, again, neither Nasdaq nor the Commission has ever accused Fog

Cutter of misleading or failing to disclose material information to the investing public. Indeed, it is undisputed that Fog Cutter promptly disclosed each of the facts and circumstances that Nasdaq subsequently cited to justify its determination that the public interest required delisting the Company.

Instead, this case is about the SEC's abuse of discretion in upholding Nasdaq's delisting decision. As stated, that decision was not based on any violation of the securities laws or Nasdaq rules or regulations. Rather, it was based solely on a subjective, inadequately explained judgment that continued listing of the Company would be contrary to the public interest. Like Nasdaq, the Commission improperly ignored critical facts and otherwise inadequately explained its determination to uphold Nasdaq's draconian sanction. It also failed either to faithfully apply previous decisions of this Circuit and other appellate courts or to treat Fog Cutter in the same way that the securities regulators have treated similarly situated issuers.

Nasdaq's decision to delist Fog Cutter and the Commission's determination to uphold that sanction are principally based on two actions the Fog Cutter Board of Directors (the "Board") took in response to Mr. Wiederhorn's guilty pleas to two criminal violations, neither of which violations involved the securities laws or Fog Cutter's business: (1) retaining Mr. Wiederhorn as Co-Chief Executive Officer and Co-Chairman of the Board; and (2) paying Mr. Wiederhorn a \$2

million leave of absence payment as well as his regular compensation under his employment agreement while he was incarcerated. Prior to these events, Fog Cutter had disclosed the existence of the investigation and the risks associated with it in its public filings going back to 2001. When the Board made the decisions that formed the basis of Nasdaq's decision, it promptly disclosed them and the reasons it made those decisions. Following these disclosures, the Company's stock continued to trade at prices well above the Nasdaq-required minimum price. Nevertheless, Nasdaq deemed after-the-fact that the public interest required delisting the Company, even while it failed to find or even allege that Fog Cutter or Mr. Wiederhorn have ever violated the securities laws or any Nasdaq rule or regulation.

Nasdaq's decision was contrary both to the public interest and to Nasdaq's obligation to safeguard its members and their shareholders. It ignored certain facts demonstrating that the Board acted in the best interest of the Company's shareholders, both in the decisions it made regarding Mr. Wiederhorn and in disclosing those decisions and the reasons for them. The Commission's Order similarly ignored these critical facts – facts demonstrating that (1) Fog Cutter is a strong company, whose Board has consistently acted to protect the Company's value and its shareholders' investments while maintaining a track record of transparent disclosure, and (2) continued listing of the company posed no threat to

the integrity of the public markets. In addition, the Commission's Order failed to address how the facts (or at least the facts upon which it chose to focus) justified treating Fog Cutter differently than other issuers who have not been delisted even though their CEOs were found to have engaged in criminal conduct that violated the federal securities laws or obstructed justice. Under these circumstances, this petition should be granted and the Commission's Order should be vacated.

STATEMENT OF FACTS

A. Fog Cutter And Andrew Wiederhorn

In the years preceding the events here at issue, Fog Cutter evolved under Mr. Wiederhorn's leadership from a real estate investor to a diversified business. By June 2004, in addition to its traditional real estate and other investment activities, it functionally controlled a national restaurant business and a commercial mortgage lending and brokerage company. Its operating segments currently consist of: (a) Fatburger Holdings, Inc. ("Fatburger"), a restaurant chain with annual system-wide sales in excess of \$65 million and over 1,000 system-wide employees; (b) a majority interest in the George Elkins Mortgage Banking Company ("George Elkins"), which has consistently increasing annual production (\$650 million in 2003, over \$700 million in 2004, and \$1.2 billion in 2005), and substantial business relationships with national insurance companies, Wall Street, and major investment banks; (c) real estate holdings, including the lease or ownership of

nearly 80 properties in 29 states and Europe; and (d) other investment banking and financing activities. *See* 2004 Form 10-K/A, filed June 3, 2005 (“2004 Form 10-K/A”), at 3-7 (R. 1289-1293) (JA 512-516). Fog Cutter’s business strategy is to continue to develop its restaurant operations, expand its real estate business, and identify and acquire interests in underperforming or undervalued businesses and then use its management skills and financial acumen to help them reach their potential. *Id.*

Fog Cutter has had an active Board and independent members who take seriously their responsibilities to act in the best interests of the Company’s shareholders. The Board had seven members during the relevant time period, five of whom were independent by Nasdaq’s standards as set forth in Nasdaq Marketplace Rule 4200(a)(15). *See* 2003 Form 10-K/A, filed June 28, 2004 (“2003 Form 10-K/A”), at 35-36 (R. 143-44) (JA 68-69). Those independent directors had the experience and expertise necessary to make sound business judgments. At the time of the Board decisions that form the basis of Nasdaq’s delisting decision, both the Compensation Committee and the Audit Committee consisted entirely of independent directors. *See, e.g.*, R. 644-45; JA 270-71 (minutes of Audit Committee meeting on May 11, 2004, listing five independent directors as members); R. 338-40; JA 241-43 (minutes of Compensation

Committee meeting on May 12, 2004, listing three independent directors as members).

Mr. Wiederhorn has been Fog Cutter's chief architect since he co-founded it. As CEO, Mr. Wiederhorn was responsible for developing Fog Cutter's strategy and overseeing its operations. While Mr. Wiederhorn and his relatives control a majority of Fog Cutter's stock, Fog Cutter has had significant minority ownership, with about 47% of the Company's common stock owned by persons or entities unrelated to Mr. Wiederhorn or his family in any way during the relevant period. *See* Schedule 14A, Definitive Proxy Statement, dated November 1, 2004 ("2004 Proxy Statement"), at 3-5 (R. 1014-1016) (JA 387-389).

B. Mr. Wiederhorn's Guilty Plea And The Circumstances Prompting It: Neither Related To The Business Of Fog Cutter

Prior to founding Fog Cutter, Mr. Wiederhorn founded Wilshire Credit Corporation ("WCC"), the first of a series of companies (collectively known as "Wilshire") created to acquire and service pools of loans, often sub-prime or defaulted loans. *See* 2004 Form 10-K/A, at 8 (R. 1294) (JA 517). Wilshire acquired these pools primarily through funds borrowed from institutional investors. WCC serviced (i.e., served as collection agent for) these loans, for which it earned fees. *Id.* In 1995, Capital Consultants, Inc. ("CCI"), a Portland, Oregon-based investment adviser that managed, *inter alia*, union pension funds, became one of WCC's lenders. *See* Press Release, dated July 20, 2004 (R. 197-202) (JA 122-

127). By 1998, Wilshire owned pools of loans valued in excess of \$2.5 billion and CCI had committed to lend WCC up to \$160 million over a number of years, secured by WCC's interest in specified loan pools and the fees to which it was entitled for servicing all of the loan pools owned by Wilshire (the "Financing Agreement"). *Id.*

In August 1998, the collapse of the Asian economy and a bond default by Russia triggered a "flight to quality" that devastated the sub-prime lending sector. *Id.* Beginning in September 1998, many of Wilshire's secured lenders panicked and began the wholesale devaluation of the assets Wilshire pledged to secure its borrowings. *Id.* The resulting margin calls from these lenders stripped Wilshire of cash and required Wilshire to liquidate bonds and loan pools at fire-sale prices. Between September 1, 1998 and October 15, 1998, Wilshire's share price dropped from \$25 to less than \$5.

To deal with its cash crisis, WCC approached CCI for an additional loan of \$6 million and the release of \$19.3 million of WCC's funds held by CCI as a cash reserve under the Financing Agreement. CCI agreed to both. *Id.* After doing so, its principal, Jeffrey Grayson, demanded one additional item: the return of personal guaranties he had given a Wilshire-affiliated company in early 1998 as part of an agreement under which it acquired two defaulted loans from CCI. *Id.*

Based on the advice given to Mr. Wiederhorn and WCC's other principal officer by in-house counsel, they acquiesced to Mr. Grayson's demand. *Id.*

Despite these steps, over the course of the next three months, Wilshire was forced to file for bankruptcy protection, and it negotiated a restructuring of its debt and business. CCI was one of numerous lenders that participated in this restructuring. *Id.* CCI insisted (for reasons no one else understood at the time) that, in addition to the equity position it acquired in "the new Wilshire," WCC's obligation not be extinguished, even though it came out of the reorganization with no assets or operations.

As Mr. Wiederhorn, "the new Wilshire," and many others learned years later, CCI insisted on retaining WCC's paper obligation as part of a plan to hide investment losses from its clients. *Id.* In essence, it used this obligation to operate a Ponzi scheme. *Id.* As the scheme began to unravel, both the Commission and the Department of Labor (which had jurisdiction due to CCI's role as an investment manager for union pension funds) began to scrutinize CCI's operations. In the fall of 2000, both agencies secured the appointment of a Receiver to take over and liquidate CCI's operations. *Id.* The Receiver ultimately determined that between January 1999 and September 2000, CCI's Ponzi scheme cost its clients in excess of \$100 million.

A criminal investigation followed the collapse of CCI. Mr. Wiederhorn and WCC's other principal officer, Lawrence Mendelsohn, were notified in March 2001 that they were targets of this investigation. *See* 2003 Form 10-K/A, at 10-11 (R. 124-25) (JA 49-50). Both were then officers and directors of Fog Cutter. *Id.* The Company promptly disclosed to the public the target status of both men. *See* Form 10-Q filed May 9, 2001, at 9.¹

A grand jury investigation ensued. Although the Company is obviously not privy to matters occurring before the grand jury, it presumes that an exhaustive effort was made to determine whether Mr. Wiederhorn (and Mr. Mendelsohn for that matter, although he is no longer with the Company) played a role in CCI's Ponzi scheme, bore any responsibility for its collapse, or engaged in any fraudulent conduct whatsoever. The grand jury concluded its work without making any such accusation against Mr. Wiederhorn or Mr. Mendelsohn.

The violation that prosecutors ultimately determined could be pursued against Mr. Wiederhorn was the "intentless" offense created by 18 U.S.C. § 1954, which prohibits any person from giving "any thing of value" to a fiduciary of a

¹ Courts may take judicial notice of the contents of relevant public disclosure documents required to be filed with the SEC as facts "capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned." *Kramer v. Time Warner, Inc.*, 937 F.2d 767, 774 (2d Cir. 1991) (internal quotation omitted).

union pension fund “because of” an act by the fiduciary. The government concluded that Mr. Wiederhorn’s acquiescence to Mr. Grayson’s demand for the return of Grayson’s guaranties met the elements of this statute. The government further contended, and the court agreed, that this was a “general intent” offense and therefore that Mr. Wiederhorn’s undisputed good faith reliance on the advice of counsel and other professionals was irrelevant. (R. 871-82) (308-19) (describing Mr. Wiederhorn’s allocution). In addition, in the course of their scrutiny of Mr. Wiederhorn’s personal tax returns, the government came to believe that he had reported a capital loss on his 1998 return for a transaction that did not appear to be the result of an arm’s length negotiation. Although Mr. Wiederhorn in fact lost money on the transaction, and despite the fact that it was designed and approved by his tax attorneys and accountants and resulted in no reduction in his tax liability and no loss to the government, the prosecutors concluded that he should also be charged with filing a false tax return.

On June 3, 2004, Mr. Wiederhorn pled guilty to one violation of 18 U.S.C. § 1954 and one violation of 26 U.S.C. § 7203, and was sentenced to 18 months in custody. *See* Form 8-K, filed June 4, 2004 (R. 102-114) (JA 27-39). Mr. Wiederhorn served 15 months in custody and six weeks in a work release program, and was reinstated as Chairman and CEO of Fog Cutter in November 2005.

C. The Fog Cutter Board's Actions

When it became apparent that the government was intent upon pursuing charges against Mr. Wiederhorn, Fog Cutter's Board was faced with a series of difficult decisions. As the minutes of the Board's meetings during this time attest, the Board grappled with the best way to ensure the ongoing value of certain of its investments that were irrevocably tied to Mr. Wiederhorn's continued involvement with the Company. In addition, the Board determined that maintaining the goodwill and involvement of Mr. Wiederhorn in Fog Cutter was a necessary factor in the Company's future success: Mr. Wiederhorn built the Company and was the chief architect of its successful strategy for growth. (R. 103-09.) (JA 28-34.)

During this time, Mr. Wiederhorn repeatedly informed the Board that he believed the charges being levied against him were unfounded and that he intended to fight what could be a protracted and costly legal battle against those charges.

The Board made two decisions with respect to Mr. Wiederhorn that form the basis for the Nasdaq's decision to delist. *First*, the Board amended Mr. Wiederhorn's employment agreement in August 2003. *Second*, after significant negotiations with Mr. Wiederhorn, the Board agreed to pay him a \$2 million lump sum as part of a Leave of Absence Agreement it executed in June 2004 at the time of his plea agreement, which itself included a \$2 million restitution payment.

As is evident by its consideration of these decisions, discussed in more detail below, the Board determined that the benefit to the Company's shareholders of retaining Mr. Wiederhorn's services and securing his continued involvement with the Company outweighed the costs of making these decisions, which it knew could be controversial. Recognizing that Fog Cutter's successful business strategy, its past success, and its future growth were attributable to Mr. Wiederhorn's leadership and continued involvement with the Company, the Board made these decisions for three primary reasons:

- The value of one of the Company's most significant assets, its majority interest in George Elkins, was inextricably tied to Mr. Wiederhorn's continued service as an officer or director of Fog Cutter. (R. 103, 109, 225, 237-28.) (JA 28, 34, 129, 141-42.) If Mr. Wiederhorn was removed from those positions, George Elkins' minority shareholders would have the right to repurchase Fog Cutter's majority interest at a fire-sale price relative to its value. (R. 109.) (JA 34.)
- Amending Mr. Wiederhorn's employment agreement would allow the Board to retain Mr. Wiederhorn as CEO and as a Director, and thus the Company and its shareholders would continue to benefit (as they had since Mr. Wiederhorn founded the Company) from his substantial

experience and leadership. (R. 311-28.) (JA 206-23.) The Board determined that it made sense to keep Mr. Wiederhorn on as CEO even if he reached a settlement with the government since the claims did not involve Fog Cutter and did not involve any intentional corporate malfeasance. *Id.*

- Entering into a Leave of Absence Agreement, and making the lump sum payment demanded by Mr. Wiederhorn, would allow the Company to move forward, put the events surrounding Wilshire in the past, and focus on future growth and business opportunities free from the considerable detrimental effects of Mr. Wiederhorn's continued fight with the government. (R. 103-08, 374-78.) (JA 28-33, 263-67.)

As explained in further detail below, each of these business judgments was the result of careful consideration by an active and independent Board intent upon preserving the value of the Company's assets for all of its shareholders.

1. George Elkins

In May 2002, Fog Cutter purchased a 51% ownership interest in George Elkins, a California mortgage banking operation that provided brokerage services related to the production of more than \$650 million in commercial real estate mortgages in 2003 and over \$700 million in 2004. *See* 2003 Form 10-K/A at 4 (R. 120) (JA 45), 2004 Form 10-K/A at 3 (R. 1289) (JA 512). What was initially a

\$2.25 million investment has continued to grow in value, and Fog Cutter's interest could be valued as high as \$10 million today (not to mention the future value it will continue to receive from George Elkins). Despite the events involving Mr. Wiederhorn, *all* of George Elkins's lenders (Wall Street firms, national insurance companies and major banks) have continued to deal with the Company.

When Fog Cutter acquired this majority interest, the sellers remained as principals and minority owners. *See* Stock Purchase Agreement, § 8.3 (R. 1091-92) (JA 435-36); Operating Agreement, § 12.8 (R. 1026-1027) (JA 339-400). During the negotiations for Fog Cutter's investment, which commenced after Fog Cutter had informed the market that Mr. Wiederhorn was a target of the grand jury investigating CCI's collapse, the George Elkins sellers expressed concern about the negative consequences of a change in management if Mr. Wiederhorn left Fog Cutter, and wanted a remedy if he did so.² The heavily negotiated agreement under which Fog Cutter acquired a majority interest in George Elkins enables George Elkins's minority owners to buy Fog Cutter's majority interest at a fixed price substantially below its market value if Mr. Wiederhorn were to leave his positions

² The George Elkins sellers' concern that Mr. Wiederhorn continue to be involved with the Company as an officer or director is independent and compelling evidence of how critical Mr. Wiederhorn has been and will be to Fog Cutter's continued growth and success, and how his active involvement in the Company's affairs will continue to benefit all.

with Fog Cutter. *See* Stock Purchase Agreement, § 8.3 (R. 1091-92) (JA 435-36).

The Operating Agreement governing the investment provides for essentially the same rights. *See* Operating Agreement, § 12.8 (R. 1026-1027) (JA 339-400).

When the Company made a public filing indicating that the government's investigation was nearing an end, the two principals for the minority interest holders of George Elkins contacted Mr. Wiederhorn and, in the course of discussions, expressed their intent to exercise the foregoing right to repurchase their interests if Mr. Wiederhorn were to leave the Company. (R. 237) (JA 141.)

In light of Mr. Wiederhorn's value as an asset of the Company and the George Elkins minority shareholders' position, the Board concluded at that time that it was imperative that Mr. Wiederhorn remain as both co-CEO and a board member in order to protect this investment. (R. 109, 237, 376-77.) (JA 34, 141, 265-66.) Faced with a difficult situation, the Board elected to protect its investment and realize the full value in George Elkins by retaining Mr. Wiederhorn as co-CEO and a director.

2. The Board's Actions Relating to the Terms of Mr. Wiederhorn's Employment

In the summer of 2003, Mr. Wiederhorn initiated a re-negotiation of the terms of his employment by the Company. (R. 245.) (JA 149.) Mr. Wiederhorn hoped to be able to persuade the government not to pursue a charge against him for a no-intent crime that he allegedly committed only after seeking and receiving

advice from his counsel, but he also began to plan for a possible settlement with the government. A critical aspect of this planning involved whether, and under what terms, he would continue to be involved with the Company if he agreed to settle with the government.

Before the amendment, Mr. Wiederhorn's employment agreement provided that he could be terminated "for cause" upon conviction of a felony; if the Company fired Mr. Wiederhorn without cause, certain other provisions of the agreement would be triggered, including a requirement that the Company pay Mr. Wiederhorn an amount equivalent to three times his annual salary and bonus payments, an amount that would have totaled \$6 to \$7 million. In addition, as outlined above, if Mr. Wiederhorn were fired, with or without cause, from his position as CEO and removed as a Director, the George Elkins minority shareholders' repurchase rights would have been triggered, thus causing the Company to lose millions of dollars in potential future earnings from that investment.

The Board recognized that it was important to preserve Mr. Wiederhorn's goodwill in order to benefit from his substantial experience and leadership and to protect the value of the George Elkins investment. (R. 245.) (JA 149.) In addition, it hoped to avoid tying its hands in the future by being limited by an employment agreement with Mr. Wiederhorn that would circumscribe its options with respect to

his continued involvement with the Company if he decided to settle the charges against him. The Board wanted to continue to employ Mr. Wiederhorn on terms that would allow it whatever flexibility in the future might be necessary to allow Mr. Wiederhorn to continue his association with Fog Cutter in the face of any potential settlement with the government, the terms of which were unknowable at the time of the negotiations over Mr. Wiederhorn's employment agreement. Based on the fact that the investigation and potential charges against Mr. Wiederhorn did not involve Fog Cutter and did not involve any allegations of fraud or intentional corporate wrongdoing, the Board agreed to exclude from the definition of a "for cause" termination any termination based on Mr. Wiederhorn's conviction of a felony *unrelated to Fog Cutter*. See 2003 Form 10-K/A, at 38-39 (R. 145-46) (JA 70-71); *see also* R. 245, 1043; JA 149, 411.

Faced with a difficult situation, the Board acted to preserve an asset that it determined were critical to the Company's future success: Mr. Wiederhorn's continued employment by the Company. The Board's decision was reasonable under the circumstances, and does not present a basis on which to delist Fog Cutter.

3. The Leave of Absence Agreement

Nasdaq concluded and the SEC appeared to agree that the Board's decision to include a \$2 million payment as part of the Leave of Absence Agreement did

nothing more than reward past misconduct. Nasdaq and the SEC, however, focused on one element of the Leave of Absence Agreement – the payment of a negotiated sum – and ignored the context in which the Board negotiated an agreement it believed was in the Company’s and shareholders’ best interests.

The simple fact is that the Leave of Absence Agreement was the product of a negotiation by two sides – Fog Cutter and Mr. Wiederhorn. It is critical to understand that the Board’s decisions depended in part on Mr. Wiederhorn’s decision about whether to settle or fight an indictment; in turn, Mr. Wiederhorn’s decision depended on how Fog Cutter would treat him should he settle and plead guilty. One factor that weighed heavily on Mr. Wiederhorn was his financial situation during his incarceration. Mr. Wiederhorn made clear to the Board that his final condition of settling with the government was his ability to obtain satisfactory financial terms providing security for his family and, if he could not do so, he would have to fight what would likely have become a protracted legal battle. (R. 239-42, 374-78, 1043-45) (JA 143-46, 263-67, 411-13.)

As Mr. Wiederhorn’s negotiations with the government continued from March through June 2004, so did the Board’s deliberations. As reflected in meeting minutes, the Compensation Committee discussed transition issues at its meetings on March 2, March 11, March 24, April 14, and May 12, 2004. (R. 329-40.) (JA 232-43.) In addition, the full Board discussed the government

investigation or transition issues on March 30, April 27, and June 2, 2004. (R. 341-359.) (JA 244-262.) The Board sought the advice of counsel on a number of occasions as to what courses of action were available to it. The Board weighed the distraction to the Company and its CEO, and the potential costs of protracted litigation (including potential litigation with Mr. Wiederhorn over his understanding of his rights under his employment agreement) against the costs and benefits of a settlement with Mr. Wiederhorn that would bring finality. (R. 108-09.) (JA 33-34.)

Initially, the Board discussed terminating Mr. Wiederhorn and providing for some type of severance package but, after the George Elkins minority interest holders expressed their intent to exercise the repurchase rights described above, it became apparent that Mr. Wiederhorn's separation could cost Fog Cutter greatly. (R. 108-09, 376.) (33-34, 265.) Thus, the Board decided that Mr. Wiederhorn's termination was not in Fog Cutter's best interests and began negotiating with Mr. Wiederhorn for a leave of absence. Those negotiations led Fog Cutter and Mr. Wiederhorn to enter into the Leave of Absence Agreement.

As the parties explained in the recitals to the Leave of Absence Agreement (filed on Form 8-K on June 4, 2004), and as Fog Cutter explained in a white paper that it publicly released, the Board decided that the Leave of Absence Agreement

was in Fog Cutter's best interests. (R. 102-114, 374-78.) (JA 27-39, 263-67.) It did so for four key reasons:

First, Mr. Wiederhorn's goodwill and continued positions at Fog Cutter were and are critical to Fog Cutter's success and the preservation of its investments' values, including the value of the George Elkins investment. Maintaining Mr. Wiederhorn as a director was thus the only way for the Board to preserve the value of this key investment for the benefit of the Company's shareholders. (R. 109, 374-78.) (JA 34, 263-67.)

Second, Mr. Wiederhorn's actions at issue did not involve Fog Cutter, were performed only after the research, review and recommendations of legal counsel and other expert advice, and did not involve accounting fraud or other corporate financial malfeasance. (R. 107-08, 375.) (JA 32-33, 264.) Had any of the charges to which Mr. Wiederhorn pled guilty involved these types of acts, the Board would not have entered into the Leave of Absence Agreement.

Third, Mr. Wiederhorn's decision not to fight the government in a lengthy and protracted criminal proceeding and to enter into the Leave of Absence Agreement allowed Fog Cutter and its management not to get bogged down in a protracted public issue that would have distracted Fog Cutter significantly from its business. Mr. Wiederhorn made clear that he would not plead guilty as proposed in the settlement offer from the government if no agreement was reached with

respect to his leave. Absent any agreement, he would have had to defend himself against the criminal investigation (and any subsequent criminal charges), resulting in a continuation of the “black cloud” that the investigation had cast over the Company. The best financial interests of the Company and its shareholders compelled not terminating Mr. Wiederhorn. (R. 109, 374-79) (JA 34, 263-68.)

Fourth, entering into the Leave of Absence Agreement avoided lengthy and expensive potential litigation with Mr. Wiederhorn based on his understanding of his rights under his employment agreement. (R. 108-09, 243, 375-76.) (JA 33-34, 147, 264-65.) Because Mr. Wiederhorn’s employment agreement provided for termination with cause only if he were convicted of a felony (and not simply if he were indicted), if Mr. Wiederhorn chose to fight the indictment, the Company could not terminate him without risking litigation with him over the terms of his employment and a potential liability to the Company of \$6 to \$7 million. *Id.* Entering into the Leave of Absence Agreement avoided lengthy and expensive potential litigation with Mr. Wiederhorn based on his understanding of his rights under his employment agreement. *Id.*

In short, the Board had three options: (1) fire Mr. Wiederhorn, lose the value of the George Elkins investment (potentially valued at up to \$10 million) and Mr. Wiederhorn’s continued leadership, be subject to costly, disruptive litigation over Mr. Wiederhorn’s understanding of his employment agreement, and

potentially be required to pay \$6 to \$7 million in severance payments to Mr. Wiederhorn; (2) wait for Mr. Wiederhorn to wage a lengthy battle against the government at trial, which would have prolonged the distraction to the Company for several more years, and could have similarly resulted in the need to pay Mr. Wiederhorn severance if the Board chose not to renew his employment agreement in the intervening time (again, a potential liability of \$6-7 million); or (3) work out a settlement with Mr. Wiederhorn that would allow him to remain involved with the Company, protect his goodwill and the value of the George Elkins investment, and allow the Company to move past this issue once and for all. The Board, based on the economic reality of the above options, reasonably chose the third option.

THE PROCEEDINGS BELOW

On June 16, 2004, Nasdaq staff requested certain documents from Fog Cutter pursuant to Nasdaq Marketplace Rule 4330(c), which provides in pertinent part that Nasdaq “may request additional information, public or non-public, deemed necessary to make a determination regarding a security’s initial or continued inclusion.” Over the next five weeks, in addition to requesting documents, Nasdaq spoke to a director of the Company by telephone, but took no on-the-record testimony. By letter dated July 20, 2004, the staff notified Fog Cutter that it had decided to delist the Company pursuant to Nasdaq Marketplace

Rules 4300 and 4330(a)(3). (R. 188-196.) (JA 113-121.) These Rules are set forth in Addendum 2 to this brief.

Following Nasdaq staff's determination to delist the Company, Fog Cutter requested review of that determination before a Listing Qualifications Panel (the "Panel") and a Listing and Hearing Review Council (the "Council"). The Council's decision, which upheld the delisting decision, ultimately rested on "[Mr.] Wiederhorn's regulatory history, along with his ability to exert influence over the operations of the Company and apparent influence over Board actions." Council Decision at 6 (R. 1260) (JA 6); *see also* Council Decision at Addendum 1. Specifically, in support of its decision, the Council pointed to: the serious nature of the violations to which Mr. Wiederhorn pled guilty; the Board's decision to renegotiate Mr. Wiederhorn's employment agreement in August 2003; the \$2 million Leave of Absence payment to Mr. Wiederhorn; and the independence of the Board and the extent to which it discharged its duty to the Company's shareholders. The Council's decision rested solely on the purported "public interest" concerns raised by these facts; it did not suggest that Fog Cutter had run afoul of the securities laws or any other Nasdaq Rules. The Council's decision summarily dismissed, in a single sentence, the "difficulties and pressures" faced by the Company. Council Decision at 6 (R. 1260) (JA 6).

Fog Cutter timely filed an Application for Review of the Council's decision by the Commission on May 23, 2005. (R. 1271-84.) (JA 494-507) Following briefing, the Commission entered an Opinion and Order on December 21, 2005 dismissing the application for review. *See* Addendum 1, JA 8-20. The Commission's Opinion focused, as did the Council's decision, on the Board's actions in amending Mr. Wiederhorn's employment agreement in 2003, paying him under the terms of the negotiated Leave of Absence Agreement in 2004, and in retaining Mr. Wiederhorn as a principal of the business during and after his sentence. The Commission's Opinion wholly ignored that the Company had consistently disclosed the facts upon which Nasdaq based its decision to the investing public and that the Company's share price had continued to be at least three times Nasdaq-required minimum on decent trading volumes throughout the relevant period. The Opinion also summarily dismissed Fog Cutter's argument that Nasdaq's treatment of Fog Cutter was inconsistent with the manner in which it had treated other similarly-situated issues; the Commission's only discussion of this point was to recite the truism that "each case is to be decided on its own facts and circumstances." Opinion at 11, JA 18.

Fog Cutter timely filed an Application for Review of the Commission's decision by this Court on February 17, 2006.

STANDARD OF REVIEW

The Commission's findings of fact, if supported by substantial evidence, are conclusive. Exch. Act. § 25(a)(4); 15 U.S.C. § 78y(a)(4). The Commission's other conclusions must be set aside if they are arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law. 5 U.S.C. § 706(2)(A); *Wonsover v. SEC*, 205 F.3d 408, 412 (D.C. Cir. 2000). This standard includes review to verify whether the Commission complied with its own standards. *WHX Corp. v. SEC*, 362 F.3d 854, 859 (D.C. Cir. 2004).

STANDING

Fog Cutter has standing to pursue this Petition for Review, and this Court has jurisdiction to hear and decide it, under Section 25(a)(1) of the Exchange Act, 15 U.S.C. §78y(a)(1) (2005) ("A person aggrieved by a final order of the Commission entered pursuant to this title may obtain review of the order in the United States Court of Appeals ... for the District of Columbia Circuit, by filing in such court, within 60 days after the entry of the order, a written petition requesting that the order be modified or set aside in whole or in part.").

SUMMARY OF ARGUMENT

The Commission's Opinion, which upheld the Council's delisting sanction, is unsupported by both the facts on which the SEC chose to focus and the facts it chose to ignore. Both the Nasdaq and the SEC concluded, without more, that the

public interest required the Nasdaq's ultimate sanction of delisting Fog Cutter based solely on the facts that (1) its CEO, Mr. Wiederhorn pled guilty to two offenses, neither of which involved the securities laws or Fog Cutter's business, and (2) the Company's Board decided to retain him, and to make a leave of absence payment and continue his regular compensation while he was incarcerated. But the facts are that that Fog Cutter was and is a well-managed company with strong corporate governance, a history of compliance with all Nasdaq and Commission rules, and a track record of transparency. For the reasons detailed below, the Board took action in response to Mr. Wiederhorn's guilty plea to preserve corporate assets, in the best interests of its shareholders. The Board correctly recognized that Mr. Wiederhorn's continuing commitment to the Company and his return to an active role after his incarceration were essential to preserving the Company's core business units. Much shareholder value was at stake, and the Board properly acted to minimize the risk of losing the value of those business units. All of these facts were ignored by the SEC and Nasdaq in their decisions.

Moreover, even assuming, incorrectly, that the Board's decisions could in hindsight be faulted, that is not justification for the Commission's decision to uphold the draconian sanction of delisting. There is no question that Fog Cutter promptly disclosed all the relevant facts to shareholders and prospective investors,

and shareholders and investors essentially stuck with the Company despite these disclosures. It is not the SEC's or Nasdaq's role to Monday-morning-quarterback the business judgment of a Board of Directors and delist those companies it would run differently. While the regulators may have a different view about whether those decisions were in the best interests of Fog Cutter's shareholders, such a disagreement should not form the basis of a determination to exclude the Company's securities from the public markets.³

In addition, neither the integrity of the market nor the interests of current or future shareholders was put at risk either by Mr. Wiederhorn's guilty plea or the Board's reaction to it. As to the first, Nasdaq never asserted, and the Commission did not find, that Fog Cutter or any of its officers or directors engaged in fraudulent conduct, or that Fog Cutter's public filings contained any material omissions or misstatements. As to the second, the Company had for years ensured that its current and prospective investors were aware that Mr. Wiederhorn was the target of an investigation that could result in his prosecution, conviction and

³ Fog Cutter's shareholders – fully informed in light of the Company's record of disclosure – expressed continuing support for Mr. Wiederhorn and the directors who made the decisions with which the Nasdaq and Commission disagree, as evidenced by the fact that 97% of the shareholders voted to re-elect these directors in December 2004, including a majority of the minority shareholders unrelated to Mr. Wiederhorn. *See* Form 10-K/A, filed June 3, 2005, at 11 (R. 1297)* (JA 520). *(Petitioner's opening brief incorrectly cited R. 1299; the correct cite is to R. 1297, which appears in the Joint Appendix at 520.)

incarceration, and the public had absorbed that information. *See, e.g.*, Form 10-Q filed May 9, 2001, at 9; *see also infra* at pp. 40-42. When this possibility became a reality, the market absorbed that fact (along with the terms of the Leave of Absence Agreement) as well, and investors continued to trade in the Company's securities at prices well above Nasdaq minimums.

This is a relatively straightforward case of an issuer's Board of Directors making a series of difficult business decisions, making full disclosures in real time, and hence allowing the market to operate as designed. In contrast to the cover-ups of recent years in which the integrity of the marketplace was damaged by companies that actively misled regulators and investors, Fog Cutter's public statements, while not necessarily imparting good news, have consistently reported the facts to its investors and regulators. Delisting the Company, based only on second-guessing by Nasdaq of the Board's business decisions, is a disproportionate response to the reasonable steps taken by the Company's Board to preserve the value of the Company's assets for its shareholders and to comply with Nasdaq's rules.

In short, the Commission's decision to dismiss Fog Cutter's Application for Review of the Council's delisting decision is unsupported by the facts and unjustified under applicable rules. It is also out of step with actions (and more significantly, inactions) taken by the Commission, Nasdaq and other national

exchanges with respect to other similarly situated issuers. Therefore, Fog Cutter respectfully requests that this Court vacate Commission's order.

ARGUMENT

I. THE COMMISSION ABUSED ITS DISCRETION BY UPHOLDING, IN AN INADEQUATELY EXPLAINED DECISION, THE NASDAQ'S EQUALLY INADEQUATELY EXPLAINED DECISION TO DELIST THE COMPANY BASED SOLELY ON PURPORTED PUBLIC INTEREST CONCERNS

A. The Record Does Not Support The Drastic Sanction Imposed By Nasdaq And Upheld By The Commission

The facts here – whether those that the Commission cited or the ones that were brought to its attention but that it nevertheless ignored in its Opinion – do not support the drastic sanction of delisting. Rather, the record shows that the Board made reasonable and prudent business decisions when faced with extraordinary circumstances. While the Commission may disagree with those decisions, disagreements over business judgments are not the type of threat to the public interest that have traditionally been grounds to strip a company's shareholders of their ability to trade in the company's securities on a national exchange. In this case, moreover, the Company had an undisputed track record of transparency, meaning that there was and is no threat to future investors. Simply put, the market was and is working: an issuer faced with a difficult situation kept its shareholders and the investing public informed, and those shareholders and investors had already absorbed the information and reacted to it (to a fairly limited extent) well

before the delisting decision. There was no pro-investor or other public interest need to delist Fog Cutter, and the Commission's decision should accordingly be vacated.

One circumstance in which appellate courts vacate SEC decisions imposing sanctions occurs when, as here, the sanction is “palpably disproportionate to the violation” and/or is not supported with “a meaningful statement of findings and conclusions, and the reasons or basis therefor, on all the material issues of fact, law, or discretion presented on the record.” *McCarthy v. SEC*, 406 F.3d 179, 188 (2d Cir. 2005) (vacating SEC order upholding New York Stock Exchange suspension of floor trader where the SEC “made no findings regarding the protective interests to be served by removing McCarthy from the floor of the Stock Exchange” but instead “merely recite[d], in general terms, the reasons why McCarthy's conduct [was] illegal”). Of paramount concern, of course, is whether the sanction “protects the trading public from further harm.” *Id.* Here, the SEC failed to provide any, much less an adequate, explanation why the ultimate sanction of delisting was necessary, thereby abusing its discretion. *See, e.g., Rockies Fund, Inc. v. SEC*, 428 F.3d 1088, 1099 (D.C. Cir. 2005) (vacating in part SEC's imposition of the harshest available sanctions where the “SEC's analysis [supporting the sanction] was not just superficial; it was nonexistent”); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 184-85 (2d Cir. 1976) (finding that penalty of

expulsion from trading “too severe” in light of the nature of petitioner’s transgressions and mitigating factors, and reducing the sanction to a one-year suspension that had already expired).

Neither Nasdaq nor the Commission has ever asserted that Fog Cutter or any of its officers or directors violated *any* provisions of the securities laws. Moreover, the facts underlying Mr. Wiederhorn’s guilty plea had nothing to do with Fog Cutter. Rather, they involved a different, private company and Mr. Wiederhorn’s personal tax return. Under these circumstances, delisting Fog Cutter is disproportionate given the absence of any charge that the Company violated any laws, that its officers or directors violated any laws in connection with their roles at the Company, or that the Company or its officers misled the investing public in any way.

Because the Commission has upheld the ultimate sanction in its enforcement arsenal – delisting the Company – the factual record must warrant such a drastic remedy, and the Commission must explain how the facts warrant the sanction. Neither such circumstance exists here. The record contains no facts, and the SEC has pointed to no facts, demonstrating that the public interest would be harmed by Fog Cutter’s continued listing on Nasdaq. In short, the Commission has failed to identify or support any remedial interest served by delisting Fog Cutter.

The facts Nasdaq and the Commission relied upon are nothing more than a series of business decisions with which they disagree; such a basis does not bear the weight of the drastic sanction of delisting a Company. The Commission points to the Board's decisions to (1) amend Mr. Wiederhorn's employment agreement, (2) retain him as co-CEO and co-Chairman, and (3) enter the Leave of Absence agreement and pay him a lump sum and continue his salary to preserve his continued leadership, which the Board considered to be critical to the company's future.⁴ These were *business decisions* that Fog Cutter promptly disclosed to the investing public – not violations of the securities laws, and not failures to comply with Nasdaq's or the Commission's rules.

Here, neither the Nasdaq nor the SEC ever alleged – much less demonstrated – that Fog Cutter intended to mislead, or has ever misled, the public. As the record makes clear, Fog Cutter has been consistently forthright with the investing public and regulators: indeed, its public disclosures dating back to the Company's 2001

⁴ Nasdaq and the Commission point to these business decisions as evidence of Mr. Wiederhorn's influence over the Board, glossing over the fact that five of the seven directors were independent by Nasdaq's own standards when they were making these challenged decisions by stating that the Board members had "family, business or social ties" to Mr. Wiederhorn. Opinion at 4 n.6; *see also* R. 229-30; JA 133-34 (background information on the independent directors). Such ties, which exist with respect to many issuers' Boards, similarly cannot support the Commission's decision; in any event, pointing to such ties ignores the stated, publicly-disclosed business reasons enumerated by the Board for acting as it did.

Form 10-K detail the issues facing Mr. Wiederhorn and the Company's consideration of them. Fog Cutter and its Board have neither misrepresented nor misled the investing public, and the public has continued to buy its stock at prices well above the mandated minimum bid price for continued listing.

Certainly, the Commission cannot rely on the mere fact that Fog Cutter's CEO has been convicted of a crime – unrelated to the securities laws – to support its delisting decision. That much is clear from the Commission's own recent decision in *In re e-Smart Tech., Inc.*, Exch. Act Rel. No. 34-50514, 2004 WL 2309336 (Oct. 12, 2004). There, the issuer failed to timely file periodic reports required for three years, asserting that this failure to file was precipitated in part by the distraction of dealing with the arrest of and charges filed against its president and CEO and one of its main investors. Though these charges were later dropped, the main investor was subsequently convicted of wire fraud in a separate case during the period the company failed to timely file reports. *Id.* at *2. When the company subsequently filed reports for the period in which these problems arose, it failed to disclose the investor's conviction. In her initial decision, the ALJ found that the appropriate sanction for these reporting violations was to revoke the registration of the company's common stock. *In re e-Smart Tech., Inc.*, 2004 WL 407490, at *7 (Mar. 4, 2004).

The Commission remanded, based in large part on the fact that e-Smart had filed numerous reports between the initial decision and the remand decision. *In re e-Smart Tech.*, 2004 WL 2309336, *2 (Oct. 12, 2004). Without even commenting on the continued involvement of the president and CEO who had been charged, or the conviction of the main investor, the Commission stated that “although we consider e-Smart’s violations serious, we also believe the company’s subsequent filing history is an important factor to be considered in determining whether revocation is necessary or appropriate for the protection of investors.” *Id.* at *2.

On remand, the ALJ declined to suspend or revoke the company’s registration. The ALJ found “the likelihood of future violations absent and the need for a strong sanction no longer necessary”; moreover, “the effect of any suspension ... would be to harm investors unfairly, rather than to serve any deterrent or remedial function.” *In re e-Smart Tech.*, 2005 WL 274086, at *8 (Feb. 3, 2005). Similarly here, delisting Fog Cutter unfairly punishes investors and serves no deterrent or remedial function.

It bears emphasis that the facts that were deemed insufficient to warrant revocation in *e-Smart* are more egregious than those here. *A fortiori*, the Commission should have rejected Nasdaq’s delisting decision here. In contrast to *e-Smart*, Fog Cutter disclosed the facts relating to Mr. Wiederhorn’s legal circumstances in a timely and thorough manner. Neither the SEC nor Nasdaq has

ever taken issue with Fog Cutter's record of disclosure to its investors. Delisting Fog Cutter is the same kind of draconian remedy the Commission and the ALJ rejected in *e-Smart* and that should be rejected here.

The SEC's attempt to distinguish *e-Smart* does not bear weight. The Commission sought to dismiss this precedent by pointing out (accurately) that Fog Cutter's shares continued to trade on the pink sheets at two to four times Nasdaq-mandated minimum, whereas the revocation sanction in *e-Smart* would have meant that the company could no longer have traded publicly absent an exemption. Opinion at 11 n.31, JA 18. While revocation may in some circumstances have more drastic effects than delisting, there is no question that delisting is a severe sanction. Just as revocation is the most severe sanction the SEC may impose, delisting is the most severe sanction Nasdaq can impose. Moreover, the issue here is not whether revocation is a more severe remedy than delisting. Rather, the issue is the Commission's treatment of an issuer that associates with individuals charged with and convicted of felonies. In *e-Smart*, the Commission nowhere suggested that, while revocation of registration was too severe, some lesser penalty might be appropriate. Rather, despite the egregious facts with which the Commission was faced, the proceedings were dismissed without any enforcement sanction whatsoever. Under these circumstances, *e-Smart* mandates against delisting Fog Cutter simply because of Mr. Wiederhorn's conviction or the payment to him

pursuant to the Leave of Absence Agreement. *Cf. Goldstein v. SEC*, No. 04-0434, -- F.3d --, 2006 WL 1715766 (D.C. Cir. June 23, 2006) (invalidating SEC's "hedge fund rule" on grounds, in part, that the SEC failed to adequately justify departing from its own prior interpretation of a regulation).

The *only* precedent upon which the SEC relied as support for its decision was its own decision in *In re JJFN Servs. Inc.*, Exch. Act Rel. No. 34-93943, 1997 WL 722029 (Nov. 21, 1997).⁵ There, the Commission upheld Nasdaq's decision to deny initial listing of a company whose "promoter" had pled guilty to three separate tax violations in connection with a prior business. The Commission noted that the promoter had "admitted to a pattern of conduct violative of the tax laws that persisted for three years," and, while it said it was not relying on this fact, it also noted that "the Commission twice has brought enforcement actions against [the promoter] or entities with which he is associated." *Id.* at *5 n.6.

There are two critical factual differences between *JJFN* and this case. *First*, unlike the principal in *JJFN*, who had engaged in a "pattern" of illegal conduct in connection with his company over an extended period of time, Mr. Wiederhorn pled guilty to one "intentless" offense and an offense related to his personal (not company) tax returns. Moreover, Mr. Wiederhorn's convictions stemmed from

⁵ There is no evidence of which we are aware that *JJFN* petitioned for review of the Commission's decision.

actions he took after relying on the advice of attorneys and tax advisors. The Commission dismissed the importance of this fact by mislabeling it a “collateral attack” on Mr. Wiederhorn’s conviction. *See* Opinion at 8 n.16. The Commission missed the point. The relevance of the advice of counsel in this context is not the fact of Mr. Wiederhorn’s conviction, but rather the fact that his reliance on the advice of counsel demonstrates that Mr. Wiederhorn has no propensity to violate the law. *Cf. Howard v. SEC*, 376 F.3d 1136, 1147-48 (D.C. Cir. 2004) (finding that reliance on counsel tends to negate scienter).

Second, the public interest considerations involved in the two cases vary markedly in light of the companies’ record of disclosures to those investors. JJFN’s prospectus included a single paragraph describing the founder’s convictions, several years after the events at issue. *See* Form 424B2, filed May 13, 1996, at 30. In contrast, Fog Cutter filed numerous quarterly or annual statements over a period of several years that described, in real time and considerable detail, the issues relating to Mr. Wiederhorn, as well as issuing press releases and Form 8-Ks relating to particular events and decisions made by the Board. *See* pp. 40-42. Thus informed, Fog Cutter’s shareholders continued to trade the Company’s shares at levels and prices well above Nasdaq minimums. These circumstances, not present in *JJFN*, demonstrate that delisting is not necessary or even appropriate in the public interest.

At all events, a single, nearly decade-old, unappealed decision cannot support a delisting decision today in light of intervening changes in the securities regulators' approach to these issues. As discussed below, regulators have not delisted issuers that have, more recently than JJFN, faced similar issues: Martha Stewart Living Omnimedia ("MSLO") and Steve Madden, Ltd. ("Steve Madden") continue to be listed despite their principles having been convicted of obstruction of justice and securities fraud, respectively, and those companies' decisions to continue associating with them. *See discussion infra* at pp. 45-47. The Commission's reliance on a decade-old decision, without addressing its more recent treatment of other issuers, demonstrates the arbitrariness of its decision.

B. The Commission Wholly Failed To Address Critical Facts Relating To The Board's Motivation And The Company's Record Of Disclosures

The Commission's Opinion impermissibly ignored both critical facts relating to the Board's motivation for acting as it did with respect to Mr. Wiederhorn and Fog Cutter's record of fulsome disclosure to investors. Rather than address these facts, the Commission dismissed them by asserting that "the issue here ... is not the Board's business judgment, but rather the public interest." Opinion at 11. But, these undisputed facts are directly relevant to whether the public interest requires delisting Fog Cutter, and the Commission therefore abused its discretion by ignoring them.

In any event, the foundation of the Commission's decision (as well as Nasdaq's decision) is a distrust of the Board's business judgment, so facts relating to the Board's business judgment are surely relevant. The Commission believed that the Board "put Wiederhorn's interests above those of the shareholders," and that delisting was therefore appropriate. *Id.* Thus, it is puzzling that, in evaluating the Board's business judgment and finding it wanting, the Commission wholly ignored (1) the Board's actual, publicly-disclosed reasons for acting as it did, (2) Fog Cutter's track record of transparency about Mr. Wiederhorn's status and the Board's actions regarding him, and (3) the shareholders' continued support of the Board's business decisions about which Nasdaq complained.

First, the record here contains "mitigating facts and circumstances" relating to the Board's actual motivation for acting as it did that must be, but were not, considered in evaluating Nasdaq's delisting decision. *McCarthy v. SEC*, 406 F.3d 179, 189 (2d Cir. 2005). As the Company consistently disclosed to Fog Cutter's shareholders and regulators, discussed *supra*, the Board's actions were motivated by the goal of preserving shareholder value, and the shareholders themselves recognized and rewarded those actions by continuing to trade the stock at levels well above Nasdaq-prescribed minimums and reelecting the Board.

As this Court's decision in *WHX* makes clear, the Commission was not permitted to ignore such facts and circumstances, particularly where the challenged

actions could have actually *benefited* shareholders. In *WHX*, the company made a tender offer that the SEC found violated the All Holder's Rule. *WHX Corp. v. SEC*, 362 F.3d 854, 858 (D.C. Cir. 2004). The company argued that the single, isolated violation of the Rule, even if proven, was insufficient to support the cease-and-desist order that the SEC imposed. *Id.* This Court agreed, finding that the Commission failed to explain how the company's actions demonstrated a risk of future violations, which must be shown in order to justify a cease-and-desist order. *Id.* at 859. The Court noted that the Commission's opinion "fail[ed] to establish any serious harm to the shareholders or the marketplace caused by the record holder condition," and that the Commission "at no point [considered] the possibility that allowing conditions such as [the issuer's] might actually have benefited" the company's shareholders, by "increasing the chances that a lucrative merger would succeed, or might benefit shareholders generally by increasing the capacity of the market for corporate control or discipline management." *Id.* at 861.

The Commission committed a similar error here. It eschewed any discussion or analysis of the facts relating to the Board's motivation, and instead simply recited maxims about "market risk" and the "imprimatur of listing on a particular market" to support its decision. Opinion at 11, JA 18. As this Court has recognized, "bland assertions" that rules or regulations are "important," without firmly establishing how the facts support the imposition of sanctions for violating

those rules, are an insufficient basis upon which to impose an administrative sanction.⁶ *WHX*, 362 F.3d at 861. Therefore, the Commission’s simple assertion that “[l]isting a security on a market creates expectations among investors that listed companies meet basic standards of corporate governance and financial soundness” (Opinion at 11, JA 18) is, without more, insufficient to support delisting Fog Cutter.

In its Opinion, the Commission pointed to the fact that Fog Cutter reported a net loss during the period on which it paid the Leave of Absence expenses. *Id.* Surely the Commission cannot mean to hold that a company’s shares should be delisted simply because the company made a business decision that resulted in a loss during a given period. And yet, this is the *only* concrete fact to which the agency points to support its apparent determination that the “basic standards of ... financial soundness” are missing. Opinion at 11, JA 18. This thin reed cannot support a determination that delisting is necessary or in the public interest for, if it did, scores if not hundreds of companies would have to be delisted.

⁶ The Commission’s attempt to distinguish its decision in *e-Smart* fails on similar grounds. *See supra* at pp. 32-34. Here, the Commission used the same type of sweeping statements about “market risk” and “consist[ency] with policies of the Exchange Act” as this Court rejected in *WHX*, without explaining how the sanction imposed mitigated those risks or addressed those policies.

Second, the Commission did not mention, much less consider, Fog Cutter's record of public disclosure about the events at issue or the shareholders' continued support of the Company (in continued active trading of its shares) and the Board (in reelecting the Directors by an overwhelming majority). Throughout the period during which Mr. Wiederhorn was under investigation, Fog Cutter kept its shareholders, regulators and prospective investors fully informed about the government's investigation of Mr. Wiederhorn – and neither Nasdaq nor the Commission has taken *any* issue with Fog Cutter's public disclosures.⁷ In addition, the Company specifically disclosed the potential negative outcome of the government's investigation and the potential negative consequences of such an outcome.⁸ As the investigation of Mr. Wiederhorn progressed, the Company

⁷ See 2003 Form 10-K/A, at 10-11 (R. 124-25) (JA 49-50) (disclosing the progress of government and criminal investigations and specifically identifying Mr. Wiederhorn as a target of a grand jury investigation); Form 10-K filed March 3, 2003 at 14 (same); Form 10-K/A filed August 1, 2003, at 14 (same); Form 10-K filed March 22, 2002, at 10 (disclosing the existence of government and criminal investigations and specifically identifying Mr. Wiederhorn as a subject of a grand jury investigation).

⁸ See 2003 Form 10-K/A, at 10 (R. 124-25) (JA 49-50) (disclosing potential negative consequences of an indictment being returned against Mr. Wiederhorn or his guilty plea to one or more offenses, including (a) the “strong possibility” that Mr. Wiederhorn would be unable to continue as a director and officer of the Company, including the risk that incarceration would be required and that the Company would need to ensure that an appropriate management team was in place, (b) an adverse effect on the Company's stock price, and (c) inquiries by regulatory agencies, such as the Nasdaq and the Commission).

developed and executed plans for alternative corporate leadership – keeping investors and shareholders informed of those plans as well.⁹

The Company continued this practice of full disclosure when Mr. Wiederhorn pled guilty in June 2004. Fog Cutter immediately disclosed Mr. Wiederhorn's guilty plea to its investors and regulators, issuing statements disclosing the plea and the Leave of Absence Agreement it entered into with Mr. Wiederhorn, as well as its plans to ensure the continued success of the Company for its shareholders. *See* Form 8-K filed June 4, 2004, at 1 (R. 102-114) (JA 27-39) (attaching Leave of Absence Agreement). The Company also issued a white paper, setting forth all of the facts and circumstances surrounding Mr. Wiederhorn's plea and laying out, in detail, the Board's reasoning behind the decisions it made with respect to Mr. Wiederhorn. *See* Press Release dated July 6, 2004 (R. 197-202) (JA 122-27).

Fog Cutter's shareholders, thus informed, continued to trade in the Company's securities throughout the period at levels well above Nasdaq minimums. Even after Mr. Wiederhorn's plea, the Board's actions with respect to Mr. Wiederhorn, and Nasdaq's decision to delist the Company, Fog Cutter's

⁹ *See* 2003 Form 10-K/A, at 10 (R. 125) (JA 50) (disclosing that “[t]he Company has in place a plan to deal with the possible need to replace Mr. Wiederhorn on a

shareholders have continued to support the Board and its actions. In December 2004, 97% of the shareholders, including a majority of the minority shareholders unrelated to Mr. Wiederhorn, voted to re-elect Mr. Wiederhorn and the directors who made the decisions challenged by Nasdaq. *See* Form 10-K/A, filed June 3, 2005, at 11 (R. 1299) (JA 522). This fact, which the Order failed to even address, demonstrates that the investing public never lost confidence in Fog Cutter's Board or Mr. Wiederhorn. The shareholders have recognized that the stability of this independent Board, and Mr. Wiederhorn's continued leadership, are critical to preserving the value of their investment in Fog Cutter.

In short, the Commission not only impermissibly second-guessed the Board's business judgment, but it upheld an exceptionally harsh sanction without an explanation of why such a sanction was necessary to serve any remedial or public interest purpose and without considering all of the relevant facts. That is the very kind of Commission approach that this Court rejected in *WHX* and *Rockies Fund* and that the Second Circuit rejected in *McCarthy*. This Court should do the same here.

short- or long-term basis that minimizes the adverse effects that his departure may cause.”).

II. THE COMMISSION ABUSED ITS DISCRETION BY FAILING TO JUSTIFY THE DISPARATE TREATMENT OF FOG CUTTER VIS-À-VIS OTHER SIMILARLY SITUATED ISSUERS

As the Commission itself has recognized, among its duties in reviewing actions by self-regulatory organizations (“SROs”) such as Nasdaq is to determine “whether the rules of the SRO have been applied in a discriminatory or unfair manner, i.e., whether the action is substantively fair.” *In re Richardson*, Exch. Act Rel. No. 34-51236, 2005 WL 424920, at * 5 (Feb. 22, 2005) (internal quotations omitted). It is a truism that the facts of every case are unique. *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1112 (D.C. Cir. 1988). However, this Court’s review of the Commission’s Opinion necessarily encompasses an evaluation of not only whether the Commission’s decision in *this* case is supported by the facts in *this* case, but whether the Commission’s decision included “a rational explanation of why such a sanction was appropriate under the Commission’s own standards.” *WHX*, 362 F.3d at 861.

Such an evaluation and explanation is not undertaken in isolation; it necessarily involves determining whether the Commission has treated an issuer fairly in the broader context of how it treats *all* issuers in similar circumstances. This evaluation is particularly important where, as here, the Commission is “not simply rendering a policy judgment; nor is it simply regulating the securities markets; it is, rather, singling out and directly affecting the livelihood of one

commercial enterprise.” *Blinder, Robinson*, 837 F.2d at 1113. Like revocation of a company’s stock registration, delisting of a company from a national exchange is a draconian remedy not to be employed lightly. It should not be employed where, as here, it unfairly punishes shareholders. *See, e.g., In re Information Architects Corp.*, 2005 WL 2756712, at *3 (Oct. 25, 2005); *In re e-Smart Tech*, 2005 WL 274086, at *8. *See also* 3 Thomas L. Hazen, *Treatise on the Law of Securities Regulation* § 9.2[1][B] (4th ed. 2002) (“[r]evocation or suspension of trading will be invoked only when in the interests of the investing public. It will require serious violations to lead the SEC to conclude that eliminating a public market for the securities best serves the interest of investors.”). Therefore, the Commission must “craft [its decision] with care.” *Blinder, Robinson*, 837 F.2d at 1113.

Here, the “care” exercised by the Commission in crafting a “rational explanation” for its decision and addressing these arguments, which Fog Cutter raised before it, consists of a single conclusory sentence: “As we have noted on other occasions, each case is to be decided on its own facts and circumstances, and it is not appropriate to compare them.” Opinion at 10-11, JA 17-18. While the Commission’s opinion addressed some, but ignored many if not most, of the facts relating to Fog Cutter, it addressed none of the facts relating to similarly situated issuers to which Fog Cutter drew the Commission’s attention. Notably, the Commission failed to address Fog Cutter’s argument that Nasdaq should not be

permitted to delist Fog Cutter but not other companies whose boards have acted similarly with respect to their officers and directors facing similar if not more culpable circumstances.

As Fog Cutter pointed out – and the Commission virtually ignored – even in the face of similar decisions made by other issuers’ boards of directors, national exchanges including Nasdaq have allowed those issuers to remain listed, while Nasdaq delisted Fog Cutter. For example, Nasdaq has permitted the securities of Steve Madden to continue trading on its exchange despite the facts that its CEO pled guilty to felonies involving manipulation of his own company’s stock and the company continued to pay him salary while he was incarcerated and professed its desire to have him return to work after he served his sentence. Mr. Madden returned to work in April 2005 after serving two and half years in prison. The New York Stock Exchange did not delist MSLO despite Ms. Stewart’s conviction and the fact that the company retained her as non-certifying officer, paid her a salary of nearly \$1 million per year (plus bonuses), and professed its desire to have her return to work after she served her sentence; Ms. Stewart also returned to work upon her release from prison and continued to work while under house arrest. Indeed, we are unaware that the Stock Exchange or Nasdaq ever sought or even contemplated delisting proceedings with regard to any of those companies.

In contrast to Mr. Madden’s securities fraud crimes involving his own company’s IPO and Ms. Stewart’s obstruction of justice and false statement crimes, Mr. Wiederhorn pled guilty to a no-intent crime not involving the listed business and a violation of the tax laws relating to his personal tax return. While Fog Cutter kept Mr. Wiederhorn on in a more limited role and paid him a negotiated salary and a leave of absence payment, the same or at least substantively identical facts were true for Mr. Madden and Ms. Stewart. Nevertheless, while Mr. Madden’s and Ms. Stewart’s companies were not subject to delisting proceedings, Fog Cutter was delisted. Worse, the Commission approved that sanction without offering any explanation – other than the conclusory assertion that every case is unique – why it was permissible for an SRO to treat Fog Cutter differently than Steve Madden or MSLO. The Commission’s failure constitutes abuse of discretion.

As this Court cautioned more than a decade ago, “the Commission must do more than say, in effect, petitioners are bad and must be punished.” *Blinder, Robinson*, 837 F.2d at 1113. This is particularly important where it appears that disproportionately harsh sanctions are being imposed on “smaller, newer firms than [on] old-line, or at least more established, houses with the ‘right sort’ of exchange memberships.” *Id.* at 1112. The explanation for delisting Fog Cutter, but not Steve Madden or MSLO, cannot begin and end, as the Commission did,

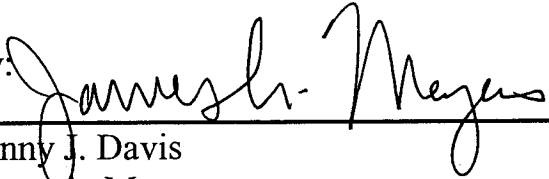
with the truism that “the facts are different.” While the facts of every case may be different, it is the reasonable, explained, even-handed application of law to those facts that must be evaluated; to do otherwise is an abuse of discretion. *See Burlington N. & Santa Fe Ry. v. Surface Transp. Bd.*, 403 F.3d 771, 777 (D.C. Cir. 2005) (“Where an agency applies different standards to similarly situated entities and fails to support this disparate treatment with a reasoned explanation and substantial evidence in the record, its action is arbitrary and capricious and cannot be upheld.”); *ANR Pipeline Co. v. FERC*, 71 F.3d 897, 901 (D.C. Cir. 1995) (“[W]here an agency departs from established precedent without a reasoned explanation, its decision will be vacated as arbitrary and capricious.”). Here, the Commission abused its discretion by failing to explain how the facts between this case and Steve Madden or MSLO were different – i.e., what was present here that was missing in those other cases, or vice versa.

CONCLUSION

For the reasons stated herein, Fog Cutter respectfully requests that this Court grant its petition and vacate the Commission's Order.

Dated: September 30, 2006 Respectfully submitted,

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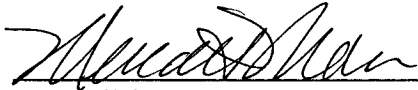
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**CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME
LIMITATION, TYPEFACE REQUIREMENTS
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This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because this brief contains 11,720 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Office Word 2003 in Times New Roman 14 pt. font.

Dated: September 30, 2006



Meredith Moss

Attorney for Petitioner Fog
Cutter Capital Group Inc.

ADDENDUM 1

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 52993 / December 21, 2005

Admin. Proc. File No. 3-11934

In the Matter of the Application of
FOG CUTTER CAPITAL GROUP, INC.
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For Review of Action Taken by

NASD

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF ASSOCIATION
ACTION

Registered securities association delisted issuer's securities after guilty plea by issuer's key executive and largest shareholder, and Board of Directors' response to guilty plea established the need to protect the integrity of market and public interest. Held, review proceedings dismissed.

APPEARANCES:

Lanny J. Davis, of Orrick, Herrington & Sutcliffe LLP, for Fog Cutter Capital Group, Inc.

Edward S. Knight, Michael S. Emen, Arnold P. Golub, and Traynham E. Mitchell, Jr., for The Nasdaq Stock Market, Inc.

Appeal filed: May 23, 2005

Last brief received: October 31, 2005

Fog Cutter Capital Group, Inc. ("Fog Cutter") appeals the decision of NASD delisting Fog Cutter's securities from The Nasdaq National Market ("Nasdaq"). NASD found that the public interest and protection of the integrity of, and public confidence in, Nasdaq required delisting. 1/ NASD based its decision on the guilty plea of Andrew Wiederhorn, who was, at the time of his plea, Fog Cutter's chairman, chief executive officer, and controlling shareholder, to two felonies and on the actions taken by Fog Cutter's Board of Directors ("Board") in anticipation of, and response to, Wiederhorn's guilty plea. 2/ We base our findings on an independent review of the record. 3/

-
- 1/ NASD relied on its authority under NASD Marketplace Rules 4300 and 4330. At the time of NASD's decision, Rule 4300 provided that, with respect to continued inclusion of securities, NASD "may deny . . . continued inclusion of particular securities . . . based on any event, condition, or circumstance which exists or occurs that makes . . . continued inclusion of the securities in Nasdaq inadvisable or unwarranted in the opinion of Nasdaq, even though the securities meet all enumerated criteria for . . . continued inclusion in Nasdaq." Rule 4330 provided that NASD may "apply additional or more stringent criteria for the . . . continued inclusion of particular securities" if NASD "deems it necessary to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, or to protect investors and the public interest." There has been no substantive change in the rules. NASD's action was based solely on public interest considerations.
- 2/ Wiederhorn pleaded guilty to payment of an illegal gratuity to an employee-benefit-plan investment advisor in violation of 18 U.S.C. § 1954 and to filing a false tax return in violation of 26 U.S.C. § 7206(1).
- 3/ Fog Cutter has moved to include its June 3, 2005, Form 10-K/A in the record. NASD, joined by Fog Cutter, asks to include Fog Cutter's Form 8-K reports dated October 12 and October 17, 2005, in the record. Rule of Practice 452, 17 C.F.R. § 201.452, requires that any motion to adduce additional evidence "shall show with particularity that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence previously." Here, none of the reports existed when the record closed. The additional evidence is material to this proceeding because the Form 10-K/A evidences the current condition of Fog Cutter's finances and operations, and the Forms 8-K evidence the current status of Wiederhorn. We hereby grant both of the motions and include the June 3, 2005, Form 10-K/A, the October 12, and October 17, 2005, Forms 8-K in the record.

II.

Wiederhorn is the founder of Fog Cutter and with family members controls approximately fifty-three percent of Fog Cutter stock. Fog Cutter is a diverse business controlling or operating a national restaurant chain and a mortgage bank in addition to real estate and investment businesses. Fog Cutter's current business strategy, devised and implemented by Wiederhorn, focuses on continued development of its restaurant operations, expansion of its real estate business, and identification of under-performing businesses that Fog Cutter can acquire and turn around. Fog Cutter represented to the Nasdaq Listing Qualifications Panel ("Panel") that Wiederhorn was responsible for Fog Cutter's transformation and remains "central to the success of [Fog Cutter] and [is] an indispensable CEO." According to the company, Wiederhorn is the "sole officer of Fog Cutter who is familiar with each of Fog Cutter's diverse business lines."

Fog Cutter also asserted that Wiederhorn needed to retain his executive positions so that Fog Cutter could retain its fifty-one percent of George Elkins Mortgage Banking Co., Inc. ("GEMB"). Fog Cutter purchased GEMB from its owners. After the purchase, these sellers retained a forty-nine percent interest in GEMB. However, under the May 2002 Stock Purchase Agreement and the Operating Agreement, the minority owners may repurchase Fog Cutter's interest in GEMB if, among other things, Wiederhorn is neither "serving on [Fog Cutter's] board of directors nor as the Chief Executive Officer." ^{4/}

In March 2001, prosecutors informed Wiederhorn that he was a target of a federal grand jury investigation involving the collapse of Capital Consultants, LLC ("CCI"), an employee-benefit-fund advisor with which other Wiederhorn-controlled company had done business. Wiederhorn kept Fog Cutter's Board informed regarding the existence and progress of the

^{4/} GEMB was acquired by a subsidiary of Fog Cutter. Under Section 8.3 of the Stock Purchase Agreement, the minority shareholders can repurchase their interest in GEMB for the "total of (1) such party's share of the Purchase Price [\$5,000], (2) the aggregate contributions to the capital of [GEMB] by [the Fog Cutter subsidiary] on or after the Closing Date, and (3) the [Fog Cutter subsidiary's] pro rata share of all accumulated earnings of [GEMB] from and after the Closing Date less the cumulative amount of distributions by [GEMB] to [the Fog Cutter subsidiary]." Fog Cutter represents that, as a result of this provision, the minority shareholders could repurchase GEMB "at a fire sale price, relative to its value," and thereby deprive Fog Cutter of substantial revenue if Wiederhorn ceased to be a director or CEO. Fog Cutter states that the minority shareholders have not exercised the right as a result of Wiederhorn's conviction.

Under the Stock Purchase Agreement, however, Wiederhorn's death or permanent disability would not constitute events that would trigger the repurchase rights of the minority shareholders.

investigation. Fog Cutter represents that, beginning in May 2001, it disclosed the investigation to the Commission and to the public in its public filings.

Between March 2001, when the Board learned of the grand jury investigation, and June 3, 2004, when Wiederhorn pleaded guilty, the Board took two actions with respect to Wiederhorn's situation that are relevant here. In 2003, Wiederhorn asked for an amended employment agreement in advance of the expiration of his then-current employment agreement. On August 11, 2003, the Board approved an amended employment agreement ("Amended Employment Agreement") for Wiederhorn. The Amended Employment Agreement altered the conditions permitting termination of Wiederhorn's employment "for cause." Under the prior employment agreement, the Board, in its discretion, could terminate Wiederhorn's employment for cause upon his conviction of a "felony (other than a felony involving a traffic offense)." Under the Amended Employment Agreement the relevant provision allowed the Board, in its discretion, to terminate Wiederhorn's employment for cause upon conviction of "a felony (other than a felony involving a traffic offense) involving [Fog Cutter]." During negotiation of the Amended Employment Agreement, the Board knew that Wiederhorn was under investigation for felonies that did not involve Fog Cutter. Fog Cutter estimated that the company would have owed Wiederhorn \$7 million had it terminated him without cause. 5/

In early 2004, Wiederhorn, by then under indictment and awaiting trial, informed the Board that he wanted to go to trial on the charges against him. 6/ Fog Cutter represents that it

5/ Under the Amended Employment Agreement, had Wiederhorn been terminated for cause, he would have been entitled to only his base salary through the date of termination and payment of unreimbursed business expenses. If, however, Fog Cutter terminated Wiederhorn without cause, it would owe him within ten days a lump sum payment comprised of the following elements: three times Wiederhorn's annual salary; three times his largest annual bonus from among the most recent three years; unreimbursed business expenses; and accrued but unpaid base salary and bonuses. Other provisions provide for accelerated vesting for benefit and incentive programs and extended coverage for medical and other benefits.

6/ In 2004, Fog Cutter's Board consisted of seven directors, five of whom were independent within the definition of NASD rules. NASD defines "independent director" as "a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which [in the board of directors' opinion] would interfere with the exercise of independent judgment" NASD Marketplace Rule 4200(a)(14). Among those explicitly excluded from the definition are employees of the corporation and immediate family members of company executives. NASD Marketplace Rule 4200(a)(14)(A), (C). All of the Fog Cutter directors, however, have family, business, or social ties to Wiederhorn. With minor changes in personnel, the same general

(continued...)

was concerned about a prolonged period of negative publicity and distraction from its business. Wiederhorn offered the Board an alternative: he would plead guilty if he could negotiate a financial package to protect his family's income and benefits during any imprisonment following a guilty plea. On June 2, 2004, the parties concluded a Leave of Absence Agreement ("Leave Agreement"). The Leave Agreement recited the Board's understanding that the crimes to which Wiederhorn intended to plead guilty did not involve acts or omissions by Wiederhorn in his capacity as an officer or director of Fog Cutter and, in one instance, did not involve criminal intent. The Leave Agreement provided that Wiederhorn's absence from his duties because of his anticipated imprisonment would be considered a leave of absence, during which time he would retain his titles (modified to "Co-CEO" and "Co-Chairman") and responsibilities. ^{7/} Financially, the Leave Agreement provided that Fog Cutter would continue to pay Wiederhorn his \$350,000 annual salary, bonuses, and other employee benefits while imprisoned. Fog Cutter also agreed to pay Wiederhorn a \$2 million "leave of absence payment" to retain his "good will, cooperation and continuing assistance, and in recognition of Wiederhorn's past service to the Company, to help avoid litigation and for other reasons." ^{8/}

On June 3, 2004, the day after concluding the Leave Agreement, Wiederhorn pleaded guilty to paying an illegal gratuity and filing a false tax return. ^{9/} The district court sentenced Wiederhorn to eighteen months imprisonment and required him to pay a \$25,000 fine and \$2 million in restitution to the receiver winding up CCI's affairs.

During the negotiation of the Leave Agreement, Wiederhorn represented that the tentative plea agreement both required him to pay the \$2 million restitution at the sentencing hearing and limited his ability to raise the funds by precluding his use of certain means of financing the

^{6/} (...continued)

composition of the Board was in effect in 2003, when the Board agreed to negotiate the Amended Employment Agreement with Wiederhorn.

^{7/} On August 13, 2004, after the Federal Bureau of Prisons informed Fog Cutter that Wiederhorn would not be allowed to conduct business as an inmate, Fog Cutter altered Wiederhorn's titles and responsibilities to reflect his inability to carry out the duties of a Chief Executive Officer under the requirements of the Sarbanes-Oxley Act. Until that time, the plan apparently was for Wiederhorn to act as Co-CEO from his prison cell. From August 13, 2004, until October 12, 2005, he was the Co-Chairman of the Board and Chief Strategy Officer of Fog Cutter.

^{8/} According to Fog Cutter's June 3, 2005, Form 10-K/A, the company spent \$4,750,000 on "leave of absence expense" during a period when the company reported a \$3,932,000 net loss.

^{9/} 18 U.S.C. § 1954 (payment of an illegal gratuity with respect to an employee benefit plan); 26 U.S.C. § 7206(1) (filing a false tax return).

restitution payment. The Board knew, therefore, that Wiederhorn would use the \$2 million payment to pay the restitution. 10/ As Fog Cutter's counsel stated to the Panel, Fog Cutter did not "like the idea of helping Wiederhorn pay a criminal penalty" but, nonetheless, did, indirectly, pay the restitution in its entirety. In a Commission filing on June 4, 2004, Fog Cutter disclosed Wiederhorn's guilty plea and the terms of the Agreement. 11/

On July 20, 2004, after concluding an investigation, NASD staff informed Fog Cutter that its securities would be delisted from Nasdaq based on public interest concerns relating to Wiederhorn's guilty plea and Fog Cutter's response to it. NASD staff considered that it was contrary to the public interest for Fog Cutter to remain listed on Nasdaq with a convicted felon exercising substantial influence over the company while incarcerated. NASD staff also concluded that the Board's negotiating Wiederhorn's Amended Employment Agreement, acquiescing to Wiederhorn's demands for financial support during his imprisonment, paying his court-ordered restitution, and retaining him in his executive and director positions during his imprisonment was not in the public interest. Fog Cutter sought review of the staff's decision before the Panel. The Panel determined that delisting was appropriate. Fog Cutter sought review of that decision by the NASDAQ Listing and Hearing Review Council ("Council"), which affirmed the Panel's decision "in order to protect the quality of and public confidence in The Nasdaq Stock Market, and to protect investors and the public interest." When the NASD Board of Governors did not review the Council's decision, Fog Cutter sought Commission review. 12/

III.

Our review of NASD's delisting of Fog Cutter is governed by Exchange Act Section 19(f). Under Section 19(f), we will dismiss Fog Cutter's appeal if we find that "the specific

10/ The record includes a complaint in a pending shareholder derivative suit in Oregon state courts. McCoon v. Wiederhorn, No. 0407-06900 (Cir. Ct. Multnomah County) (complaint filed July 6, 2004). We have not considered the suit in our resolution of this proceeding.

11/ According to Fog Cutter, even with the June 4, 2004, disclosures, its stock price remained well above Nasdaq minimums until delisting.

12/ Fog Cutter's October 12, 2005, Form 8-K reported that Wiederhorn had been released from prison and had resumed his duties as Fog Cutter's Chairman and CEO. Fog Cutter's October 17, 2005, Form 8-K reported, however, that the Bureau of Prisons objected to Wiederhorn's resumption of his former duties as being incompatible with his participation in a work-release program requiring that he be supervised. To comply with the work-release program, Fog Cutter returned Wiederhorn to the position of Chief Strategy Officer. Fog Cutter reported further that it anticipated Wiederhorn's return to his duties as CEO and Chairman upon completion of the work-release program, on or about November 22, 2005.

grounds on which such denial . . . is based exist in fact, that such denial . . . is in accordance with the rules of [NASD], and that such rules are, and were applied in a manner, consistent with the purposes of [the Exchange Act]." 13/

Under Rules 4300 and 4330, NASD has discretion to apply additional or more stringent rules to issuers listed on Nasdaq when an "event, condition, or circumstance" makes application of stricter standards advisable. 14/ NASD may also apply additional or more stringent standards to issuers to prevent fraud or manipulation, promote just and equitable principles of trade, and to protect investors and the public interest. 15/ Fog Cutter does not dispute that Wiederhorn pleaded guilty to two felonies, payment of an illegal gratuity and filing a false income tax return. Nor does Fog Cutter dispute the facts of the Board's response to Wiederhorn's guilty plea. Fog Cutter does dispute, however, that these events support the conclusion that Fog Cutter's continued listing on Nasdaq sufficiently threatened the public interest or the integrity of Nasdaq to justify delisting Fog Cutter.

NASD found Wiederhorn's two felony convictions and imprisonment serious. Although Fog Cutter describes Wiederhorn's sentence as a "relatively brief period of incarceration," we believe the sentence of eighteen months imprisonment (fourteen of which were served), payment of a \$25,000 fine, and payment of \$2 million in restitution make clear the seriousness of the offenses. 16/

13/ Exchange Act § 19(f), 15 U.S.C. § 78s(f). Fog Cutter has not alleged, and the record does not suggest, that NASD's delisting "imposes any burden on competition not necessary or appropriate in furtherance of the purposes of" the Exchange Act. See id.

14/ NASD Marketplace Rule 4300.

15/ NASD Marketplace Rule 4330.

16/ Fog Cutter notes that the payment of an illegal gratuity does not involve criminal intent. Fog Cutter does not suggest that filing a false tax return does not require intent. Conviction of the crime of filing a false tax return requires proof that a taxpayer "willfully" signed and filed a tax return he or she knew to be false. 26 U.S.C. § 7206(1). The Supreme Court of the United States has held that, in the context of filing a false tax return, the term "willful" connotes a "voluntary, intentional violation of a known legal duty." United States v. Bishop, 412 U.S. 346, 360 (1973) (summarizing previous holdings that "willful" means "bad faith or evil intent," or "evil motive and want of justification in view of all the financial circumstances of the taxpayer," or knowledge that the taxpayer "should have reported more income than he did").

(continued...)

NASD further expressed concern that Wiederhorn was Fog Cutter's Chairman, CEO, and majority shareholder and intended to continue to exert influence and control over Fog Cutter's affairs even while incarcerated. NASD did not see that there was any attempt by Fog Cutter to limit Wiederhorn's influence over the company despite his felony convictions. Fog Cutter concedes that Wiederhorn is critical to its operations.

In JJFN Services, Inc., we upheld NASD's refusal in 1996 to list JJFN, based on the 1992 felony tax fraud conviction of the company's controlling shareholder, promoter, and paid consultant. ^{17/} The convicted individual founded the company, created the service it provided to real estate developers, and otherwise played an essential role in the company. We agreed with NASD that the convicted individual's essential role supported NASD's determination not to list JJFN. We noted that NASD's listing authority "is necessarily broad." ^{18/} We further found that "[b]oth the tax and the securities regulatory schemes depend on the honor, candor, and integrity of regulated persons to report accurately to the regulatory authority the information sought by such authority," ^{19/} and that the conviction of a controlling person for "tax fraud legitimately may be considered by the NASD to be evidence of a propensity for future conduct violative of securities laws or regulations." ^{20/}

We recognize that, as Fog Cutter argues, the individual in JJFN was convicted for filing a false tax return in connection with another business while Wiederhorn's very recent tax conviction pertained to a personal return, but that distinction does not undermine the applicability of JJFN to Fog Cutter's situation. The wrong committed by an untruthful taxpayer is telling a falsehood to an agency that relies upon truthful reporting of economic activity. The nature of the wrong is not altered by the circumstance that the falsehood was uttered by the taxpayer on his personal return instead of on a business return. As we have noted, the evidence of falsehoods

^{16/} (...continued)

Fog Cutter also asserts that Wiederhorn acted with the advice of professionals. As we have suggested in other contexts, we will not permit collateral attack on Wiederhorn's convictions. See Ira William Scott, 53 S.E.C. 862, 866 (1998).

^{17/} 53 S.E.C. 335 (1997). The person at issue in JJFN pleaded guilty to, among other charges, filing a false tax return in violation of 26 U.S.C. § 7206(1), the same crime to which Wiederhorn pleaded guilty. Id. at 337 n.2. JJFN's promoter admitted filing false tax returns in 1983, 1984, and 1985 in connection with his 1992 guilty plea.

^{18/} Id. at 340.

^{19/} Id. at 338-39.

^{20/} Id. at 338.

told to the government is properly of great interest to securities regulators who operate under similar constraints as the tax authorities. 21/

Fog Cutter suggests that our opinion in JJFN can be distinguished because it made no mention of any action by the JJFN board of directors. Fog Cutter is correct, but the distinction aggravates, rather than lessens, the concerns raised by NASD with respect to Fog Cutter because the actions of Fog Cutter's Board were part of the problem. NASD determined that Wiederhorn so thoroughly influenced the Board that it provided no check upon Wiederhorn's conduct.

Although well aware that the grand jury investigation had targeted Wiederhorn, the Board agreed to the Amended Employment Agreement to prevent his termination for cause in the anticipated event that he might subsequently be convicted of crimes not involving Fog Cutter. 22/ Later, knowing that Wiederhorn was going to plead guilty to the felony charges against him, the Board negotiated the Leave Agreement that continued Wiederhorn's compensation during his incarceration and indirectly paid the restitution imposed on Wiederhorn as part of his sentence. As part of the same Agreement, the Board tried to retain Wiederhorn as co-CEO and co-Chairman during his imprisonment. 23/ Fog Cutter determined not to retain Wiederhorn as co-CEO only when the Bureau of Prisons notified Fog Cutter that Wiederhorn would not be allowed to conduct a business from prison. 24/ Fog Cutter suggests the Leave Agreement allowed the Board to keep Wiederhorn at Fog Cutter and avoid wrongful-termination litigation with Wiederhorn. We note, however, that it was the Board's limitation of its authority to terminate Wiederhorn for cause under the Amended Employment Agreement that made credible Wiederhorn's threat of such litigation.

21/ Id. at 338-39.

22/ Fog Cutter's argument that the amendment strengthened the Board's discretion ignores the fact that termination for cause was discretionary with the Board under the old agreement. The new agreement consequently sharply limited the Board's discretion to address an issue that it should have known was likely to arise.

23/ Fog Cutter has claimed that it needed to retain Wiederhorn as CEO in order to prevent the GEMB minority shareholders from repurchasing Fog Cutter's interest in GEMB. See supra n.4.

24/ See supra n.7 and accompanying text.

Fog Cutter claims that NASD's opinion was conclusory. 25/ We disagree. NASD made clear the bases for its conclusion that the public interest required the delisting of Fog Cutter: Wiederhorn's guilty plea to two felonies; his continuing influence over the company notwithstanding his imprisonment; the negotiation of the Amended Employment Agreement; the agreement to pay \$2 million to cover the cost of court-ordered restitution in addition to the other terms of the Leave Agreement; and Fog Cutter's intention to have Wiederhorn act as CEO while incarcerated. These factors led NASD to conclude that Fog Cutter, with Wiederhorn in control under only nominal Board supervision, was an issuer that presented inappropriate non-market risk to public investors and, consequently, should be delisted. 26/

Fog Cutter also seems to complain about the quality of NASD's investigation. NASD represents that it met with company representatives, counsel, and at least one board member. Fog Cutter does not deny that these contacts occurred but complains that the investigation lasted only five weeks and took no on-the-record testimony. We believe NASD acted quickly, appropriately, and in accordance with NASD rules. As NASD notes, there is no requirement for on-the-record testimony in delisting cases. Moreover, Fog Cutter's counsel stated at the beginning of the hearing that Nasdaq staff had gone out of its way to listen to the company. 27/

Fog Cutter also argues that NASD's action is inconsistent with actions taken in response to other high-profile executives who were allowed to return to their companies after serving prison terms for crimes more serious than those committed by Wiederhorn. As we have noted on

25/ Fog Cutter relies on McCarthy v. SEC, 406 F.3d 179, 188 (2d Cir. 2005). McCarthy involved an appeal of exchange disciplinary action under Exchange Act Section 19(e), 15 U.S.C. § 78s(e), and does not consider the review of actions such as delisting under Exchange Act Section 19(f). In any event, as we have discussed herein, we believe that NASD's opinion sets forth the factual predicate for its decision.

26/ See DHB Capital Group, Inc., 52 S.E.C. 740, 745 (1996).

27/ Fog Cutter's counsel opened his presentation to the Panel with the following statement:

The [Nasdaq] staff has gone out of its way to give us a hearing[,] to listen to our arguments, to even extend their own period of considerations to talk to members of our Board. We've had our disagreements, but I just wanted to establish this is going to be a very civil exchange, if there is an exchange. Because these three [Nasdaq staff] people have treated us very, very fairly and whatever happens, I wanted to compliment them on their patience as well as their civility.

other occasions, each case is to be decided on its own facts and circumstances, and it is not appropriate to compare them. 28/

Fog Cutter argues that the Board had good business reasons for its actions regarding Wiederhorn. For example, by negotiating the Leave Agreement, Fog Cutter asserts that it retained Wiederhorn's good will and managerial presence and balanced Wiederhorn's desire to provide for his family with Fog Cutter's desire to have Wiederhorn avoid a lengthy criminal trial with its attendant damaging publicity. Fog Cutter concedes that it knew the Board's decisions "could be controversial" and admits it did not request guidance from NASD staff before taking those controversial steps.

The issue here, however, is not the Board's business judgment but, rather, the public interest. Listing a security on a market creates expectations among investors that listed companies meet basic standards of corporate governance and financial soundness. We have stated that "inclusion of a security . . . entail[s] an element of judgment given the expectations of investors and the imprimatur of listing on a particular market." 29/ We have also held that "the risk associated with investing in [Nasdaq] is market risk rather than the risk that the promoter or other person exercising substantial influence over the issuer is acting in an illegal manner." 30/ We also agree with NASD that the Board, in negotiating Wiederhorn's Amended Employment Agreement and acquiescing in his desire for the Leave Agreement, put Wiederhorn's interests above those of the shareholders. 31/ For example, according to Fog Cutter's Form 10-K/A for June 2004, Fog Cutter's "leave of absence expense" totaled \$4,750,000, during a period for which Fog Cutter reported a net loss of \$3,932,000. We believe that NASD's action in delisting Fog Cutter is consistent with policies of the Exchange Act.

28/ DHB Capital Group, 52 S.E.C. at 745 (rejecting argument that another company continued inclusion in Nasdaq "although associated with a notorious securities law violator."); see Butz v. Glover Livestock Comm'n Corp., 411 U.S. 182, 187 (1973).

29/ DHB Capital Group, 52 S.E.C. at 744.

30/ Id. at 745 (quoting Tassaway, Inc., 45 S.E.C. 706, 709 (1975)).

31/ Fog Cutter's reliance on e-Smart Technologies, Inc., Initial Decision Rel. No. 272 (Feb. 3, 2005), 84 SEC Docket 2979, and other registration revocation cases to suggest that Fog Cutter's shareholders are similarly situated is misplaced, as those cases are inapposite. When the Commission revokes the registration of an issuer's securities pursuant to Exchange Act Section 12(j), that issuer's securities may not be traded publicly, absent an exemption. By contrast, while NASD has delisted Fog Cutter from its market, Fog Cutter's stock continues to be traded publicly. It is listed in the National Quotation Bureau's Pink Sheets. Over the last fifty-two weeks, Fog Cutter stock has traded between \$2.50 and \$4.00 per share.

IV.

Having found that the grounds for NASD's delisting of Fog Cutter's securities exist in fact, were based on NASD rules, and were applied in a manner consistent with the Exchange Act, we dismiss the review proceeding. 32/

An appropriate order will issue.

By the Commission (Chairman COX and Commissioners GLASSMAN, ATKINS, CAMPOS, and NAZARETH).

Jonathan G. Katz
Secretary

32/ We have considered all of the arguments advanced by the parties. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 52993 / December 21, 2005

Admin. Proc. File No. 3-11934

In the Matter of the Application of
FOG CUTTER CAPITAL GROUP, INC.
c/o Lanny J. Davis
Orrick, Herrington & Sutcliffe LLP
Washington Harbour
3050 K St., N.W.
Washington, D.C. 2007-5135

For Review of Action Taken by

NASD

ORDER DISMISSING REVIEW PROCEEDING

On the basis of the Commission's opinion issued this day, it is

ORDERED that the application for review filed by Fog Cutter Capital Group, Inc. be, and it hereby is, dismissed.

By the Commission.

Jonathan G. Katz
Secretary

BEFORE THE NASDAQ LISTING AND HEARING REVIEW COUNCIL

THE NASDAQ STOCK MARKET, INC.

In the Matter of

Fog Cutter Capital Group, Inc.
c/o Lanny J. Davis, Esq.
Orrick, Herrington & Sutcliffe LLP
3050 K Street, N.W.
Washington, D.C. 20007-5135

Concerning the Operations of
The NASDAQ Stock Market

DECISION

Docket No. NQ 4606N-04

Date: February 16, 2005¹

Fog Cutter Capital Group, Inc. (the "Company") appealed this matter to the NASDAQ Listing and Hearing Review Council (the "Listing Council"). In a decision dated October 12, 2004, the Nasdaq Listing Qualifications Panel (the "Panel") determined to delist the Company's securities from The Nasdaq National Market (the "National Market") based on public interest concerns in accordance with Nasdaq Marketplace Rules 4300 and 4330(a)(3).² After considering the written record in this matter, the Listing Council affirms the decision of the Panel on that ground.

The Company operates a restaurant business, conducts commercial mortgage lending and brokerage activities, and makes real estate investments.

Proceedings Below

In March 2001, Andrew Wiederhorn ("Wiederhorn") the Company's Chief Executive Officer, and Lawrence Mendelsohn, ("Mendelsohn") the Company's former President, received letters from the United States Attorney's Office for the District of Oregon advising them that they were targets of a grand jury investigation into the failure of Capital Consultants, L.L.C., ("CCI") an investment advisor. In August 2002, Mendelsohn resigned as President and Director of the Company, and in November 2003, he entered into an agreement with the federal government

¹ Pursuant to Rule 4845(c), to correct administrative errors, this decision shall supersede the prior decision also issued on February 16, 2005. Changes to the original decision have been italicized.

² Rules 4300 and 4330(a)(3) provide that NASDAQ may exercise its discretion in applying additional or more stringent criteria for initial or continued inclusion or suspend or terminate the inclusion of an otherwise qualified security if NASDAQ deems it necessary to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, or to protect investors and the public interest.

pursuant to which he *pled* guilty to filing a false 1998 personal tax return and agreed to cooperate in the investigation.³

On June 3, 2004, Wiederhorn, the Company's Chief Executive Officer and Chairman of the Board pled guilty to two felony counts: i) paying an illegal gratuity to *an* investment advisor,⁴ and ii) filing a false 1998 personal tax return that overstated certain capital losses. As a result, Wiederhorn was sentenced to 18 months in federal prison, and ordered to pay \$2,000,000 in restitution to the receiver of CCI and a \$25,000 fine.

In the Form 8-K filed with the Securities and Exchange Commission ("SEC") dated June 4, 2004, that disclosed Wiederhorn's guilty plea, the Company also announced that on June 2, 2004, as a result of Wiederhorn's settlement with the federal government, the Company entered into a Leave of Absence Agreement ("LOA") with Wiederhorn, under which the Company would: i) continue to pay Wiederhorn's regular annual salary of \$350,000, and bonus during his incarceration, and ii) pay Wiederhorn a "leave of absence" payment in the amount of \$2,000,000 in consideration of his "good will, cooperation, and continuing assistance, and in recognition of Wiederhorn's past service to the Company, to help avoid litigation and for the other reasons." The Company also agreed that Wiederhorn would remain Co-Chairman of the Board of Directors ("Board") as well as Co-Chief Executive Officer of the Company. Donald Berchtold,⁵ Wiederhorn's father in law, was named as co-Chief Executive Officer, and David Dale-Johnson and Don Coleman⁶ were named as co-Chairmen of the Board.

On July 20, 2004, staff notified the Company that its securities would be delisted on July 29, 2004, based upon public interest concerns relating to Wiederhorn's plea and the Company's actions in response thereto, unless the Company requested a Panel hearing.

Staff raised concerns in the staff determination letter that Wiederhorn would continue to serve as the Co-Chairman, as well as an officer while incarcerated, and questioned how he would be able to discharge his duties and responsibilities necessary to certify and sign off on the Company's financial statements as required under the Sarbanes-Oxley Act of 2002. ("Sarbanes-Oxley") Staff also questioned Wiederhorn's past and current ties to each of the Board members and the Company's actions when viewed against the backdrop of these relationships. As such, staff expressed concern with the following actions by the Company's Board of Directors:

- i) entering into the LOA with Wiederhorn, which included payment of \$2,000,000 in addition to his regular salary and bonuses,
- ii) changing Wiederhorn's employment agreement on August 11, 2003 – at a time when the Board knew that Wiederhorn faced federal felony indictments. The Company argued that Wiederhorn might be entitled to at least \$7 million in severance because the Board did not have grounds to fire him for cause under

³ See the Company's Form 10-Q for the quarter ended September 30, 2004, Part II – Other Information, Item 1. Legal Proceedings.

⁴ Wiederhorn forgave a \$3,500,000 loan guaranty in violation of 18 U.S.C. section 1954, an ERISA provision.

⁵ Donald Berchtold has been Senior Vice President of Administration at the Company since October 1999 and became a director in March 2004.

⁶ Both David Dale-Johnson and Don Coleman have been directors of the Company since October 2001.

his employment agreement. Whereas the three previous employment agreements with Wiederhorn defined one basis for termination for cause as “Executive being convicted of a felony (other than a felony involving a traffic offense)”, *the amended and restated agreement provides as follows: “Executive being convicted of a felony (other than a felony involving a traffic offense) involving the Company”*; and

- iii) allowing Wiederhorn to remain CEO and Chairman, while incarcerated, because the two individuals holding the remaining 49 percent minority interest of George Elkins Mortgage Banking Company⁷ (“George Elkins”) threatened to sue to purchase the Company’s share of the investment if Wiederhorn lost his titles.

On July 22, 2004, the Company appealed staff’s determination to the Panel, which stayed the delisting.

In its submission to the Panel dated August 16, 2004, the Company stated that it had recently learned from the Bureau of Prisons that Wiederhorn would be unable to sign the certifications required of him as Co-CEO by Sarbanes-Oxley, and as such, on August 13, 2004, the Board decided to change Wiederhorn’s officer position in the Company from Co-CEO to Chief Strategy Officer.

Also in its submission and at the Panel hearing held on September 9, 2004, the Company asserted that it is a well-managed company with strong corporate governance and a track record of transparency. It represented that the Board’s actions in connection with Wiederhorn’s guilty plea, including the execution of the leave of absence agreement and retention of Wiederhorn as an officer and director during his incarceration, were in the best interests of the Company and its shareholders. As such, the Company argued the following:

- i) Wiederhorn was allowed to remain Co-CEO and Co-Chairman to protect the value of the Company’s investment in George Elkins. If Wiederhorn left his positions, the George Elkins minority shareholders could exercise their right to purchase the Company’s 51% interest, at a price significantly lower than the market price. He was also allowed to retain his titles because neither the Company, nor Wiederhorn in his capacity as a Company officer, were involved in any of the acts that formed the basis of Wiederhorn’s guilty plea.
- ii) It paid Wiederhorn the LOA and performance bonus because Wiederhorn told the Board that if he couldn’t assure the financial security of his family, he would fight the charges against him. As such, the Board was concerned of protracted litigation involving the Company and harm to the Company’s business when it made its decision. The Board also felt that Wiederhorn was responsible for the Company’s past performance and was critical to the Company’s future success.
- iii) Execution of the leave of absence agreement allowed the Company to focus on its business going forward by avoiding the distraction of a protracted public

⁷ The Company held the remaining 51% interest in the George Elkins Mortgage Banking Company.

- issue and potential litigation with Wiederhorn regarding the relevant employment agreement, and
- iv) Wiederhorn's actions did not involve the Company, were taken on the advice of counsel and other experts, and did not involve accounting fraud or other corporate malfeasance. In fact, the Company stated that, had Wiederhorn been engaged in corporate malfeasance, accounting fraud, or intentional criminal misconduct, it would have immediately terminated his employment and denied him any compensation or bonus.

The Company argued that viewed in context and with a full understanding of facts, that the Board acted independently and in good faith with respect to Wiederhorn and as such the Company's securities should continue to be listed on Nasdaq, as it is in the best interests of the investing public.

On October 12, 2004, the Panel issued its decision. The Panel expressed deep concern regarding the charges to which Wiederhorn pled guilty. The Panel was of the opinion that the nature of the charges, which included payment of an illegal gratuity and the filing of a false tax return, and Wiederhorn's continued involvement in the Company pose a serious threat to the investing public, investor confidence in Nasdaq, and the integrity of The Nasdaq Stock Market. The Panel was particularly troubled that Wiederhorn, the Company's Chairman, CEO and 55% shareholder at the time of the events that formed the basis for the fraud convictions, continues to exert influence and control over the Company's affairs in his capacity as Chief Strategy Officer, Co-Chairman of the Board and the Company's majority shareholder while incarcerated. The Panel was not persuaded by the Company's argument that the lack of corporate malfeasance should temper its concerns regarding Wiederhorn's continued involvement in the Company's affairs. The Panel also lacked confidence in the Company's Board of Directors, which is in part comprised of Wiederhorn's friends and family, in light of the Board's ongoing concessions to Wiederhorn. Based on the facts and circumstances of this matter, the Panel determined that, in order to preserve and strengthen the quality and integrity of, and public confidence in, The Nasdaq Stock Market, and in order to protect prospective investors and the public interest, the Company's securities should be delisted from The Nasdaq Stock Market effective October 14, 2004.

Listing and Hearing Review Council Proceedings

By letter dated October 18, 2004, the Company requested that the Listing Council review the Panel's decision. The Company was afforded the opportunity to respond and supplement the record on review, and did so on November 9, 2004. In that submission, the Company argued that Nasdaq, by ignoring that Wiederhorn pled guilty to a no-intent crime that did not involve the Company, sends a message to other issuers that a guilty plea by a CEO of an issuer merits delisting, regardless of the facts and circumstances underlying that plea. Secondly, the Company contended that the delisting has established that Nasdaq will substitute, without considering all of the facts, its own sense of how a Board should make decisions affecting a company. The Company then reiterated its position with regards to the nature of the offenses to which

Wiederhorn pled guilty and the reasoning behind the negotiated LOA with Wiederhorn. The Company cited other companies that were similarly situated and asked for equal treatment.

The Company also argued that the minority shareholders that the Panel claimed to be protecting have been hurt by fluctuations in the share price and lowered trading volumes. The Company believed that its minority shareholders would be better protected by allowing those shareholders continued access to the Nasdaq marketplace.

Decision

After a review of the record in this matter, the Listing Council affirms the decision of the Panel based on public interest concerns, as set forth in Rules 4300 and 4330(a)(3).

In making this decision, the Listing Council considered Wiederhorn's guilty plea to two felony counts for the payment of an illegal gratuity to a Portland fund advisor and the filing of a false tax return that overstated certain capital losses. The serious nature of Wiederhorn's actions is demonstrated by the disposition of Wiederhorn's case, including a requirement to pay \$2,000,000 in restitution, a \$25,000 fine, and an 18-month term in a federal prison.

The SEC has held that "the tax and the securities regulatory schemes depend on the honor, candor, and integrity of regulated persons to report accurately to the regulatory authority the information sought by such authority."⁸ The SEC has further held that "the risk associated with investing in NASDAQ is market risk rather than the risk that the promoter or other persons exercising substantial influence over the issuer is acting in an illegal manner."⁹ As such, the Listing Council agrees with the Panel's concern that Wiederhorn, the Company's Chairman, CEO and 55% shareholder at the time of the events that formed the basis for the fraud convictions, continues to exert influence and control over the Company's affairs in his capacity as Chief Strategic Officer, Treasurer, Secretary, and Director and as the Company's majority shareholder, while incarcerated.¹⁰

The Listing Council was also particularly concerned with the actions of the Company's Board of Directors after Wiederhorn was identified as the target of an investigation by the U.S. Attorney's Office. It appears that the Company was aware in March 2001 that Wiederhorn had received a letter from the U.S. Attorney's Office advising him that he was a target of a grand jury investigation into the failure of Capital Consultants, LLC. As stated in staff's July 20, 2004 letter to the Company, "prosecutors were ready to indict Wiederhorn in December 2002, when Wiederhorn's attorney's agreed to waive the statute of limitations as well as the attorney-client privilege if prosecutors held off." The Listing Council found it incredulous that, with this knowledge, in August 2003, the Board renegotiated certain provisions of the Wiederhorn's employment agreement and agreed to exclude from the definition of a "for cause" termination any termination based on Wiederhorn's conviction of a felony unrelated to the Company. Based

⁸ JJFN Services, Inc., Securities Exchange Act Rel. No. 39343 (November 21, 1997).

⁹ DHB Capital Group, Inc., Securities Exchange Act Rel. No. 37069 (April 5, 1996) (quoting Tassaway, Inc., Securities Exchange Act Rel. No. 34151 (March 13, 1975)).

¹⁰ See the Company's Proxy Statement dated November 1, 2004.

on the Company's August 16, 2004 Panel submission, this negotiation was prompted by Wiederhorn, who knew of the two outstanding claims by the government and wanted to protect his earnings stream in order to provide for his family. The Board was also aware of the claims, and "believed they were ill-founded."

The Listing Council does not agree with the Company's contention that "in order to criticize the Board for agreeing to the provision, the staff must necessarily have concluded that the Board should have dismissed Wiederhorn from his positions because of his plea agreement..." In the alternative, the Board could have decided not to take the pro-active step that it took, i.e., it could have left the employment agreement as it stood prior to the renegotiation. In addition, the Listing Council finds it unconscionable that the Board agreed to pay Wiederhorn \$2,000,000 in addition to his regular salary and bonus. While the Company characterizes the \$2,000,000 as a leave of absence payment, the Listing Council believes the payment is a transparent attempt to pay Wiederhorn's court-ordered restitution related to his guilty pleas. This action is further evidence of Wiederhorn's influence over the Company, which is at odds with shareholders' interests and good corporate governance.

The Listing Council was also concerned, given the heightened scrutiny of all companies' corporate governance and the extensive efforts that have been made by Congress and Nasdaq, among others, that the Company would have allowed Wiederhorn to sign the certifications required of him as Co-Chief Executive Officer under Sarbanes-Oxley, but for the notice from the Bureau of Prisons.

Based on these and other actions of the Board, the Listing Council has concerns whether the Board, which is comprised of Wiederhorn's friends and family, has discharged its duty to the Company's shareholders. The Listing Council agrees with the Company that "thoughtful board of directors acting in their companies' best interests must make a deeper consideration of matters such as these." Based upon the record on review, the Listing Council questions whether the Board was working on behalf of the Company's best interest, or on behalf of Wiederhorn's interest.

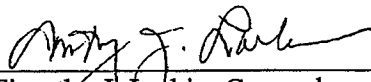
With regard to the Company's contention that its securities should be relisted in an effort to protect its minority shareholders, the Listing Council was not persuaded. In Tassaway, Inc. the Securities and Exchange Commission held that while the removal of a security may harm existing investors, "primary emphasis must be placed on the interests of prospective future investors."

Finally, in reaching its decision, the Listing Council notes that it has taken into account the difficulties and pressures faced by Wiederhorn, the Board and the Company which were created by the government investigation and resulting plea agreement. However, the Listing Council primarily takes issue with the way in which Wiederhorn and the Board conducted their affairs prior to the indictment and after Wiederhorn's guilty plea to the felony counts.

The Listing Council finds that Wiederhorn's regulatory history, along with his ability to exert influence over the operations of the Company and apparent influence over Board actions, provide grounds for denying the Company's request for continued listing in order to protect the

quality of and public confidence in The Nasdaq Stock Market, and to protect investors and the public interest. Accordingly, the Listing Council finds that the totality of the circumstances raise public interest concerns under Rules 4300 and 4330(a)(3) that make it appropriate to apply additional and more stringent criteria in order to preserve and strengthen the quality of and public confidence in Nasdaq and serve as a basis for affirming the delisting of the Company's securities. Based upon all of the specific facts and circumstances the Listing Council finds that the Panel properly determined that, in order to preserve and strengthen the quality and integrity of, and public confidence in, The Nasdaq Stock Market, and in order to protect prospective investors and the public interest, the Company's securities should be delisted from The Nasdaq Stock Market.

On Behalf of the NASDAQ Listing and Hearing Review Council,



Timothy J. Latkin, Counsel

ADDENDUM 2

PERTINENT STATUTES AND REGULATIONS

NASDAQ MARKETPLACE RULE 4300 (effective at the time of the Nasdaq's decision in July 2004)

Nasdaq ... will exercise broad discretionary authority over the initial and continued inclusion of securities in Nasdaq in order to maintain the quality and public confidence in its market. Under such broad discretion and in addition to its authority under Rule 4330(a), Nasdaq may deny initial inclusion or apply additional or more stringent criteria for the initial or continued inclusion of particular securities or suspend or terminate the inclusion of particular securities based on any event, condition, or circumstance which exists or occurs that makes initial or continued inclusion of the securities in Nasdaq inadvisable or unwarranted in the opinion of Nasdaq, even though the securities meet all enumerated criteria for initial or continued inclusion in Nasdaq.

NASDAQ MARKETPLACE RULE 4330(a)(3) (effective at the time of the Nasdaq's decision in July 2004)

Nasdaq may, in accordance with the Rule 4800 Series, deny inclusion or apply additional or more stringent criteria for initial or continued inclusion of particular securities or suspend or terminate the inclusion of an otherwise qualified security if Nasdaq deems it necessary to prevent fraudulent and manipulative acts or practices, to promote just and equitable principles of trade, or to protect investors and the public interest.

ADDENDUM 3

82 S.E.C. Docket 1118, Release No. ID - 247, 2004 WL 407490 (S.E.C. Release No.)

(Cite as: 2004 WL 407490 (S.E.C. Release No.))

▷

S.E.C. Release No.

*1 Initial Decision

IN THE MATTER OF E-SMART TECHNOLOGIES, INC., F/K/A PLAINVIEW LABORATORIES, INC.
Administrative Proceeding File No. 3-10977
March 4, 2004

BEFORE: Lillian A. McEwen, Administrative Law Judge

APPEARANCES:

Charles D. Stodghill for the Division of Enforcement, United States Securities and Exchange Commission

Maranda E. Fritz for e-Smart Technologies, Inc., f/k/a Plainview Laboratories, Inc.

INITIAL DECISION

SUMMARY

Respondent e-Smart Technologies, Inc., f/k/a Plainview Laboratories, Inc. (e-Smart), repeatedly failed to file annual and quarterly reports while its common stock was registered with the Securities and Exchange Commission (Commission) in violation of the periodic reporting requirements of Section 13(a) of the Securities Exchange Act of 1934 (Exchange Act) and Rules 13a-1 and 13a-13 thereunder. This Initial Decision revokes the registration of e-Smart's common stock.

PROCEDURAL HISTORY

The Commission initiated this proceeding, pursuant to Section 12(j) of the Exchange Act, with an Order Instituting Proceedings (OIP) on December 16, 2002, and e-Smart filed a timely Answer. Shortly before the hearing, the Division of Enforcement (Division) sought to modify the OIP, withdrawing a claim under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and the Commission granted the modification on December 9, 2003 (Modification Order). See e-Smart, Exchange Act Rel. No. 48895. I held a one-day public hearing on December 8, 2003, in New York, New York, at which e-Smart called two witnesses and the Division called none. Three exhibits from e-Smart and five exhibits from the Division were admitted into evidence. The Division and e-Smart filed Post-Hearing Briefs on January 27 and January 30, 2004, respectively. [FN1] Included with e-Smart's Post-Hearing Brief was an additional post-hearing submission, e-Smart's Form 10-QSB for the period ending September 30, 2003, not previously listed on the parties' joint exhibit list. I nonetheless take official notice of this filing, pursuant to Rule 323 of the Commission's Rules of Practice, 17 C.F.R. § 201.323, as it is publicly available over the Commission's Electronic Data Gathering, Analysis, and Retrieval System (EDGAR).

ISSUES PRESENTED

The OIP, as modified, alleges that at all relevant times, e-Smart's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. While registered, the OIP alleges, e-Smart failed to comply with the reporting requirements of Section 13(a) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1, and 13a-13, by filing materially false and misleading reports with the Commission and failing to file annual and quarterly reports for several fiscal periods. If I conclude that these allegations are true, I must then determine, pursuant to Section 12(j) of the Exchange Act, what remedial sanction, if any, is appropriate.

FINDINGS OF FACT

*2 The findings and conclusions herein are based on the entire record. I applied preponderance of the evidence as the standard of proof. *Steadman v. SEC*, 450 U.S. 91,102 (1981). All arguments and proposed findings and conclusions inconsistent with this Initial Decision were rejected.

E-Smart, formerly known as Boppers Holdings, Ind., and Plainview Laboratories, Inc., is a Nevada corporation headquartered in San Jose, California. (Div. Exs. 1, 3-5; Resp. Ex. 3.) IVI Smart Technologies, Inc., a Delaware corporation (IVI Smart), is e-Smart's parent corporation owning seventy percent of the outstanding shares of e-Smart's common stock. (Tr. 87-88; Div. Ex. 3 at 11.) Mary Grace (Grace) has served as e-Smart's president and chief executive officer (CEO) since 2001 and was company chairman prior to that. (Tr. 23.)

E-Smart's business comprises developing and producing "biometric verification security systems" for government entities to be used in combating identity theft and payment fraud. (Tr. 24; Div. Ex. 1.) Among its products is the "smart card," which is a small identification card capable of storing personal data and confirming the cardholder's identity by a fingerprint sensor embedded in the card. (Tr. 61-67; Div. Ex. 1.) Wayne Drizin (Drizin) and Tamio Saito (Saito) are co-inventors of the smart card. (Tr. 25, 177.) Drizin and Saito have been involved with e-Smart since its inception developing products and are listed on the company's patents. (Tr. 132.) Grace, Drizin, and Saito each own ownership interests in IVI Smart. (Tr. 87-88.)

On May 30, 2000, e-Smart registered its common stock with the Commission pursuant to Section 12(g) of the Exchange Act by filing a Form 10-SB (a registration statement for small business issuers). (Div. Ex. 3 at 6) The stock is quoted on the Pink Sheets and is thinly traded. (Tr. 130; Div. Ex. 3 at 12.) E-Smart's equity is financed by private transactions, and no equity has been received through the public issuance of its shares. (Tr. 123; Div. Ex. 3.) According to a quarterly report dated June 30, 2003, e-Smart owns assets worth \$107,080, of which \$57,771 is categorized as "furniture, equipment, and leasehold improvements." (Div. Ex. 3 at 3.) As of December 8, 2003, e-Smart "ha [d] no source of income," but the company maintains that it is on the verge of securing several lucrative agreements. (Tr. 72, 103.)

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Periodic Reporting

Since registering its securities, e-Smart has failed to file annual reports with the Commission on Form 10-KSB (an annual report for small business issuers) for the fiscal years ending December 31, 2000, 2001, and 2002. (Tr. 7; Div. Exs. 4-5.) E-Smart also failed to file any quarterly reports on Form 10-QSB (a quarterly report for small business issuers) for the quarterly periods between September 30, 2000, and June 30, 2003. (Tr. 7; Div. Exs. 4-5.) Between May 30, 2000, through the hearing date, e-Smart filed three unaudited quarterly reports: June 30, 2000, September 30, 2000, and June 30, 2003, the last of which was received late by the Commission on November 14, 2003. (Tr. 7, 112-13; Div. Exs. 4-5.) E-Smart also subsequently filed a Form 10-QSB for the period ending September 30, 2003. (Resp. Post-Hear. Brief at Ex. 1.) At the hearing, e-Smart admitted to failing to file its periodic reports. (Tr. 7.)

False and Misleading Reporting

*3 In or about December 2001, certain members of e-Smart's management began to experience legal problems. (Tr. 34-35.) Grace and Drizin were both arrested and charged in actions brought by the U.S. Attorney's Office for the Southern District of New York. (Tr. 132; Div. Ex. 3 at 11.) Although the proceedings were eventually dismissed against both individuals, Drizin was later convicted in 2003 of wire fraud in a U.S. district court in Arizona. (Tr. 132-33, 138.) The conduct underlying the conviction occurred in 1994, was unrelated to e-Smart's business operations, and did not involve securities fraud. (Tr. 133.)

Grace's hearing testimony regarding Drizin's arrest and conviction conflicts with prior testimony taken in Drizin's criminal trial in Arizona. In a declaration filed in that proceeding, Grace described Drizin's availability with respect to e-Smart's operations as "indispensable" to the company. (Tr. 139-40) At the hearing, however, Grace characterized Drizin's current role as not vital to e-Smart's business. (Tr. 134.) E-Smart did not disclose Drizin's arrest or 2003 conviction in its Form 10-QSB, filed for the period ending June 30, 2003. (Tr. 134-36; Div. Ex. 3.) The filing does disclose the dismissals in the Southern District of New York. (Tr. 134-36; Div. Ex. 3 at 11.)

Compliance Efforts

In mitigation of the alleged filing violations, e-Smart claims that it is presently engaged in substantial good faith efforts to update its filings and cites the recent filings of two unaudited quarterly reports as evidence. (Answer; Tr. 73-83, 111, 117, 146-47; Resp. Post-Hear. Brief 1-2.) At the hearing, Grace testified, in substance, that as a start-up company, with little or no capital, the company's failure to file periodic reports is due primarily to minimal financial resources, loss of key persons overseeing the company's financial reporting, and most notably, distractions relating to criminal proceedings brought against both her and Drizin in federal court beginning in December 2001. (Tr. 34, 74-75, 79-82, 103, 117.) Grace claimed that these distractions would no longer

interfere with the company's reporting obligations. (Tr. 80-82.)

Certified Public Accountant Anthony Russo (Russo), recently retained by e-Smart to provide financial oversight and business development, corroborated Grace's testimony on compliance and estimated the cost of auditing the company for purposes of filing annual reports would range from \$25,000 to \$35,000. (Tr. 169-70; Resp. Ex. 3.) Russo also claimed that e-Smart would file an audited annual report for the 2003 fiscal year by the end of March 2004. (Tr. 160-61.) As for e-Smart's past filing failures, Russo opined, however, that "someone with experience could have done those 10-Qs and 10-Ks with little effort" and attributed noncompliance to "economics." (Tr. 180-81.)

CONCLUSIONS OF LAW

At the outset, it is unclear what timeframe the OIP covers. The OIP, issued on December 16, 2002, alleges that e-Smart filed materially false and misleading reports and failed to file periodic reports for "several fiscal periods" and that e-Smart was registered with the Commission at all "relevant times." Many actions the Division deems violative of the securities laws, however, occur well after the OIP was issued. Generally, arguments and factual matters falling outside the scope of the order instituting proceedings are considered only for limited purposes, such as background. *Int'l S'holders Servs. Corp.*, 46 S.E.C. 378, 386 n.19 (1976) ("The range of inquiry is broad. But it is not limitless."); see also Russell W. Stein, 79 SEC Docket 3098, 3114 n.34 (Mar. 14, 2003) (rejecting argument outside scope of order instituting proceedings). Conduct falling outside the scope of the order instituting proceedings may also be relevant for purposes of assessing sanctions. *Robert Bruce Lohmann*, 80 SEC Docket 1790, 1798 n.20 (June 26, 2003); *J. Stephen Stout*, 73 SEC Docket 1441, 1467 n.64 (Oct. 4, 2000); *Joseph J. Barbato*, 53 S.E.C. 1259, 1282 (1999).

*4 E-Smart first filed its registration statement under Section 12(g) of the Exchange Act on May 30, 2000, commencing the company's periodic reporting obligations and the relevant period. The Commission instituted this proceeding on December 16, 2002. The Modification Order of December 9, 2003, simply dropped the allegation that e-Smart violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and did not extend, abridge, or otherwise discuss, the relevant time period for the facts alleged. I conclude, then, that the relevant time period for assessing whether e-Smart committed the charges set forth in the OIP must be fairly limited to the period from May 30, 2000, to December 16, 2002. See *Richmark Capital Corp.*, 77 SEC Docket 621, 650 (Mar. 18, 2002) (limiting timeframe for Division's proof of alleged violative conduct to period set forth in OIP), *aff'd*, 81 SEC Docket 2205 (Nov. 7, 2003). Those events, cited by both parties, occurring outside the scope of the OIP will be considered only as background or for assessing sanctions.

Periodic Reporting

Section 13(a) of the Exchange Act and the rules promulgated thereunder require issuers of securities, registered pursuant to Section 12 of the Exchange Act, to file periodic and

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other reports with the Commission. Exchange Act Rules 13a-1 and 13a-13 require the submission of annual and quarterly reports, respectively. Implicit in these regulations is the requirement that the reports accurately reflect the financial condition and operating results of the issuer. See SEC v. Kalvex, Inc., 425 F. Supp. 310, 316 (S.D.N.Y. 1975); SEC v. IMC Int'l, Inc., 384 F. Supp. 889, 893 (N.D. Tex. 1974), aff'd mem., 505 F.2d 733 (5th Cir. 1974), cert. denied sub nom. Evans v. SEC, 420 U.S. 930 (1975). No showing of scienter, that is, mental state embracing intent to deceive, manipulate, or defraud, is necessary to establish a violation of Section 13(a) or the regulations thereunder. SEC v. McNulty, 137 F.3d 732, 740-41 (2d Cir. 1998); SEC v. Wills, 472 F. Supp. 1250, 1268 (D.D.C. 1978).

The importance of the reporting requirements is considerable. By updating information in the issuer's registration statement, periodic reports help ensure that the investing public receives current, accurate information concerning the operation and financial condition of the company. Kalvex, 425 F. Supp. at 315-16; see also WSF Corp., 77 SEC Docket 1831, 1836 (May 8, 2002), final, 77 SEC Docket 2336 (May 24, 2002). "The reporting requirements of the [Exchange Act are] the primary tool which Congress has fashioned for the protection of investors from negligent, careless, and deliberate misrepresentations in the sale of stock and securities. Congress has extended the reporting requirements even to companies, which are relatively unknown and insubstantial." SEC v. Beisinger Indus. Corp., 552 F.2d 15, 18 (1st Cir. 1977) (quoting S. Rep. No. 88-379 (1964) (legislative history discussing disclosure requirements for over-the-counter markets)).

*5 E-Smart admits to failing to file annual and quarterly reports during the relevant period. Accordingly, e-Smart violated Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder. During the relevant period, the investing public was deprived of current, accurate financial information on e-Smart.

False and Misleading Reporting

Rule 12b-20 of the Exchange Act requires issuers of registered securities to include in their reports before the Commission all material information necessary to make the required statements, in light of the circumstances in which they are made, not misleading. In practice, "[t]his rule provides that once disclosure has been made, the issuer must be sure to add all other and further material information needed to [e]nsure that the disclosures, which have been made, are not materially misleading." United States v. Yeaman, 987 F. Supp. 373, 380 (E.D. Pa. 1997). A violation of this provision occurs when a filing contains false or misleading information that is material, or omits to state material information necessary so that the statements made are not misleading. Willis, 472 F. Supp. at 1268; Kalvex, 425 F. Supp. at 315-16. As with other corporate reporting provisions, no showing of scienter is necessary to establish a violation. SEC v. Savoy Indus., Inc., 587 F.2d 1149, 1167 (D.C. Cir. 1978); Terex Corp., 69 SEC Docket 1814, 1834 n.11 (Apr. 20, 1999).

The Division contends that e-Smart violated Rule 12b-20 of the Exchange Act because it

failed to disclose in its Form 10-QSB for the period ending June 30, 2003, that Drizin, a vital e-Smart employee, was arrested and later convicted of wire fraud. The Division's argument, however, is not persuasive. In order for a violation of 12b-20 to occur, there must be an actual filing. During the relevant period, e-Smart filed its registration statement, no annual reports, and only two quarterly reports in 2000. The Division does not contend that these filings are in violation of the reporting requirements. The quarterly report upon which the Division does rely (for the period ending June 30, 2003) did not exist at the time the instant case was instituted. This filing is beyond the scope of the OIP. Therefore, I conclude that e-Smart did not violate Rule 12b-20 of the Exchange Act. This allegation of the OIP must be dismissed.

SANCTIONS

Since I have concluded that e-Smart violated Section 13(a) of the Exchange Act and its Rules 13a-1 and 13a-13, the only remaining issue is the appropriate sanction. Section 12(j) of the Exchange Act authorizes the Commission, "as it deems necessary or appropriate for the protection of investors," to revoke the registration of a security or suspend the registration of a security for a period not exceeding twelve months if it finds, after notice and an opportunity for hearing, that the issuer of such security has failed to comply with any provision of the Exchange Act or the rules and regulations thereunder. The Division argues that revocation of e-Smart's registration of common stock is appropriate. E-Smart, on the other hand, requests a grace period within which to complete and file its audited annual reports for the years 2002 and 2003.

*6 In determining whether a sanction is appropriate under Section 12(j) of the Exchange Act, the public interest factors identified in Steadman v. SEC are instructive. 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981); see also WSF Corp., 77 SEC Docket at 1836-37 (12(j) case applying Steadman). The relevant factors under Steadman are (1) the egregiousness of the respondent's actions, (2) the isolated or recurrent nature of the infraction, (3) the degree of scienter involved, (4) the sincerity of the respondent's assurances against future violations, (5) the respondent's recognition of the wrongful nature of its conduct, and (6) the likelihood of future violations. 603 F.2d at 1140. No one factor controls. WHX Corp., 80 SEC Docket 1318, 1337 (June 4, 2003).

The severity of a sanction depends on the facts of each case and the value of the sanction in preventing a recurrence. See Berko v. SEC, 316 F.2d 137, 141-42 (2d Cir. 1963). Any failure to cooperate with the Commission to remedy the violations may suggest a propensity to engage in future violations. SEC v. First New Jersey Secs., Inc., 101 F.3d 1450, 1477 (2d Cir. 1996). Consideration of hardship and equitable factors may also be appropriate, but the public's interest in preventing future violations is paramount. SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1102 (2d Cir. 1972).

Several factors under Steadman call for a strong sanction. E-Smart's violations were not only recurrent but also egregious, lasting over three years and continuing to the present. E-Smart has never filed audited annual reports and since September 2000, has filed just

two unaudited quarterly reports, with those only becoming available near the hearing date. Grace's words may demonstrate that e-Smart recognizes the wrongfulness of its filing failures, but the company's three-year hiatus from complying with the reporting requirements exhibits a very different attitude toward the federal securities laws. Further, although e-Smart represents that it intends to bring itself into full compliance with the periodic reporting requirements no later than March 31, 2004, this endeavor seems doomed. Based on cost estimates for audited reports, a dearth in its operating revenues and available capital, and no clear evidence beyond rosy speculation that funding is forthcoming, I conclude that e-Smart's persistent noncompliance will likely continue beyond March 31, 2004.

*7 In lieu of revocation, e-Smart proposes a grace period as the appropriate sanction. Such a sanction, however, is not available under Section 12(j) of the Exchange Act. A variant of e-Smart's sanction proposal that might be authorized by Section 12(j) is a suspension of e-Smart's registration. If e-Smart fails to bring itself into compliance at the conclusion of the suspension period, the Commission, however, would be required to initiate a new administrative proceeding to revoke e-Smart's registration. The overwhelming evidence convinces me that e-Smart cannot readily remedy its periodic reporting violations, which will likely recur in the future. Accordingly, I conclude that a suspension will not sufficiently protect the investing public.

E-Smart's failure to file required periodic reports has deprived the investing public of current, reliable audited information regarding e-Smart's operations and financial condition. Although private transactions may comprise all of e-Smart's funding, the company's common stock remains publicly available, and there is little or no available information upon which existing and potential investors can rely. In fact, only the insiders know the company's true financial state, while the public is left to guess. Having considered the Steadman factors in their entirety, I conclude that the only appropriate sanction for the protection of investors is revocation of the registration of e-Smart's common stock.

CERTIFICATION OF RECORD

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I hereby certify that the record includes the items set forth in the record index issued by the Secretary of the Commission on February 18, 2004.

ORDER

Based on the findings and conclusions set forth above:

IT IS ORDERED that, pursuant to Section 12(j) of the Securities Exchange Act of 1934, the registration of the common stock of e-Smart Technologies, Inc., f/k/a Plainview Laboratories, Inc., be and it hereby is REVOKED, for the company's violations of the periodic reporting requirements of Section 13(a) of the Securities Exchange Act of 1934 and Rules 13a-1 and 13a-13 thereunder; and

~~Westlaw.~~

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IT IS FURTHER ORDERED that the allegation in the OIP that e-Smart Technologies, Inc., f/k/a Plainview Laboratories, Inc., violated Rule 12b-20 of the Securities Exchange Act of 1934, be and it hereby is DISMISSED.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that rule, a petition for review of this Initial Decision may be filed within twenty-one days after service of the decision. It shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 360(d)(1) of the Commission's Rules of Practice, 17 C.F.R. § 201.360(d)(1), within twenty-one days after service of the Initial Decision upon them, unless the Commission, pursuant to Rule 360(b)(1), determines on its own initiative to review this Initial Decision as to any party. If a party timely files a petition for review, or the Commission acts to review as to a party, the Initial Decision shall not become final as to that party.

*8 Lillian A. McEwen

Administrative Law Judge

FN1. Citations to the transcript of the hearing are noted as "(Tr. __.)". Citations to the Division's and Respondent's exhibits are noted as "(Div. Ex. __ at __.)", and "(Resp. Ex. __ at __.)". Citations to the Division's and Respondent's Post-Hearing Briefs are noted as "(Div. Post-Hear. Brief __.)", and "(Resp. Post-Hear. Brief. __.)".

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END OF DOCUMENT

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H

S.E.C. Release No.

*1 Securities Exchange Act of 1934

IN THE MATTER OF E-SMART TECHNOLOGIES, INC.,
Administrative Proceeding File No. 3-10977
October 12, 2004

ORDER REMANDING PROCEEDING

I.

On March 4, 2004, an administrative law judge issued an initial decision pursuant to Section 12(j) of the Securities Exchange Act of 1934 revoking the registration of the common stock of e-Smart Technologies, Inc. ("e-Smart" or the "Company"). [FN1] The law judge found that e-Smart failed to make required annual and quarterly filings during the period between May 30, 2000, when e-Smart filed its registration statement, and December 16, 2002, when the Order Instituting Proceedings ("OIP") was issued, and that this failure to file violated Exchange Act Section 13(a) and Exchange Act Rules 13a-1 and 13a-13. [FN2] In determining to revoke the Company's registration, the law judge rejected as overly optimistic e-Smart's claim that it would return to reporting compliance by March 31, 2004. E-Smart appealed the law judge's decision, and on March 30, 2004, the Company filed what purported to be a consolidated annual report covering its 2002 and 2003 fiscal years. [FN3] The Company also has filed reports covering the first two quarters of this year.

On July 16, 2004, we issued an order denying a motion of the Division of Enforcement to affirm summarily the law judge's decision. [FN4] In determining to deny the Division's motion, we held, among other things, that one of the premises underlying the law judge's sanctioning determination -- that the Company could not readily remedy its reporting problems -- no longer appeared valid. For essentially the same reason, we have determined to remand this proceeding for reconsideration of the law judge's sanctioning determination. To the extent we make findings, we base them on an independent review of the record, except with respect to those findings not challenged on appeal.

II.

E-Smart, a Nevada corporation, is involved in developing and producing biometric verification security systems to be used in combating identity theft and payment fraud. [FN5] On May 30, 2000, e-Smart registered its common stock pursuant to Section 12(g) of the Exchange Act [FN6] by filing Form 10-SB, a registration statement for small business issuers. After registering its common stock, e-Smart filed two unaudited quarterly reports, using Form 10-QSB, for the quarters ending June 30 and September 30, 2000. Between the September 30, 2000 filing and the issuance of the OIP on December 16, 2002, e-Smart filed no quarterly or annual reports. [FN7] The law judge found that, by failing to file annual

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and quarterly reports during the relevant period, e-Smart violated Section 13(a) of the Exchange Act and Exchange Act Rules 13a-1 and 13a-13.

At the hearing, e-Smart admitted that it had failed to make required quarterly and annual filings, and that the only issue before the law judge was the appropriate sanction. E-Smart produced evidence, primarily through the testimony of its chief executive officer, Mary Grace, that the Company's failure to file the required reports was due to a variety of factors, including lack of capital, loss of key personnel involved in the Company's financial reporting, and distractions related to criminal proceedings brought against Grace and one of the inventors of the "smart card." [FN8] E-Smart represented that it had begun to put in place controls and procedures designed to ensure that information was disclosed in accordance with the Exchange Act; it had retained new counsel for its securities work and had arranged for new accounting controls and the hiring of a new auditor. E-Smart explained that it was concentrating its resources on getting current financial information to investors. The Company represented that it expected to file a quarterly report for the quarter ending September 30, 2003 by the end of December, 2003, and an annual report for the years ending December 31, 2002 and December 31, 2003 by March 31, 2004 at the latest. Thereafter, it would turn to the preparation and submission of the forms that should have been submitted during the period between 2000 and 2003. [FN9]

*2 Although the Company in late December 2003 filed a Form 10-QSB for the third quarter of 2003, as it had represented it would do, the law judge gave little credence to the Company's assertions regarding its ability to return to reporting compliance. The law judge determined that, although e-Smart represented that it intended to "bring itself into full compliance with the periodic reporting requirements" by March 31, 2004, "this endeavor seems doomed." [FN10] Because "overwhelming evidence" convinced the law judge that e-Smart could not "readily remedy its periodic reporting violations," which she found "likely to recur in the future," she concluded that a suspension -- the only sanction other than a revocation available under Section 12(j) under the circumstances of this case -- would not sufficiently protect the investing public. [FN11] She therefore revoked the registration of e-Smart's securities.

On March 30, 2004, shortly after issuance of the law judge's decision, e-Smart filed audited financial statements and other information for the Company on Form 10-KSB for fiscal years 2002 and 2003. On May 17, 2004, e-Smart timely filed its quarterly report on Form 10-QSB for the first three months of 2004, and on August 16, 2004, e-Smart timely filed its quarterly report on Form 10-QSB for the second three months of 2004. [FN12]

III.

The purpose of the periodic reporting requirements is to supply the investing public with current, accurate financial information about an issuer so that investors may make informed decisions. [FN13] The reporting requirements of the Exchange Act are "the primary tool which Congress has fashioned for the protection of investors from negligent, careless, and deliberate misrepresentations in the sale of stock and securities." [FN14]

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It is undisputed that e-Smart violated Section 13(a) and Rules 13a-1 and 13a-13 by failing to make required periodic reports. The law judge characterized e-Smart's violations as both recurring and egregious, and found that the Company's actions prior to the initiation of this proceeding raised serious doubts as to its future compliance with the periodic reporting requirements.

After the law judge issued her opinion, however, e-Smart filed annual and quarterly reports on a timely basis. [FN15] Thus, the investing public now has access to current, audited financial information about the Company. Moreover, the Company has begun to fill the gaps in its reporting history by filing the reports it failed to file during the period between the filing of its registration statement and the issuance of the OIP. [FN16] Although we consider e-Smart's violations serious, we also believe the Company's subsequent filing history is an important factor to be considered in determining whether revocation is "necessary or appropriate for the protection of investors." [FN17] Under the circumstances, therefore, we believe it is appropriate to provide the law judge an opportunity to assess her sanctioning determination in light of e-Smart's subsequent reporting [FN18] record.

*3 Accordingly, IT IS ORDERED that this proceeding be, and it hereby is, remanded to the administrative law judge for further proceedings in accordance with this opinion. [FN19] The law judge is ordered to file the decision on remand with the Office of the Secretary within 120 days from the date of service of this order.

By the Commission.

Jonathan G. Katz

Secretary

FN1. E-Smart Techs., Inc., Initial Decision Rel. No. 247 (Mar. 4, 2004), 82 SEC Docket 1194. Exchange Act Section 12(j), 15 U.S.C. § 78l(j), in relevant part, authorizes the Commission "as it deems necessary or appropriate for the protection of investors to deny, ... to suspend for a period not exceeding twelve months, or to revoke the registration of a security" if the issuer of the security has failed to comply with any provision of the securities laws or any rule thereunder.

FN2. Section 13(a), 15 U.S.C. § 78m(a), requires, among other things, that every issuer of a security registered pursuant to Section 12 of the Exchange Act, 15 U.S.C. § 78l, file with the Commission annual and quarterly reports as prescribed by the Commission.

Rule 13a-1, 17 C.F.R. § 240.13a-1, requires issuers of securities registered pursuant to Section 12 to file an annual report on the appropriate form "for each fiscal year after the last full fiscal year for which financial statements were filed in its registration statement." The filing must be made "within the period specified in the appropriate form." Id. Rule 13a-13, 17 C.F.R. § 240.13a-13, requires, with certain exceptions not relevant here, that every issuer of a security registered pursuant to Section 12 who is required to file annual reports pursuant to Section 13, and who has filed or intends to file such re-

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ports on Form 10-K and Form 10-KSB, to file quarterly reports on Form 10-Q and 10-QSB, within a specified period, for each of the first three quarters of each fiscal year of the issuer, commencing with the first fiscal quarter following the most recent fiscal year for which full financial statements were included in the registration statement.

FN3. We note that our rules do not provide for the filing of consolidated annual reports.

FN4. E-Smart Techs., Inc., Exchange Act Rel. No. 50030 (July 16, 2004), ___ SEC Docket ___.

FN5. Among its products is a "smart card," an identification device that can store personal data and confirm the cardholder's identity by a fingerprint sensor embedded in the card.

FN6. 15 U.S.C. § 781(g).

FN7. Between the issuance of the OIP and December 8, 2003, when the law judge held a hearing in this matter, e-Smart filed an unaudited quarterly report on Form 10-QSB for the quarter ending June 30, 2003. This report was received late, on November 14, 2003.

FN8. In a quarterly report on Form 10-QSB filed in late 2003, the Company indicated that the proceeding against the CEO had subsequently been dismissed.

FN9. Although the law judge found that e-Smart had claimed that it intended to "bring itself into full compliance" with the periodic reporting requirements by March 31, the hearing transcript indicates that e-Smart did not represent that it would submit the filings due between September 30, 2000 and December 16, 2002 by that date.

FN10. 82 SEC Docket at 1200.

FN11. Id. Section 12(j) also allows the Commission to suspend the effective date of the registration of a security, an action not applicable here.

FN12. Additionally, on June 30, 2004, e-Smart filed a Form 10-QSB for the quarter ending March 31, 2003, and on September 8, 2004, e-Smart filed a Form 10-KSB for the fiscal years ending December 31, 2001 and December 31, 2002. These reports, like e-Smart's other filings, are available through the Commission's website, www.sec.gov. Rule 323 of our Rules of Practice, 17 C.F.R. § 201.323, allows us to take official notice of "any matter in the public official records of the Commission."

FN13. SEC v. Beisinger Indus. Corp., 552 F.2d 15, 18 (1st Cir. 1977).

FN14. Id. Administrative proceedings under Section 12(j) are one of the remedies the Exchange Act provides to address the problem of publicly traded companies that are delinquent in the filing of their Exchange Act reports and thereby deprive investors of accurate financial information upon which to make informed investment decisions. See n.17, *infra*. Section 12(j) proceedings play an important role in the Commission's enforcement pro-

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gram because many publicly traded companies that fail to file on a timely basis are "shell companies" and, as such, attractive vehicles for fraudulent stock manipulation schemes. Revocation under Section 12(j) can make such issuers less appealing to persons who would put them to fraudulent use.

FN15. The Division concedes that the law judge's "assessment of e-Smart's capacity to submit audited reports by March 31, 2004 ultimately turned out to be incorrect," but argues that this fact "does not establish that her determination was unfounded when it was made."

FN16. The law judge's statement that e-Smart was unlikely to "bring itself into full compliance with the periodic reporting requirements by March 31," 82 SEC Docket at 1200, could be read as a prediction that e-Smart would not make all the required filings that it should have made during the period between May 30, 2000 and December 16, 2002, the period encompassed by the OIP, by March 31, 2004. However, the law judge's mention of the March 31, 2004 date suggests that she was referring not to all the delinquent filings, but rather to e-Smart's repeated representations at the hearing that it would file a Form 10-KSB for 2002 and 2003 by March 31. See, e.g., 82 SEC Docket at 1199 (characterizing e-Smart's position as "request[ing] a grace period within which to complete and file its audited annual reports for the years 2002 and 2003"). E-Smart's emphasis on filing its Form 10-KSB as expeditiously as possible, while not remedying the delinquencies on which the findings of violation were based, did provide current, audited financial information to the investing public, which, as noted above, fulfilled the purpose behind the periodic reporting requirements. Additionally, e-Smart's Forms 10-QSB for the quarters ending March 31 and June 30, 2004 provide additional information to investors.

FN17. We note that, in addition to revocation or suspension of registration under Section 12(j), the Exchange Act provides other remedies to address reporting violations. See Exchange Act Section 15(c)(4), 15 U.S.C. § 78o(c)(4) (allowing Commission to issue order requiring issuer to comply with reporting requirements, upon specified terms and conditions and within specified time; if necessary, the Commission may apply to a United States District Court for enforcement of such an order, Exchange Act Section 21(e), 15 U.S.C. § 78p(e)); Exchange Act Section 21C, 15 U.S.C. § 78u-3 (allowing Commission to impose cease-and-desist order). While these remedies are not available in the current proceeding because it was not instituted pursuant to those provisions, they may be utilized by us in a future proceeding involving similar circumstances.

FN18. On June 17, 2004, the Company filed a motion seeking oral argument, which we deny. Rule 451(b) of our Rules of Practice, 17 C.F.R. § 201.451(b), states that motions for oral argument should "accompany[] the initial brief on the merits." E-Smart's initial brief was filed on April 27, 2004 and, therefore, its oral argument request could be denied as untimely. Moreover, Rule 451(a) of our Rules of Practice, 17 C.F.R. § 201.451, provides that "[m]otions for oral argument with respect to whether to affirm all or part of an initial decision by a hearing officer shall be granted unless exceptional circumstances make oral argument impractical or inadvisable," and we believe that oral argument would be inadvisable in light of our determination to remand this proceeding. See James F. Glaza, Exchange

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Act Rel. No. 50474 (Sept. 29, 2004), ___ SEC Docket ___, ___ n.14 (denying oral argument request where proceeding remanded to law judge); D.E. Wine Inv., Inc., Exchange Act Rel. No. 43929 (Feb. 6, 2001), 74 SEC Docket 2573, 2581 n.25 (denying oral argument request where proceeding dismissed).

Our decision in this case is dependent on the particular facts and circumstances involved, and should not be construed as suggesting that a determination to revoke an issuer's registration will be reconsidered simply because the issuer as returned to reporting compliance and begun to submit long overdue filings. Other considerations, including the need for finality in Commission administrative proceedings, may justify a different result.

FN19. We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

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END OF DOCUMENT

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S.E.C. Release No.

***1 Initial Decision**

IN THE MATTER OF E-SMART TECHNOLOGIES, INC., F/K/A PLAINVIEW LABORATORIES, INC.
Administrative Proceeding File No. 3-10977
February 3, 2005

BEFORE: Lillian A. McEwen, Administrative Law Judge

APPEARANCES:

Charles D. Stodghill for the Division of Enforcement, United States Securities and Exchange Commission

Maranda E. Fritz for e-Smart Technologies, Inc., f/k/a Plainview Laboratories, Inc.

INITIAL DECISION ON REMAND

SUMMARY

In light of recent filings of delinquent periodic reports, this Initial Decision on Remand denies the Division of Enforcement's (Division) renewed request for revocation of the registration of the common stock of Respondent e-Smart Technologies, Inc., f/k/a Plainview Laboratories, Inc. (e-Smart), and imposes no sanction for e-Smart's violations of the periodic reporting requirements of the Securities Exchange Act of 1934 (Exchange Act).

PROCEDURAL HISTORY

The Securities and Exchange Commission (SEC or Commission) initiated this proceeding on December 16, 2002, pursuant to Section 12(j) of the Exchange Act, with an Order Instituting Proceedings (OIP). On March 4, 2004, after a public hearing, I issued an Initial Decision that found e-Smart in violation of the periodic reporting requirements of Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 thereunder, and revoked the registration of its common stock. e-Smart Techs., Inc., 82 SEC Docket 1194. Following its review, the Commission remanded the proceeding on October 12, 2004, by an Order Remanding Proceeding (Remand Order) to provide me an opportunity to assess the sanctioning determination in light of certain late filings made by e-Smart. e-Smart Techs., Inc., Exchange Act Release No. 50514.

On December 10, 2004, prior to a hearing on remand, this Office received e-Smart's Motion to Amend the OIP to Add Cease and Desist Proceedings, which the Division opposed. The Commission has decided to rule on that motion. On December 13, 2004, I held a one-day remand hearing in New York, New York, at which e-Smart called two witnesses and the Division called none, but furnished two exhibits that were admitted into evidence. Also at that

time, the parties jointly submitted stipulations, and I allowed e-Smart until January 14, 2005, to supplement the record with any additional past-due filings. E-Smart made such filings on December 29, 2004, and on January 10, 2005, and both parties filed posthearing remand briefs on January 19, 2005. [FN1]

ISSUE PRESENTED

E-Smart, while its common stock was registered with the Commission, violated the periodic reporting requirements of Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 by failing to file periodic reports between May 30, 2000, and December 16, 2002. The only issue on remand is whether my earlier sanction, the revocation of e-Smart's common stock, remains appropriate.

FINDINGS OF FACT

*2 The findings and conclusions of this Initial Decision on Remand are based on the entire record, including those findings made in the March 4, 2004, Initial Decision and the Remand Order. All such findings by the Commission and the undersigned are incorporated herein. [FN2] For any remaining factual findings, I applied preponderance of the evidence as the standard of proof. Steadman v. SEC, 450 U.S. 91, 102 (1981). Any arguments and proposed findings and conclusions made by the parties that are inconsistent with this Initial Decision on Remand were rejected.

Company Background

E-Smart, formerly known as Boppers Holdings, Inc., and Plainview Laboratories, Inc., is a Nevada corporation headquartered in San Jose, California. IVI Smart Technologies, Inc., a Delaware corporation, is e-Smart's parent corporation, owning seventy percent of the outstanding shares of e-Smart's common stock. Mary Grace (Grace) has served as e-Smart's president and chief executive officer (CEO) since 2001 and was company chairman prior to that time.

E-Smart's business comprises developing and producing "biometric verification security systems" for government entities to be used in combating identity theft and payment fraud. Among its products is the "smart card," a small identification card that stores personal data and confirms the cardholder's identity by a fingerprint sensor embedded in the card. E-Smart's stock is quoted on the Pink Sheets under the symbol "ESMT" and is thinly traded. (Official Notice.) At the time of the December 8, 2003, hearing, e-Smart's equity was financed by private transactions, and no equity had been received through the public issuance of its shares. At that time, e-Smart "ha[d] no source of income" and could only surmise that it was on the verge of securing several lucrative agreements. It has received approximately \$11 million in funding over the last year or so and has recently executed contracts that will generate future revenues. (Tr. 107-108.) E-Smart, however, presently needs an infusion of cash to continue doing business, as the company has no revenue producing contracts or excess capital at this time. (Tr. 104-07.)

Filing History

On May 30, 2000, e-Smart registered its common stock with the Commission pursuant to Section 12(g) of the Exchange Act by filing a Form 10-SB/12G (a registration statement for small business issuers). As previously found: During the timeframe beginning with the date of its registration to December 16, 2002, the issuance date of the OIP (the relevant period), e-Smart failed to file annual reports with the Commission on Form 10-KSB (an annual report for small business issuers) for the fiscal years ending December 31, 2000, 2001, and 2002. [FN3] It also failed to file quarterly reports on Form 10-QSB (a quarterly report for small business issuers) for the quarterly periods ending March 31, 2001, June 30, 2001, September 30, 2001, March 31, 2002, June 30, 2002, and September 30, 2002. On the eve of the December 8, 2003, hearing, e-Smart filed late a quarterly report and an amendment for the period ending June 30, 2003, and just after the hearing, it filed late a quarterly report for the period ending September 30, 2003. (Official Notice.) Both filings are for periods outside the relevant period.

*3 On March 4, 2004, based on e-Smart's admissions of these failed filings at the underlying hearing, I found e-Smart in violation of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder and revoked the registration of its common stock for the protection of investors. [FN4] I considered e-Smart's last-minute filings in my sanctioning determination.

After the March 4, 2004, Initial Decision was rendered, e-Smart began filling in the gaps in its reporting history, while keeping current with its ongoing reporting obligations. (Remand Order at 3-4; Official Notice.) It subsequently filed a "consolidated annual report" covering its 2002 and 2003 fiscal years on March 30, 2004, which the Commission considered and stated in its Remand Order was not in accordance with its rules. (Remand Order at 2 & n.3.) On September 8, 2004, e-Smart also made a delinquent filing of its missing annual reports covering fiscal years 2001 and 2002, which also took the form of a consolidated report—that is, combining two fiscal years into one form. (Tr. 83; Official Notice.) On December 13, 2004, e-Smart filed an amendment to its Form 10-KSB covering the fiscal year 2003. (Official Notice.)

At the time of the remand hearing, e-Smart remained delinquent on quarterly reports for the first three quarters of the years 2001 and 2002 and on an annual report for the fiscal year ending December 31, 2000. (Div. Ex. 1-2.) E-Smart was granted an additional extension at the remand hearing to make all its past-due filings, so that they could be considered as part of the record in this case. (Tr. 127.) On December 29, 2004, e-Smart made late filings for the relevant quarterly periods ending March 31, 2001, June 30, 2001, September 30, 2001, March 31, 2002, June 30, 2002, and September 30, 2002. (Official Notice.) On January 10, 2005, e-Smart filed its last missing report, an audited annual report for the fiscal year 2000. (Official Notice.) By January 14, 2005, the date the record in this case was closed, e-Smart had filed all its missing reports due for the relevant period and had met its ongoing periodic reporting requirements. (Official Notice; Remand Order at 4; Div. R. Brief at 1-2.) On average, e-Smart's periodic reports were late by 990 days.

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The following chart tracks e-Smart's filing history over the relevant period. (Official Notice.) It includes the type of report filed, the period covered, the approximate due date, the actual date on which e-Smart made the filing, and the number of days the filing was delinquent (if applicable):

Report	For Period Ending	Appx. Due Date	Filing Date	Days Late
10 SB-12 G	Registration	N/A	May 5, 2000	N/A
10 QSB	June 30, 2000	Aug. 15, 2000	Aug. 11, 2000	timely filed
10 QSB	Sept. 30, 2000	Nov. 15, 2000	Oct. 5, 2000	timely filed
10 QSB-A	Sept. 30, 2000	N/A	Oct. 10, 2000	N/A
10 KSB	Dec. 31, 2000	Mar. 31, 2001	Jan. 10, 2005	1,381
10 QSB	Mar. 31, 2001	May 15, 2001	Dec. 29, 2004	1,324
10 QSB	June 30, 2001	Aug. 15, 2001	Dec. 29, 2004	1,232
10 QSB	Sept. 30, 2001	Nov. 15, 2001	Dec. 29, 2004	1,140
10 KSB	Dec. 31, 2001	Mar. 31, 2002	Sept. 8, 2004*	892
10 QSB	Mar. 31, 2002	May 15, 2002	Dec. 29, 2004	959
10 QSB	June 30, 2002	Aug. 15, 2002	Dec. 29, 2004	867
10 QSB	Sept. 30, 2002	Nov. 15, 2002	Dec. 29, 2004	775
10 KSB	Dec. 31, 2002	Mar. 31, 2003	Mar. 3, 2004*, Sept. 8, 2004*	338

*4 These reports were filed as consolidated reports covering more than one year: the March 3, 2004, filing covered fiscal years 2002 and 2003, and the September 8, 2004, filing covered fiscal years 2001 and 2002.

Compliance Efforts

At the December 8, 2003, hearing, e-Smart conceded that it had not filed periodic re-

ports for the relevant period, but claimed that it was engaged in substantial good faith efforts to update and remedy its filings. Grace, as e-Smart's CEO, acknowledged that she was fully aware of the importance of the reporting requirements. (December 8, 2003, hearing transcript at 118-121.) The company's failure to file periodic reports was due primarily to minimal financial resources, loss of key persons overseeing the company's financial reporting, and most notably, distractions relating to criminal proceedings brought against both Grace and another in federal court beginning in December 2001. Anthony Russo (Russo), a Certified Public Accountant for e-Smart, and his auditing firm were hired in about November 2003 to oversee and help prepare e-Smart's periodic reports for filing with the Commission. (Tr. 65-67; 78-80.) Russo testified at the December 8, 2003, hearing that "someone with experience could have done [the past-due] 10-Qs and 10-Ks with little effort" and also attributed the company's noncompliance to "economics." Russo also made assurances that the company would file an audited annual report for the fiscal year 2003 by the end of March 2004.

At the December 13, 2004, remand hearing, Russo again summarized e-Smart's compliance efforts to date and explained why e-Smart chose to file consolidated annual reports combining two fiscal years, or what Russo called a "two-year comparable report." (Tr. 67-84.) Russo acknowledged that the company was still missing certain periodic reports from the relevant period explaining that, in attempting to best allocate e-Smart's resources and supplying investors with current financial information, he determined it more important to file ongoing reports than those from periods of e-Smart's financial history when transactions were not taking place. (Tr. 90-93.) As for the filing of consolidated reports, Russo stated, "[I]t's a format broadly accepted in larger companies, and I felt it was expeditious, it was more meaningful to have comparative financial statements, and it indeed has everything that two separate reports would have. ... There's nothing substantial omitted." (Tr. 73-74.) Russo admitted, however, that he never had the consolidated format approved by, nor did he otherwise discuss the format with, a representative of the SEC's Division of Corporation Finance. (R. Tr. 81.) Russo also acknowledged that even though a company that is registered pursuant to Section 12 of the Exchange Act has no papers, records, or transactions, the company still has the obligation to file periodic reports. (Tr. 114.)

CONCLUSIONS OF LAW: SANCTIONS

Periodic Filing Requirements

*5 Under Section 12(j) of the Exchange Act, the Commission is authorized "as it deems necessary or appropriate for the protection of investors" to revoke the registration of a security or to suspend the registration of a security for a period not exceeding twelve months if it finds that the issuer of such security has failed to comply with any provision of the Exchange Act or the rules and regulations thereunder. Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder require issuers of securities, registered pursuant to Section 12 of the Exchange Act, to file annual and quarterly reports with the Commission.

The Commission's periodic reporting requirements help ensure that the investing public receives current, accurate information concerning the operation and financial condition of the company. SEC v. Kalvex, Inc., 425 F. Supp. 310, 315-16 (S.D.N.Y. 1975). Periodic reporting helps provide investors with "available adequate information upon which to base their judgment whether to buy, sell, or hold registrant's securities"; reporting also benefits creditors who are considering transactions with reporting companies, not involving purchase and sale of securities. SEC v. Beisinger Indus. Corp., 421 F. Supp. 691, 694 (D. Mass. 1976), aff'd, 552 F.2d 15 (1st Cir. 1977).

"The reporting requirements of the Exchange Act are the primary tool which Congress has fashioned for the protection of investors from negligent, careless, and deliberate misrepresentations in the sale of stock and securities." e-Smart, Exchange Act Release No. 50514 at 5 (citing SEC v. Beisinger Indus. Corp., 552 F.2d 15, 18 (1st Cir. 1977)) (internal quotation marks omitted). As stated in the Commission's Remand Order:

Administrative proceedings under Section 12(j) are one of the remedies the Exchange Act provides to address the problem of publicly traded companies that are delinquent in the filing of their Exchange Act reports and thereby deprive investors of accurate financial information upon which to make informed investment decisions. Section 12(j) proceedings play an important role in the Commission's enforcement program because many publicly traded companies that fail to file on a timely basis are "shell companies" and, as such, attractive vehicles for fraudulent stock manipulation schemes. Revocation under Section 12(j) can make such issuers less appealing to persons who would put them to fraudulent use.

Id. at n.14 (internal citations omitted).

Issue on Remand

It remains undisputed that, during the relevant period, e-Smart violated Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 by failing to file annual and quarterly reports, violations which the Commission considers to be serious. (Remand Order at 5, n.16.) Pursuant to the Remand Order, the only issue now is whether revocation of the registration of e-Smart's common stock remains appropriate in light of the company's subsequent filings of all its delinquent reports for the relevant period. (Remand Order at 5-7.) (describing subsequent filing history as "an important factor to be considered in determining whether revocation is 'necessary and appropriate for the protection of investors'") As authorized by the OIP pursuant to Section 12(j) of the Exchange Act, the only sanctions presently available are revocation or suspension of the registration of e-Smart's common stock for the previously found violations. (Remand Order at n.17; OIP at 2.)

*6 The Division's position on the appropriate sanction remains unchanged following the Remand Order. It argues that revocation continues to be the only appropriate sanction for e-Smart's repeated failure to comply with applicable periodic reporting requirements, even in light of the company's "belated efforts" to bring itself into compliance. (Div. R.

Brief at 1-2, 8.) According to the Division, the public interest factors still weigh in favor of revocation, and even though e-Smart "may have now satisfied" its filing obligations, this "should not shield it from sanctions for its past reporting failures." (Div. R. Brief at 8-9.) The Division also warns that lifting the sanction of revocation would undermine the principal objective of the reporting requirements, that of providing "investors with timely reports that accurately reflect the financial condition and operating results of the issuer." (Div. R. Brief at 9.) "To hold otherwise," the Division concludes, "would encourage noncompliance by issuers until they are actually faced with a revocation order and would be contrary to the interests of the investing public." (Div. R. Brief at 9.)

E-Smart contends that neither revocation nor suspension of the registration of its common stock is appropriate now that it has filed all its delinquent reports-"even those which are entirely historical." (Resp. R. Brief at 1.) It asserts that no punitive sanction is necessary to protect the investing public because each and every periodic filing is now publicly available. (Resp. R. Brief at 1.) E-Smart further argues that again imposing the sanction of revocation would be unprecedented and unwarranted, and would serve only to damage, and not protect, investors. (Resp. R. Brief at 1, 8.) As an alternative to a sanction ordering revocation or suspension, e-Smart represents that it would accept a cease-and-desist order, if the sanction becomes available. (Resp. R. Brief at 2, 8 n.4.)

Sanction Considerations

When fashioning the appropriate sanction under Section 12(j) of the Exchange Act, the public interest factors identified in Steadman v. SEC are instructive. 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981); see also WSF Corp., 77 SEC Docket 1831, 1836-37 (May 8, 2002), final, 77 SEC Docket 2336 (May 24, 2002) (applying Steadman factors in a 12(j) proceeding). The relevant factors under Steadman are (1) the egregiousness of the respondent's actions, (2) the isolated or recurrent nature of the infraction, (3) the degree of scienter involved, (4) the sincerity of the respondent's assurances against future violations, (5) the respondent's recognition of the wrongful nature of its conduct, and (6) the likelihood of future violations. 603 F. 2d at 1140.

*7 The severity of the sanction depends on the facts and the circumstances of each case. See Berko v. SEC, 316 F.2d 137, 141-42 (2d Cir. 1963). No one Steadman factor is controlling. WHX Corp., 80 SEC Docket 1318, 1337 (June 4, 2003). In considering the likelihood of future violations, the fact that respondent is presently complying with the securities laws does not preclude sanction. See SEC v. Fehn, 97 F.3d 1276, 1295-96 (9th Cir. 1996) (affirming a permanent injunction).

Application

When it came to filing its periodic reports during the relevant period, e-Smart was far from the model company. Its violations of the reporting requirements of the Exchange Act, for Steadman purposes, were both recurrent and egregious. As one example, among many, it

took the company nearly four years to file its audited annual report for the fiscal year 2000. In fact, during the first four years of its existence, e-Smart never filed an audited annual report and, during the relevant period, filed only two unaudited quarterly reports, the first two due after its registration. E-Smart shirked its responsibility to provide the public with current, accurate information upon which to make informed investment decisions. This failure to file timely periodic reports deprived investors, as well as potential investors, of vital information regarding e-Smart's business operations and financial condition. Although the company knew of its reporting obligations at the time, it blamed noncompliance on lack of capital, loss of key personnel overseeing company reporting, and distractions related to criminal proceedings brought against its CEO and another. Most importantly, while the company was experiencing its most troubled times, the investing public was left unaware of the company's position.

In the March 4, 2004, Initial Decision, I made it clear that, after considering the public interest factors, revocation was the appropriate sanction: the company was in violation, its violations were egregious and recurrent, and the likelihood of future violations appeared great. As for its financial condition, e-Smart appeared to lack the necessary operating revenue and available capital to meet its periodic filing obligations. This, combined with its past violations, made future violations likely. On March 30, 2004, however, the company filed a consolidated annual report covering 2002 and 2003. In making the filing, e-Smart kept its promise made at the December 8, 2003, hearing but did not cure all its filing deficiencies. Thereafter, as it appealed the March 4, 2004, Initial Decision, e-Smart continued filling in the gaps in its reporting history by filing a consolidated annual report for the fiscal years 2001 and 2002, while also keeping current with its ongoing periodic reporting. Following the remand hearing, when the record remained open, e-Smart filed all seven remaining delinquent periodic reports for the relevant period. All told, however, e-Smart's periodic reports for the relevant period were filed an average of 990 days late.

*8 I conclude that, but for the institution of this administrative proceeding, it is unlikely e-Smart would have made the filings that it has made. At times during the proceeding, e-Smart appeared ignorant of the Commission's processes and acted as if its difficulties posed an exception to the reporting requirements. Ultimately, this conduct contributed to the delay in filing of what it deems "historical filings," as if an accurate, timely history of an issuer would not be important to interested investors. Because e-Smart is a Section 12 issuer, however, it is obligated to file its periodic reports "within the period specified in the appropriate form." If the company is unable to file such reports, the company may file an SEC Form 15 pursuant to Exchange Act Section 12 and Rule 12g-4, which voluntarily deregisters the stock and suspends the reporting obligations under Section 13(a) of the Exchange Act. [FN5] See 17 C.F.R. § 240.12g-4(a). During the relevant period, e-Smart took no such action.

Nonetheless, now on remand, in view of the Steadman public interest factors, the Remand Order, and e-Smart's subsequent filings of past-due periodic reports, I conclude that no remedial sanction is appropriate. As the Commission held in its Remand Order, e-Smart,

"while not remedying the delinquencies on which the findings of violation were based, did provide current, audited financial information to the investing public, which ... fulfilled the purpose behind the periodic reporting requirements." Subsequent periodic filings (current as well as those past due) have provided additional information to investors, furnishing them with a fuller picture of the company's condition. (Remand Order 5, 6 & n.16.)

Additionally, the testimony of Grace and Russo shows that e-Smart recognizes the wrongfulness of its past violations. It assures that future violations will not occur. Since the institution of this proceeding, e-Smart hired staff that has undertaken extensive compliance efforts to cure past reporting deficiencies and keep current with ongoing reporting requirements. Further, based on the company's recent infusion of working capital, signed business contracts, and diligent and expensive efforts to file past-due reports, e-Smart no longer appears to be the type of shell company susceptible to fraudulent use that the SEC's enforcement program targets in Section 12(j) proceedings. (Remand Order at 5 n. 14.)

In view of the foregoing, despite the egregiousness and recurrent nature of e-Smart's violations, I find the likelihood of future violations absent and the need for a strong sanction no longer necessary. The Division's request for revocation of the registration of e-Smart's common stock must therefore be denied. See 4 Louis Loss & Joel Seligman, Securities Regulation 1891-92 (3d ed., rev. vol. 2000) (describing involuntary revocation of a security's registration as a draconian remedy and unnecessarily harmful to innocent security holders in view of the availability of other regulatory tools that ensure the filing of adequate reports); 3 Thomas L. Hazen, Treatise on the Law of Securities Regulation § 9.2[1][B] (4th ed 2002). I also conclude that suspension of e-Smart's registration of its common stock (a remedy not pursued by the Division, but available) is equally inappropriate. The effect of any suspension, as with revocation, would be to harm investors unfairly, rather than to serve any deterrent or remedial function now that the company has filed, albeit untimely, all its delinquent reports. Both remedies, in light of e-Smart's later compliance efforts, would also deprive investors unnecessarily of a public market for the trading of their securities. See Loss & Seligman at 1897 (citing legislative history for Exchange Act Section 15(c)(4), a parallel provision to Section 12(j) for persons who cause a company's violations of the reporting requirements).

*9 Having reconsidered the Steadman factors in light of e-Smart's subsequent filings and recent compliance, I deny the Division's renewed request for revocation of the registration of e-Smart's common stock and conclude, under the circumstances, that no sanction should be imposed for e-Smart's violations.

CERTIFICATION OF RECORD

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I hereby certify that the record includes the items set forth in the record index issued by the Secretary of the Commission on January 14, 2005.

ORDER

Based on the findings and conclusions set forth above, the Division of Enforcement's request for sanctions against Respondent e-Smart Technologies, Inc., f/k/a Plainview Laboratories, Inc., for the violations found in the March 4, 2004, Initial Decision is hereby DENIED.

This Initial Decision on Remand shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision on Remand within twenty-one days after service of the Initial Decision on Remand. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision on Remand, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial Decision on Remand will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision on Remand as to a party. If any of these events occur, the Initial Decision on Remand shall not become final as to that party.

Lillian A. McEwen

Administrative Law Judge

FN1. E-Smart's posthearing remand brief was erroneously dated April 26, 2004. It was received in this Office by fax on January 19, 2005.

FN2. Unless otherwise noted, all factual findings are drawn directly from the Findings of Fact section of the March 4, 2004, Initial Decision, which may be found at e-Smart, 82 SEC Docket at 1195-1197. Where appropriate, I have taken official notice of company filings, pursuant to Rule 323 of the Commission's Rules of Practice, as they are publicly available over the Commission's Electronic Data Gathering, Analysis, and Retrieval System. Such instances are noted as "(Official Notice)." Citations to the Remand Order are noted as "(Remand Order at __.)", to the transcript of the December 13, 2004, remand hearing are noted as "(Tr. __.)", and to the Division's exhibits, introduced at the remand hearing, are noted as "(Div. Ex. __ at __.)". Citations to the Division's and Respondent's post-hearing remand briefs are noted as "(Div. R. Brief at __.)", and "(Resp. R. Brief at __.)".

FN3. The annual report for the fiscal year 2002 was due by March 31, 2003, a date outside the relevant period. The untimely filed report was included within the scope of the OIP and among e-Smart's violations for its close proximity to the relevant period. See Richmond Capital Corp., 81 SEC Docket 2205, 2217 (Nov. 7, 2003). Neither party objected to its inclusion.

Westlaw.

84 S.E.C. Docket 2741, Release No. ID - 272, 2005 WL 274086 (S.E.C. Release No.)

(Cite as: 2005 WL 274086 (S.E.C. Release No.))

FN4. The Division also alleged that e-Smart violated Rule 12b-20 of the Exchange Act. The March 4, 2004, Initial Decision dismissed this allegation, and the ruling was not appealed to the Commission. e-Smart Techs., Inc., 83 SEC Docket 1235, 1236 n.7 (July 16, 2004) (Commission Order on Motions for Summary Affirmance).

FN5. After an issuer files a Form 15, termination of the registration of a class of securities takes effect in ninety days, or such shorter period as the Commission may determine. 17 C.F.R. § 240.12g-4(a). Only the issuer's duty to file reports pursuant to Exchange Act Section 13(a) is suspended upon the filing of a Form 15; all other reporting and filing obligations remain in effect. 17 C.F.R. § 240.12g-4(b).

84 S.E.C. Docket 2741, Release No. ID - 272, 2005 WL 274086 (S.E.C. Release No.)

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CBriefs and Other Related Documents

United States Court of Appeals, District of Columbia Circuit.

Phillip GOLDSTEIN, et al., Petitioners

v.

SECURITIES AND EXCHANGE COMMISSION, Respondent.

No. 04-1434.

Argued Dec. 9, 2005.

Decided June 23, 2006.

Background: Investment advisory firm and a hedge fund petitioned for review of an order of the Securities and Exchange Commission (SEC) regulating “hedge funds” under the Investment Advisers Act (IAA).

Holding: The Court of Appeals, Randolph, Circuit Judge, held that hedge fund rule requiring that investors in a hedge fund be counted as clients of the fund's adviser for purposes of fewer-than-fifteen-clients exemption from registration under IAA was invalid as conflicting with purposes underlying the statute.

Rule vacated and remanded.

West Headnotes

[1] Securities Regulation 349B ↪ 223

349B Securities Regulation

349BI Federal Regulation

349BI(I) Investment Advisors

349Bk223 k. In General. Most Cited Cases

Securities and Exchange Commission (SEC) hedge fund rule requiring that investors in a hedge fund be counted as clients of the fund's adviser for purposes of fewer-than-fifteen-clients exemption from registration under Investment Advisers Act (IAA) was invalid as conflicting with purposes underlying the statute. Investment Advisers Act of 1940, § 203(b)(3), 15 U.S.C.A. § 80b-3(b)(3); 17 C.F.R. § 275.203(b)(3).

[2] Statutes 361 ↪ 219(4)

361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k213 Extrinsic Aids to Construction

361k219 Executive Construction

361k219(4) k. Erroneous Construction; Conflict with Statute. Most Cited Cases

To determine whether Congress has foreclosed an agency's interpretation of a statute, words of the statute should be read in context, the statute's place in the overall statutory scheme should be considered, and the problem Congress sought to solve should be taken into account.

West CodenotesHeld Invalid 17 C.F.R. § 275.203(b)(3)-1(d)(1) 17 C.F.R. § 275.203(b)(3)-2(a)

On Petition for Review of an Order of the Securities and Exchange Commission.

Philip D. Bartz argued the cause for petitioners. With him on the briefs was Cameron Cohick.

Jacob H. Stillman, Solicitor, Securities & Exchange Commission, argued the cause for respondent. With him on the brief were Giovanni P. Prezioso, General Counsel, Randall W. Quinn, Assistant General Counsel, and Dominick V. Freda, Senior Counsel.

Before: RANDOLPH and GRIFFITH, Circuit Judges, and EDWARDS, Senior Circuit Judge.

Opinion for the Court filed by Circuit Judge RANDOLPH. RANDOLPH, Circuit Judge.

*1 This is a petition for review of the Securities and Exchange Commission's regulation of “hedge funds” under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 et seq. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed.Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279) (“*Hedge Fund Rule*”). Previously exempt because they had “fewer than fifteen clients,” 15 U.S.C. § 80b-3(b)(3), most advisers to hedge funds must now register with the Commission if the funds they advise have fifteen or more “shareholders, limited partners, members, or beneficiaries.” 17 C.F.R. § 275.203(b)(3)-2(a). Petitioners Philip Goldstein, an investment advisory firm

Goldstein co-owns (Kimball & Winthrop), and Opportunity Partners L.P., a hedge fund in which Kimball & Winthrop is the general partner and investment adviser (collectively "Goldstein") challenge the regulation's equation of "client" with "investor."

I.

"Hedge funds" are notoriously difficult to define. The term appears nowhere in the federal securities laws, and even industry participants do not agree upon a single definition. *See, e.g.*, SEC Roundtable on Hedge Funds (May 13, 2003) (comments of David A. Vaughan), *available at* <http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm> (citing fourteen different definitions found in government and industry publications). The term is commonly used as a catch-all for "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public." President's Working Group On Financial Markets, *Hedge Funds, Leverage, And The Lessons Of Long-Term Capital Management 1* (1999) ("*Working Group Report*"); *see also* Implications Of The Growth Of Hedge Funds: Staff Report To The United States Securities And Exchange Commission 3 (2003) ("*Staff Report*") (defining "hedge fund" as "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act").

Hedge funds may be defined more precisely by reference to what they are *not*. The Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq., directs the Commission to regulate any issuer of securities that "is or holds itself out as being engaged primarily ... in the business of investing, reinvesting, or trading in securities." *Id.* § 80a-3(a)(1)(A). Although this definition nominally describes hedge funds, most are exempt from the Investment Company Act's coverage because they have one hundred or fewer beneficial owners and do not offer their securities to the public, *id.* § 80a-3(c)(1), or because their investors are all "qualified" high net-worth individuals or institutions, *id.* § 80a-3(c)(7).^{FN1} Investment vehicles that remain private and available only to highly sophisticated investors have historically been understood not to present the same dangers to

public markets as more widely available investment companies, like mutual funds.^{FN2} *See Staff Report, supra*, at 11-12, 13.

*2 Exemption from regulation under the Investment Company Act allows hedge funds to engage in very different investing behavior than their mutual fund counterparts. While mutual funds, for example, must register with the Commission and disclose their investment positions and financial condition, *id.* §§ 80a-8, 80a-29, hedge funds typically remain secretive about their positions and strategies, even to their own investors. *See Staff Report, supra*, at 46-47. The Investment Company Act places significant restrictions on the types of transactions registered investment companies may undertake. Such companies are, for example, foreclosed from trading on margin or engaging in short sales, 15 U.S.C. § 80a-12(a)(1), (3), and must secure shareholder approval to take on significant debt or invest in certain types of assets, such as real estate or commodities, *id.* § 80a-13(a)(2). These transactions are all core elements of most hedge funds' trading strategies. *See Staff Report, supra*, at 33-43. "Hedging" transactions, from which the term "hedge fund" developed, *see* Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 Temp. L. Rev., 681, 684-85 & n. 18 (2000), involve taking both long and short positions on debt and equity securities to reduce risk. This is still the most frequently used hedge fund strategy, *see Staff Report, supra*, at 35, though there are many others. Hedge funds trade in all sorts of assets, from traditional stocks, bonds, and currencies to more exotic financial derivatives and even non-financial assets. *See, e.g.*, Kate Kelly, *Creative Financing: Defying the Odds, Hedge Funds Bet Billions on Movies*, Wall St. J., Apr. 29, 2006, at A1. Hedge funds often use leverage to increase their returns.

Another distinctive feature of hedge funds is their management structure. Unlike mutual funds, which must comply with detailed requirements for independent boards of directors, 15 U.S.C. § 80a-10, and whose shareholders must explicitly approve of certain actions, *id.* § 80a-13, domestic hedge funds are usually structured as limited partnerships to achieve maximum separation of ownership and management. In the typical arrangement, the general partner manages the fund (or several funds) for a fixed fee and a per-

--- F.3d ---

--- F.3d ---, 2006 WL 1715766 (C.A.D.C.), Fed. Sec. L. Rep. P 93,890

(Cite as: --- F.3d ---)

centage of the gross profits from the fund. The limited partners are passive investors and generally take no part in management activities. See *Staff Report, supra*, at 9-10, 61.

Hedge fund advisers also had been exempt from regulation under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 et seq. (“Advisers Act”), a companion statute to the Investment Company Act, and the statute which primarily concerns us in this case. Enacted by Congress to “substitute a philosophy of full disclosure for the philosophy of *caveat emptor*” in the investment advisory profession, *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963), the Advisers Act is mainly a registration and anti-fraud statute. Non-exempt “investment advisers” must register with the Commission, 15 U.S.C. § 80b-3, and all advisers are prohibited from engaging in fraudulent or deceptive practices, id. § 80b-6. By keeping a census of advisers, the Commission can better respond to, initiate, and take remedial action on complaints against fraudulent advisers. See id. § 80b-4 (authorizing the Commission to examine registered advisers' records).

*3 Hedge fund general partners meet the definition of “investment adviser” in the Advisers Act. See 15 U.S.C. § 80b-2(11) (defining “investment adviser” as one who “for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities”); *Abrahamson v. Fleschner*, 568 F.2d 862, 869-71 (2d Cir.1977) (holding that hedge fund general partners are “investment advisers”), overruled in part on other grounds by *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979). But they usually satisfy the “private adviser exemption” from registration in § 203(b)(3) of the Act, 15 U.S.C. § 80b-3(b)(3). That section exempts “any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under [the Investment Company Act].” Id. As applied to limited partnerships and other entities, the Commission had interpreted this provision to refer to the partnership or entity itself as the adviser's “client.” See 17

C.F.R. § 275.203(b)(3)-1. Even the largest hedge fund managers usually ran fewer than fifteen hedge funds and were therefore exempt.

Although the Commission has a history of interest in hedge funds, see *Staff Report, supra*, at app.A, the current push for regulation had its origins in the failure of Long-Term Capital Management, a Greenwich, Connecticut-based fund that had more than \$125 billion in assets under management at its peak. In late 1998, the fund nearly collapsed. Almost all of the country's major financial institutions were put at risk due to their credit exposure to Long-Term, and the president of the Federal Reserve Bank of New York personally intervened to engineer a bailout of the fund in order to avoid a national financial crisis. See generally Roger Lowenstein, *When Genius Failed: The Rise And Fall Of Long-Term Capital Management* (2000).

A joint working group of the major federal financial regulators produced a report recommending regulatory changes to the regime governing hedge funds, and the Commission's staff followed with its own report about the state of hedge fund regulation. Drawing on the conclusions in the *Staff Report*, the Commission over the dissent of two of its members issued the rule under review in December 2004 after notice and comment. The Commission cited three recent shifts in the hedge fund industry to justify the need for increased regulation. First, despite the failure of Long-Term Capital Management, hedge fund assets grew by 260 percent from 1999 to 2004. *Hedge Fund Rule*, 69 Fed.Reg. at 72,055. Second, the Commission noticed a trend toward “retailization” of hedge funds that increased the exposure of ordinary investors to such funds. This retailization was driven by hedge funds loosening their investment requirements, the birth of “funds of hedge funds” that offered shares to the public, and increased investment in hedge funds by pension funds, universities, endowments, foundations and other charitable organizations. See id. at 72,057-58. Third, the Commission was concerned about an increase in the number of fraud actions brought against hedge funds. See id. at 72,056-57. Concluding that its “current regulatory program for hedge fund advisers [was] inadequate,” id. at 72,059, the Commission moved to require hedge fund advisers to register under the Advisers Act so that it could gather “basic

information about hedge fund advisers and the hedge fund industry,” “oversee hedge fund advisers,” and “deter or detect fraud by unregistered hedge fund advisers,” *id.*

*4 [1] The *Hedge Fund Rule* first defines a “private fund” as an investment company that (a) is exempt from registration under the Investment Company Act by virtue of having fewer than one hundred investors or only qualified investors, *see* 15 U.S.C. § 80a-3(c)(1), (7); (b) permits its investors to redeem their interests within two years of investing; and (c) markets itself on the basis of the “skills, ability or expertise of the investment adviser.” 17 C.F.R. § 275.203(b)(3)-1(d)(1). For these private funds, the rule then specifies that “[f]or purposes of section 203(b)(3) of the [Advisers] Act (15 U.S.C. § 80b-3(b)(3)), you must count as clients the shareholders, limited partners, members, or beneficiaries ... of [the] fund.” *Id.* § 275.203(b)(3)-2(a). The rule had the effect of requiring most hedge fund advisers to register by February 1, 2006.^{FN3}

II.

The dissenting Commissioners disputed the factual predicates for the new rule and its wisdom. Goldstein makes some of the same points but the major thrust of his complaint is that the Commission's action misinterpreted § 203(b)(3) of the Advisers Act, a charge the Commission dissenters also leveled. This provision exempts from registration “any investment adviser who during the course of the preceding twelve months has had fewer than fifteen *clients*.” 15 U.S.C. § 80b-3(b)(3) (emphasis added). The Act does not define “client.” Relying on *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 842-43, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984), the Commission believes this renders the statute “ambiguous as to a method for counting clients.” Br. for Resp. 21. There is no such rule of law. The lack of a statutory definition of a word does not necessarily render the meaning of a word ambiguous, just as the presence of a definition does not necessarily make the meaning clear. A definition only pushes the problem back to the meaning of the defining terms. *See Alarm Indus. Commc'ns Comm. v. FCC*, 131 F.3d 1066, 1068-70 (D.C.Cir.1997); *Doris Day Animal League v. Veneman*, 315 F.3d 297, 298-99 (D.C.Cir.2003).

[2] If Congress employs a term susceptible of several meanings, as many terms are, it scarcely follows that Congress has authorized an agency to choose *any* one of those meanings. As always, the “words of the statute should be read in context, the statute's place in the overall statutory scheme should be considered, and the problem Congress sought to solve should be taken into account” to determine whether Congress has foreclosed the agency's interpretation. *PDK Labs. Inc. v. DEA*, 362 F.3d 786, 796 (D.C.Cir.2004) (“*PDK I*”) (internal quotation marks omitted).

“Client” may mean different things depending on context. The client of a laundry occupies a very different position than the client of a lawyer. Even for professional representation, the specific indicia of a client relationship—contracts, fees, duties, and the like—vary with the profession and with the particulars of the situation. An attorney-client relationship, for example, can be formed without any signs of formal “employment.” *See Restatement (Third) Of The Law Governing Lawyers § 14 & cmt. c* (2000) (“The client need not necessarily pay or agree to pay the lawyer; and paying a lawyer does not by itself create a client-lawyer relationship”). Matters may be very different for the client of, say, an architectural firm.

*5 The Commission believes that an amendment to 203(b)(3) suggests the possibility that an investor in a hedge fund could be counted as a client of the fund's adviser. In 1980, Congress added to § 203(b)(3) the following language: “For purposes of determining the number of clients of an investment adviser under this paragraph, no shareholder, partner, or beneficial owner of a business development company ... shall be deemed to be a client of such investment adviser unless such person is a client of such investment adviser separate and apart from his status as a shareholder, partner, or beneficial owner.”^{FN4} Act of Oct. 21, 1980, Pub.L. No. 96-477, § 202, 94 Stat. 2275, 2290 (1980). This language was inserted against a backdrop of uncertainty created by the Second Circuit's decision in *Abrahamson v. Fleschner*. The *Abrahamson* court held that hedge fund general partners were “investment advisers” under the Advisers Act, 568 F.2d at 869-71. In its original opinion, the court specified that the general partners were advisers “to the limited partners.” *See* Robert C. Hacker & Ronald D.

Rotunda, *SEC Registration of Private Investment Partnerships After Abrahamson v. Fleschner*, 78 Colum. L. Rev. 1471, 1484 n. 72 (1978). The final published opinion omits those four words, see *Abrahamson*, 568 F.2d at 871 n. 16, suggesting that the court expressly declined to resolve any ambiguity in the term “client.” If—as we generally assume—Congress was aware of this judicial confusion, see, e.g., *Beethoven.com LLC v. Librarian of Congress*, 394 F.3d 939, 945-46 (D.C.Cir.2005), the 1980 amendment could be seen as Congress’s acknowledgment that “client” is ambiguous in the context of § 203(b)(3). There are statements in the legislative history that suggest as much. See, e.g., *H.R. Rep. NO. 96-1341*, at 62 (1980) (“[W]ith respect to persons or firms which *do not* advise business development companies, the ... amendment ... is not intended to suggest that each shareholder, partner, or beneficial owner of a company advised by such person or firm *should or should not* be regarded as a client” (emphasis added)). Although “the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one,” *PDK I*, 362 F.3d at 794-95 (quoting *United States v. Price*, 361 U.S. 304, 313, 80 S.Ct. 326, 4 L.Ed.2d 334 (1960)), the 1980 amendment might be seen as introducing another definitional possibility into the statute. See *PDK Labs, Inc. v. DEA*, 438 F.3d 1184, 1192-93 (D.C.Cir.2006).^{FN5}

On the other hand, a 1970 amendment to § 203 appears to reflect Congress’s understanding at the time that investment company entities, not their shareholders, were the advisers’ clients. In the amendment, Congress eliminated a separate exemption from registration for advisers who advised only investment companies and explicitly made the fewer-than-fifteen-clients exemption unavailable to such advisers. Investment Company Amendments Act of 1970, Pub.L. No. 91-547, § 24, 84 Stat. 1413, 1430 (1970). This latter prohibition would have been unnecessary if the shareholders of investment companies could be counted as “clients.”

*6 Another section of the Advisers Act strongly suggests that Congress did not intend “shareholders, limited partners, members, or beneficiaries” of a hedge fund to be counted as “clients.” Although the statute does not define “client,” it does define “investment adviser” as “any person who, for compensation, engages in the business of advising others,

either *directly* or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.” 15 U.S.C. § 80b-2(11) (emphasis added). An investor in a private fund may benefit from the adviser’s advice (or he may suffer from it) but he does not receive the advice *directly*. He invests a portion of his assets in the fund. The fund manager—the adviser—controls the disposition of the pool of capital in the fund. The adviser does not tell the *investor* how to spend his money; the investor made that decision when he invested in the fund. Having bought into the fund, the investor fades into the background; his role is completely passive. If the person or entity controlling the fund is not an “investment adviser” to each individual investor, then *a fortiori* each investor cannot be a “client” of that person or entity. These are just two sides of the same coin.

This had been the Commission’s view until it issued the new rule. As recently as 1997, it explained that a “client of an investment adviser typically is provided with individualized advice that is based on the client’s financial situation and investment objectives. In contrast, the investment adviser of an investment company need not consider the individual needs of the company’s shareholders when making investment decisions, and thus has no obligation to ensure that each security purchased for the company’s portfolio is an appropriate investment for each shareholder.” *Status of Investment Advisory Programs Under the Investment Company Act of 1940*, 62 Fed.Reg. 15,098, 15,102 (Mar. 31, 1997). The Commission said much the same in 1985 when it promulgated a rule with respect to investment companies set up as limited partnerships rather than as corporations. The “client” for purposes of the fifteen-client rule of § 203(b)(3) is the limited partnership not the individual partners. See 17 C.F.R. § 275.203(b)(3)-1(a)(2). As the Commission wrote in proposing the rule, when “an adviser to an investment pool manages the assets of the pool on the basis of the investment objectives of the participants as a group, it appears appropriate to view the pool—rather than each participant—as a client of the adviser.” *Safe Harbor Proposed Rule*, 50 Fed.Reg. at 8741.

The Supreme Court embraced a similar conception of the adviser-client relationship when it held in *Lowe v. SEC*, 472

U.S. 181, 105 S.Ct. 2557, 86 L.Ed.2d 130 (1985), that publishers of certain financial newsletters were not “investment advisers.” *Id.* at 211, 105 S.Ct. 2557; see 15 U.S.C. § 80b-2(11)(D). After an extensive discussion of the legislative history of the Advisers Act, the Court held that existence of an advisory relationship depended largely on the character of the advice rendered. Persons engaged in the investment advisory profession “provide personalized advice attuned to a client’s concerns.” *Lowe*, 472 U.S. at 208, 105 S.Ct. 2557. “[F]iduciary, person-to-person relationships” were “characteristic” of the “investment adviser-client relationship[.]” *Id.* at 210, 105 S.Ct. 2557. The Court thought it “significant” that the Advisers Act “repeatedly” referred to “clients,” which signified to the Court “the kind of fiduciary relationship the Act was designed to regulate.” *Id.* at 208 n. 54, 201 n. 45, 105 S.Ct. 2557. This type of direct relationship exists between the adviser and the fund, but not between the adviser and the investors in the fund. The adviser is concerned with the fund’s performance, not with each investor’s financial condition.

*7 The Commission nevertheless is right to point out that the *Lowe* Court was not rendering an interpretation of the word “client.” See *Hedge Fund Rule*, 69 Fed.Reg. at 72,069 n. 174. Because it was construing an exception to the definition of “investment adviser,” we do not read too much into the Court’s understanding of the meaning of “client.” See *Nat’l Cable & Telecomms. Ass’n v. Brand X Internet Servs.*, --- U.S. ---, ---, 125 S.Ct. 2688, 2700, 162 L.Ed.2d 820 (2005).

As we have noted before, “[i]t may be that ... the strict dichotomy between clarity and ambiguity is artificial, that what we have is a continuum, a probability of meaning.” *PDK I*, 362 F.3d at 797. Here, even if the Advisers Act does not foreclose the Commission’s interpretation, the interpretation falls outside the bounds of reasonableness. “An agency construction of a statute cannot survive judicial review if a contested regulation reflects an action that exceeds the agency’s authority. It does not matter whether the unlawful action arises because the disputed regulation defies the plain language of a statute or because the agency’s construction is utterly unreasonable and thus impermissible.” *Aid Ass’n for Lutherans v. United States Postal Serv.*, 321 F.3d

1166, 1174 (D.C.Cir.2003); see also *id.* at 1177-78; *Am. Library Ass’n v. FCC*, 406 F.3d 689, 699 (D.C.Cir.2005).

“The ‘reasonableness’ of an agency’s construction depends,” in part, “on the construction’s ‘fit’ with the statutory language, as well as its conformity to statutory purposes.” *Abbott Labs. v. Young*, 920 F.2d 984, 988 (D.C.Cir.1990). As described above, the Commission’s interpretation of the word “client” comes close to violating the plain language of the statute. At best it is counterintuitive to characterize the investors in a hedge fund as the “clients” of the adviser. See *Am. Bar Ass’n v. FTC*, 430 F.3d 457, 471 (D.C.Cir.2005). The adviser owes fiduciary duties only to the fund, not to the fund’s investors. Section 206 of the Advisers Act, 15 U.S.C. § 80b-6, makes it unlawful for any investment adviser—registered or not—“to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.” *Id.* § 80b-6(2). In *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963), the Supreme Court held that this provision created a fiduciary duty of loyalty between an adviser and his client. See *id.* at 191-92, 84 S.Ct. 275; *id.* at 201, 84 S.Ct. 275 (“The statute, in recognition of the adviser’s fiduciary relationship to his clients, requires that his advice be disinterested.”); see also *Hedge Fund Rule*, 69 Fed.Reg. at 72,059 & n. 57. In that case, the duty of loyalty required an adviser to disclose self-interested transactions to his clients. The Commission recognizes more generally that the duty of loyalty “requires advisers to manage their clients’ portfolios in the best interest of clients,” and imposes obligations to “fully disclose any material conflicts the adviser has with its clients, to seek best execution for client transactions, and to have a reasonable basis for client recommendations.” *Id.* at 72,054.

*8 If the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest. Consider an investment adviser to a hedge fund that is about to go bankrupt. His advice to the fund will likely include any and all measures to remain solvent. His advice to an investor in the fund, however, would likely be to sell. For the same reason, we do not ordinarily deem the shareholders in a corporation the “clients” of the corporation’s lawyers or accountants. See

RESTATEMENT, *supra*, § 96 cmt.b (“By representing the organization, a lawyer does not thereby also form a client-lawyer relationship with all or any individuals ... who have an ownership or other beneficial interest in it, such as its shareholders.”). While the shareholders may benefit from the professionals’ counsel indirectly, their individual interests easily can be drawn into conflict with the interests of the entity. It simply cannot be the case that investment advisers are the servants of two masters in this way.^{FN6}

The Commission’s response to this argument is telling. It argues that the *Hedge Fund Rule* amends *only* the method for counting clients under § 203(b)(3), and that it does not “alter the duties or obligations owed by an investment adviser to its clients.” 69 Fed.Reg. at 72,070. We ordinarily presume that the same words used in different parts of a statute have the same meaning. See *Sullivan v. Stroop*, 496 U.S. 478, 484, 110 S.Ct. 2499, 110 L.Ed.2d 438 (1990). The Commission cannot explain why “client” should mean one thing when determining to whom fiduciary duties are owed, 15 U.S.C. § 80b-6(1)-(3), and something else entirely when determining whether an investment adviser must register under the Act, *id.* § 80b-3(b)(3). Cf. *Mobil Oil Corp. v. EPA*, 871 F.2d 149, 153 (D.C.Cir.1989).

The Commission also argues that the organizational form of most hedge funds is merely “legal artifice,” Br. for Resp. 41, to shield advisers who want to advise more than fifteen clients and remain exempt from registration. See *Hedge Fund Rule*, 69 Fed.Reg. at 72,068. But as the discussion above shows, form matters in this area of the law because it dictates to whom fiduciary duties are owed.

The *Hedge Fund Rule* might be more understandable if, over the years, the advisory relationship between hedge fund advisers and investors had changed. The Commission cited, as justification for its rule, a rise in the amount of hedge fund assets, indications that more pension funds and other institutions were investing in hedge funds, and an increase in fraud actions involving hedge funds. All of this may be true, although the dissenting Commissioners doubted it. But without any evidence that the role of fund advisers with respect to investors had undergone a transformation, there is a disconnect between the factors the Commission cited and the rule it promulgated. That the Commission wanted a

hook on which to hang more comprehensive regulation of hedge funds may be understandable. But the Commission may not accomplish its objective by a manipulation of meaning.

*9 The Commission has, in short, not adequately explained how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter. See *Shays v. FEC*, 414 F.3d 76, 96-97 (D.C.Cir.2005) (explaining that agency interpretation is not “reasonable” if it is “arbitrary and capricious”). The Commission points to its finding that a hedge fund adviser sometimes “may not treat all of its hedge fund investors the same.” *Hedge Fund Rule*, 69 Fed.Reg. at 72,069-70 (citing different lock-up periods, greater access to information, lower fees, and “side pocket” arrangements). From this the Commission concludes that each account of a hedge fund investor “may bear many of the characteristics of separate investment accounts, which, of course, must be counted as separate clients.” *Id.* at 72,070. But the Commission’s conclusion does not follow from its premise. It may be that different classes of investors have different rights or privileges with respect to their investments.^{FN7} This reveals little, however, about the *relationship* between the investor and the adviser. Even if it did, the Commission has not justified treating *all* investors in hedge funds as clients for the purpose of the rule. If there are certain characteristics present in some investor-adviser relationships that mark a “client” relationship, then the Commission should have identified those characteristics and tailored its rule accordingly.

By painting with such a broad brush, the Commission has failed adequately to justify departing from its own prior interpretation of § 203(b)(3). See *Mich. Pub. Power Agency v. FERC*, 405 F.3d 8, 12 (D.C.Cir.2005) (citing *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (D.C.Cir.1970)). As we have discussed, in 1985 the Commission adopted a “safe harbor” for general partners of limited partnerships, enabling them to count the partnership as a single “client” for the purposes of § 203 so long as they provided advice to a “collective investment vehicle” based on the investment objectives of the limited partners as a group. *Safe Harbor Proposed Rule*, 50 Fed.Reg. at 8741. This “safe harbor” remains part of the Commission’s rules

and has since been expanded to include corporations, limited liability companies, and business trusts (hedge funds sometimes take these less common forms, *see Staff Report, supra*, at 9-10 & n. 27). The *Hedge Fund Rule* therefore appears to carve out an exception from this safe harbor solely for investment entities that have fewer than one hundred-one but more than fourteen investors. Compare 17 C.F.R. § 275.203(b)(3)-1, with *id.* § 275.203(b)(3)-2. As discussed above, the Commission does not justify this exception by reference to any change in the nature of investment adviser-client relationships since the safe harbor was adopted. Absent such a justification, its choice appears completely arbitrary. *See Northpoint Technology, Ltd. v. FCC*, 412 F.3d 145, 156 (D.C.Cir.2005) (“A statutory interpretation ... that results from an unexplained departure from prior [agency] policy and practice is not a reasonable one.”).

*10 Nor is this choice any more rational when viewed in light of the policy goals underlying the Advisers Act. *See Abbott Labs.*, 920 F.2d at 988. The Commission recites Congress's findings in § 201 that investment advisory activities “substantially ... affect ... national securities exchanges ... and the national economy,” 15 U.S.C. § 80b-1(3), and concludes that “[i]n enacting [section 203(b)(3)], Congress exempted from the registration requirements a category of advisers whose activities were not sufficiently large or national in scope.” *Hedge Fund Rule*, 69 Fed.Reg. at 72,067. The Commission reasons that because hedge funds are now national in scope, treating the entity as a single client for the purpose of the exemption would frustrate Congress's policy. If Congress did intend the exemption to prevent regulation only of small-scale operations—a policy goal that is clear from neither the statute's text nor its legislative history—the Commission's rule bears no rational relationship to achieving that goal. The number of investors in a hedge fund—the “clients” according to the Commission's rule—reveals nothing about the scale or scope of the fund's activities. It is the volume of assets under management or the extent of indebtedness of a hedge fund or other such financial metrics that determines a fund's importance to national markets. One might say that if Congress meant to exclude regulation of small operations, it chose a very odd way of accomplishing its objective—by excluding investment companies with one hundred or fewer investors and investment advisers

having fewer than fifteen clients. But the *Hedge Fund Rule* only exacerbates whatever problems one might perceive in Congress's method for determining who to regulate. The Commission's rule creates a situation in which funds with one hundred or fewer investors are exempt from the more demanding Investment Company Act, but those with fifteen or more investors trigger registration under the Advisers Act. This is an arbitrary rule.

The petition for review is granted, and the *Hedge Fund Rule* is vacated and remanded.

So ordered.

FN1. Hedge funds are usually differentiated from other exempted investment vehicles like private equity or venture capital funds by their investing and governance behavior. *See Hedge Fund Rule*, 69 Fed.Reg. at 72,073 nn. 224-225.

FN2. Mutual funds make up the vast majority of registered investment companies, with about \$6.4 trillion under management in December 2002. *See Staff Report, supra*, at 1 n. 4. Although precise data are unavailable, some estimates of the size of the hedge fund industry range from about \$600 billion, *id.*, to close to \$900 billion, *Hedge Fund Rule*, 69 Fed.Reg. at 72,055 & n. 20.

FN3. Application of the rule also triggers certain regulations that apply only to *registered* advisers. Most importantly, registered advisers must open their records to the Commission upon request, 15 U.S.C. § 80b-4, and cannot charge their clients a performance fee unless such clients have a net worth of at least \$1.5 million or at least \$750,000 under management with the adviser. *Id.* § 80b-5; 17 C.F.R. § 275.205-3; *see also Hedge Fund Rule*, 69 Fed.Reg. at 72,064 (citing “salutary effect” of this rule to limit “retailization”).

FN4. A “business development company”—commonly known as a venture capital company—is defined in 15 U.S.C. § 80a-2(a)(48) as a “closed-end company which” operates for the pur-

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--- F.3d ---, 2006 WL 1715766 (C.A.D.C.), Fed. Sec. L. Rep. P 93,890

(Cite as: --- F.3d ---)

pose of making investments in certain securities and making “available significant managerial assistance with respect to the issuers of such securities.”

FN5. There is irony in the Commission's reliance on this amendment to demonstrate the ambiguity of “client.” As we discuss below, the Commission in 1985 established a “safe harbor,” allowing advisers to count certain limited partnerships as *single clients* specifically in order to provide “greater certainty” about the meaning of the term. Definition of “Client” of Investment Adviser for Certain Purposes Relating to Limited Partnerships, 50 Fed.Reg. 8740, 8740 (Mar. 5, 1985) (“*Safe Harbor Proposed Rule*”). In so doing, the Commission declared that it “should [not] distinguish such a limited partnership from a business development partnership,” and that it was therefore “incorporat[ing] the approach of the 1980 Amendments into a limited partnership rule.” *Id.* at 8741.

FN6. In the *Hedge Fund Rule*, 69 Fed.Reg. at 72,070 n. 187, and again at oral argument, Tr. of Oral Argument 16-17, the Commission argued that the fiduciary duties created by the anti-fraud provisions of the Advisers Act did in fact extend to the relationship between an adviser and the limited partners of a hedge fund. The Commission relies on *Abrahamson v. Fleschner*, in which the Second Circuit found that limited partners of a hedge fund stated a cause of action against the general partner for fraud under § 206. 568 F.2d at 877-78. The anti-fraud provision also applies, however, to persons other than clients. See 15 U.S.C. § 80b-6(4). In the absence of further specification, *Abrahamson* can only be read for the proposition that investors in a hedge fund may sustain an action for fraud against the fund's adviser. Cf. *United States v. Elliott*, 62 F.3d 1304, 1311-13 (11th Cir.1995) (holding that adviser-client relationship was not required for criminal fraud conviction under § 206).

FN7. This is in fact a common arrangement throughout the law of business organizations.

Many corporations, for example, have different classes of common or preferred stock. Although different classes of stockholders have different rights or privileges, the basic fiduciary duties of managers to shareholders remain uniform.

C.A.D.C.,2006.

Goldstein v. S.E.C.

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Briefs and Other Related Documents ([Back to top](#))

- [2005 WL 1636146](#) (Appellate Brief) Brief of the Securities and Exchange Commission, Respondent (Jun. 23, 2005) Original Image of this Document (PDF)
- [2005 WL 1666936](#) (Appellate Brief) Reply Brief of Petitioners Phillip Goldstein, Kimball & Winthrop, Inc., and Opportunity Partners L.P. (Jun. 23, 2005) Original Image of this Document (PDF)
- [2005 WL 1666937](#) (Appellate Brief) Opening Brief of Petitioners Phillip Goldstein, Kimball & Winthrop, Inc., and Opportunity Partners L.P. (Jun. 23, 2005) Original Image of this Document with Appendix (PDF)
- [04-1434](#) (Docket) (Dec. 21, 2004)

END OF DOCUMENT

H

S.E.C. Release No.

*1 Initial Decision

IN THE MATTER OF INFORMATION ARCHITECTS CORPORATION
Administrative Proceeding File No. 3-11822
October 25, 2005

BEFORE: Carol Fox Foelak, Administrative Law Judge

APPEARANCES:

Marshall Gandy for the Division of Enforcement, Securities and Exchange Commission

Gregory Bartko for Respondent Information Architects Corporation

SUMMARY

This Initial Decision dismisses the proceeding against Information Architects Corporation (Information Architects). The charges concerned irregularities in the required periodic reports filed during 2004 by Information Architects.

I. INTRODUCTION

A. Procedural Background

The Securities and Exchange Commission (Commission) initiated this proceeding on February 11, 2005, with an Order Instituting Proceedings (OIP), pursuant to Section 12(j) of the Securities Exchange Act of 1934 (Exchange Act). Information Architects was served with the OIP on June 27, 2005, and filed an Answer to the OIP on July 12, 2005. At an August 25, 2005, prehearing conference the parties requested leave to file cross motions for summary disposition and consented to an initial decision based on the pleadings. Leave was granted, pursuant to 17 C.F.R. § 201.250(a). Info. Architects Corp., Admin. Proc. No. 3-11822 (A.L.J. Aug. 25, 2005). The parties filed their motions for summary disposition and a joint statement of stipulated facts on October 6, 2005. No replies were filed.

The Findings of Fact in this Initial Decision are based on the joint statement of stipulated facts, which is admitted into evidence as Joint Exhibit 1, [FN1] and the Commission's public official records concerning Information Architects, of which official notice is taken pursuant to 17 C.F.R. § 201.323. There is no genuine issue with regard to any material fact, and this proceeding may be resolved by summary disposition, pursuant to 17 C.F.R. § 201.250. All arguments and proposed findings and conclusions that are inconsistent with this decision were considered and rejected.

B. Allegations and Arguments of the Parties

The OIP alleges that Information Architects's securities are registered under Section 12(g) of the Exchange Act, that its annual report for the year ended December 2003 contained an auditors' report not prepared or issued by the auditors identified, and that the error was compounded in the following three quarterly reports and in an amended annual report. Thus, the OIP alleges, Information Architects violated Exchange Act Section 13(a) and Rules 12b-20, 13a-1 and 13a-13 as well as the antifraud provisions of the Securities Act of 1933 (Securities Act) and the Exchange Act -- Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5. The Division requests that the registration of Information Architects's stock be revoked or suspended.

*2 Information Architects acknowledges the inaccurate filings but states that, as shown by Joint Exhibit 1, the inaccuracies were due to its good faith reliance on a financial consultant and that it has amended the inaccurate filings and is otherwise in good standing and current on its periodic reports. Information Architects requests that the proceeding be dismissed.

II. FINDINGS OF FACT

Information Architects provides employment screening and background investigation services. Ex. 1 at 1. The Commission's public official records show that Information Architects's common stock has been registered with the Commission pursuant to Section 12(g) of the Exchange Act since 1997. Its Form 10-KSB for the year ended December 31, 2003, and the three following Forms 10-QSB contained inaccuracies, as did an amended 2003 Form 10-KSB filed January 4, 2005. [FN2] Ex. 1 at 3-6. The 2003 Form 10-KSB and amended Form 10-KSB were signed and certified by Michael Clark (Clark), who was Information Architects's President, and the Forms 10-QSB were signed and certified by Clark and by William Overhulser (Overhulser), the company's Chief Operating Officer. Ex. 1 at 1-6. Information Architects had engaged Marvin Winick (Winick) to manage the preparation of its financial statements and the preparation, review, and filing of the periodic reports at issue. Ex. 1 at 2. Winick had held himself out to management of Information Architects as trained and knowledgeable in the corporate accounting field and competent to perform the duties he agreed to perform on behalf of Information Architects. Ex. 1 at 2-4.

The 2003 Form 10-KSB, as prepared by Winick, represented that Information Architects had retained Russell & Atkins (R&A) as its auditor and that its financial statements were audited. Ex. 1 at 3-4. The Form 10-KSB contained an Auditor Report and Consent purportedly signed by R&A. Ex. 1 at 3-4. Each of Information Architects's following three Forms 10-QSB compared the financial results for the current quarter with those for the 2003 year, represented as "audited." Ex. 1 at 4. The amended 2003 Form 10-KSB, also prepared by Winick, contained an Auditor's Report indicating that the December 31, 2003, financial statements had now been audited by a different firm. Ex. 1 at 5.

Clark and Overhulser had no reason to doubt Winick or the accuracy of the reports at issue at the time they were filed but subsequently learned that neither R&A nor the second

auditor had audited the financial statements as represented. Ex. 1 at 4, 6. Thereafter, Information Architects filed an amended 2003 Form 10-KSB that contained audited financial statements and amended quarterly reports, as well, to the satisfaction of Commission staff. Ex. 1 at 7-8. The Commission's public official records show that it also timely filed its 2004 Form 10-KSB and Forms 10-QSB for the first two quarters of 2005 so that it is now current in its filings.

III. CONCLUSIONS OF LAW

Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 require public corporations to file annual and quarterly reports with the Commission. The requirement that reports be filed carries with it the obligation that those filings be accurate. See SEC v. Savoy Indus., Inc., 587 F.2d 1149, 1165 (D.C. Cir. 1978). Additionally, Exchange Act Rule 12b-20 requires a filer to supplement required information with "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading."

*3 As a "small business issuer" for the purpose of the disclosure requirements, Information Architects filed annual reports on Form 10-KSB. See 17 C.F.R. § 228.10(a)(1); see generally 17 C.F.R. §§ 228.10-.702 (Regulation S-B) (setting forth disclosure requirements for small business issuers). As required by 17 C.F.R. § 228.310, financial statements included with Form 10-KSB must be prepared in accordance with Generally Accepted Accounting Principles and must be audited by an independent accountant. Pursuant to 17 C.F.R. § 228.310 Note 2, the report and qualifications of the independent accountant must comply with 17 C.F.R. § 210.2. [FN3] See 17 C.F.R. § 210.2-02 (specifying requirements for accountants' reports).

The filings at issue were deficient and not accurate. The 2003 Form 10-KSB lacked audited financial statements and falsely identified R&A as having audited them. All the filings at issue falsely represented that the 2003 financial statements were audited. Thus, Information Architects violated Exchange Act Section 13(a) and Rules 13a-1 and 13a-13.

Based on the evidence of record, it is concluded that Information Architects did not violate Securities Act Section 17(a) or Exchange Act Section 10(b) and Rules 10b-5 and 12b-20.

IV. SANCTION

The only remedies available in this proceeding are revocation or suspension of registration of Information Architects's securities. Under the particular circumstances of this case, in light of e-Smart Tech., Inc., 83 SEC Docket 3586 (Oct. 12, 2004), e-Smart Tech., Inc., 84 SEC Docket 2979 (A.L.J. Feb. 3, 2005), and sanction considerations set forth in Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), the registration of Information Architects' stock will not be revoked or suspended.

Information Architects has recognized its violations and mitigated them by filing amended, compliant, periodic reports for the periods that were covered by the violative reports. Commission staff has found no fault with its subsequent periodic reports, Form 10-KSB for 2004 and the Forms 10-QSB for the first two quarters of 2005. In short, it is now in full compliance with its reporting requirements, and the investing public has access to past and current audited financial information. [FN4] Future violations are unlikely. Scierter is absent. A mitigating factor is that the violations resulted from Information Architects' unknowingly ill-placed reliance on an individual who appeared reliable but deceived corporate officers. In light of the above considerations, the sanctions of revocation or suspension will not be imposed, and the proceeding will be dismissed.

V. ORDER

*4 IT IS ORDERED that this administrative proceeding IS DISMISSED.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Carol Fox Foelak

Administrative Law Judge

FN1. Citations to Joint Exhibit 1 will be noted as "Ex. 1 at ___."

FN2. Forms 10-KSB and 10-QSB may be filed, in lieu of Forms 10-K and 10-Q, by a company that is a "small business issuer." See 17 C.F.R. § 228.10(a).

FN3. Part 210 of 17 C.F.R. (17 C.F.R. §§ 210.1-.12) is also known as Regulation S-X.

FN4. In e-Smart Tech., Inc. the Commission stated that a company's subsequent filing history is an important factor to be considered in determining whether revocation is "necessary or appropriate for the protection of investors" within the meaning of Section 12(j) of the Exchange Act. Nevertheless, the Commission warned that its decision was dependent on the particular facts of that proceeding and not to be construed as suggesting that a

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Release No. ID - 299, 2005 WL 2756712 (S.E.C. Release No.)
(Cite as: 2005 WL 2756712 (S.E.C. Release No.))

determination to revoke an issuer's registration will be reconsidered simply because the issuer has begun to submit long overdue filings during a proceeding to revoke its registration. e-Smart Tech., Inc., 83 SEC Docket at 3592 & n. 18.

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END OF DOCUMENT

Release No. 39343, Release No. 34-39343, 65 S.E.C. Docket 2055, 1997 WL 722029
(S.E.C. Release No.)
(Cite as: 1997 WL 722029 (S.E.C. Release No.))

C

Securities and Exchange Commission (S.E.C.)
*1 Securities Exchange Act of 1934

IN THE MATTER OF THE APPLICATION OF JJFN SERVICES, INC.
100 QUENTIN ROOSEVELT BOULEVARD
SUITE 202

GARDEN CITY, NEW YORK 11530
FOR REVIEW OF ACTION TAKEN BY THE NATIONAL ASSOCIATION OF SECURITIES DEALERS,
INC.
Administrative Proceeding File No. 3-9229
November 21, 1997

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- DENIAL OF NASDAQ SMALLCAP MARKET LISTING
Control Person's Felony Tax Conviction

Registered securities association acted consistently with its rules and the purposes of the federal securities laws in denying an issuer's request that its securities be included in the association's automatic quotation system, because the issuer's controlling shareholder, paid consultant, and promoter has been convicted of felony tax law violations. Held, review proceeding is dismissed.

APPEARANCES:

Richard M. Asche, of Litman, Asche & Gioiella, LLP, for JJFN Services, Inc.

Robert E. Aber, Sara Nelson Bloom, and Arnold P. Golub, for the Nasdaq Stock Market, Inc.

Appeal filed: January 21, 1997

Last brief filed: May 6, 1997

I.

JJFN Services, Inc. ("JJFN" or the "Company") appeals the decision of the National Association of Securities Dealers, Inc. ("NASD") denying its application to include the Company's securities on the Nasdaq SmallCap Market. The NASD denied JJFN's application based on the 1992 felony tax conviction of David Miller, the Company's controlling shareholder, promoter, and paid consultant. [FN1] We base our findings on an independent review of the record.

II.

JJFN, a Delaware corporation, was organized in late 1995. Its primary business is the

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purchase of model homes from real estate developers and the subsequent leaseback of such homes to the developers from whom they were purchased. According to the Forms 10-K and 10-Q filed with us by the Company, David Miller is a "key person" who has been engaged as a "financial consultant" to the Company since its inception, and may be deemed the Company's "promoter." Miller has a consulting contract with JJFN under which he is paid \$180,000 per year for his services. By comparison, the annual salary of JJFN's highest-paid employee, the Company's president and chief executive officer, is \$120,000. As specified in its consulting contract with Miller, JJFN has reserved the right to purchase a "key man" insurance policy on Miller's life, naming itself as the beneficiary. As of June 30, 1996, Miller and members of his family owned or controlled more than half of the 15.96 million JJFN shares then-outstanding.

In April 1992, Miller pleaded guilty to three felony tax fraud charges, [FN2] admitting that in 1983, 1984, and 1985 he filed, and conspired with others to file, false federal tax returns on behalf of a company of which he was the president and chief executive officer. Miller was sentenced in October 1992 to 20 months in prison, fined \$40,000, and assessed the costs of his incarceration. [FN3] He entered federal prison in December 1992, was paroled in December 1993, and was released from custody in May 1994. In November 1995, Miller paid the \$40,000 fine, as well as \$18,054 in incarceration costs.

*2 Three months later, on February 1, 1996, JJFN applied to the NASD for inclusion of its securities in the Nasdaq SmallCap Market. In the ensuing months, Nasdaq staff contacted JJFN to request additional information about the application and about Miller's conviction.

By letter dated July 22, 1996, Nasdaq staff denied JJFN's application based on David Miller's association with the Company. The staff asserted that, given Miller's "regulatory history" and the "potential influence and control he may exercise over the Company . . . it would be to the detriment of the investing public" to list JJFN's shares on the Nasdaq SmallCap Market.

JJFN appealed the staff's decision to the Nasdaq Listing Qualifications Panel ("Qualifications Panel"). After a hearing at which Miller and certain officers of JJFN testified, the Qualifications Panel, by letter dated August 22, 1996, found that Miller's "involvement in [JJFN] both as a shareholder and as a consultant is substantial." The panel determined that Miller's felony tax fraud convictions "related to his role as the officer of a company." The panel further explained that it was affirming the staff's denial of JJFN's application "in order to preserve and strengthen the quality of and public confidence in the market, and in order to protect prospective investors and the public interest."

In late August 1996, JJFN appealed the Qualifications Panel's decision to the Nasdaq Listing and Hearing Review Committee ("Review Committee"). In early September, while that appeal was pending, Miller offered to place in an irrevocable voting trust all JJFN shares held by him and members of his family, and the Company offered to terminate Miller's con-

sulting contract. One week later, Miller offered in addition to sell to an independent third party all JJFN shares "personally owned by him." [FN4]

By letter dated December 20, 1996, the Review Committee affirmed the Qualifications Panel's decision to deny inclusion of JJFN's securities in the Nasdaq SmallCap Market. Although the Review Committee noted Miller's offers to terminate his consulting contract with JJFN, to sell his JJFN shares, and to place the shares held by his family in a voting trust, it found that Miller "appear[s] to play an essential role in [JJFN]" and that JJFN is "dependent on [Miller's] expertise." The Review Committee voiced its concern that Miller's "past violative conduct might indicate a propensity to engage in conduct detrimental of [sic] public investors."

III.

JJFN seeks reversal of the NASD's action and an order directing the NASD to include JJFN's securities in the Nasdaq SmallCap Market. We will uphold the NASD's decision to deny JJFN's request for inclusion if we find "that the specific grounds on which such denial . . . is based exist in fact, that such denial . . . is in accordance with [NASD rules], and that such [NASD] rules are, and were applied in a manner, consistent with the purposes of" the Securities Exchange Act of 1934 ("Exchange Act"), unless we find that the NASD's "denial imposes any burden on competition not necessary or appropriate in furtherance of the purposes" of the Exchange Act. [FN5]

*3 A. JJFN contends that there is no basis in fact for the NASD's conclusion that Miller might have a "propensity to engage in conduct detrimental of [sic] public investors." We disagree. Notwithstanding JJFN's assertion that the NASD's "concern with Mr. Miller appears to be more cosmetic than real," Miller's conviction for tax fraud legitimately may be considered by the NASD to be evidence of a propensity for future conduct violative of securities laws or regulations. Both the tax and the securities regulatory schemes depend on the honor, candor, and integrity of regulated persons to report accurately to the regulatory authority the information sought by such authority. [FN6]

JJFN also challenges the NASD's conclusion that Miller plays an "essential role" in the Company. The record supports the NASD's conclusion that Miller is "essential" to the Company and that the Company is dependent on his expertise. As noted, Miller has a generous consulting contract with JJFN, controls the Company, and is a key person and the promoter of JJFN. In addition, JJFN's president and its general counsel both testified that Miller "invented" JJFN and the idea of the sale-leaseback of model homes, that Miller is responsible for designing and structuring all of the complex financial transactions into which JJFN has entered, and that Miller negotiated and closed all of the Company's deals to date. [FN7] In the words of JJFN's general counsel, "[i]t's clear that Miller is important to the Company. Very important to the Company."

JJFN also contends that the NASD failed to consider Miller's offer to "divest himself and his family of all stock in JJFN" and otherwise to remove himself from involvement with the Company. As an initial matter, JJFN overstates Miller's offer. Miller offered to end his consulting contract with JJFN, to place in an irrevocable voting trust all shares of

JJFN owned by members of his family, and to sell those shares "personally owned by him," but not to dispose of the much larger block of shares beneficially owned or otherwise controlled by him and members of his family.

While the Review Committee explained in detail Miller's offer to disengage from JJFN, it nevertheless stated that Miller "appear[s] to play an essential role in [JJFN]" and that JJFN is "dependent on [Miller's] expertise." That the Review Committee discounted Miller's offer is understandable, given that the record establishes that Miller is crucial to JJFN and that neither Miller nor the Company has suggested that another JJFN employee or consultant can undertake Miller's responsibilities, or has proposed a plan for the Company's continued viability without Miller.

B. JJFN argues that the NASD's denial of JJFN's application was not in accordance with NASD rules. Specifically, the Company claims that the NASD exceeded its authority and "abused its discretion" in denying JJFN's application for inclusion of its securities in Nasdaq on the basis of Miller's felony tax fraud conviction. The NASD's authority to deny an application for inclusion, however, is necessarily broad, and, in our view, the NASD properly exercised its investor protection responsibilities in denying JJFN's application. [FN8] As we have stated previously, investors are entitled to assume that the securities in the system meet the system's standards, [FN9] and that "the risk associated with investing in Nasdaq is market risk rather than the risk that the promoter or other persons exercising substantial influence over the issuer is acting in an illegal manner." [FN10]

*4 JJFN also asserts that the NASD's denial of JJFN's application constitutes the "de facto promulgation" of a new rule barring absolutely the inclusion in Nasdaq of issuers that have control persons or key personnel who have been convicted of a felony. We disagree. "The inclusion of a security for trading in Nasdaq . . . should not depend solely on meeting quantitative criteria, but should also entail an element of judgment given the expectations of investors and the imprimatur of listing on a particular market." [FN11] The denial at issue here is a reasoned decision made on consideration of all of the facts and circumstances presented, and does not reflect a blanket rule.

C. JJFN does not contend that the rules pursuant to which the NASD denied its application for inclusion are inconsistent with the purposes of the Exchange Act, nor is there support in this record for such a proposition. [FN12] Rather, JJFN appears to claim that the NASD did not apply its rules in a manner consistent with the Exchange Act.

JJFN asserts that the NASD's denial of JJFN's application is arbitrary because it is allegedly inconsistent with prior NASD listing decisions. JJFN also asserts that NASD has approved other applications for inclusion in Nasdaq subject to the creation of a voting trust similar to that offered by Miller for the JJFN shares that he and his family hold. Each application for inclusion in Nasdaq, however, must be considered in light of all of the facts and circumstances presented, and should not be determined by comparison with the actions taken in other proceedings. [FN13]

JJFN also claims that the Nasdaq staff, in its review of the application, expressed concern with JJFN's debt-to-equity ratio and impliedly promised that, should Miller and certain of his family convert \$1.75 million in loans to the Company into common stock,

JJFN's application would be approved. JJFN states that Miller and his family converted the debt to common stock in reliance on this statement by the staff, and assertedly were injured when the NASD failed to list the stock. The record, however, does not support that the Nasdaq staff made such representations to JJFN. Moreover, our authority to order the NASD to include an issuer's securities is governed by Exchange Act Section 19(f), not by a theory of promissory estoppel or quasi-contract. [FN14] Lastly, the actions or representations of the Nasdaq staff with respect to JJFN's application do not bind the NASD and cannot be the basis for requiring the inclusion of JJFN's securities on Nasdaq. [FN15]

D. Finally, we do not find that the NASD's denial imposes an unnecessary or inappropriate burden on competition. This argument is not advanced by JJFN, and the record does not support such a finding. [FN16]

IV.

We find that a factual basis exists to deny JJFN's application for inclusion of its securities in the Nasdaq SmallCap Market; that the NASD acted with respect to JJFN in accordance with its rules; that the NASD's rules are, and were applied in a manner, consistent with the purposes of the securities laws; and we do not find that the NASD's denial of JJFN's application for inclusion imposes an unnecessary or inappropriate burden on competition. Accordingly, this review proceeding shall be dismissed.

*5 An appropriate order will issue. [FN17]

By the Commission (Chairman LEVITT, Commissioners JOHNSON, HUNT, CAREY, and UNGER)

Jonathan G. Katz

Secretary

FN1. The NASD invoked its authority under NASD Marketplace Rules 4300 and 4330. Rule 4300 provides that, with respect to initial inclusion in the Nasdaq SmallCap Market, the NASD [M]ay deny initial inclusion [in the Nasdaq Smallcap Market] or apply additional or more stringent criteria for the initial . . . inclusion of particular securities . . . based on any event, condition, or circumstance which exists or occurs that makes initial . . . inclusion of the securities in Nasdaq inadvisable or unwarranted in the opinion of [the NASD], even though the securities meet all enumerated criteria for initial . . . inclusion in [the Nasdaq Smallcap Market].

Rule 4330 provides in turn that the NASD may "deny inclusion or apply additional or more stringent criteria for the initial . . . inclusion of particular securities" if the NASD "deems it necessary to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, or to protect investors and the public interest."

FN2. Miller pleaded guilty to violations of 26 U.S.C. § 7206(1) ("Fraud and false statements -- Declaration under penalty of perjury"), 26 U.S.C. § 7206(2) ("Fraud and false statements -- Aid or assistance"), and 18 U.S.C. § 371 ("Conspiracy to commit offense

[against] or to defraud the United States").

FN3. Miller also was assessed and has paid costs of \$50 for each of the three felony counts.

FN4. It appears from the record that Miller owns personally 1.46 million shares (about nine percent of JJFN's issued stock), but controls with members of his family nearly 9.7 million additional shares.

FN5. Section 19(f) of the Exchange Act, 15 U.S.C. § 78s(f).

FN6. JJFN also asserts that Miller's conviction is not relevant because it is "remote in time." While the conduct on which the conviction was based occurred more than ten years ago, Miller admitted to a pattern of conduct violative of the tax laws that persisted for three years. In addition, the conviction itself and Miller's resulting prison term are relatively recent.

The Company further argues that Miller's conviction must be viewed in light of his entire career, which "has been unmarked by any escutcheon except his tax conviction." Contrary to this assertion, however, this Commission twice has brought enforcement actions against Miller or entities with which he is associated. In 1970, we ordered the temporary suspension of trading in a company of which Miller was the chief financial officer out of concern that information that the company had filed with us about its financial condition might not be accurate. Exchange Act Rel. No. 8944 (July 28, 1970), 1970 WL 9786 (S.E.C.). In 1973, we obtained a permanent injunction by consent against Miller and a company of which he was the president. The district court's order required the filing with us of, among other reports, three years of delinquent Forms 10-K and enjoined future violations of Exchange Act § 13(a) and the rules and regulations thereunder. S.E.C. v. Met Sports Centers, Inc., and David Miller, Civil Action No. 192-73 (D.D.C. Apr. 24, 1973) (order entering final judgment of permanent injunction). Neither action is a stated basis for the NASD's decision to deny JJFN a Nasdaq listing, and, accordingly, we have not considered these prior actions in our decision here, except in evaluating the Company's contention described above.

FN7. As the Company's general counsel testified before the Qualifications Panel, "[Miller] is a designer. He invented the program, he structured it. He puts the right people in place, he gets people who are loyal and productive to do what needs to be done, and then he designs the next product." The Company's president and CEO testified that "[w]hat [Miller] brings to the Company is not only a huge contact base in the financial community, but he can structure complex financial transactions that I've never had any exposure to."

FN8. See supra n.1 (discussing the NASD's authority to deny an application for inclusion in Nasdaq). It is important that the NASD have this broad authority, given that "[s]ecurities listed for trading or included in Nasdaq often qualify for margin loans and are exempt from many of the state blue sky laws" and from our Penny Stock Sales Practice and Disclosure Rules (Rules 3a51-1, 15g-1 to 15g-6, 15g-8 and 15g-9 under the Exchange

Release No. 39343, Release No. 34-39343, 65 S.E.C. Docket 2055, 1997 WL 722029
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Act). Exchange Act Rel. No. 34151 (June 3, 1994), 56 SEC Docket 2654, 2656-57.

FN9. Tassaway, Inc., 45 S.E.C. 706, 709 (1975).

FN10. Exchange Act Rel. No. 34151, 56 SEC Docket at 2656.

FN11. Id.

FN12. This Commission approved the predecessor to NASD Marketplace Rule 4300, finding that the rule is "consistent with the requirements of the [Exchange Act] and the rules and regulations thereunder applicable to the NASD." Id.

FN13. DHB Capital Group, Inc., Exchange Act Rel. No. 37069 (April 5, 1996), 61 SEC Docket 2049, 2056. See also J.V. Ace & Co., Inc., and Joseph V. Ace, 50 S.E.C. 461, 467 (1990).

We have not reviewed the NASD decisions to which JJFN refers; our reference to them here does not indicate our endorsement or disapproval of those decisions.

FN14. See supra n.5 and accompanying text.

FN15. Cf. Peter T. Higgins, 51 S.E.C. 865, 868 n.10 (1993) (holding that erroneous advice from NASD staff does not alter respondent's obligation to pay arbitration award).

FN16. We also note that a public market already is made in JJFN shares -- the Company currently is listed on the NASD's OTC Bulletin Board.

FN17. All of the arguments advanced by the parties have been considered. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

*6 SECURITIES EXCHANGE ACT OF 1934

Rel. No. 39343 / November 21, 1997

Admin. Proc. File No. 3-9229

In the Matter of the Application of JJFN Services, Inc.

100 Quentin Roosevelt Boulevard

Suite 202

Garden City, New York 11530

For Review of Action Taken by the NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

ORDER DISMISSING REVIEW PROCEEDING

On the basis of the Commission's opinion issued this day, it is

Westlaw.

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ORDERED that the application for review filed by JJFN Services, Inc. be, and it hereby is, dismissed.

By the Commission.

Jonathan G. Katz

Secretary

Release No. 39343, Release No. 34-39343, 65 S.E.C. Docket 2055, 1997 WL 722029 (S.E.C. Release No.)

END OF DOCUMENT

Westlaw

Release No. 51236, Release No. 34-51236, 84 S.E.C. Docket 3092, 2005 WL 424920
(S.E.C. Release No.)
(Cite as: 2005 WL 424920 (S.E.C. Release No.))

H
S.E.C. Release No.

*1 Securities Exchange Act of 1934

IN THE MATTER OF THE APPLICATION OF HARRY M. RICHARDSON
FOR REVIEW OF ACTION TAKEN BY NASD
c/o Charles R. Mills, Esq.
Kirkpatrick & Lockhart LLP
1800 Massachusetts Avenue, N.W.
Suite 200
Washington, DC 20036-1221
Administrative Proceeding File No. 3-11437
February 22, 2005

Appeal filed: March 18, 2004

Last brief received: June 29, 2004

APPEARANCES:

Charles R. Mills, Kathryn A. Sellig, and Jon A. Stanley, of Kirkpatrick & Lockhart LLP,
for Harry M. Richardson.

Marc Menchel, Alan B. Lawhead, Deborah F. McIlroy, Leavy Mathews III, and Jennifer C.
Brooks for NASD.

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DENIAL OF APPLICATION TO ASSOCIATE

Registered securities association denied member's application to permit employment of
individual subject to a statutory disqualification. Held, review proceeding is remanded.

I.

Harry M. Richardson ("Richardson") appeals from a denial by NASD of a member firm's ap-
plication to continue as a member with Richardson as an associated person. The application
was necessary because Richardson is subject to two statutory disqualifications: an injunc-
tion and a bar order imposed by the Commission with a right to reapply after three years.
We base our determinations on an independent review of the record.

II.

On March 4, 1999, Richardson settled a civil action filed against him by the Commission
by consenting to the entry of an injunction against future violations of Section 17(a) of
the Securities Act of 1933; Section 10(b) of the Securities Exchange Act of 1934 and Rule

10b-5 thereunder; Section 15B(c)(1) of the Securities Exchange Act of 1934, [FN1] and Municipal Securities Rulemaking Board ("MSRB") Rules G-17 and G-19. [FN2] Richardson also settled a related administrative proceeding without admitting or denying the Commission's allegations that he "in connection with two 'pool' municipal bond offerings made material misrepresentations and omissions pertaining to the size of the pools and the intended use of the bond proceeds, and advised the pools to purchase unsuitable securities." [FN3] The Commission further alleged that Richardson "in connection with three land development municipal bond offerings made material misrepresentations and omissions pertaining to the value of the land, developer, and capitalization of the project." [FN4] Pursuant to the settlement, Richardson consented to being barred from association with any broker, dealer, investment adviser, investment company or municipal securities dealer, with a right to reapply for association after three years. [FN5]

In April 2003, more than three years after the entry of the Commission's bar order, Emmett A. Larkin Company, Inc. ("Emmett Larkin" or "the Firm"), applied to NASD to allow the Firm to continue in NASD membership with Richardson as an employee. After obtaining an agreement from Emmett Larkin for special supervisory conditions for Richardson, NASD's Department of Member Regulation recommended that the application be approved. After a hearing, NASD's National Adjudicatory Council ("NAC") in February 2004 denied the Firm's application. The NAC based its decision solely on the municipal bond misconduct underlying both Richardson's injunction and the Commission's bar order, finding that misconduct to be so serious that readmitting Richardson would not be in the public interest or consistent with investor protection.

*2 The NASD decision acknowledged the tension between the denial and Commission precedent in Paul Edward Van Dusen. [FN6] NASD characterized the holding of Van Dusen as requiring, in cases where the Commission has settled an administrative proceeding involving the same misconduct that underlies a permanent injunction and has imposed a bar with the right to reapply after a specified time, that "NASD may not consider the underlying misconduct in a subsequent application by the barred person to re-enter the securities industry at the expiration of the limited bar." NASD decided to deny the Firm's application on the basis of the underlying misconduct, however, since it

strongly believe[s] that this guidance in Van Dusen fails to take into account properly the separate analysis in which NASD is charged with engaging when an applicant seeks readmission. It conflates two separate processes - the one in which someone is barred from the industry and given the ability after a period of time to reapply, and the separate process by which NASD is charged with the duty to evaluate whether an applicant can be permitted to function in a particular registered capacity consistent with the public interest and investor protection.

This appeal followed.

III.

Our review of NASD's denial of the Firm's application is governed by standards set forth in Section 19(f) of the Exchange Act. [FN7] We must dismiss Richardson's appeal if we find that the specific grounds on which NASD based its action exist in fact, that the denial is in accordance with NASD rules, and that those rules were applied in a manner consistent with the purposes of the Exchange Act, unless we determine that NASD's action imposes an unnecessary burden on competition. [FN8]

The grounds on which NASD based its decision, Richardson's statutory disqualifications resulting from the injunction and the Commission bar order, exist in fact. [FN9] Moreover, the record gives no indication that the proceeding was not in compliance with NASD rules. [FN10] Whether NASD's application of its rules in reviewing applications involving certain statutorily disqualified persons was consistent with the purposes of the Exchange Act can be determined by applying the principles set forth in *Van Dusen* and our subsequent decision in *Arthur H. Ross*. [FN11]

Underlying much of NASD's argument is its characterization of *Van Dusen* as setting forth a rigid "exclusionary rule" that precludes NASD from considering all relevant factors in reviewing applications like the one at issue here. To the contrary, *Van Dusen* and *Ross* encourage analysis that looks at all relevant factors, including, among others, misconduct in which a statutorily disqualified person may have engaged since the misconduct that gave rise to the statutory disqualification, the nature and disciplinary history of a prospective employer, and the proposed supervisory structure to which the statutorily disqualified person would be subject. [FN12]

*3 *Van Dusen* and *Ross* do not preclude consideration of the misconduct that led to the statutory disqualification and the bar with a right to reapply. Rather, these cases require that the misconduct be considered in an appropriate context and given appropriate weight. For example, the misconduct could be considered as forming a part of a pattern, or in evaluating how well the employer firm's proposed scheme of supervision was designed to prevent the type of conduct that had resulted in the bar order. [FN13] Quite simply, *Van Dusen* and *Ross* instruct that an SRO ordinarily may not deny reentry based solely on the underlying misconduct that led to the statutory disqualification and the conditional bar; something more is needed. [FN14]

Thus, *Van Dusen* and *Ross* recognize that the misconduct underlying a statutory disqualification may play a role in the consideration of an application like the one at issue here. [FN15] Requiring that NASD generally consider new information leaves ample room for NASD to consider a wide range of appropriate factors. [FN16] *Van Dusen* and *Ross* neither force nor preclude any particular outcome. [FN17]

Specifically, *Van Dusen* involved an NASD denial of association to a person subject to two statutory disqualifications, an injunction and a Commission bar from association with a broker-dealer in a supervisory capacity, with a right to apply after 18 months. [FN18] We set aside NASD's denial because it was premised on NASD's finding that the underlying misconduct that had led to *Van Dusen*'s statutory disqualification was sufficiently egre-

gious that Van Dusen's association would not be consistent with the public interest. [FN19] We determined that the denial of the application on that basis was inconsistent with the purposes of the Exchange Act and unfair. We were careful to make clear, however, that such applications should not be granted automatically simply because the passage of time had made application possible; instead, a variety of relevant factors should be considered. [FN20]

Ross involved a person subject to statutory disqualification based on a Commission order that barred him from associating in any proprietary or supervisory capacity, with the right to apply after three and one-half years. [FN21] NASD denied Ross's application to perform supervisory functions and become a principal in the firm that employed him. Although the record contained new information that perhaps reflected adversely on Ross's ability to function in his proposed employment in a manner consistent with the public interest, it appeared that "NASD also gave substantial weight to matters related to the Commission Order," and we could not determine the degree to which NASD's action was based upon the behavior that resulted in the bar order rather than the new information. [FN22] Because we could not conclude that NASD's decision was consistent with the purposes of the Exchange Act, we remanded the proceeding. We stated that "our expressed policy in cases of this type ... requires that the NASD generally confine its analysis to new information," but explained that the misconduct that led to a statutory disqualification could play a legitimate role in that analysis in appropriate circumstances. [FN23]

*4 NASD does not attempt to distinguish Richardson's case from Van Dusen and Ross. It argues, instead, that Van Dusen (and implicitly Ross) should be overturned. NASD argues that the Commission "committed two fundamental errors" in deciding Van Dusen. First, NASD argues, the Commission "misread the relevant statutory provision when it imported the requirement [found in Section 19(e)(2) of the Exchange Act, 15 U.S.C. § 78s(e)(2)] that sanctions in [self-regulatory organization or "SRO"] disciplinary actions should not be excessive into its review of the application of a statutorily disqualified individual [under Exchange Act Section 19(f), 15 U.S.C. § 78s(f)]." Second, it argues, the Commission "incorrectly relied on its 1975 policy regarding disqualified individuals who apply directly to the Commission for readmission into the securities industry" because NASD has never adopted such a policy and should be allowed to follow its own policy, "which includes analyzing the seriousness of the misconduct that relates to a permanent injunction."

NASD misreads Van Dusen by arguing that Van Dusen erroneously applies a standard applicable to our review of sanctions imposed in disciplinary proceedings to the review of denials of applications to continue NASD membership despite the employment of a statutorily disqualified person. In Van Dusen, we discussed the remedial purpose behind disciplinary actions, but we did so in the context of explaining that, in determining a sanction in a disciplinary action, we engage in an analysis that determines the public interest by weighing the alleged misconduct and the need to avoid visiting unnecessarily harsh consequences on wrongdoers. [FN24] The reference to disciplinary actions does not suggest that the same analysis used in disciplinary actions should be used in considering applica-

tions to associate. To the contrary, the reference acknowledges that an analysis of public interest requirements based solely on the underlying misconduct has already been performed and that an application to associate after the time determined to be in the public interest has expired requires a different analysis.

NASD correctly states that the policy quoted by the Commission in Van Dusen -- "When hereafter the Commission specifies a date after which [an] application [for re-entry] may be made, the Commission upon a proper showing will generally act favorably upon the application" -- originally appeared in a release that dealt with applications for association that were directed to the Commission itself, not an SRO. [FN25] By relying on that policy in Van Dusen, however, we clearly indicated our view that it also was relevant in SRO consideration of applications to associate. [FN26] As explained above, Ross expanded on Van Dusen by suggesting ways in which consideration of the underlying misconduct might appropriately be part of an SRO's process.

*5 NASD also argues that Van Dusen was incorrectly decided because it inappropriately articulated a substantive fairness requirement. NASD contends that the purposes of the Exchange Act do not encompass such a requirement, but only basic procedural guarantees. [FN27] We disagree. Congress clearly intended that the substantive fairness of NASD deliberations subject to the Commission's review; one of the goals of the 1975 Amendments was to strengthen the Commission's oversight of SROs. [FN28] The Commission has an obligation to ensure "that [self-regulatory power] is used effectively to fulfill the responsibilities assigned to the self-regulatory agencies, and that it is not used in a manner inimical to the public interest or unfair to private interests." [FN29] Among the Commission's responsibilities in reviewing SRO actions under Section 19(f) is to determine whether the rules of the SRO have been applied "in a discriminatory or unfair manner," i.e., whether the action is substantively fair. [FN30]

We also reject NASD's argument that Van Dusen and Ross are inconsistent with the anti-fraud purpose of the Exchange Act and with NASD's duty to protect investors from unreasonable risk by ensuring high ethical standards in the securities industry. [FN31] Van Dusen and Ross are not inconsistent with NASD's duty to critically scrutinize applications involving statutorily disqualified persons with a view to protecting investors. Rather, they articulate an analytic framework within which to consider such applications.

NASD's arguments ignore the impact that allowing the conduct underlying a statutory disqualification to provide the sole basis for denial of applications like the one at issue here would have on the Commission's own anti-fraud and investor protection efforts. If persons contemplating settlements with the Commission know that SROs, through denial of reentry applications, may, in effect, routinely extend those persons' bar from the securities industry beyond the period after which the settlement would allow them to reapply, based solely on the misconduct leading to the settlement, the incentive to settle would diminish markedly. Thus, allowing NASD to ignore Van Dusen and Ross would undermine our ability to settle cases in pursuance of our anti-fraud and investor protection goals. [FN32]

NASD argues that Van Dusen and Ross, in providing guidance on which factors NASD should examine in statutory disqualification hearings, allow disqualified individuals to craft their applications "to take advantage of Van Dusen." We believe it is entirely appropriate for statutorily disqualified persons to look to our decisions in Van Dusen and Ross and to understand that, before an application to associate will be approved, they will need to demonstrate, among other things, a clean disciplinary history subsequent to the statutorily disqualifying event, and that they would be well-advised to choose to associate with a firm with a good disciplinary record and an appropriate supervisory structure. Moreover, since Van Dusen and Ross do not purport to provide exhaustive lists of factors, applicants must still formulate their applications as their specific circumstances require.

IV.

*6 We hold that Van Dusen and Ross remain the appropriate standards by which NASD should evaluate Richardson's application. [FN33] NASD did not conduct its evaluation of Richardson's application consistently with those precedents, instead focusing exclusively on the municipal bond misconduct underlying the Commission bar order against Richardson. Therefore we are unable to determine whether the denial of Richardson's application is consistent with the purposes of the Exchange Act, and accordingly we remand for further consideration not inconsistent with this opinion.

An appropriate order will issue. [FN34]

By the Commission (Chairman DONALDSON and Commissioners GLASSMAN, GOLDSCHMID, ATKINS, and CAMPOS).

Jonathan G. Katz

Secretary

FN1. 15 U.S.C. § 77q(a); 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5; 15 U.S.C. § 78o-4(c)(1).

FN2. SEC v. First Cal. Capital Mkts. Group, Inc., C 97-02761 CRB (N.D. Cal., Apr. 5, 1999). The settlement also required Richardson and his employer to disgorge \$600,000, and Richardson to pay a \$40,000 civil penalty.

FN3. H. Michael Richardson, Securities Exchange Act Rel. No. 41448 (May 25, 1999), 69 SEC Docket 2622 (order instituting proceedings, making findings and imposing remedial sanctions).

FN4. Id. The Commission also alleged that sale of the municipal bonds violated MSRB Rules G-17 and G-19. Id.

FN5. Id.

FN6. 47 S.E.C. 668 (1981).

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FN7. 15 U.S.C. § 78s(f).

FN8. Id. Richardson does not claim, and the record does not support a finding, that NASD's action has imposed an unnecessary burden on competition.

FN9. Richardson's argument that the events that were the basis for the bar order are "not a legally cognizable basis in fact to deny" his readmission, and therefore no grounds for the denial exist in fact, has no merit. The statutory disqualifications do exist in fact. Moreover, as discussed in more detail infra, Richardson's suggestion that the events underlying the injunction and bar order are "not legally cognizable" as a basis for denying his application overstates the breadth of our holding in Van Dusen.

FN10. Although Richardson has not raised the issue, we note that the record does not indicate whether the Hearing Panel or the Statutory Disqualification Committee ever submitted written recommendations as required by NASD Procedural Rule 9524(a)(10), or whether they were considered by the NAC, as required by Rule 9524(b)(1). See Reuben D. Peters, Exchange Act Rel. No. 49819 (June 7, 2004), 82 SEC Docket 3959, 3966 n.15.

Richardson argues that, because NASD "intentionally act[ed] in derogation of ... controlling Commission precedent," i.e., Van Dusen, its denial of the Firm's application "cannot be deemed to be in accordance with NASD rules." Richardson does not specifically identify any NASD rule that has been violated, and this argument therefore appears to be an assertion that the denial was not consistent with the purposes of the Exchange Act. See infra.

FN11. Arthur H. Ross, 50 S.E.C. 1082 (1992). NASD made no reference to Ross in its decision denying the Firm's application.

FN12. Van Dusen, 47 S.E.C. at 671-72 (identifying several factors for consideration, but stating that list represented "only some of the matters that must be carefully weighed and considered." Id. at 671. NASD's argument that Commission precedent prevents it from considering all relevant factors is ironic, given that in this case it based its decision on a single factor -- the misconduct underlying the statutory disqualification.

FN13. Ross, 50 S.E.C. at 1085 n.10.

FN14. As we emphasized in Van Dusen, our objective in imposing sanctions pursuant to Exchange Act Section 15 is to "afford investors protection without visiting upon the wrongdoers adverse consequences not required in achieving the statutory objectives." 47 S.E.C. at 671 (quoting Commonwealth Sec. Corp., 44 S.E.C. 100, 101-02 (1969)). In determining that Richardson should be subject to a bar with a right to apply for association in three years, we considered at that time how much protection the public interest requires, based on the nature and seriousness of the misconduct underlying the bar, and weighed the need for that protection against the importance of avoiding adverse consequences to Richardson that are not necessary to protect the public interest. See H. Michael Richardson, Exchange Act Rel. No. 41448 (May 25, 1999), 69 SEC Docket 2622, 2623-24 (noting Commission determination "that it is appropriate and in the public interest to accept Richardson's Offer of

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Settlement," which included the provision of a right to reapply in three years).

Where an initial public interest determination was made by an entity other than the Commission, different considerations may apply. See Ross, 50 S.E.C. at 1085 & n.13 (NYSE settlement not binding on NASD); see also Stephen R. Flaks, 46 S.E.C. 891, 894 n.6 (1977) (upholding NASD denial of application to associate, even though Commission had granted approval, because denial was based on independent ground of separate NASD bar, rather than on Commission bar).

FN15. In rare circumstances, the underlying conduct that led to the statutory disqualification may be sufficiently egregious, in light of the environment at the time of the application to associate, to warrant denial of the application. That is not the case here, however.

FN16. See M.J. Coen, 47 S.E.C. 558, 563-64 (1981) ("In cases of this sort, which are based on a prior statutory disqualification, Congress has granted the Association broad discretion."). See also Halpert & Co., 50 S.E.C. 420, 422 (1990) ("Particularly in matters involving a firm's employment of persons subject to a statutory disqualification, it is appropriate to recognize the NASD's evaluation of appropriate business standards for its members."). Moreover, we note that NASD has broad discretion in imposing conditions on the employment relationship of a statutorily disqualified person to the employing firm. See, e.g. Scott E. Wiard, Exchange Act Rel. No. 50393 (Sept. 16, 2004), 83 SEC Docket 2752, 2754.

FN17. NASD cites Robert B. Graham, Sr., 51 S.E.C. 449, 454 (1993) to support its argument that the Commission has no power to veto a decision by the NASD to disallow the association of a statutorily disqualified person. The Commission was evenly divided on the issues raised in Graham, so the language on which NASD relies does not represent the position of the Commission. 51 S.E.C. at 456. In any event, since Ross and Van Dusen do not dictate the outcome of NASD proceedings, they do not purport to create veto power in the Commission. We note, however, that, as discussed above, Section 19(f) contemplates that the Commission, under prescribed conditions, will set aside an NASD determination to deny access to a statutorily disqualified person.

FN18. Van Dusen, 47 S.E.C. at 669.

FN19. Id. at 670-71.

FN20. Id. at 671-72.

FN21. Ross, 50 S.E.C. at 1083.

FN22. Id. at 1084-85.

FN23. Id.

FN24. 47 S.E.C. at 670-71.

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FN25. Applications for Relief from Disqualification, Exchange Act Rel. No. 11267 (Feb. 26, 1975), 6 SEC Docket 346, quoted in Van Dusen, 47 S.E.C. at 671.

FN26. NASD contends that its by-laws, not the policy set forth in Van Dusen, provide the applicable standard for NASD review of applications that would allow the association of statutorily disqualified persons. Congress has made clear, however, that NASD's regulatory authority is subject to Commission oversight. See S. Rep. No. 94-75, 23 (cautioning against fallacious impression that industry and government fulfill same function in regulatory framework, enjoy same order of authority, or deserve same degree of deference and noting that SROs "exercise authority subject to SEC oversight" and "have no authority to regulate independently of the SEC's control"). To the extent that NASD by-laws might allow consideration of Richardson's underlying misconduct beyond that permitted under Commission precedent, Commission precedent controls. We note, however, that NASD has not specifically identified anything in its by-laws that is inconsistent with Van Dusen or Ross.

FN27. In the alternative, NASD argues that any substantive fairness requirement was satisfied in Richardson's case because evidence of the misconduct that underlies the statutory disqualification is admissible under the Federal Rules of Evidence. See Fed. R. E. 403 (allowing exclusion of evidence if probative value is substantially outweighed by danger of unfair prejudice). NASD proceedings are not governed by the Federal Rules of Evidence. Moreover, Van Dusen and Ross do not preclude consideration of the underlying misconduct. They merely provide a context in which it may be considered.

FN28. "In the new regulatory environment created by this bill, self-regulation would be continued, but the SEC would be expected to play a much larger role than it has in the past to ensure that there is no gap between self-regulatory performance and regulatory need." S. Rep. No. 94-75, 2.

FN29. S. Rep. No. 94-75, 23.

FN30. Id. at 132.

FN31. See United States v. O'Hagan, 521 U.S. 642, 658 (1997) (primary objective of Exchange Act was "to insure honest securities markets and thereby promote investor confidence."); Citadel Sec. Corp., Exchange Act Rel. No. 49666 (May 7, 2004), 82 SEC Docket 3249, 3255 ("[I]n order to ensure the protection of investors, NASD may demand a high level of integrity from securities professionals").

FN32. Although the decision to settle an administrative proceeding is a complex function of multiple factors, the right to reapply for association is often an important aspect of a settlement. Settlement terms should be administered in accordance with the fair expectations of the settling parties.

FN33. On July 12, 2004, an order was issued, pursuant to delegated authority, denying a motion filed by NASD requesting oral argument in connection with this matter. Pursuant to Rule of Practice 430(a), NASD has requested our review of that order.

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Rule of Practice 451 provides that we will consider appeals (other than those from initial decisions by a Commission hearing officer) on the basis of the papers filed by the parties without oral argument unless we determine that the presentation of facts and legal arguments in the briefs and record and the decisional process would be significantly aided by oral argument. NASD contends that oral argument is necessary because the important policy issues at stake warrant careful consideration that necessarily will be aided by oral argument.

We do not believe that NASD has shown that oral argument will significantly aid our decision-making process. The parties have thoroughly briefed the factual and legal issues in this proceeding, and their contentions are presented before us in a manner that have permitted us to fully evaluate and determine the matters at issue. Accordingly, the request of NASD for oral argument is denied.

FN34. We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

In the Matter of the Application of HARRY M. RICHARDSON

c/o Charles R. Mills, Esq.

Kirkpatrick & Lockhart LLP

1800 Massachusetts Avenue, N.W.

Suite 200

Washington, DC 20036-1221

For Review of Action Taken by NASD

ORDER REMANDING APPEAL FROM REGISTERED SECURITIES ASSOCIATION

*7 On the basis of the Commission's opinion issued this day, it is

ORDERED that the review proceeding of the application by Emmett A. Larkin Company, Inc. to employ Harry M. Richardson as a general securities representative is hereby remanded to NASD for further consideration.

By the Commission.

Jonathan G. Katz

Secretary

Release No. 51236, Release No. 34-51236, 84 S.E.C. Docket 3092, 2005 WL 424920 (S.E.C.)

Westlaw.

Release No. 51236, Release No. 34-51236, 84 S.E.C. Docket 3092, 2005 WL 424920
(S.E.C. Release No.)
(Cite as: 2005 WL 424920 (S.E.C. Release No.))

Release No.)

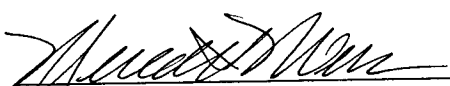
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CERTIFICATE OF SERVICE

I hereby certify that, on this 20th day of September, 2006, I have caused two true copies of Petitioner Fog Cutter Capital Group Inc.'s Final Opening Brief to be sent by courier and by electronic mail to:

Dominick V. Freda, Esq.
U.S. Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549
fredad@sec.gov

I further certify that, on this 20th day of September, 2006 I have caused fourteen copies of Petitioner Fog Cutter Capital Group Inc.'s Final Opening Brief to be delivered by hand to the Clerk of the Court.


Meredith Moss