UNITED STATES SECURITIES AND EXCHANGE COMMISSION v. SENTINEL MANAGEMENT GROUP, INC.

No. 07-C-4684

UNITED STATES SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. SENTINEL MANAGEMENT GROUP, INC., ERIC A. BLOOM, and CHARLES K. MOSLEY, Defendants.

United States District Court, N.D. Illinois, Eastern Division.

March 30, 2012.

United States Securities and Exchange Commission, Plaintiff, represented by Andrea Robin Wood, U.S. Securities and Exchange Commission, Daniel Steven Ryan, U.S. Securities & Exchange Commission, Eric M. Phillips, U.S. Securities and Exchange Commission, James Aaron Davidson, Securities & Exchange Commission & John E Birkenheier, Securities & Exchange Commission.

Eric A. Bloom, Defendant, represented by Terence H. Campbell, Cotsirilos, Tighe, Streicker, Poulos, & Campbell, Ltd., Theodore Thomas Poulos, Cotsirilos, Tighe, Streicker, Poulos, & Campbell, Ltd. & Matthew S Ryan, Cotsirilos, Tighe & Streicker.

Charles K. Mosley, Defendant, represented by Charles L. Nesbit, Attorney at Law & Stephen I. Peck, Law Offices of Stephen Peck, P.C..

National Futures Association, deponent, represented by Charles F. Smith, Jr., Skadden Arps Slate Meagher & Flom, LLP CH.

Frederick Grede, Movant, represented by J. Kevin McCall, Jenner & Block LLP, Chris C. Gair, Jenner & Block LLP, John F. Kinney, Jenner & Block LLP & Vincent E. Lazar, Jenner & Block LLP.

MEMORANDUM OPINION

CHARLES P. KOCORAS, District Judge.

This matter comes before the court on Plaintiff United States Securities and Exchange Commission's ("SEC") motion for summary judgment against Defendants Eric A. Bloom ("Bloom") and Charles K. Mosley ("Mosley") (collectively, "Defendants"). Defendant Bloom has filed a cross-motion for summary judgment. For the reasons set forth below, the SEC's and Bloom's cross-motions for summary judgment are denied. The SEC's motion for summary judgment against Mosley as to Counts I, II, IV, VI, and VIII is granted.

BACKGROUND

Sentinel's Trading Structure

Sentinel Management Group ("Sentinel") was an investment advisor registered with the SEC and a futures commission merchant ("FCM") registered with the Commodity Futures Trading Commission ("CFTC"). Bloom was the President and Chief Executive Officer of Sentinel for nearly twenty years and controlled the company's day-to-day operations. Bloom also served as Sentinel's Chief Compliance Officer from January 2006 through August 2007 and was responsible for reviewing Sentinel's policies to ensure its compliance with federal, state, and internal regulations. Mosley was Sentinel's Vice President, Head Trader, and Portfolio Manager for approximately five years and was responsible for supervising Sentinel's investing and trading activities.

Sentinel managed short-term investment portfolios for various types of advisory clients, including FCMs, hedge funds, financial institutions, pension funds, and individuals. Sentinel's business model was the first of its kind. Sentinel's investors could select a particular portfolio in which to invest, though Sentinel maintained the sole discretion to purchase or sell securities in each portfolio. Although Sentinel's maintained two primary portfolios, Bloom represented that Sentinel could customize the available

portfolios to meet an investor's particular needs.

Rather than own any particular security in a given portfolio, Sentinel's clients would each own a pro rata interest in the portfolio. As the portfolios generated interest, Sentinel allocated this interest to the investors in proportion to each investor's pro rata share, less Sentinel's management fees. This structure provided Sentinel's clients with same-day liquidity, as Sentinel was not required to sell any of its long-term securities to honor its investors' redemption requests. Rather, if a client withdrew its funds from a portfolio, the pro rata share of every other investor in that portfolio would increase accordingly.

Sentinel's Account Structure

Sentinel maintained three separate custodial accounts for its investments at the Bank of New York Mellon Corporation ("BONY"). These accounts were referred to as SEG 1, SEG 2, and SEG 3. SEG 1 held excess margin funds of registered FCMs with domestic customer deposits, SEG 2 held assets of FCMs with foreign customer deposits, and SEG 3 held assets for all other types of clients. Sentinel also maintained a House Portfolio for its proprietary trading. The House Portfolio was available to individuals affiliated with Sentinel. Bloom controlled Fountainhead Investments, Inc., an entity that invested in the House Portfolio. Mosley personally invested in the House Portfolio and additionally received a bonus equal to 10% of the trading gains in the House Portfolio. These bonuses totaled several hundred thousands of dollars over the course of Mosley's employment.

Sentinel cleared the majority of its securities transactions through two clearing systems at BONY: the GSCX and DTC systems. Sentinel cleared government securities through the GSCX system while corporate bonds cleared through the DTC system. Sentinel maintained separate SEG 1, SEG 2, and SEG 3 accounts on both clearing systems. Sentinel's clearing account on the GSCX and DTC systems were known as the SEN account and the FC1 account, respectively. The clearing accounts also held securities for Sentinel's House Portfolio. Generally, all transactions involving government securities were cleared through the SEN account, and all transactions involving corporate bonds were cleared through the FC1 account. However, Sentinel did not have separate clearing accounts for its House Portfolio on the GSCX and DTC systems.

Sentinel's, Bloom's, and Mosley's Representations to Clients

Sentinel's marketing materials, and Bloom personally, indicated that Sentinel operated much like a money market mutual fund and that its investments were relatively low-risk. Sentinel represented that the securities in the SEG 1 account would have a minimum credit rating of AA and that those in its SEG 3 account would be investment-grade. Sentinel's marketing materials, and Bloom personally, further represented that Sentinel's segregated account structure protected its clients' investments from a Sentinel or BONY bankruptcy, and the only inherent risks in the investments was from standard market fluctuations and Sentinel's potential use of leverage.

Sentinel's Relationship with BONY

Sentinel and BONY's relationship was governed by a series of agreements, each of which was negotiated and signed by Bloom. BONY provided Sentinel with financing through a loan secured by Sentinel's clearing accounts. The BONY loan was not a committed financing arrangement, but rather was an overnight loan that was reentered every night. BONY maintained the discretion whether and to what extent to extend the loan to Sentinel each day, and Sentinel maintained the discretion whether and to what extent to request the loan each night. As part of its agreements with BONY, Sentinel was to segregate the funds and securities in each SEG account from its own assets and from other SEG accounts. Sentinel would use the funds from the loan for client redemptions, to purchase securities for clients who indicated they would deposit money with Sentinel but had not yet done so, and as part of a leveraged investment strategy. At its peak, the BONY loan escalated to over $573,000,000 in June 2007.

BONY required that Sentinel maintain enough securities in its SEN clearing account on a daily basis to collateralize the loan. At the end of each day, BONY would transfer as many securities as it needed to collateralize the loan from the SEN accounts, which also held securities for the House Portfolio, into another account, designated the SLM account. If Sentinel did not have enough securities in its clearing

accounts to collateralize the loan, it would transfer securities from one of the SEG accounts into the SEN accounts, and then BONY would transfer them to the SLM account where they would be held to secure the loan. Crystal York ("York"), the employee primarily responsible for booking the loan each night, testified that she indiscriminately chose which securities to pledge as collateral with no consideration for how Sentinel allocated the BONY loan among the portfolios. York testified that she generally used the highest valued securities, most often SEG 1 assets, to pledge for the loan. In the summer of 2007, Bloom instructed Sentinel employees to primarily use SEG 3 securities to collateralize the BONY loan, and to use SEG 1 securities only if the SEG 3 securities were insufficient.

The SEC alleges that due to the arbitrary nature by which York selected securities to pledge as collateral, Sentinel's clients' securities were being used to collateralize the portion of the loan that benefitted the House Portfolio. The SEC alleges that Bloom and Mosley were aware that clients' securities were being used as collateral for the BONY loan to benefit the House Portfolio.

Sentinel's Use of Leverage

In early 2004, the CFTC changed its rules to allow FCMs to use repurchase agreements as a form of leverage. Bloom recommended that Sentinel increase the amount of leverage in its client portfolios to take advantage of this rule change. Sentinel began using reverse repurchase agreements ("reverse repos"), in which Sentinel would sell a security to a broker for cash at below-market value with an express commitment to repurchase that security at a higher price. The difference between the sale price and repurchase price is known as a "haircut." Sentinel profited through its use of reverse repos to the extent that the securities' increase in value over the duration of the reverse repo agreement exceeded the haircut. By 2007, Sentinel was highly leveraged due to its extensive use of reverse repos. The SEC maintains that Bloom and Mosley were aware of Sentinel's extensive use of leverage and that the use of reverse repos exposed Sentinel's clients to greater risks.

Sentinel's Interest Payments

Bloom developed a spreadsheet that Sentinel employees used to determine what interest rate to pay to each of its investors' portfolios on a daily basis. The SEC alleges that either Bloom or Mosley would either directly set the interest rates in the spreadsheet or instruct Sentinel employees where to set the interest rates. The SEC further alleges that Sentinel commingled the total amount of interest earned by both the client securities and Sentinel's proprietary securities and then redistributed it among the various portfolios. Because the House Portfolio maintained below-grade securities, the SEC alleges that Sentinel distributed interest from these high-risk securities to its investors.

Sentinel sent each of its clients a daily statement reflecting the amount of interest that had accrued on each investment. The SEC alleges that because the interest generated by the portfolios was pooled and redistributed arbitrarily, the interest rates set by Bloom and Mosley bore no relation to the securities held in the clients' segregated accounts.

Sentinel's Collapse

In June 2007, a broker with whom Sentinel had over one billion dollars in outstanding reverse repos began to redeem these repos with Sentinel. In July 2007, another broker with whom Sentinel had approximately $600 million in outstanding reverse repos followed suit. Sentinel drew on the BONY loan to pay off these brokers, and the outstanding amount of the loan ballooned to over $570 million. On August 13, 2007, Sentinel tapped out its sources of funds, including the BONY loan, and ran out of cash to meet its clients' redemptions. On August 17, 2007, BONY sent a letter to Bloom stating that Sentinel was in default under the terms of the loan agreements and that BONY had the right to sell the securities pledged as collateral. That same day, Sentinel filed for Chapter 11 bankruptcy.

On June 16, 2008 the SEC filed a First Amended Complaint in which it alleged that Bloom, Mosley, and Sentinel violated various federal securities laws. Throughout the subsequent investigation, Bloom invoked his Fifth Amendment right against self-incrimination. Although Mosley answered the SEC's complaint, he too subsequently invoked his Fifth Amendment rights. On January 5, 2009 Sentinel consented to judgment on the SEC's complaint. The SEC now moves for summary judgment against Bloom and Mosley, the only remaining defendants.

LEGAL STANDARD

Summary judgment is appropriate when the pleadings, discovery, disclosures, and affidavits establish that there is no genuine issue of material fact, such that the movant is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(a); Winsley v. Cook Cnty., 563 F.3d 598, 602-03 (7th Cir. 2009). A genuine issue of material fact exists when, based on the evidence, a reasonable jury could find in favor of the non-moving party. Trinity Homes LLC v. Ohio Cas. Ins. Co., 629 F.3d 653, 656 (7th Cir. 2010). A non-movant's failure to respond to a motion for summary judgment does not automatically result in a judgment for the movant. Raymond v. Ameritech Corp., 442 F.3d 600, 608 (7th Cir. 2006). Rather, the ultimate burden of persuasion remains with the movant to show that it is entitled to judgment as a matter of law. Id. In considering a motion for summary judgment, a court construes all facts and draws all reasonable inferences in favor of the non-moving party. Smith v. Hope Sch., 560 F,3d 694, 699 (7th Cir. 2010).

DISCUSSION

SEC v. BLOOM

I. EVIDENTIARY MATTERS

As a preliminary matter, Bloom challenges the SEC's reliance on two pieces of evidence. First, Bloom moves to strike the affidavit of Jacques Sauliere ("Sauliere"), the co-CEO of a company that invested money with Sentinel. Bloom maintains that although Sauliere submitted an affidavit, he subsequently evaded a deposition by Bloom. Because Sauliere subsequently submitted to a deposition, Bloom's motion to strike Sauliere's affidavit is denied as moot.

Second, Bloom seeks to strike Mosley's answer to the SEC's complaint. A court may exclude a witness' testimony from consideration on a motion for summary judgment if the witness invokes his Fifth Amendment right against self-incrimination on cross-examination. United States v. Parcels of Land, 903 F.2d 36, 43 (1st Cir. 1990) (collecting cases). Although Mosley initially answered the complaint, he subsequently invoked his Fifth Amendment right against self-incrimination to all substantive questions when deposed by Bloom's attorneys. Therefore, the SEC may not rely on Mosley's answer in its motion for summary judgment against Bloom, as Bloom has not been afforded an opportunity to meaningfully cross-examine Mosley. However, Mosley's answer is admissible in the SEC's motion for summary judgment against Mosley himself.

II. COUNTS I, II, AND III

Counts I, II, and III allege that Bloom violated Section 17(a)(1) of the Securities Act, 15 U.S.C. § 77q(a)(1) ("Count I"), Sections 17(a)(2) and (a)(3) of the Securities Act, 15 U.S.C. §§ 77q(a)(2), (3) ("Count II"), and Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 9240.10b-5 ("Count III"). These statutes prohibit fraud in connection with securities transactions. To establish a violation under Section 10(b) of the Exchange Act and Rule 10b-5, the SEC must show that the defendants "(1) made (2) a false statement or omission of material fact (3) with scienter (4) in connection with the purchase or sale of securities."1 McConville v. SEC, 465 F.3d 780, 786 (7th Cir. 2006) (citing SEC v. Maio, 51 F.3d 623, 630 (7th Cir. 1995)). The elements for a claim under Section 17(a)(1) are identical, and the SEC's claims in Counts I and III thus rise and fall together. Maio, 51 F.3d at 631. The elements for a claim under Sections 17(a)(2) and (3) are nearly identical, with one exception: negligence rather than scienter is sufficient to establish culpability under these sections. See Aaron v. SEC, 446 U.S. 680, 697(1980); SEC v. Holschuh, 694 F.2d 130, 143 (7th Cir. 1982).

A. "Made"

The Supreme Court recently limited the scope of primary liability under the federal securities laws in Janus Capital Grp., Inc. v. First Derivative Traders, 131 S.Ct. 2296 (2011). The court held that the "maker" of a statement for purposes of Rule 10b-5 is "the person or entity with ultimate authority over the statement, including its content and whether or how to communicate it." Id. at 2302. The Court explained that "[o]ne who prepares or publishes a statement on behalf of another is not its maker." Id.

In light of this decision, the SEC does not dispute that Bloom was not the maker of the statements contained in Sentinel's prospectuses and marketing materials. Accordingly, we will only consider statements personally made by Bloom in evaluating the SEC's allegations that Bloom violated Section 10(b) of the Exchange Act and Rule 10b-52.

B. False Statement or Omission of Material Fact

The SEC alleges that Bloom misrepresented the risk associated with Sentinel's investment strategy in four ways: (1) Bloom failed to disclose Sentinel's extensive use of leverage; (2) Bloom misrepresented that investors' assets would be properly segregated; (3) Bloom failed to disclose that Sentinel commingled interest from its House and client accounts; and (4) Bloom misrepresented that Sentinel would not invest in below-grade securities.

To the extent that Bloom made such misrepresentations, we find that the alleged misrepresentations are material as a matter of law. An omission or misrepresentation is material if there is a substantial likelihood that full disclosure would have been viewed by the reasonable investor as having altered the "total mix" of information made available. Basic Inc. v. Levinson, 485 U.S. 224, 231 (citing TSC Indus, v. Northway, Inc., 426 U.S. 438, 449 (1976)). Moreover, misrepresentations and omissions are material as a matter of law if they are "so obviously important to an investor, that reasonable minds cannot differ on the question of materiality." TSC Indus., 426 U.S. at 450.

On these facts, reasonable minds cannot differ as to whether the information allegedly omitted by Bloom was obviously important to investors. Extensive undisclosed use of leverage, commingling of assets, commingling of interest, and investing in below-grade securities would undoubtedly affect an investor's decision to invest in Sentinel, particularly CFM investors that are only allowed to invest their funds conservatively. The misrepresentation of the risk associated with their investments is therefore material as a matter of law. We now turn to whether the Bloom misrepresented these risks as alleged by the SEC.

1. Sentinel's Use of Leverage

First, the SEC maintains that Bloom did not disclose the extent to which Sentinel's portfolios were leveraged. Sauliere, the co-CEO of an investment advisor to Discus Fund Limited ("Discus"), an investor in Sentinel, claimed that throughout his conversations with Bloom, Bloom never disclosed Sentinel's use of leverage. Sauliere further stated that he did not ask Bloom about leverage because the use of leverage was "fundamentally inconsistent with the nature and purpose of the investment." Bloom represented to Sauliere that Sentinel operated much like a money market mutual fund, and Sauliere presumed that leverage would be used, if at all, only to meet large redemption requests.

However, Sentinel's use of leverage was disclosed to Sauliere, to some extent, through Sentinel's standard Investment Management Agreement, SEC registration forms, and annual financial statements. Sentinel's standard Investment Management Agreement, signed by Discus, provides that Sentinel may use repos and bank loans in its portfolios. Sentinel's SEC registration forms, which were provided to Discus and all existing and prospective investors, stated that Sentinel "from time to time, may use [reverse repos] and/or bank loans as part of its investment strategy. . . . The utilization of either [reverse repos] and/or bank loans inherently creates a leveraged portfolio when used." The registration forms further stated that "[w]hile the use of leverage may enable the Registrant to enhance returns, it may also exacerbate losses incurred by such portfolio." Finally, Sentinel's audited financial statements disclosed both the extent of Sentinel's use of reverse repos as well as the extent to which Sentinel's securities were used to collateralize the BONY loan.

The SEC claims that these representations were insufficient to disclose Sentinel's actual, consistent, and extensive reliance on leverage. For example, the SEC maintains that Sentinel's financial statements failed to disclose which securities were pledged for collateral for the BONY loan, and the SEC's expert further opined that the daily statements issued to clients were misleading for the same reason. The SEC's expert concluded that Sentinel's disclosures were inadequate, although he also conceded that reasonable minds could differ as to the adequacy of Sentinel's disclosures. In response to the SEC's allegations, Bloom provided evidence that, on more than one occasion, he personally disclosed Sentinel's actual use of leverage to investors. Given the weight of the evidence presented by both

parties, the adequacy of Sentinel's disclosure of its use of leverage is a question best suited for a jury.

2. Segregation of Investors' Assets

Second, the SEC maintains that Bloom misrepresented that its investors' assets would be properly segregated from Sentinel's proprietary securities. Bloom personally told several investors that their assets would in fact be segregated from those of Sentinel, BONY, and certain other investors. Additionally, Bloom represented to Sauliere that Discus' funds would remain segregated and were thus beyond the reach of Sentinel's or BONY's creditors.

The SEC alleges that Sentinel desegregated its investors' assets in order to pledge them as collateral for the BONY loan to fund trading in the House Portfolio. Bloom does not dispute that a portion of the loan was used to finance trading in the House Portfolio. However, he maintains that the loan was allocated to both the client portfolios and the House Portfolio, and the securities in each account were pledged as collateral for the portion of the loan allocated for their respective benefit. Therefore, Bloom contends, there was no misrepresentation, as investor assets were only desegregated to leverage the portfolio for the portfolio's benefit, and thus investor assets were "properly" segregated.

The testimony of York and Jeff Logan ("Logan"), an Assistant Trader at Sentinel, strongly suggests otherwise. York was charged with the primary responsibility of booking the BONY loan on a daily basis, and when she was unavailable, Logan would book the loan. Both York and Logan testified that when the securities of the House Portfolio were insufficient to fully collateralize the BONY loan, they would indiscriminately select the largest securities, usually from SEG 1, to pledge as collateral. Although this testimony creates a strong presumption that client securities were indiscriminately pledged to collateralize the BONY loan, neither Logan nor York were able to state with absolute certainty that investors' securities were pledged as collateral for the portion of the BONY loan benefitting the House portfolio. Moreover, the SEC has presented no evidence to conclusively establish that investors' assets were pledged as collateral to benefit other portfolios, including the House Portfolio. Therefore, there is a genuine issue of material fact as to whether Sentinel improperly pledged client securities to collateralize the BONY loan for the benefit of the House Portfolio.

3. Purchase of Below-Grade Investments

Bloom represented to several investors that Sentinel would not include below-grade securities in their respective portfolios. The SEC alleges that Sentinel nevertheless purchased below-grade investments that yielded higher returns than the more conservative investments in the client portfolios. According to the SEC, Sentinel purchased below-grade investments for the House Portfolio and used the returns from these investments to enhance the interest paid to its investors. In this manner, Sentinel could outperform its competitors.

Sentinel was permitted to maintain securities that, while investment-grade at the time of purchase, subsequently fell to below-grade. Neither party has presented evidence establishing that the allegedly below-grade securities were, in fact, below-grade at the time of their purchase. Therefore, there is a genuine issue of material fact as to whether Sentinel misrepresented that it did not purchase below-grade investments for its client portfolios.

4. Commingling of Interest

Finally, the SEC alleges that Bloom misrepresented the manner in which interest was generated in the client portfolios. As discussed above, the SEC maintains that Sentinel allocated interest generated by the higher-risk investments in the House Portfolio to the client portfolios to generate a higher yield for Sentinel's investors than Sentinel's competitors could generate. Bloom personally represented to at least two investors that the interest earned by a portfolio is paid only to the investors in that portfolio.

Bloom developed a spreadsheet to determine the interest to allocate to each investor on a daily basis. York was assigned the primary responsibility of completing the spreadsheet. The spreadsheet divided the various investments into various "customer groups," and each customer group was assigned an interest rate. Mosley generally provided these rates, though when Mosley was unavailable, York testified that she would ask Bloom what rates to input into the spreadsheet. The SEC's expert testified that the

interest rates were arbitrarily set and that the "earnings of the individual client accounts was really ad hoc and random in nature."

The difference between the interest that a portfolio accrued and that which was paid out was reflected on the spreadsheet, and the SEC maintains that this "difference" represents the extent to which the interest earned by some portfolios was allocated to different portfolios. An examination of the spreadsheet strongly supports the SEC's position. The SEG 1 and SEG 2 accounts generally reflected a negative "difference," i.e., interest was paid in excess of the interest generated by securities in that account. Similarly, the House account generally reflected a positive "difference," indicating that the House Portfolio was allocated less interest than the portfolio had generated. Presumably, the excess interest paid to the segregated portfolios was taken from the interest paid on securities in the House Portfolio. However, we are unable to make this determination with certainty, as the SEC has not provided sufficient evidence in support of this interpretation. Rather, the SEC relies exclusively on Mosley's answer and York's deposition testimony. As previously discussed, Mosley's answer is inadmissible against Bloom. Moreover, York's testimony is insufficient to establish the SEC's position, as York repeatedly stated that she did not know what the "difference" column represented. In light of this evidence, neither the SEC nor Bloom has established whether Sentinel commingled interest, and summary judgment on this point is inappropriate for both parties.

Because Bloom has presented evidence sufficient to create a genuine issue of material fact as to whether he misrepresented how Sentinel paid interest to its investors, the SEC's motion for summary judgment on Count III is denied. However, Bloom's cross-motion for summary judgment may be granted if he can show that there is no genuine dispute as to the remaining elements, i.e., whether he acted with a sufficiently culpable state of mind and whether the alleged misrepresentations were in connection with the purchase or sale of securities.

C. Mental State

Liability under Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 require that a defendant act with scienter, i.e., that he either knew that the representations made to investors were false or, at a minimum, that he recklessly disregarded a substantial risk that they were false. SEC v. Lyttle, 538 F.3d 601, 603 (7th Cir. 2008). Recklessness in this context is "an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." Id. (quotation omitted). Liability under Sections 17(a)(2) and (3) of the Securities Act, on the other hand, only require that a defendant acted negligently with respect to the alleged misrepresentations. Holschuh, 694 F.2d at 143. Where a defendant has invoked his Fifth Amendment right against self-incrimination, a court may draw an adverse inference with respect to the defendant's state of mind. Lyttle, 538 F.3d at 604. However, scienter is an issue generally not appropriate for summary judgment. See P.H. Glatfelter Co. v. Voith, Inc., 784 F.2d 770, 774 (7th Cir. 1986); Provenz v. Miller, 102 F.3d 1478, 1489 (9th Cir. 1996); Wechsler v. Steinberg, 773 F.2d 1054, 1058-59 (2d Cir. 1984).

Bloom contends that the evidence establishes that he did not have the requisite mental state to commit the violations alleged in Counts I through III. Regarding his allegedly inadequate disclosure of Sentinel's extensive use of leverage, Bloom refers to an e-mail exchange with Daniel Bernstein ("Bernstein"), an attorney he consulted in connection with compliance concerns. In this exchange, Bloom sought confirmation that the disclosures in Sentinel's registration statements sufficiently disclosed Sentinel's use of leverage. Bernstein testified that he believed the registration statements sufficiently disclosed Sentinel's use of leverage. However, he based his opinion on Bloom's representations about how Sentinel would use leverage but could not recall what those representations were when deposed. Moreover, Bloom's reliance on Bernstein's advice does not conclusively establish his good faith, but is merely one factor to consider in making this determination. See SEC v. McNamee, 481 F.3d 451, 455 (7th Cir. 2007) (stating that "advice of counsel may show that a person lacked a culpable intent") (emphasis added); Markowski v. SEC, 34 F.3d 99, 104-05 (2d Cir. 1994) (finding that defendant's reliance "was not a complete defense, but only one factor for consideration"). Therefore, the evidence submitted by Bloom does not warrant summary judgment.

Regarding Bloom's alleged misrepresentation that investors' securities would be segregated from Sentinel's proprietary securities, Bloom maintains that there is no evidence that he condoned the

pledging of investors' assets to collateralize the house loan. On at least one occasion, Bloom instructed York to stop using SEG 1 assets to collateralize the BONY loan. However, on other occasions Bloom instructed Sentinel employees to use SEG 1 assets as collateral if there was insufficient collateral in the SEG 3 account. Therefore, Bloom has not met his burden of establishing that he did not knowingly or recklessly allow for investors' securities to collateralize the house loan.

Bloom further contends that he acted in good faith with respect to any allegations regarding the BONY loan. The account structure at BONY was audited by several entities, including the SEC, Sentinel's independent auditors, and the National Futures Association ("NFA"), a self-regulatory organization for the futures industry. After conducting audits, none of these entities found that the BONY loan was improperly structured.

Bloom's "good faith" argument is insufficient to warrant summary judgment for several reasons. First, "good faith, without more, does not necessarily preclude a finding of recklessness." SEC v. Infinity Group Co., 212 F.3d 180, 192 (3rd Cir. 2000). Second, the SEC's audit was conducted in 2002, well before any alleged misconduct occurred. Third, the misconduct alleged by the SEC was not condoned by the auditors. For example, although the auditors may have determined that there was nothing wrong with pledging securities in the investors' portfolios as collateral for the BONY loan for the benefit of those portfolios, the SEC alleges that Sentinel pledged its investors securities as collateral for the benefit of the House Portfolio. Therefore, Bloom has not established that he lacked scienter with respect to the SEC's claims that Sentinel failed to segregate its investors' assets.

Regarding Bloom's alleged misrepresentations concerning how Sentinel generated interest, Bloom contends that Mosley was charged with the responsibility of setting the daily interest rates. However, York testified that when Mosley was unavailable, she would obtain the interest rates from Bloom. Moreover, on one occasion, Bloom explained to York that the manner in which the interest rates were calculated resulted in one portfolio "stealing" interest from another. Although he advised York to take remedial action to correct the discrepancy, he was nevertheless aware of the practice, and a jury could reasonably conclude that his failure to continue to monitor the interest rate calculations was reckless. Therefore, there is a genuine issue of material fact as to Bloom's knowledge of Sentinel's alleged commingling of interest.

For all of these reasons, Bloom has thus failed to sufficiently establish that he did not possess the requisite mental state for liability under Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, or Rule 10b-5.

D. In Connection With the Purchase or Sale of Securities[3]

Finally, Bloom contends that the alleged fraud was not "in connection with" the purchase or sale of securities. As a threshold matter, we examine whether, as a matter of law, the portfolios that Sentinel offered to its clients were securities as defined by the securities laws.

1. Sentinel's Investors Purchased Investment Contracts

Section 2(a)(1) of the Securities Act, 15 U.S.C. § 77b(a)(1), and Section 3(a)(10) of the Exchange Act, 15 U.S.C. § 78c(a)(10), include investment contracts within the definition of securities. For the purposes of the securities laws, an investment contract is a contract "whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946). Here, Sentinel offered investment contracts to potential investors because the investors invested their money in a pooled fund with other investors, i.e., a common enterprise, and they expected a return on their investment solely from Sentinel's efforts. This interpretation is consistent with Bloom's own characterization of Sentinel's business model. In an e-mail to an investor, Bloom stated that "[a]lthough Sentinel is not registered as a money market mutual fund, we operate in a similar fashion." It is well-established that mutual funds are securities that are subject to the securities laws. Peoria Union Stock Yards Co. Retirement Plan v. Penn Mut. Life Ins. Co., 698 F.2d 320, 324 (7th Cir. 1983). Moreover, just as with mutual funds, "if you hand over your money to someone to invest in his securities portfolio, and he promises to remit to you your proportional share of the income of the portfolio, minus his charges, . . . you and he have an investment contract." Id. This is precisely the arrangement that Sentinel had with its investors. Therefore, the investment agreements

entered into by Sentinel and its investors were, as a matter of law securities.

2. "In Connection With"

The only remaining question is whether the alleged misrepresentations were "in connection with" the purchase or sale of securities. The SEC alleges that Bloom misrepresented Sentinel's use of a highly leveraged investment strategy, the manner in which Sentinel generated the interest paid to its investors, that Sentinel only purchased investment-grade securities, and that Sentinel properly segregated its investors' assets. These representations were allegedly made to induce investors to enter into the investment contracts with Sentinel, and these representations were therefore "in connection with" the purchase or sale of securities as a matter of law.

Bloom nevertheless contends that the transactions between Sentinel and its investors were not in connection with the purchase or sale of securities because Sentinel's investors lacked any investment authority. In support of his contention, Bloom cites O'Brien v. Continental Ill. Nat'l Bank & Trust, 593 F.2d 54 (7th Cir. 1979). The plaintiffs in O'Brien were trustees of trust funds that entered into an agreement with a bank under which the bank would invest the trust funds. Id. at 57. Under the agreement, the bank was given full discretion to make investments. Id. The bank then purchased and sold securities of companies that had outstanding loans to the bank. Id. Plaintiffs alleged that the bank failed to disclose its conflicts of interest as well as adverse information about the investment quality of some of the securities it purchased for the funds. Id. The Seventh Circuit reasoned that because the bank maintained the sole discretion to select investments for the trust, there were no investment decisions to be made by the plaintiffs and therefore no such decisions were affected by the bank's nondisclosures. Id. at 60. The only decision affected by the bank's nondisclosures was the decision whether to terminate the agreement, a decision which was not a securities transaction. Id. Therefore, the court held that the bank's nondisclosures were not in connection with the purchase or sale of securities.

O'Brien is distinguishable for several reasons. First, Bloom ignores the critical fact that Sentinel directly sold securities to its investors in the form of investment contracts, as discussed above. Therefore, whereas the plaintiffs in O'Brien were not faced with a decision to purchase or sell securities, Sentinel's clients were faced with a very clear investment decision: whether to enter into an investment contract with Sentinel.

Second, the O'Brien court based its decision, in part, on an underlying policy concern. The Seventh Circuit highlighted the fact that entertaining claims of violations of the securities laws based on a plaintiff's allegation that she would have bought or sold a security would potentially flood the courts with insincere allegations of securities violations. As the court stated, "allowing such a claim would permit plaintiffs . . . to await without risk the outcome of the investments made by the investment agent or trustee and then select an appropriate theory on which to challenge those that proved unsuccessful." Id. As this case does not involve a private right of action, however, there is no such concern here.

Finally, unlike the plaintiffs in O'Brien, Sentinel's investors were able, to some extent, to control the investments that Sentinel would make with their money. Sentinel offered its investors "customized portfolios" to better meet each of "its clients' investment objectives." In at least one e-mail exchange, Bloom indicated to an investor that Sentinel would customize portfolios if the investor's needs differed from those of the existing portfolios. Another investor executed an appendix to Sentinel's standard investment agreement that limited the allowable investments for the investor to U.S. treasuries. Unlike the plaintiffs in O'Brien, Sentinel's investors did not grant unfettered discretion to purchase or sell securities with the investors' funds but rather maintained some control over the allowable investments.

For each of these reasons, the alleged misrepresentations were "in connection with" the purchase and sale of securities.

IV. AIDING AND ABETTING CLAIMS AGAINST BLOOM

Counts IV, VI, and VIII allege that Bloom aided and abetted Sentinel's violation of various securities laws. To establish aiding and abetting liability, the SEC must show: (1) a primary violation of the underlying securities laws; (2) the defendant acted with scienter; and (3) the defendant substantially

assisted in the primary violation. Monetta Fin. Serv., Inc. v. SEC, 390 F.3d 952, 956 (7th Cir. 2004); SEC v. Benger, 697 F.Supp.2d 932, 938 (N.D. Ill. 2010).

A. Count IV

In Count IV, the SEC alleges that even if Bloom is not primary liable for Sentinel's violations of Section 10(b) of the Exchange Act and Rule 10b-5, he is nevertheless secondarily liable for aiding and abetting Sentinel's violations of these provisions under Section 20(e) of the Exchange Act, 15 U.S.C. § 78t(e). For the reasons discussed above, the SEC has failed to conclusively establish a primary violation of Section 10(b) or Rule 10b-5, and Bloom has failed to establish the absence of such a violation. Therefore, both motions for summary judgment on Count IV are denied.

B. Count VI

In Count VI, the SEC alleges that Bloom aided and abetted Sentinel's violations of Sections 206(1) and (2) of the Investment Advisers Act of 1940 (the "Advisers Act"), 15 U.S.C. §§ 80b-6(1), (2). Sections 206(1) and (2) prohibit fraud by an investment adviser upon the adviser's "clients" or "prospective clients." 15 U.S.C. §§ 80b-6(1), (2).

Bloom contends that Sentinel's clients were the portfolios that it managed rather than the individual investors to those portfolios, and that Sentinel did not defraud these portfolios. In support of his position, Bloom relies exclusively on SEC v. Goldstein, 451 F.3d 873 (D.C. Cir. 2006). In Goldstein, a hedge fund manager challenged the SEC's rule under the Advisers Act that required investors in a hedge fund to be counted as clients of the fund's advisor for the purpose of determining whether the adviser qualified for an exemption for registration. Id. at 874. The court held that the investors in the hedge fund were not the manager's clients because the manager owed a fiduciary duty to the hedge fund itself rather than to the individual investors. Id. The court based its holding in large part on the nature of hedge funds, which generally reflect the absence of an adviser-investor relationship in several material respects: investors in hedge funds do not receive investment advice directly from the adviser; the investors are passive in the fund's investment decisions; the adviser has no obligation to ensure that fund investment decisions are appropriate investments for each shareholder; and the adviser's advice is not tailored to an investor's particularized needs. Id. at 878-82, Bloom maintains that for all practical purposes, its pooled portfolios were hedge funds and that Goldstein therefore precludes liability under the Advisers Act for alleged fraud perpetrated on Sentinel's investors, as Sentinel's only clients were the pooled portfolios.

Goldstein is inapplicable for two reasons. First, the relationship between Sentinel and its investors contains several indicia of an advisor-investor relationship that are absent from the traditional hedge fund structure. For example, Sentinel's investment agreements included client-specific investment guidelines that Sentinel was bound to follow when making investment decisions on behalf of the investor. Additionally, Bloom told multiple investors that Sentinel could customize its portfolios to meet the investors' particular needs. Therefore, because Sentinel is not akin to a traditional hedge fund manager, Goldstein does not preclude liability under the Advisers Act. See United States v. Lay, 612 F.3d 440, 884 (6th Cir. 2010) (applying Advisers Act to hedge fund manager because the investors in the hedge fund did not play an entirely passive role in the investments); Goldenson v. Steffens, 2011 WL 3424246, at *26 (finding that a hedge fund advisor assumed the role of advisor to the fund's investors by tailoring their investment to their individual objectives).

Second, the application of Goldstein would lead to an impractical result in this case. If, as Bloom contends, the pooled portfolios were hedge funds, then under Goldstein these portfolios would be Sentinel's clients, and Sentinel would owe a fiduciary duty to those portfolios. But who would enforce this fiduciary duty? Unlike hedge funds, which are legal entities, the portfolios are merely amalgamations of securities and have no legal identity.

Bloom can therefore be held liable under Sections 206(1) and 206(2) of the Advisers Act if the SEC can establish that (1) Sentinel violated the Advisers Act; (2) Bloom substantially assisted in this violation; and (3) Bloom acted with scienter. See Monetta, 390 F.3d at 956; Benger, 697 F. Supp. 2d at 938. The SEC's allegations under the Advisers Act are predicated on the same facts supporting its allegations of fraud under Section 10(b) of the Exchange Act and Rule 10b-5. For the reasons discussed in our Section

10(b) and Rule 10b-5 analysis, the SEC has not conclusively established a primary violation by Sentinel, and Bloom has similarly failed to establish the absence of such a violation. Therefore, both the SEC's and Bloom's motions for summary judgment as to Count VI are denied.

C. Count VIII

In Count VIII, the SEC alleges that Bloom aided and abetted Sentinel's violation of Section 206(4) of the Advisers Act, 15 U.S.C. § 80b-6(4), and Rule 206(4)-2 promulgated thereunder, 17 C.F.R. § 275.206(4)-2(a)(1). Section 206(4) prohibits acts or business practices that are fraudulent, deceptive, or manipulative, and Rule 206(4)-2 provides that it is fraudulent, deceptive, or manipulative for an investment advisor to commingle client funds and securities. See SEC v. Slocum, Gordon & Co., 334 F.Supp.2d 144, 178 (D.R.I. 2004). Notably, Bloom does not challenge the SEC's motion for summary judgment on Count VIII, though we will nevertheless examine whether Sentinel has adequately supported its motion on this charge.

It is undisputed that Sentinel cleared all of its securities through either the SEN or FC1 clearing accounts and that these accounts also held securities for the House Portfolio. Therefore, investors' assets were necessarily commingled with Sentinel's proprietary assets whenever they were transferred to a clearing account. Commingling of securities creates liability under Section 206(4) and Rule 206(4)-2, even if the investors' securities are only routed there for a short period of time. Slocum, 334 F. Supp. 2d at 178. Therefore, Sentinel commingled its clients' and proprietary assets every time it moved a segregated security into the clearing account in violation of Section 206(4) of the Advisers Act and Rule 206(4)-2.

However, the evidence does not establish that Bloom acted with scienter, i.e. that he believed that the use of a common clearing account was improper. Although Bloom was aware of the segregation requirements imposed by the Advisers Act, the use of a single clearing account was not questioned by any of the independent audits conducted by various groups. Therefore, summary judgment for either party is inappropriate on Count VIII.

SEC v. MOSLEY4

I. COUNTS I, II, AND III

Counts I, II, and III against Mosley are identical to those asserted against Bloom: Counts I and II allege that Mosley violated Sections 17(a)(1) through (a)(3) of the Securities Act, and Count III alleges that Mosley violated Section 10(b) of the Exchange Act and Rule 10b-5.

A. The Janus Decision

As a threshold matter, Mosley argues that the Supreme Court's holding in Janus precludes liability under Counts I, II, and III of the SEC's complaint. In particular, Mosley contends that the SEC has not shown that he "made" any material misstatement or omissions. In response, the SEC has withdrawn its motion for summary judgment on Count III against Mosley.

Mosley contends that Janus also precludes his liability under Counts I and II for alleged violations of Section 17(a) of the Securities Act. Although Janus did not involve Section 17(a), the Seventh Circuit has held that the elements of a claim under Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act are identical. Maio, 51 F.3d at 631.

The holding in Janus was predicated on two bases, both of which are unique to Section 10(b) claims. First, the Supreme Court largely based its holding on the definition of the word "make," which is present in Rule 10b-5 but not so in Section 17(a). Janus, 131 S.Ct. at 2302-04. Whereas Rule 10b-5 prohibits an individual from "making" any untrue statement of material fact, Section 17(a) prohibits an individual from "employ[ing] any device, scheme, or artifice to defraud," "obtain[ing] money or property by means of any untrue statement of material fact," and "engag[ing] in any [fraudulent] transaction, practice, or course of business." 15 U.S.C. §§ 77q(a)(1)-(3) (emphasis added). The Janus decision was largely based on the Supreme Court's interpretation of the word "make," which is notably absent from Section 17(a).

Second, the policy underlying the Janus decision is inapplicable to a claim brought by the SEC under Section 17(a). In Janus, the Supreme Court expressed concern that a broad definition of "make" would improperly expand the scope of private suits under Rule 10b-5. Janus, 131 S.Ct. at 2302. However, Section 17(a) does not create a private right of action. Schlifke v. Seafirst Corp., 866 F.2d 935, 942-43 (7th Cir. 1989), Therefore, the Supreme Court's policy concerns in Janus are not implicated by claims brought by the SEC under Section 17(a).

Mosley cites to a solitary case, SEC v. Kelly, 2011 WL 4431161 (S.D.N.Y. Sept. 22,2011), that extended the Janus holding to claims under Section 17(a). In Kelly, the district court stated that "it would be inconsistent to require that a defendant have made the misleading statement to be liable under [Rule 10b-5] but not under [Section 17(a)]." Id. at *5. However, the court in Kelly did not expressly consider the policy reasons underlying the Janus decision, and we are therefore unpersuaded by the court's reasoning. Moreover, our conclusion is reinforced by several cases that have applied nearly identical reasoning to this precise issue. See e.g., SEC v. Tambone, 550 F.3d 106, 128 (1st Cir. 2008); SEC v. Geswein, 2011 WL 4565861, at *2 (N.D. Ohio Sept. 29, 2011); SEC v. Mercury Interactive, 2011 WL 5871020, at *3 (N.D. Cal. Nov. 23, 2011); SEC v. Daifotis, 2011 WL 3295139, at *5-*6 (N.D. Cal. Aug. 1, 2011). Therefore, Janus does not preclude Mosley's liability under Section 17(a).

C. Counts I and II

In Count I, the SEC alleges that Mosley violated Section 17(a)(1) of the Securities Act, which prohibits an individual from employing any device, scheme, or artifice to defraud investors in connection with the offer or sale of securities. 15 U.S.C. § 77q(a)(1). In Count II, the SEC alleges that Mosley violated Sections 17(a)(2) and (a)(3), which proscribe obtaining money or property by means of a misrepresentation and by engaging in a course of business that operates as a fraud upon an investor, respectively. The SEC alleges that Mosley violated these provisions in two ways: (1) by knowingly utilizing the portion of the BONY loan collateralized by investors' securities to generate returns for the House Portfolio; and (2) by pooling the interest generated by Sentinel's portfolios and then redistributing it across the portfolios.

Mosley, as Sentinel's Vice President and Head Trader, had knowledge of Sentinel's trading practices and was charged with the primary responsibility of implementing these practices. Although there is no evidence that Mosley was directly responsible for pledging investors' securities to collateralize the portion of the BONY loan benefitting the House Portfolio, he admitted in his answer that he was aware that this practice had been occurring at Sentinel. By desegregating investors' securities to collateralize the BONY loan for the benefit of the House Portfolio, Sentinel was engaging in a fraud whereby it was risking its investors' assets to benefit its proprietary trading account. Mosley was aware of this practice and earned hundreds of thousands of dollars in bonuses from the investments in the House Portfolio, which was in effect subsidized by investors' securities.

Furthermore, Mosley admitted that Sentinel would pool the interest generated by the various portfolios, including the House Portfolio, and distribute that interest across the investors' portfolios. Mosley further admitted that the interest distributed to investors bore no relation to the interest that the investors' securities had actually accrued. Mosley does not dispute that the interest was commingled, but rather claims that Bloom was primarily responsible forsetting the interest rates. However, Mosley has not provided any evidence to support this position. Moreover, his claim is belied by the testimony of York and Logan, who both testified that Mosley would set the rates on a daily basis, while Bloom only did so when Mosley was unavailable.

The evidence thus establishes that Mosley actively and knowingly participated in Sentinel's scheme to defraud its investors, obtained money by means of Sentinel's misrepresentations, and engaged in a course of fraudulent business. Summary judgment is thus granted in favor of the SEC on Counts I and II of the complaint.

II. COUNT IV, VI, AND VIII

In Counts IV, VI, and VIII, the SEC alleges that Mosley aided and abetted Sentinel's violations of Section 10(b) of the Exchange Act and Rule 10b-5, Sections 206(1) and (2) of the Advisers Act, and Section 206(4) of the Advisers Act and Rule 206(4)-2 promulgated thereunder. To succeed on a claim for aiding

and abetting a securities violation, the SEC must show: (1) a primary violation of the underlying securities law, (2) the defendant acted with scienter, and (3) the defendant substantially assisted the primary violation. Monetta, 390 F.3d at 956; Benger, 697 F. Supp. 2d at 938.

As discussed above, Mosley admitted that Sentinel used investors' assets to collateralize portions of the BONY loan used to benefit the House Portfolio and that Sentinel pooled the interest generated by the portfolios and redistributed the interest so as to generate higher returns for certain portfolios. For reasons discussed throughout this Memorandum Opinion, this conduct sufficiently constitutes violations of Section 10(b) of the Exchange Act, Rule 10b-5, Sections 206(1), 206(2), and 206(3) of the Advisers Act, and Rule 206(4)-2. The SEC has thus conclusively established a primary violation of these provisions.

Mosley's admissions also require a finding that he acted with scienter. Mosley testified that as of 2006, he was aware of Sentinel's use of client assets to collateralize the portion of the BONY loan allocated for the benefit of the House Portfolio. Regarding Sentinel's calculation of interest, Mosley was generally tasked with setting the interest rates on a daily basis, and it cannot be reasonably disputed that he knew that the method used to determine how to allocate the interest bore no relation to the actual rate of return of those portfolios. Moreover, the arguments Mosley makes against a finding that he acted with scienter are unsupported by the evidentiary record. Therefore, there is no genuine issue that Mosley acted with scienter.

Finally, the SEC has established that Mosley substantially assisted the primary violation. As Head Trader, Mosley implemented Sentinel's fraudulent trading practices on a daily basis. Therefore, summary judgment on Counts IV, VI, and VIII are granted in favor of the SEC.

CONCLUSION

For the foregoing reasons, the SEC's motion for summary judgment against Bloom is denied. Bloom's cross-motion for summary judgment against the SEC is also denied. The SEC's motion for summary judgment against Mosley is granted with respect to Counts I, II, IV, VI, and VIII.

Footnotes

1. The parties have tailored their arguments to the "misrepresentation" theory of liability of Rule 10b-5(b), which requires that a defendant make a false statement or omission of material fact. Rule 10b-5 also permits other theories of liability. For example, Rule 10b-5(a) prohibits an individual from employing "any device, scheme or artifice to defraud" investors, and Rule 10b-5(c) prohibits an individual from engaging "in any act, practice, or course of business which operates . . . as a fraud or deceit" upon an investor. 17 C.F.R. §§ 240.10b-5(a), (c). As the parties do not address these alternative theories of liability, the ensuing analysis is limited to allegations under the misrepresentation theory of liability under Rule 10b-5(b).

2. Ultimately, does not significantly affect the SEC's allegations against Bloom, as Bloom personally made statements similar or identical to the statements contained in Sentinel's marketing materials that the SEC maintains were misrepresentations.

3. Section 10(b) of the Exchange Act prohibits fraud in connection with "the purchase or sale" of securities, whereas Section 17(a) prohibits fraud in connection with the "offer or sale" of securities. As the offer, purchase, and accompanying sale of securities are all at issue in this case, there is no meaningful distinction between the statutes with respect to this element.

4. Mosley did not file a response to the SEC's Statement of Material Facts (the "SEC's Statement") as required by Local Rule 56.1. Therefore, all well-supported facts as set forth in the SEC's Statement are deemed admitted. N.D. Ill. L.R. 56.1(b)(3)(C); , 683 (7th Cir. 2003). Moreover, we will not consider any unsubstantiated facts contained in Mosley's reply brief in considering the SEC's motion for summary judgment.