UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI

CASE NO. 12-CV-80-CEJ

SECURITIES AND EXCHANGE COMMISSION,	)
	)
Plaintiff,	)
v.	)
	)
BURTON DOUGLAS MORRISS,	)
ACARTHA GROUP, LLC,	)
MIC VII, LLC,	)
ACARTHA TECHNOLOGY PARTNERS, LP, and	)
GRYPHON INVESTMENTS III, LLC,	)
	)
Defendants, and	)
	)
MORRISS HOLDINGS, LLC,	)
	)
Relief Defendant.	)
	)

PLAINTIFF'S
RESPONSE AND MEMORANDUM OF
LAW IN OPPOSITION TO DEFENDANT
MORRISS AND RELIEF DEFENDANT MORRISS
HOLDINGS' MOTIONS TO DISMISS THE COMPLAINT
OR, IN THE ALTERNATIVE, MOTIONS FOR A MORE DEFINITE STATEMENT

I. INTRODUCTION

Defendant Burton Douglas Morriss and Relief Defendant Morriss Holdings' motions to dismiss ignore factual allegations, apply incorrect pleading standards, and misconstrue the elements of the charged offenses. Neither motion contains a viable reason why the Court should dismiss the Securities and Exchange Commission's Complaint.

First, Morriss and Morriss Holdings ask the Court to dismiss the Commission's Complaint claiming the Commission has failed to allege fraud with particularity under Federal Rule of Civil Procedure 9(b). In doing so, however, Morriss and Morriss Holdings rely on pleading standards and additional elements that only apply to private securities lawsuits, not Commission enforcement actions.

Second, in the same vein, both contend the Commission engaged in "shotgun" or "puzzle" pleading by failing to connect factual allegations to the specific counts in the Complaint. In making these arguments, however, they ignore the Commission's factual allegations and the Complaint's organization of them. They also disregard the fact that the Commission's causes of action all sound in fraud and require similar evidentiary showings. Both parties also misinterpret the case law regarding such pleading styles. Under the applicable pleading standards, the Commission has, in an organized manner, alleged more than enough facts showing the fraud Morriss as well as Acartha Group, LLC, MIC VII, LLC, Acartha Technology Partners, LP ("ATP"), and Gryphon Investments III, LLC, (collectively, the "Investment Entities") committed.

Third, in a cursory fashion, Morriss and Morriss Holdings also challenge the Complaint's sufficiency in alleging several elements of the Commission's causes of action. Specifically, Morriss and Morriss Holdings contend the Commission failed to sufficiently allege (a) the fraud was "in connection with" the offer, purchase, or sale of a security; (b) the defendants acted with scienter; and (c) the defendants false and misleading statements were material. These arguments, however, suffer the same defects as discussed above, in that their arguments ignore the Commission's factual allegations, misstate each element's legal standard, and misconstrue the relevant case law.

What makes Morriss' and Morriss Holdings' arguments particularly unpersuasive is the fact that the Commission has previously, in its Motion for Emergency Asset Freeze and Other Relief, described in detail how the allegations in the Complaint meet each element of the charged offenses. In doing so, the Commission also provided evidence to support each fact alleged in the Complaint. Indeed, the Court has already concluded not only that the Commission properly alleged securities fraud, but that it has demonstrated a *prima facie* case against Morriss and the Investment Entities. (Asset Freeze Order And Other Emergency Relief, DE 59 at 2).

II. PROCEDURAL AND FACTUAL BACKGROUND

A. Procedural Background

The Commission filed its Complaint on January 17, 2012, against Morriss, the Investment Entities, and Relief Defendant Morriss Holdings. (DE 1). The Complaint alleges Morriss and the Investment Entities violated Section 17(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77q(a) (Counts I-II); Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and Exchange Act Rule 10b-4, 17 C.F.R. § 240.10b-5 (Count III), and Morriss, Acartha Group, and Gryphon Investments, violated Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940 ("Advisers Act"), 15 U.S.C. §§ 80b-6(1), 80b-6(2), and 80b-6(4), and Advisers Act Rule 206(4)-8(a)(2), 17 C.F.R. § 275.206-4(8)(a)(2) (Counts V & VII). The Complaint also alleges Morriss aided and abetted violations of Exchange Act Section 10(b) and Rule 10b-5 (Count IV), and Advisers Act Sections 206(1), 206(2), and 206(4) and Rule 206(4)-8(a)(2) (Counts VI & VIII).

In contrast, the Complaint does not allege Morriss Holdings violated the Securities Act, Exchange Act, or Advisers Act. Instead Morriss Holdings is included as a relief defendant because it received fraud proceeds, which the Commission seeks to recover.

As discussed below, to decide this motion, the Court must accept as true the facts alleged in the Complaint, and draw any reasonable inferences in the Commission's favor. The facts in the Commission's Complaint relevant to this motion are:

From 2005 through 2011, Morriss through the private equity funds and management companies he controlled, the Investment Entities, transferred approximately $9.1 million of investor funds to himself and his family holding company Morriss Holdings. (DE 1, ¶¶ 1, 4-9). Morriss used these funds for personal expenditures, such as taking vacations, satisfying personal loans, and paying alimony. (*Id.*, ¶ 1). Morriss, through the Investment Entities he controlled, disguised these transfers as loans without the knowledge or consent of investors. (*Id.*).

Morriss personally solicited investments into both the management companies – Acartha Group and Gryphon Investments – as well as the underlying private equity funds MIC VII and ATP. (*Id.* ¶¶ 13, 16). Investors invested in the funds MIC VII and ATP to receive a portion of carried interest or net profit from the sale of a portfolio company. (*Id.* ¶ 14). Acartha Group managed the day-to-day management of the funds and selected the companies in which to invest. (*Id.*). Investors who invested in the management companies did so to receive a portion of the carried interest owed to those companies, and, with respect to Gryphon Investments, the opportunity to convert their shares to holdings in ATP. (*Id.*, ¶ 16).

Starting in 2005, Morriss transferred money from Acartha Group to himself and Morriss Holdings for his personal use. (*Id.*, ¶¶ 19-20, 29). At the same time, Morriss also conducted similar transfers from MIC VII, ATP, and Gryphon Investments. (*Id.*). In 2008, Morriss began to experience severe financial difficulties, requiring him to sell personal assets. (*Id.*, ¶ 23). He also became delinquent on several million dollars in personal loans. (*Id.*). As a result, Morriss continued to move money from the Investment Entities to himself and Morriss Holdings for personal use. (*Id.*).

Indeed, by the summer of 2009, Morriss and Morriss Holdings owed the Investment Entities approximately $2 million. (*Id.*, ¶ 24). Morriss continued to transfer money from the

Investment Entities to himself even though the Acartha Group and the other Investment Entities' financial conditions were deteriorating. (*Id.*, ¶ 25). Between 2008 and 2011, Morriss transferred new investor money at an increasing pace:

- From March 2008 through June 2009, Gryphon Investments raised $3.75 million from investors. Of that amount, Gryphon Investments transferred $1.7 million to Morriss and Morriss Holdings for Morriss' personal use. It also transfered $305,000 to Wachovia Bank to satisfy Morriss' personal line of credit. These transfers occurred almost immediately after investors wired funds to Gryphon Investments. (*Id.*, ¶¶ 26, 44).

- From September 2009 through August 2010, Morriss took at least $1.4 million out of $6 million in new ATP investor funds. (*Id.*, ¶ 26).

- From December 31, 2009 through September 30, 2011, net transfers from Acartha Group to Morriss and/or Morriss Holdings ballooned to at least $6.6 million. (*Id.*, ¶ 28).

The Investment Entities disguised these transfers as loans or accounts receivables without the knowledge or consent of investors. (*Id.*, ¶ 1). Indeed, over the course of Morriss' misappropriation, the Investment Entities changed the manner in which they recorded the transfers, from "netting" agreements, to uncollateralized promissory notes with no due dates, to one consolidated note between Morriss Holdings and Acartha Group (*Id.*, ¶¶ 21-22, 27).

In addition, Morriss also borrowed $2.5 million in MIC VII's name and ultimately, used those loan proceeds to pay off his personal line of credit. (*Id.*, ¶¶ 37-38). To cover up this misappropriation, Morriss admitted new MIC VII investors solely to repay the $2.5 million MIC VII loan, without the unanimous consent of existing investors, as required by the fund's operating agreement. (*Id.*, ¶ 39). The result was the dilution of existing MIC VII's investors' interests. (*Id.*, ¶ 40).

Morriss and the Investment Entities failed to disclose that Morriss could or would use investor proceeds for his own personal use. Morriss personally solicited investors through email, telephone calls, and personal meetings. (*Id.*, ¶ 13). Specifically, the offering documents Morriss and the Investment Entities provided to investors failed to disclose Morriss would use investor funds for his personal use, let alone take out unsecured, personal loans from the Investment Entities. (*Id.*, ¶ 30).

In fact, the offering documents for ATP and, to an extent, Gryphon Investments, explicitly prohibited Morriss from taking loans. (*Id.*, ¶¶ 31, 33). At the same time, the offering documents for Acartha Group and MIC VII misled investors by using vague, broad, and inconsistent language. (*Id.*, ¶ 31). Morriss specifically requested that the Investment Entities include such vague and broad language. (*Id.*,¶ 31).

In addition, Morriss and Gryphon Investments made a number of false statements to investors. For example, in May 2008 Morriss misrepresented to investors Gryphon Investments would use investor money only to fund working capital and other company expenditures. (*Id.*, ¶¶ 26, 44). At the same time, Morriss also misrepresented to Gryphon Investments investors that purchasing Series A shares in the company would entitle them to guaranteed dividends and the right to convert their shares to ATP interests (*Id.*, ¶ 41). Moreover Morriss and Gryphon Investments misrepresented to investors that Gryphon Investments managed ATP, when in reality Acartha Group acted as its manager. (*Id.*, ¶ 42).

Based on these allegations and supporting evidence, the Court entered orders appointing a Receiver over the Investment Entities and freezing all of the assets of the Investment Entities and Morriss Holdings. (DE 16, 17). The Court entered the orders after concluding the Commission had demonstrated "a *prima facie* case of securities laws violations by *the Defendants*." (*Id.* at 2) (emphasis added). On February 28, 2012, Morriss and Morriss Holdings filed their motions to dismiss. (DE 83, 86).

III. LEGAL STANDARD – MOTION TO DISMISS

A. Applicable Standards

In reviewing a Rule 12(b)(6) motion, the Court must accept as true all facts alleged in the Complaint, view the complaint in the light most favorable to the plaintiff, and give the plaintiff the benefit of reasonable factual inferences. *Braden v. Wal-Mart Stores, Inc.*, 588 F.3d 585, 595 (8th Cir. 2009); *Northstar Indus., Inc. v. Merrill Lynch & Co., Inc.*, 576 F.3d 827, 831-32 (8th Cir. 2009).

Morriss begins his argument for dismissal by discussing the notice pleading standards the Supreme Court evaluated in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007). (DE 87 at 6). However, nothing in that opinion casts any doubt on the fact that here the Commission has satisfied the standards for notice pleading under Federal Rule of Civil Procedure 8(a). While *Twombly* did disclaim the long-standing benchmark that a district court cannot dismiss a complaint unless the plaintiff can prove no set of facts in support of its claim, it did not change the pleading landscape as much as Morriss would have the Court believe.

For example, *Twombly* did not change the long-standing criterion of Rule 8(a)(2) that all the plaintiff must do is set forth "a short and plain statement of the claim showing that the pleader is entitled to relief." *Braden*, 588 F.3d at 595 (internal quotation and citation omitted). *See also McMillian v. AMC Mortgage Servs., Inc.*, 560 F. Supp. 2d 1210, 1212 (S.D. Ala. 2008). The Court's inquiry at the motion-to-dismiss stage still focuses on whether the challenged pleadings "give the defendant fair notice of what the . . . claim is and the grounds on which it rests." *McMillian*, 560 F. Supp. 2d at 1212 (*quoting Erickson v. Pardus*, 551 U.S. 89, 93 (2007)).

In analyzing a motion to dismiss, the "Complaint should be read as a whole, not parsed piece by piece to determine whether each allegation, in isolation, is plausible." *Braden*, 588 F.3d at 595. The *Twombly* standard "simply calls for enough facts to raise a reasonable expectation that discovery will reveal evidence" of the required element. *Rivell v. Private Health Care Sys., Inc.*, 520 F.3d 1308, 1309-10 (11th Cir. 2008). It is sufficient if the complaint succeeds in "identifying facts that are suggestive enough to render [the challenged element] *plausible*." *Id.* at 1310 (emphasis added). Put another way, "the proper test is whether the complaint 'contains either direct or inferential allegations respecting all the material elements necessary to sustain a recovery under some viable legal theory.'" *McMillian*, 560 F. Supp. 2d at 1213 (citation omitted).

The test is not a "probability requirement," meaning that "a well-pleaded complaint may proceed even if it strikes a savvy judge that actual proof of the facts alleged is improbable, and 'that a recovery is very remote and unlikely.'" *Braden*, 588 F.3d at 585 (quoting *Twombly*, 550 U.S. at 556).

It is plain from these cases that the threshold for withstanding a motion to dismiss based on a claim of inadequate pleading is still exceedingly low. It is equally plain the Commission's Complaint easily surpasses this threshold. As demonstrated in Section II above and in more detail in Section IV below, the facts alleged in the Commission's Complaint are more than enough to give defendants fair notice.

IV. ARGUMENT

A. The Commission Has Alleged Fraud With Sufficient Particularity

In their motions, both Morriss and Morriss Holdings[1] argue the Commission fails to allege the defendants' fraudulent conduct with the requisite particularity. They are wrong. Morriss and Morriss Holdings improperly cite additional elements and heightened legal standards that apply to private securities litigation, not a Commission enforcement action. Additionally, both overlook or ignore the detailed factual allegations, which sufficiently describe the defendants' fraudulent conduct.

1. Elements Of The Violations Alleged

Counts I through VIII of the Complaint allege fraud violations under Section 17(a) of the Securities Act, Section 10(b) and Rule 10(b)(5) of the Exchange Act, and Sections 206(1), (2), and (4) and Rule 206(4)-8 of the Advisers Act. Counts IV, VI, and VIII allege Morriss aided and abetted fraud under the Exchange Act and Investment Advisers Act.

Section 17(a) of the Securities Act, which proscribes fraudulent conduct in the offer or sale of securities, and Section 10(b) of the Exchange Act and Rule 10b-5, which proscribe fraudulent conduct in connection with the purchase or sale of securities, prohibit essentially the same type of practices. *United States v. Naftalin*, 441 U.S. 768 (1979). To establish a violation

[1] Contrary to its claim, the Commission does not allege Morriss Holdings violated Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act (DE 84 at 3-5); instead Morriss Holdings is a relief defendant. "A relief defendant . . . may be joined to aid in the recovery of relief and has no ownership interest in the property which is the subject of the ligation." *SEC v. George*, 426 F.3d 786, 798 (6th Cir. 2005) (internal quotation and citations omitted). "Federal courts may order equitable relief against such a person who is not accused of wrongdoing in a securities enforcement action where that person: (1) has received ill-gotten funds; and (2) does not have a legitimate claim to those funds." *Id.* (quotations and citations omitted). The Commission alleges Morriss Holdings received much of the funds Morriss misappropriated from the Investment Entities (*see* DE 1, ¶¶ 19-28), and it is included in the Complaint to ensure later recovery of those misappropriated funds. *See George*, 426 F.3d at 798. Consequently, the Court should disregard Morriss Holdings' motion to dismiss as it relates to whether it violated federal securities laws. We do not allege the company did.

under these provisions, the Commission must show: (1) a misrepresentation or omission (2) that is material (3) in the offer of or in connection with the purchase or sale of a security (4) made with scienter (5) in interstate commerce. *SEC v. Chemical Trust*, 00-8015-CIV, 2000 WL 33231600, at *9 (S.D. Fla. Dec. 19, 2000); *SEC v. Hasho*, 784 F. Supp. 1059, 1106 (S.D.N.Y. 1992).[2]

Alternatively, Securities Act Section 17(a) and Exchange Act 10(b) and Rule 10b-5(a) and (c), do not require proof of a false or misleading statement. "[R]ather primary liability [can be] based on the use of a 'fraudulent device' in connection with the sale of securities." *SEC v. Durgarian*, 477 F. Supp. 2d 342, 350-51 (D. Mass. 2007).

Morriss would have the Court impose additional elements not applicable to this enforcement action. Specifically, he contends the Commission must demonstrate investors reasonably relied on the alleged misrepresentations and omissions as well as investor loss. (DE 87 at 10-11). Morriss is wrong. "Unlike private litigants seeking damages, the Commission is not required to prove that any investor actually relied on the misrepresentations or that the misrepresentations caused any investor to lose money." *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir. 1985).

The elements for establishing violations of the fraud provisions of the Advisers Act are similar to the elements for violations of Sections 17(a) and 10(b). Section 206(1) of the Advisers Act prohibits any investment adviser from, directly or indirectly, employing any device, scheme or artifice to defraud any client or prospective client. Section 206(2) of the Advisers Act prohibits any transaction, practice or course of business which operates as a fraud or deceit upon

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[2] A finding of scienter, however, is not required to establish a violation of Section 17(a)(2) or (3) of the Securities Act. *Aaron v. SEC*, 446 U.S. 680, 696-97 (1980). Sections 17(a)(2) and (3) prohibit, in connection with the offer or sale of securities, fraudulent or deceitful business practices and obtaining money by untrue statements or omissions of material facts. Violations of these sections may be established by showing negligence. *SEC v. Hughes Capital Corp.*, 124 F.3d 449, 453-54 (3d Cir. 1997).

any client or prospective client. Scienter is required for a violation of Section 206(1), but not for Section 206(2). *Steadman v. SEC*, 603 F.2d 1126, 1134 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981); *Capital Gains*, 375 U.S. at 184, 191-92.[3]

2. *Pleading Fraud With Particularity Under Rule 9(b)*

Federal Rule of Civil Procedure 9(b) requires plaintiffs to plead the circumstances of fraud "with particularity." While the standard plainly requires more specific facts than in non-fraud cases, both Morriss and Morriss Holdings cite incorrect standards on which the Court should rely in a Commission enforcement action.

First, Rule 9(b) does not abrogate the concept of notice pleading set forth in Rule 8(a). *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1202 (11th Cir. 2001); *SEC v. Physicians Guardian Unit Inv. Trust*, 72 F. Supp. 2d 1342, 1352 (M.D. Fla. 1999) (denying motion to dismiss on grounds that plaintiff did not plead fraud with enough specificity); *SEC v. Tiffany*, 535 F. Supp. 1160, 1166 (E.D. Mo. 1982) (holding that Rule 9 does not render the general principles of notice pleading inapplicable). The purpose of Rule 9(b) is to ensure allegations of fraud are specific enough to provide sufficient notice of the acts complained of and eliminate those complaints filed as a pretext for discovery of unknown wrongs. *SEC v. Ginsburg*, Case No. 99-8694-Civ, 2000 WL 1299020 at *2 (S.D. Fla. Jan. 10, 2000). In considering a motion to dismiss for failure to plead fraud with particularity, a court "must be careful to harmonize the directives of Fed. R. Civ. P. 9(b) with the broader policy of notice pleading." *Physicians Guardian*, 72 F. Supp. 2d at 1352.

Second, pleading with particularity under Rule 9(b) does not require the plaintiff to plead "detailed evidentiary matter." *Ross v. A.H. Robins Co.*, 607 F.2d 545, 557 n.20 (2d Cir. 1979)

[3] Section 206(4) of the Advisers Act provides for similar prohibitions and does not require a showing of scienter. *Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles* (SEC Rel. No. IA-2628, Aug. 9, 2007).

(reversing dismissal of a private Section 10(b) action). Indeed, the "SEC is not required to plead detailed evidence concerning each and every fraudulent act alleged . . . ." *SEC v. Levin*, 232 F.R.D. 619, 624 (C.D. Cal. 2005). The complaint need only provide a reasonable delineation of the underlying acts and transactions allegedly constituting the fraud. *Anderson v. Transglobe Energy Corp.*, 35 F. Supp. 2d 1363, 1369-70 (M.D. Fla. 1999) (denying motion to dismiss on grounds that plaintiff did not plead fraud with particularity). A complaint pleads fraud with sufficient particularity if it alleges the substance of the fraudulent acts, who engaged in the fraud and when the fraud occurred – *i.e.* "the first paragraph of any newspaper story." *Ritchie Capital Mgmt., LLC v. Jeffries*, 653 F.3d 775, 764 (8th Cir. 2011) (internal quotation and citations omitted). *See also Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 549-550 (8th Cir. 1997) (noting under Rule 9(b) a complaint must allege the time, place, and contents of false representations) (citations omitted).

In their motions, Morriss and Morriss Holdings apply the heightened pleading standard set forth in the Private Securities Litigation Reform Act of 1995 ("PSLRA"). (*See, e.g.*, DE 84 at 7-10, 13; DE 87 at 14, 20-23). The PSLRA mandates more stringent pleading standards in private securities fraud actions by requiring private plaintiffs to: (1) plead with particularity the facts surrounding the alleged fraud, including identifying the specific misleading statements or omissions and the reasons why they are misleading; and (2) plead with particularity the facts permitting a strong inference of scienter. *Andropolis v. Red Robin Gormet Burgers, Inc.*, 505 F. Supp. 2d 662, 675 (D. Colo. 2007) (internal quotations and citations omitted). *See also* 15 U.S.C. §§ 78u-4(b)(1)-(2). These standards, however, do not apply here. Thus, because "this is an SEC enforcement proceeding, not a private securities action and thus it is not subject to the heightened pleading standards of the [PSLRA]." *SEC v. Shanahan*, 4:07CV270 JCH, 2008 U.S.

Dist. LEXIS 100641, at *11 n.7 (E.D. Mo. Dec. 12, 2008). Consequently, Morriss and Morriss Holdings ask for more particularity than the law requires in this enforcement action.

Applying the proper standard, the Commission has sufficiently alleged fraud with particularity. The Complaint identifies the who, where, what, when, and how of both the fraudulent misstatements and omissions made by Morriss, Acartha Group, MIC VII, ATP, and Gryphon Investments as well as the schemes they carried out to defraud investors.

3. <u>Misstatements & Omissions</u>

First, the Complaint states *when* the misstatements and omissions took place: between 2005 and 2011. (*See, e.g.*, DE 1, ¶¶ 1, 17, 21, 32-35, 43). The Complaint provides even more particularity in its factual allegations describing the *what* and the *where* – *i.e.* the fraudulent misstatements and omissions and where they were made. Indeed, the Complaint identifies exact documents Morriss disseminated to investors that included false and misleading statements, such as:

- Section 7.7 of ATP's 2008 Agreement of Limited Partnership, which falsely advised Morriss could not take ATP funds for personal transfers or loans. (*Id.*, ¶ 32).

- Section 4.1.9 of Gryphon Investments' 2008 Limited Liability Company Operating Agreement, which falsely advised the company would not use investor funds for personal transfers or loans to Morriss. (*Id.*, ¶ 33).

- MIC VII's 2005 Amended and Restated Limited Liability Company Operating Agreement, which misled investors by using vague language and failing to advise MIC VII would transfer investor money to Morriss and Morriss Holdings. (*Id.*, ¶ 34).

- Acartha Group's 2007 PPM, which misled investors by using vague language and failing to advise it would transfer investor money to Morriss and Morriss Holdings. (*Id.*, ¶ 35).

- Morriss' May 2008 representations to investors that purchasing Gryphon Investment's Series A Cumulative Preferred Shares would entitle investors to a 10% annual dividend, a portion of the company's carried interest from ATP, and

> the right to convert Series A shares to common partnership interests in ATP. Morriss also misrepresented the investment funds would be used solely for working capital and Gryphon Investment expenditures. (*Id.*, ¶ 43).

These allegations satisfy the pleading requirements of Rule 9(b).[4] *SEC v. Medical Capital Holdings, Inc.*, SACV 09-0818 DOC, 2010 WL 809406, at *2 (C.D. Cal. Feb. 24, 2010) (holding complaint met Rule 9(b) standards by listing PPMs used to defraud investors). Furthermore, the Complaint alleges that due to these misrepresentations and omissions, Morriss defrauded investors out of at least $6.6 million (excluding the $2.5 million Morriss misappropriated from MIC VII as discussed below). (*Id.*, ¶ 28).

Contrary to Morriss Holdings' claim, the Commission also alleges with particular specificity *how* these statements and omissions were false and misled investors. For example, the Complaint alleges:

- As early as 2005, Morriss took investor funds from Acartha Group and the other Investment Entities. (*Id.*, ¶ 21).

- By 2009, Morriss and Morriss Holdings took and owed Acartha Group, MIC VII, ATP, and Gryphon Investments approximately $2 million. (*Id.*, ¶ 24).

- Between March 2008 and June 2009, Morriss transferred $1.7 million in new investor funds from Gryphon Investments to himself and Morriss Holdings for his own personal use, with most of the transactions occurring almost immediately after investors wired funds. (*Id.*, ¶ 26, 44). Morriss failed to disclose these transactions to investors. (*Id.*).

- From September 2009 through August 2010, Morriss took at least $1.4 million out of approximately $6 million in new ATP investor funds. (*Id.*, ¶ 26).

Moreover, the Commission has also sufficiently alleged the *who*. Contrary to Morriss'

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[4] Morriss Holding's claim the Complaint includes no allegation that the offering documents were distributed to investors is unavailing. The Commission alleges Morriss used the offering documents to solicit investors (DE 1, ¶ 1), and that he solicited investors using email, telephone calls, and face-to-face meetings (*id.*, ¶ 13). These allegations sufficiently demonstrate Morriss provided the offering documents to investors. At a minimum, the allegations permit the Court to draw a reasonable inference that investors received the offering and management documents. *Ritchie Capital Mgmt.*, 653 F.3d at 764 (holding court must draw reasonable inferences in favor of non-moving party).

and Morriss Holdings' claims, the Complaint does not "lump" multiple defendants together. (DE 84 at 3, 4, 8; DE 87 at 10). Instead, it comports with the requisite pleading standards by describing each defendant's role in making and disseminating the misrepresentations and omissions. *SEC v. Ficeto*, CV 11-1637-GHK, 2011 WL 7445580, *3 (C.D. Cal. Dec. 20, 2011) (holding Rule 9(b) satisfied when complaint provides information on each defendant and his or its role in the fraudulent transactions). The Complaint specifically alleges that Morriss: (1) solicited investments in the Investment Entities through emails, telephone calls, and meetings with potential investors (*id.*, ¶ 13); (2) deliberately requested the inclusion of vague and misleading language in the offering and operating documents he and the Investment Entities disseminated to investors (*id.*, ¶ 31); and (3) misrepresented to potential and actual investors the features of an investment in Gryphon Investments' Series A Preferred Shares (*id.*, ¶ 43). As to each Investment Entity, the Complaint, as discussed above, details with specificity a number of false and misleading statements placed within their offering and management documents to deceive investors. (*Id.*, ¶¶ 31-35).[5]

Morriss and Morriss Holdings also argue the Complaint does not meet Rule 9(b)'s standards because it does not identify which investors they defrauded. Contrary to the defendants' argument, "in SEC actions to enjoin securities violations, the SEC need not plead that at least one investor actually received and relied on the false statements." *Medical Capital Holdings*, 2010 WL 809406, at *3 (citing *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993)). Regardless, the Complaint alleges to whom these false and misleading statements were made – potential and actual Investment Entity investors. (*Id.*, ¶¶ 13-16, 19, 26, 30-36, 42-

[5] Morriss' reliance on *Parnes*, 122 F. 3d at 550, is misguided. In that case, the private plaintiff failed to provide *any* details as to the identity of the goods and services the defendant sold at allegedly inflated prices. *Id.* In contrast, as described above, the Commission's Complaint provides specific details about the misrepresentations and omissions, including the specific documents in which they appear.

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4. Schemes To Defraud

Morriss and Morriss Holdings do not contest the sufficiency of the Commission's allegations of the defendants' involvement in two schemes to defraud as charged in Counts I, III, and IV – VIII; nor could they. The Commission provided detailed factual allegations regarding both schemes to defraud.

In the first scheme, the defendants misappropriated more than $9 million in investor funds for Morriss' personal use and concealed it from investors in two ways: (1) by providing false, broad, and vague offering and operating materials to investors (*id.*, ¶¶ 19, 21, 24, 26, 30-35, 43-45); and (2) classifying the transfers to Morriss and Morriss holdings as loans, which Morriss had no intention to repay (*id.*, ¶¶ 1, 20, 21-24, 27, 28). As discussed above, the Complaint explains the *when* of the fraud scheme – 2005 through 2011 – and the *what* – the misstatements and omissions that permitted Morriss to misappropriate investor funds for his personal use. The Complaint also explains the *who* and the *how* of the fraud scheme. First, Morriss created and disseminated the deceptive offering materials, made misstatements to investors regarding how the Investment Entities would use investors' funds, and misappropriated investor funds to finance his extravagant lifestyle. (*Id.*, ¶¶ 13, 19, 20, 21-26, 28, 31). Second, Acartha Group, MIC VII, ATP, and Gryphon Investments each included false and misleading information in their offering documents, transferred investor money to Morriss and Morriss Holdings, and classified the transfers as loans to conceal their impropriety. (*Id.*, ¶¶ 1, 21-28, 30-36, 42-44).

In the second scheme, from 2008 through 2010, Morriss, Acartha Group, MIC VII, and ATP fraudulently diluted the shares of MIC VII investors by adding additional investors without first obtaining existing investors' unanimous consent as the Operating Agreement required. (*Id.*, ¶¶ 37-41). Morriss, Acartha Group, and MIC VII put the scheme in place to cover up Morriss' use of MIC VII funds to satisfy his personal line of credit. As the Complaint alleges in detail, in July 2008, MIC VII obtained a $2.5 million loan from Wachovia, which Morriss personally guaranteed. (*Id.*, ¶ 27). MIC VII used the $2.5 million to acquire stock in a portfolio company on behalf of investors, which MIC VII then sold to ATP for $2.5 million. (*Id.*). Instead of paying back the loan, Morriss took the $2.5 million for personal use, leaving the Wachovia loan unsatisfied. (*Id.*, ¶ 38). In 2010, Morriss, without permission from existing MIC VII investors, recruited new investors to satisfy the outstanding loan. (*Id.*, ¶ 39). Paragraph 40 of the Complaint alleges in detail the complex transactions Morriss, Acartha Group, and MIC VII executed to add new MIC VII investors, unbeknownst to existing investors. (*Id.*,¶ 40). As a result of this fraudulent scheme, Morriss, Acartha Group, and MIC VII diluted the value of existing MIC VII investors' shares. (*Id.*, ¶ 41).

These detailed factual allegations clearly describe the specific role each defendant played in the fraud and provides more than a "reasonable delineation of the underlying acts and transactions allegedly constituting the fraud." *Anderson*, 35 F. Supp. 2d 1369-70. *See also SEC v. Homa*, 99 C 6895, 2000 WL 1100783 at *3-*4 (N.D. Ill. Aug. 4, 2000) (same).

B. The Complaint Does Not Engage In "Shotgun" or "Puzzle" Pleading

Morriss and Morriss Holdings assert the Complaint reflects so-called "shotgun" or "puzzle" pleading. These catch phrases are of no help in analyzing whether a particular complaint meets the applicable pleading requirements. In *Mellette v. Branch*, No. 07-cv-02065-WDM-KMT, 2008 WL 4001044, at *9 (D. Colo. Aug. 26, 2008), the court rejected the defense argument that the complaint was a shotgun or puzzle pleading. The court noted the classic form of a "shotgun" pleading "begins with a long list of general allegations, most of which are immaterial to most of the claims for relief." *Id.* at *8. But the complaint in *Mellette* did not suffer from that problem, because "most, if not all of the general and specific allegations do support the various claims for relief to one degree or another" and repeating general and specific allegations in succeeding claims did not make the complaint defective. *Id.* at *9.

Similarly the Commission's Complaint alleges facts material to the claims for relief, and the incorporation of the factual allegations into each claim does not make the Complaint defective. Indeed, each of the claims for relief sound in fraud, whose elements overlap significantly. *See* Section IV(B)(1) above. Particularly telling is that both Morriss and Morriss Holdings' motions to dismiss attack the causes of action in the Complaint wholesale and do not differentiate between Counts I – VIII. That is because their motions implicitly recognize that all of the allegations form the basis of each of the counts.

In contrast, the cases on which Morriss and Morriss Holdings rely alleged both fraud and non-fraud causes of action, which rested upon separate factual bases. *See, e.g.*, *SEC v. Fraser*, CV-09-00443-PHX-GMS, 2009 WL 2450508 (Aug. 11, 2009) (fraud and record-keeping claims); *SEC v. Mercury Interactive, LLC*, C 07-2822 JF, 2008 WL 454443 (N.D. Cal. Sept. 30, 2008) (fraud, registration, and record-keeping claims); *Wagner v. First Horizon Pharm. Corp.*, 464 F.3d 1273 (11th Cir. 2006) (fraud and registration statement violation claims in PSLRA action). Moreover, unlike the PSLRA complaint in *Wagner*, in which the first 175 paragraphs of the Complaint were not connected to the claims alleged in any particular way, the incorporated factual allegations in the Commission's Complaint relate directly to the claimed misstatements, omissions, and schemes to defraud. In stark contrast, the Commission's Complaint includes 45 paragraphs, which clearly and succinctly detail the factual bases for each of the causes of action.

The Complaint is sufficiently straightforward so that the defendants can answer its allegations. *SEC v. Das*, No. 8:10CV102, 2010 WL 4615336, at *6 (D. Neb. Nov. 4, 2010) (rejecting attack on SEC complaint as being a "shotgun pleading," because the complaint asserted claims against only two defendants and it was not difficult to discern "which . . . act(s) engaged in by which . . . defendant(s) applies to which (if any) claims") (quoting and distinguishing *Fraser*, 2009 WL 2450508, at *13).

The Complaint makes clear which claims are asserted against which defendant. Each claim for relief specifies in its title which defendants are charged. Moreover, as discussed above, the Complaint details in particularity the fraudulent activities of each defendant separately. The Complaint's structure also clearly demarcates the fraud alleged. For example, paragraphs 19-29 allege Morriss' misappropriation of funds from the Investment Entities; paragraphs 30-36 allege each of the defendants' misrepresentations and omissions to investors; paragraphs 37-41 allege Morriss, Acartha Group, and MIC VII's scheme to defraud existing MIC VII investors; and paragraphs 42-45 allege Moriss, Acartha Group, and Gryphon Investments' misstatements and omissions to investors. In short, the Complaint is sufficiently straightforward that defendants are able to answer its allegations.

C. The Commission Properly Alleges The Elements Of Securities Fraud

Both Morriss and Morriss Holdings also claim the Commission has failed to sufficiently allege various elements of securities fraud. Specifically, both argue the Commission has failed to allege: (1) the fraud was "in connection with" the offer, sale, or purchase of securities; (2) the defendants' scienter in committing fraud; and (3) the defendants' false and misleading statements to investors were material. Again, Morriss and Morriss Holdings misstate the law and ignore large swaths of the Complaint in making their claims.

1. *<u>"In Connection With"</u>*

Morris and Morriss Holdings make two arguments relating to whether the fraud alleged constitutes securities fraud. First, they argue that the Commission has failed to sufficiently allege the investment opportunities marketed and sold to investors were, in fact, securities. Second, they argue the Complaint does not include any factual allegations demonstrating the fraud was in connection with the offer, sale, or purchase of a security. Morriss and Morriss Holdings arguments ignore the Complaint's factual allegations and the law

(i) <u>Investments Sold By Defendants Were Securities</u>

The investments the defendants offered and sold were "securities" as defined by Section 2(a)(1) of the Securities Act, Section 3(a)(1) of the Exchange Act, and Section 202(18) of the Advisers Act:[6]

> The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit sharing agreement, . . . , transferable share, investment contract, . . . , or in general, any instrument commonly known as a "security"; . . .[7]

The investment opportunities the defendants offered and sold meet the legal definition of a "security" because Morriss and the Investment Entities offered and sold them as shares in the entities, which entitled investors to receive portions of the entities' carried interest. (*See, e.g.*, DE 1, ¶¶ 13-18, 43). Indeed, Gryphon Investments characterized the investment it offered to investors to be securities. (*Id.*,¶ 43). Gryphon Investments' own characterization of its investment opportunity offering securities is sufficient to characterize them as securities where, as here, there are "no countervailing factors that would [lead] a reasonable person to question this characterization,' of the units as investments." *Diaz Vicente v. Obernauer*, 736 F. Supp. 679, 693 (E.D. Va. 1990) (quoting *Reves v. Ernst & Young*, 494 U.S. 56, 68 (1990).

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6 These sections are substantially identical and lead to the same result for the purpose of this analysis.

7 Section 3(a)(10) of the Exchange Act.

Alternatively, the investment interests Morriss and the Investment Entities offered were investment contracts, and therefore securities. An investment contract is characterized by (1) an investment of money, (2) in a common enterprise, based upon (3) an expectation of profits to be derived from the entrepreneurial or managerial efforts of others. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946); *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975).

The term "investment of money" connotes an arrangement whereby an investor commits assets to an enterprise or venture in such a manner as to subject himself to financial losses. *Stowell v. Ted S. Finkel Investment Services, Inc.*, 489 F. Supp. 1209, 1220 (S.D. Fla. 1980). Here, investors purchased the shares or membership interests with money in hope of reaping future profits through the funds' portfolio company investment decisions. (DE 1, ¶¶ 5-8, 13-17, 43) These shares or membership interests were and continue to be subject to loss based upon the success or failure of the Investment Entities' decisions.

Courts have addressed the "common enterprise" element in terms of both horizontal and vertical commonality, and the circuits are split in their interpretation of this element. Horizontal commonality demands that the fortunes of two or more investors be joined in a pooling of interests. *Wals v. Fox Hills Development Corp.*, 24 F.3d. 1016, 1018 (7th Cir. 1994). Broad vertical commonality requires only a finding that the fortunes of investors are linked to the efforts of the promoter or third parties. *See SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478-479 (5th Cir. 1974). In contrast, narrow vertical commonality requires that the fortunes of investors be interwoven with, and dependent on, the efforts and success of the promoter or third parties. *Brodt v. Bache & Co.*, 595 F.2d 459, 460-61 (9th Cir. 1978). The Eighth Circuit has not adopted a specific "common enterprise" test, requiring district courts to examine the investment contract at issue for either type of commonality. *Top of Iowa Coop. v. Schewe*, 6 F. Supp. 2d 843, 852 (N.D. Iowa 1998).

Here, horizontal commonality exists because the defendants pooled investor funds together to invest in the Investment Entities' underlying portfolio companies. (DE 1, ¶¶ 13-18, 43). As a result, the investors in each of the Investment Entities shared and continue to share in the profits derived (or losses incurred) from any subsequent sale of any of the investments in underlying portfolio companies. *See, e.g, Milnark v. M-S Commodities, Inc.*, 457 F.2d 274, 276-77 (7th Cir. 1972) (holding that pooling of funds along with "joint participation in the same investment enterprise" satisfied the common enterprise requirement); *French v. Essentially Yours Indus., Inc.*, No. 1:07-CV-817, 2008 WL 2065223, at *4-5 (W.D. Mich. May 13, 2008) (holding that profit sharing pool meets horizontal commonality test); *Wuliger v. Eberle*, 414 F. Supp. 2d 814, 821 (N.D. Ohio 2006) (same). In addition, both narrow and broad vertical and commonality exist here because the fortunes of investors in the Investment Entities were and continue to be dependent on the success of Investment Entities and the portfolio companies in generating a profit. (DE 1, ¶ 14-18, 43).

Finally, the third prong of *Howey* is satisfied because investors expected their profits to be determined solely from the entrepreneurial or managerial efforts of Acartha Group, Gryphon Investments, MIC VII, and ATP to locate successful private equity investments. (*Id.*). Courts traditionally look to "the amount of control that the investors retain[ed over their investment] under their written agreements," as well as the actual ability of the investors to manage their investments, in determining whether the investment meets the third prong of the *Howey* test. *SEC v. Unique Fin. Concepts, Inc.*, 196 F.3d 1195, 1201 (11th Cir. 1999). Here, the Defendants had exclusive control over the use of investor funds. (DE 1, ¶ 14-18, 43). Investors relied solely on the efforts of the Defendants to invest their money and generate profits.

(ii) <u>Misstatements And Omissions Were "In Connection With" Sale Of Securities</u>

The federal courts have long adopted a broad interpretation of the "in connection with" language of Section 10(b). *SEC v. Zandford*, 535 U.S. 813, 819-20 (2002). This is in keeping with the Supreme Court's holding that the Exchange Act should be "construed not technically and restrictively, but flexibly to effectuate its remedial purposes." *Id.* at 819 (internal quotation marks omitted). To that end, courts have held that any statement or conduct reasonably calculated to reach or affect the average investor satisfies the "in connection with" requirement of Section 10(b). *Hasho*, 784 F. Supp. at 1106.

This broad interpretation of the "in connection with" language is especially true in actions where the Commission is the plaintiff. *Rana Research, Inc.*, 8 F.3d at 1362. In Commission enforcement actions, the meaning of this language "remains as broad and flexible as is necessary to accomplish the statute's purpose of protecting investors." *Id.* Therefore, conduct that is part of a fraudulent scheme whose result involves securities transactions meets the "in connection with" requirement. *Zandford*, 535 U.S. at 822-23 (reversing Fourth Circuit's dismissal of complaint for failing to meet the "in connection with" test). Moreover, Section 17(a) of the Securities Act does not require showing securities were bought or sold. Fraud in connection with merely offering securities is a violation of the statute.[8]

[8] The cases upon which Morriss relies are clearly distinguishable. (DE 87 at 14-15). First, all of the cases involve private securities actions. For example, in *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1487 (9th Cir. 1991), the Ninth Circuit required that fraudulent conduct must precede investors' purchase of securities when the private plaintiff must allege that the fraud induced them to make the purchase. As discussed above, the Commission, however, need not demonstrate such reliance. Second, the cases all pre-date the Supreme Court's *Zanford* decision, which established a much more broad-based application of the requirement in enforcement actions.

Under this broad standard, the Commission alleges sufficient facts to show the defendants' misstatements, omissions, and schemes to defraud were in connection with the offer, purchase, or sale of securities.

First, the alleged misstatements and omissions relate directly to the offer, sale, and purchase of the securities themselves – the statements were included in the offering and operating agreements discussed above, which the defendants provided to investors. (DE 1, ¶¶ 31-35). Moreover, Morriss made specific misrepresentations in 2008 when marketing Gryphon Investment shares to investors. Specifically, Morriss misrepresented to investors, among other things, Gryphon Investments would only use investor money (received from the sale of the shares) to fund working capital and other business expenditures. (*Id.*, ¶ 43.)

Second, the temporal nature of the misappropriations demonstrates the sufficient nexus between the alleged misstatements and omissions and the offer, purchase, or sale of securities. At the time Morriss and the Investment Entities disseminated the offering and operating agreements to investors – 2005 through 2011 – Morriss and the Investment Entities had already transferred funds from each of the entities to Morriss and Morriss Holdings, for Morriss' personal use. (*Id.*, ¶ 21, 29). In other words, prior to disseminating these documents, Morriss and the Investment Entities knew they were false or misleading.

With respect to Gryphon Investments, the Commission alleges between March 2008 and June 2009, after investors placed their investment, Gryphon Investments transferred those funds almost immediately to Morriss, Morriss Holdings, or to a bank to satisfy interest on Morriss' personal line of credit. (*Id.*, ¶ 44). Similarly, from September 2009 through August 2010, Morriss took at least $1.4 million of new ATP investor funds for his personal use. (*Id.*, ¶ 26).

These actions demonstrate the defendants knew the statements they made to investors about allowed uses of funds were false and misleading.

Contrary to Morriss and Morriss Holding's claims, the misstatements regarding Morriss' misappropriations were not subsequent and unrelated to the offer, purchase, or sale of the securities. The very funds Morriss and the Investment Entities misappropriated were proceeds of the security sales. *See Zanford*, 535 U.S. at 820-21. Indeed, the facts alleged in the Complaint are nearly identical to that in *Zanford*, which involved a stock broker who misappropriated proceeds from the sale of a client's securities without the customer's knowledge or consent. *Id.* at 815. In *Zanford*, the Supreme Court the concluded the defendant's misappropriation of the proceeds of his client's brokerage account satisfied the "in connection with" requirement because the deception to the client coincided with sales of securities. *Id.* at 820-21. Similarly here, the defendants misappropriated investors' funds without their knowledge or consent, and the misappropriation coincided with Morriss' and the Investment Entities' false and misleading statements regarding permitted uses of investor funds. *See id.*

Likewise, the scheme in which Morriss and the Investment Entities fraudulently diluted the shares of existing MIC VII investors through adding additional investors without first obtaining existing investors' unanimous consent also satisfies the "in connection with" requirement. This scheme involved a series of securities transactions, as detailed in Complaint paragraph 40, to conceal from existing MIC VII investors the addition of new investors and the fact that Morriss misappropriated $2.5 million from MIC VII.

2. <u>*The Commission Has Properly Alleged Scienter*</u>

Morriss and Morriss Holdings also contend the Commission fails to allege scienter, which is a required element for claims under Securities Act Section 17(a)(1), Exchange Act

Section 10(b) and Rule 10b-5, and Advisers Act Section 206(1). In doing so, Morriss and Morriss Holdings ignore allegations in the Complaint and misstate the legal standard.

Scienter is the mental state of intending to deceive, manipulate, or defraud. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). The Eighth Circuit has concluded that scienter may be established "(1) from facts demonstrating a mental state embracing intent to deceive, manipulate, or defraud; (2) from conduct which rises to the level of severe recklessness; or (3) from allegations of motive and opportunity." *Detroit Gen. Retirement Sys. v. Medtronic, Inc.*, 621 F.3d 800, 808 (8th Cir. 2010) (citation omitted).

Relying on cases involving private securities fraud litigation, Morriss Holdings incorrectly claims the Commission must allege scienter with specificity. "[U]nlike a private plaintiff who must allege scienter with particularity under the [PSLRA], the SEC may allege scienter generally under the explicit language of Rule 9(b), which states that '[m]alice, intent, knowledge, and other conditions of a persons mind may be alleged generally.'" *Medical Capital Holdings*, 2010 WL 809406, at *3 (quoting *SEC v. Berry*, 580 F. Supp. 2d 911, 920 (N.D. Cal. 2008)). *See also*, *Tiffany*, 535 F. Supp. at 1167 ("The SEC is not under an obligation to plead facts or specifically aver the defendant's state of mind."); *Mercury Interactive*, 2008 WL 454443, at *3 ("[T]he SEC may allege scienter in conclusory fashion.") (citing *SEC v. Levin*, 232 F.R.D. 619, 623 (C.D. Cal. 2005)). Furthermore, the scienter of corporate officers is imputed to the firm for purposes of liability under the securities laws. *SEC v. Blinder, Robinson & Co.*, 542 F. Supp. 468, 476 n.3 (D. Colo. 1982) (citing *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1096-97 n.16-18 (2d Cir. 1972)). Consequently, allegations supporting the intent of Morriss, the CEO of Acartha Group, and as a result, the managing member and partner of the Investment Entities (DE 1, ¶¶ 1-2, 4-8), are imputed to the Investment Entities. *Id.*

The Complaint sufficiently alleges Morriss, and in turn, the Investment Entities, acted with scienter. Starting with the Complaint's first paragraph, the Commission alleges Morriss fraudulently transferred approximately $9.1 million of investor funds to himself for personal use. In doing so, he failed to advise investors he would use their money for such purposes. (DE 1, ¶ 1). The Commission also alleges the Investment Entities disguised the transfers to Morriss as loans and/or receivables. (*Id.*). The Commission alleges further details demonstrating Morriss' and the Investment Entities' scienter. As early as 2005, Morriss knew he was taking funds from Acartha Group and the Investment Entities. (DE 1, ¶ 21). Indeed, by the end of 2009, Morriss knew he owed the Investment Entities approximately $2 million, and by August 2011, $6.6 million (excluding a separate $2.5 million Morriss misappropriated from MIC VII). (*Id.*, ¶¶ 22-28). Morriss used these funds for personal expenditures. (*Id.*, ¶ 29). Morriss took this money knowing (1) doing so was harming the Investment Entities and (2) he could not reimburse the entities due to his deteriorating financial situation. (*Id.*, ¶¶ 23, 25).

Moreover, Morriss knew the Investment Entities' offering and management documents falsely advised investors Morriss could not use investor funds for personal use (*i.e.* loans) or failed to disclose Morriss' intent to do so. (*Id.*, ¶¶ 30-35). In fact, Morriss played a role in creating these documents, which were provided to investors. (*Id.*, ¶ 31). Consequently, Morriss and, as a result the Investment Entities, acted with scienter because he intentionally or acted with serve recklessness in providing false and misleading information to investors regarding the use of their funds.[9]

[9] Morriss' argument the Complaint is contradictory in that it alleges Morriss misappropriated investor funds, but classified such transfers as loans misses the mark. Indeed, Morriss misled investors by advising them he would not use their money for personal expenditures – either as loans or transfers. Moreover, Morriss and the Investment Entities disguised these transfers to Morriss as loans to conceal his misappropriation. (*Id.*, ¶¶ 1, 21-27). The Investment Entities' recording of the transfers as non-collateralized notes, Morriss' repeated failure to satisfy these notes, and his deteriorating finances, all

Similarly, Morriss knowingly misrepresented to investors that Gryphon Investments was the manager for ATP and that it would only use investor funds for working capital and company expenditures. (*Id.*, ¶ 43). Morriss made these statements knowing Acartha Group was actually ATP's manager and, as evidenced by the immediate transfer of investor funds to himself and Morriss Holdings, that he would use Gryphon Investments' investor funds for personal expenditures. (*Id.*, ¶ 44). Moreover, Morriss promised Gryphon Investments investors that their shares were convertible to interests in ATP, even though Morriss did not permit such transfers. (*Id.*, ¶ 45)

Morriss also demonstrated an intent to deceive in his scheme to dilute existing MIC VII investors' interests without their knowledge to satisfy a MIC VII $2.5 million Wachovia loan Morriss utilized for personal use. Neither Morriss nor MIC VII disclosed to investors Morriss' receipt of the $2.5 million loan proceeds. (*Id.*, ¶ 39). Moreover, Morriss deliberately circumvented MIC VII's operating agreement by concocting a fraudulent scheme to admit additional investors into MIC VII without the required unanimous consent of existing investors. (*Id.*). He did this solely to add additional investors to satisfy the $2.5 million Wachovia loan Morriss misappropriated for his own use. (*Id.*, ¶¶ 40-41).

3. <u>The Alleged Misstatements and Omissions Were Material</u>

Morriss and Morriss Holdings also claim the Commission's allegations fail to demonstrate the defendants' false and misleading statements were material. They also argue the defendants had no duty to disclose Morriss used investor funds for personal expenditures. These arguments fail because Morriss and Morriss Holdings ignore the Commission's factual

demonstrate that Morriss knew or was severely reckless in not knowing the impropriety of these transfers, which he could not pay back. (*Id.*, ¶¶ 21, 22-27).

allegations and the applicable legal standard. Moreover, Morriss improperly asks the Court to make factual determinations in resolving a motion to dismiss.

Materiality is a mixed question of fact and law that courts may rarely resolve at the motion to dismiss stage. *In re Amdocs Ltd. Sec. Litig.*, 390 F.3d 542, 547 (8th Cir. 2004) (noting "materiality is generally a question of fact reserved for the jury"); *In re Unicapital Corp. Sec. Litig.*, 149 F. Supp. 2d 1353, 1364 (S.D. Fla. 2001) (declining to dismiss complaint on materiality grounds); *In re Twinlab Corp. Sec. Litig.*, 103 F. Supp. 2d 193, 201 (E.D.N.Y. 2000) (same). A court should not dismiss a complaint on the grounds that statements or omissions are immaterial unless they "are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 162 (2d Cir. 2000).

Even if the Court were to examine, at this early stage, whether the defendants' false and misleading statements were material, case law and common sense demonstrate the Commission has sufficiently alleged materiality. "To fulfill the materiality requirement there must be substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (*quoting TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). Information is material if "a reasonable investor might have considered [it] important in the making of [the investment] decision." *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972).

A reasonable investor would certainly think it was important that Morriss was using investor funds for himself rather than investing it as promised, no matter how the Investment Entities recorded such misappropriations on their books. *SEC v. Mannion*, 789 F. Supp. 2d

1321, 1341 (N.D. Ga. 2011) (holding "a reasonable factfinder could conclude that it is material that the advisors of the Fund used Fund assets for purposes other than for the benefit of the Fund") (citation omitted); *I-Enterprise Co. v. Fraper Fisher Jurvetson Mgmt. Co. V*, C-0301561-MMC, 2005 WL 3590984, at *22 (N.D. Cal. Dec. 30, 2005) ("a reasonable trier of fact could find that an investor would deem it material that fund assets were being used to purchase stock for others at the fund's expense, even if that money was later repaid."); *SEC v. Saltzman*, 127 F. Supp. 2d 660, 666 (E.D. Pa. 2000) (holding allegations of misappropriation of fund assets in violation of partnership agreement are material); *Seeman v. Arthur Anderson & Co.*, 896 F. Supp. 250, 258 (D. Conn. 1995) (holding that misappropriation of funds is material information to investors); *SEC v. White*, 87-6971-CIV, 1988 WL 110014, at *2 (S.D. Fla. Jul. 20, 1988) (holding as material defendant "falsely representing to an investor that funds previously invested would be 'rolled over' at maturity when, in fact, the funds purportedly invested had been misappropriated").

Likewise, the defendants' misrepresentations to investors that new investors could only join MIC VII with the unanimous consent of existing investors were material. MIC VII investors invested in the fund based on the understanding MIC VII could not dilute their shares without their unanimous prior consent. Here, the defendants' actions resulted in the exact opposite. Reasonable investors would want to know that Morriss, Acartha Group, and MIC VII engaged in this dilution scheme because it ultimately decreased their share of potential MIC VII returns.

Morriss' argument that his misappropriation of funds cannot be material to sophisticated private equity investors is both incorrect and an inappropriate factual argument. First, as a matter of law and common sense, no matter how sophisticated the investor, he or she would find it material to know that instead of using their funds for private equity investments as promised, Morriss was using it for personal expenditures. *See I*-Enterprise, 2005 WL 3590984, *22; *Saltzman*, 127 F. Supp. 2d at 666; *Seeman*, 896 F. Supp. at 258; *White*, 1988 WL 110014, at *2. Second, Morriss asks the Court to inappropriately determine at this stage of the case whether the misstatements "are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." *Ganino*, 228 F.3d at 162.

Morriss and Morriss Holdings also contend that, with respect to the alleged omissions, the defendants had no duty to disclose Morriss' misappropriation of investor funds or his scheme to dilute existing MIC VII investors' interest. Their argument ignores the fact that once Morriss and the Investment Entities made representations to investors about the use of investor funds and the power afforded to managing partners/members, the federal securities laws imposed on them the obligation not to mislead investors. "When a corporation does make a disclosure – whether it be voluntary or required – there is a duty to make it complete and accurate." *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 26 (1st Cir. 1987) (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860-61 (2d Cir. 1968)). *See also In re K-tel Intern., Inc. Sec. Litig*, 300 F.3d 881, 898 (8th Cir. 2002) ("A duty arises, however, if there have been inaccurate, incomplete or misleading disclosures . . . even absent a duty to speak, a party who discloses material facts in connection with securities transactions assumes a duty to speak fully and truthfully on those subjects.") (citations and internal quotations omitted). Once the defendants advised investors in their offering and management documents what they could and could not use investor fund for, they were obliged to be complete and accurate. In other words, they were required to advise investors Morriss took investor funds for personal use.

Moreover, as discussed above, Morriss and Morriss Holdings overlook the fact that violations of Section 10(b) and Rule 10b-5, as alleged in the Complaint, are not limited to making false statements. Liability can be established against defendants who participate in a course of conduct or a "device, scheme, or artifice that operates as a fraud on sellers or buyers of securities," even if they do not make a false statement or fail to disclose material information. *Zanford*, 535 U.S. at 819-22. This fraudulent conduct, which gives rise to violations of Rule 10b-5(a) and (c), "creates an independent duty to disclose. Failure to do so thus gives rise to a violation of Rule 10b-5(b)." *SEC v. Santos*, 355 F. Supp. 2d 917, 920 (N.D. Ill. 2003), quoting *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 381-82 (S.D.N.Y. 2003). "[S]ilence that conceals *illegal activity* is therefore intrinsically misleading and (presuming the illegality is also material), is always violative of Rule 10b-5(b)." *Santos*, 355 F. Supp. 2d at 920 (emphasis added) (citing *Initial Public Offering*, 241 F. Supp. 2d at 382). *See also In re Enron Corp. Sec. Litig.*, 529 F. Supp. 2d 644, 739 (S.D. Tex. 2006) (same). Consequently, Morriss and Morriss Holdings duty to disclose argument fails.

D. Investment Advisers Act Claims

Morriss also contends the Commission's Advisers Act claims fail because we do not allege Morriss was an investment adviser. He also argues as to Counts V and VI, which allege violations of Advisers Act Sections 206(1) and 206(2), the Commission fails to allege Morriss defrauded the private equity funds ATP and MIC VII. Again, Morriss' argument ignores the detailed factual allegations in the Complaint.

First, the Commission sufficiently alleges Morriss, Acartha Group, and Gryphon Investments were investment advisers. Section 202(a)(11) of the Advisers Act defines an investment adviser "as any person who, for compensation, engages in the business of advising others … as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." Morriss, Acartha Group, and Gryphon Investments satisfy the definition of "investment adviser" because they received compensation for their investment advice – management fees and a portion of MIC VII's and ATP's profits. (DE 1, ¶¶ 4, 5, 8, 13-17). Moreover, Morriss received additional compensation through the misappropriation of funds described above. Misappropriation of client funds constitutes compensation for purposes of the Advisers Act. *In matter of Alexander V. Stein*, 1995 SEC Lexis 3628, 52 SEC Docket 296, 300 n. 13 (Jun. 8, 1995) (holding that misappropriating investor funds satisfies compensation requirement) (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)). Also, as investment managers, Acartha Group and Gryphon Investments (and Morriss as CEO of Acartha Group) made investment decisions for the MIC VII and ATP funds and reported to investors about the value of their investments. (DE 1, ¶ 14-16). Thus, Morriss, Acartha Group, and Gryphon Investments are subject to the antifraud provision of Section 206 of the Advisers Act.

Second, the Commission has properly alleged Morriss, Acartha Group, and Gryphon Investments violated Advisers Act Sections 206(1) and 206(2), which prohibit investment advisers from, directly or indirectly, employing any device, scheme or artifice to defraud any client or prospective client. In *Goldstein v. SEC*, 451 F.3d 873, 883 (D.C. Cir. 2006), the D.C. Circuit held that "client," as defined by the Advisers Act, includes the funds advisers' manage, but not the funds' underlying shareholders, limited partners, members, or beneficiaries – *i.e.* investors. Consequently, under the Advisers Act, Morriss, Acartha Group, and Gryphon Investments' clients include the private equity funds they managed, MIC VII and ATP. *Id.* at 880; *Mannion*, 789 F. Supp. 2d at 1338. As alleged in the Complaint, Morriss and Acartha Group controlled the ATP and MIC VII funds (DE 1, ¶¶ 4-5, 13-17). Under the Advisers Act, as the funds' investment advisers, Morriss, Acartha Group, and Gryphon Investments owed a fiduciary duty to act for the benefit of the funds. *Transamerica Mortg. Adviser, Inc. v. Lewis*, 444 U.S. 11, 17 (1979). Morriss, through his control of Acartha Group and Gryphon Investments, violated that fiduciary duty to the funds by misappropriating more than $9 million in investor funds for his personal use, harming the funds' financial viability. (DE 1, ¶ 25, 29, 31).

Morriss' argument that ATP and MIC VII cannot be considered "defrauded clients" because they are also named as defendants in other causes of action ignores Morriss, Acartha Group, and Gryphon Investments owed the funds fiduciary duties of care and loyalty, regardless of the activity of those funds. *Transamerica Mortg.*, 444 U.S. at 17. Moreover, as alleged in the Complaint, the funds were merely legal constructs Morriss and Acartha Group created. (*Id.*, ¶¶ 4-5, 14, 17). Morriss controlled all aspects of the funds and directed them to defraud investors, as alleged in the Securities Act and Exchange Act violations.[10] Consequently, the alleged Securities Act and Exchange Act causes of action are consistent with the Section 206(1) and 206(2) Advisers Act claims.

E. Aiding & Abetting

Last, Morriss argues that because the Commission fails to sufficiently allege violations of Exchange Act Section 10(b) and Rule 10b-5 as well as Advisers Act Sections 206(1), 206(2), and 206(4) Counts III, V, and VII, we also fail to allege that Morriss aided and abetted those violations as alleged in Counts IV, VI, and VIII. As discussed in detail above, because Morriss' arguments lack merit, the Court should also reject his arguments as to aiding and abetting.

[10] Morriss does not argue the Complaint fails to allege violations of Advisers Act Section 206(4) and Rule 20694)-8(a)(s) (Counts VII and VIII). Those causes of action are distinct from Sections 206(1) and 206(2), in that they prohibit fraud related to *investors* in pooled investment vehicles (such as private equity funds) not the adviser's clients. *SEC v. Young*, No. 09-1634, 2011 WL 1376045, at *7 n.4 (E.D. Pa. Apr, 12, 2011) (citations omitted).

V. CONCLUSION

For the forgoing reasons, the Commission respectfully requests that the Court deny Morriss and Morriss Holdings' motions to dismiss.

Respectfully submitted,

March 26, 2012 By: s/ Adam L. Schwartz__

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CERTIFICATE OF SERVICE

I hereby certify that on March 26, 2012, I electronically filed the foregoing with the Clerk of the Court by using the CM/ECF system which will send a notice of electronic filing to the following:

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