

## Securities Regulation Daily Wrap Up, TOP STORY—Arguments at ALJ appeal consider constitutional issues and Advisers Act violations, (Jun. 8, 2015)

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By Amanda Maine, J.D.

Attorneys for the SEC's Division and Enforcement and officers at a real estate investment firm made their case before the Commission regarding an allegedly fraudulent repurchase agreement and undisclosed commissions. The two sides also presented their arguments as to whether administrative law judges are "inferior officers" under Article II of the U.S. Constitution (*In the Matter of Timbervest, LLC*, oral argument, June 8, 2015).

**Background.** Timbervest, LLC is an SEC-registered investment adviser that manages approximately \$1.2 billion in investments related to timber and environmental and ecological remediation through various client funds. In September 2013, the SEC instituted administrative proceedings against Timbervest and four of its executives and managing partners: CEO Joel Barth Shapiro, Chief Investment Officer Walter William Anthony Boden III, Chief Operating Officer Donald David Zell, Jr., and President Gordon Jones II. The order instituting administrative proceedings alleged that Timbervest sold a tract of timberland in Alabama on behalf of a client and caused the client to pay a brokerage fee to Boden without disclosing the fee. Timbervest was served as the investment adviser to the client (BellSouth, which eventually merged with AT&T). Timbervest was also the adviser to an investment fund holding BellSouth's (later, AT&T's) private pension plan assets, which was governed by ERISA. ERISA prohibited Timbervest from selling properties to other funds that it managed.

The SEC also alleged that Timbervest repurchased the same property a few months later on behalf of a different client pursuant to a side agreement negotiated by Boden prior to the tract's sale and that Boden did not disclose this to either client. In addition, Timbervest allegedly sold tracts of timberland in Kentucky on behalf of a client and again caused the client to pay a brokerage fee to Boden without disclosing the fee. The commissions collected by Boden from the sale of these properties were split with his attorney and with Shapiro, Jones, and Zell. The SEC also alleged that the payments to Boden were structured in a manner that concealed the identities of the recipients.

In August 2014, Administrative Law Judge Cameron Elliot issued his initial decision. The initial decision found that Timbervest violated Investment Advisers Act Sections 206(1) and 206(2) and that the individual respondents caused, aided, and abetted Timbervest's Section 206 violations regarding the repurchase agreement. However, due to mere negligence that did not rise to the level of scienter, the ALJ found that Jones and Zell aided, abetted, and caused only Timbervest's Section 206(2) violation regarding the real estate commissions. Both Timbervest and the Division of Enforcement appealed the initial decision to the full Commission.

**Timbervest's arguments.** At oral argument, counsel for Timbervest and the individual respondents contested the ALJ's initial decision on both substantive and constitutional grounds. Stephen Councill, representing the respondents, said that much of the evidence making up the record was insufficient to support a finding against them because evidence has been lost, memories have faded, and witnesses have disappeared. In addition, the associational bars sought by the Division were punitive, not remedial in nature, and were therefore barred by the statute of limitations.

According to Councill, the Boden fee agreement was adequately disclosed to the client. He pointed out that no one that had worked for the client had testified at the hearing and that the Division's "star witness" had made prior statements that were inconsistent with his testimony at the ALJ hearing, and that this was indicative of his flawed memory. Councill also maintained that the repurchase price was fair and that both deals were negotiated independently and provided great value to the clients. The testimony provided by the Division's witness that the transaction value unfair to BellSouth was also inconsistent, Councill said.

George Kostolampros also spoke on behalf of the respondents, arguing that the SEC's ALJ proceedings are unconstitutional under Article II of the U.S. Constitution because ALJs are "inferior officers" and, under *Free*

*Enterprise Fund v. Public Company Accounting Oversight Board* (U.S. 2010), they may not be separated from presidential supervision and removal by more than one layer of tenure protection. The Commission has taken the position that because ALJ initial decisions are not final, they are not inferior officers under the Constitution, but simply employees. Kostolampros argued that an ALJ has unilateral authority to tip a decision one way or the other. ALJs possess significant authority to control the hearing by making factual and credibility findings, which are instrumental because they form the record upon which the Commission will base its decision in case of appeal. As inferior officers who exercise significant authority in presiding over an administrative trial, their two layers of tenure protection violate the Separation of Powers, according to Kostolampros.

**Division of Enforcement's arguments.** Anthony J. Winter, representing the Division of Enforcement, took issue with Council's characterization of the SEC's case as based on lost memories and missing documents. No one testified that any documents were lost and the Division's witnesses actually were credible and were not "afflicted by the malady of wholesale memory loss" like the respondents were, Winter said. Winter also disputed the respondents' contention that both AT&T (as successor to BellSouth) and Timbervest's other client party to the repurchase were both happy with the transaction and it was beneficial to both clients, pointing to a lawsuit filed by AT&T suing Timbervest for fraud.

Regarding the associational bars on the four individual respondents, Winter argued that, contrary to the findings of the ALJ, the bars were remedial, not punitive, and as such were not barred by the statute of limitations. Winter said the associational bars were appropriate because of the respondents' "egregious" conduct and scienter as displayed by their use of a middleman and "byzantine" payment structure used to conceal the commission payments; the cavalier attitude they displayed at the hearing; false and misleading testimony given by the respondents at the hearing; the fact that they engaged in a pattern of misconduct that could be repeated in the future; and that they had recently sought money to launch two more funds and were still in the industry potentially harming future investors.

Commissioner Kara Stein inquired why the Division was appealing the finding that Jones and Zell were only negligent regarding the commission payment charge. Winter responded that the Division had shown that they knew that ERISA prohibited Timbervest selling properties to other funds that it managed, and at the very least, their conduct was reckless.

David Mendel argued the Division's case on the constitutional issue. Mendel cited *Landry v. FDIC* (U.S. 2000), which upheld a lower court ruling that FDIC administrative law judges were not inferior officers under the Appointments Clause, to support the Division's assertions. ALJs at the FDIC are "functionally equivalent" to the Commission's ALJs, he stated, and are not executive officers. Under *Landry*, FDIC ALJs are not inferior officers because they do not exercise significant authority pursuant to the laws of the U.S. and because they are not "final decisions." Similarly, SEC ALJs issue only initial decisions, which are not final and do not carry legal force until the Commission issues an order of finality. The Commission also has complete control over ALJs, can grant interlocutory appeals, or even decide not to use ALJs at all. Mendel also noted that a footnote in *Free Enterprise* stated that the decision, which dealt with members of the Public Company Accounting Oversight Board, did not apply to ALJs.

**Timbervest's rebuttal.** Counsel for the respondents were given the opportunity to rebut the Division's arguments. Council said that the AT&T lawsuit cited by Winter involved violations of ERISA, not the Investment Advisers Act. Regarding the alleged scienter on the part of Jones and Zell, Council maintained that ALJ Elliot did not actually take into consideration the evidence presented, but simply made characterizations not based on what was in the record. Kostolampros advised that the Solicitor General of the Department of Justice had written regarding *Landry* that the court did not purport to establish any categorical rule that administrative law judges are employees rather than inferior officers. He also noted that the *Free Enterprise* footnote referenced by Mendel specifically states that the opinion does not address the question about the status of administrative law judges.

The proceeding is No. ID-658.

Attorneys: Stephen Councill (Rogers & Hardin LLP) and George Kostolampros (McKenna Long & Aldridge LLP ) for Timbervest, LLC, Joel Barth Shapiro, Walter William Anthony Boden, III, Donald David Zell, Jr., Gordon Jones II. Anthony J. Winter and David Mendel for the SEC's Division of Enforcement.

Companies: Timbervest, LLC

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