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UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. JOHN V. BIVONA; SADDLE RIVER ADVISORS, LLC; SRA MANAGEMENT ASSOCIATES, LLC; FRANK GREGORY MAZZOLA, Defendants, and SRA I LLC; SRA II LLC; SRA III LLC; FELIX INVESTMENTS, LLC; MICHELE J. MAZZOLA; ANNE BIVONA; CLEAR SAILING GROUP IV LLC; CLEAR SAILING GROUP V LLC, Relief Defendants.	Case No. 3:16-cv-01386-EMC **PLAINTIFF SECURITIES AND EXCHANGE COMMISSION'S BRIEF IN SUPPORT OF THE PROPOSED AMENDMENTS TO THE JOINT DISTRIBUTION PLAN AND IN OPPOSITION TO THE SRA INVESTOR GROUP'S AMENDED ALTERNATIVE PLAN** Date: October 23, 2018 Time: 1:30 p.m. Courtroom: 5 Judge: Edward M. Chen

TABLE OF AUTHORITIES

PROCEDURAL BACKGROUND

Plaintiff Securities and Exchange Commission ("SEC" or "Commission") hereby submits this Brief in support of the Amended Proposed Joint Distribution Plan ("Amended Joint Plan") and in opposition to the SRA Investor Group's Amended Alternative Plan ("Alternative Plan").[1] The parties are still deadlocked after two meet and confer sessions involving counsel for the Receiver, Investor Group, Global Generation Group, LLC and Progresso Ventures, LLC.

Over a year ago, the Court determined that a pooling of the receivership's assets was necessary due to defendants' commingling. Order Regarding Preliminary Findings Related to Proposed Joint Distribution Plan at 15-17 (Court's findings of extensive commingling that complicates any effort to trace or segregate the shares owned by investors) (ECF 246). The Amended Joint Plan's consolidated *pro rata* distribution adheres to the Court's determination by using all receivership assets to compensate investors. In contrast, the Investor Group's Alternative Plan ignores the Court's determination by limiting investors' distributions to the success or failure of the particular company in which the investor intended to invest. Given defendants' prior fraud and commingling, a receivership controlled by a fiduciary under the Court's continuing supervision remains necessary to continue to gather and distribute receivership assets. Despite this critical need, the Investor Group proposes terminating the receivership and placing former Saddle River Advisors salesperson, Joshua Cilano, in charge of the investors' assets. Their plan is contrary to the Court's admonition that before any former insider could manage assets in this proceeding, the insider would undergo examination of their past conduct and role and would be disqualified if implicated in prior misconduct. ECF 246 at 28.

The Investor Group's plan effectively perpetuates defendants' Ponzi scheme by restoring the status quo ante before the SEC filed this action in March 2016 and by ignoring a fraud that has never

[1] The Amended Joint Plan is Attachment A to this Brief. This Amended Joint Plan is substantially the same as the Amended Plan submitted to the Court on March 15, 2018. When the SEC submitted the Amended Plan in March 2018, the SEC also responded to the Court's questions regarding distribution plans in the February 9, 2018 Minute Order ("February 2018 Minute Order") (ECF 309). ECF 317 at 1-6. The SEC will not repeat its responses to the February 2018 Minute Order, except to explain the Amended Joint Plan.

been factually challenged. As demonstrated below, case precedents and equitable principles support approval of the Amended Joint Plan over the Investor Group's Alternative Plan.

ANALYSIS OF COMPETING DISTRIBUTION PLANS

I. The Court Should Adopt the Amended Joint Plan to Provide *Pro Rata* Distributions to All Investors and Unsecured Creditors.

A. The Law Supports Consolidated *Pro Rata* Distributions Where Assets Are Commingled.

As the Commission previously demonstrated, defendants John Bivona, Saddle River Advisors, LLC and SRA Management Associates, LLC operated the receivership entities like a Ponzi scheme, with the commingling and misappropriating investor money. SEC's Joint Motion at 2-10 (ECF 197); Declaration of M. Monica Ip, CPA (ECF 200). To best rectify the commingling and fraud, the Amended Joint Plan provides for the *pro rata* distribution to receivership investors and creditors from the proceeds of a consolidated pool. The pool comprises the pre-IPO interests held by receivership entities Clear Sailing Group IV, LLC and Clear Sailing Group V, LLC ("Clear Sailing") for the receivership investment funds – i.e., Felix Multi-Opportunity Funds I and II, LLC ("FMOF I and II"), NYPA Funds I and II, LLC ("NYPA I and II") and SRA I, II and III, LLC ("SRA Funds"). Amended Joint Plan at 5. The Amended Joint Plan disallows claims of insiders and any claims made on behalf of insiders. The Amended Joint Plan also terminates management agreements, and disallows claims for management fees and advisory fees. *Id*. at 6-7. This ensures that those who participated in the misconduct and mismanagement of the Receivership entities do not benefit from the distributions resulting from the Receivership assets. *See SEC v. Byers*, 637 F. Supp. 2d 166, 178, 184 (S.D.N.Y. 2009) (approving plan barring payments to insiders due to commingling and fraud).

The Amended Joint Plan's consolidated *pro rata* distribution structure is consistent with precedent involving other equitable receiverships. *See SEC v. Sunwest Management, Inc.*, 2009 U.S. Dist. LEXIS 93181 at *34 (D. Or. Oct. 2, 2009) (authorizing consolidated *pro rata* investor recoveries from a pool of real estate holdings); *SEC. v. Byers*, 637 F. Supp. 2d at 178 (authorizing consolidated *pro rata* investor recoveries from a combined pool of real estate portfolios). In particular, courts use a consolidated pool of assets to repay investors in Ponzi-scheme frauds. *SEC v. Byers*, 637 F. Supp. 2d at 177 (stating that consolidated distribution is appropriate where earlier

investors might have received benefit from later investors' money) (citing *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 89 (2d Cir. 2002)). *Pro rata* distribution is also particularly appropriate where it is difficult to trace investor funds to specific assets, or where recordkeeping is inconsistent, inaccurate, or changed after the fact. *SEC v. Sunwest Management*, 2009 U.S. Dist. LEXIS 93181 at * 28-29.

B. Investors and Unsecured Creditors Should Receive Equal Treatment as Fraud Victims.

The Amended Joint Plan provides that investors and unsecured creditors will receive *pro rata* distributions based upon the net out-of-pocket investments for investors and the debt owed to creditors. Amended Joint Plan at 9 (defining "Unsecured Claims" and "Unsecured Creditor Claims"). Treating investors and unsecured creditors in the same fashion is appropriate because the equities require that "all victims of the fraud be treated equally." *See United States v. Real Property Located at 13328 and 13324 State Highway 75 North*, 89 F.3d 551, 553-54 (9th Cir. 1996) (approving plan to have all investors recover from sale of real property that was purchased with money from a particular investor) (citing *Cunningham v. Brown*, 265 U.S. 1, 12-13 (1924)).

Unsecured creditors Global Generation and Progresso Ventures should receive a distribution for their principal losses on the same *pro rata* basis as the investors. The SEC previously demonstrated that defendants misappropriated Global Generation's and Progresso Ventures' money to carry out their fraudulent scheme in much the same way that they diverted the money of FMOF, NYPA and SRA Fund investors. SEC's Joint Motion at 4-10 (describing initial fraudulent purchase of Palantir Technologies, Inc. shares and then later share shortfalls)(ECF 197). The Amended Joint Plan therefore provides a *pro rata* recovery for Global Generation and Progresso Ventures of their net out of pocket losses even if treated as unsecured creditors by the Court. Global Generation and Progresso Ventures will have the opportunity to recover court-awarded interest and costs after all investors receive their principal back. Amended Joint Plan at 9, 14.

C. The Amended Joint Plan Distributes Assets to All Defrauded Investors.

All of the receivership investors are victims of defendants' fraud and commingling. This is true even where the specific company in which an investor intended to invest failed or declined in value due to unrelated business developments. *See United States v. Wilson*, 659 F.3d 947, 956 (9th

Cir. 2011) ("courts generally will not indulge in tracing when doing so would allow one fraud victim to recover all of his losses at the expense of other victims"). Where commingling exists, the distribution plan should provide all similarly situated investors with an opportunity to submit a claim for a share of the distribution proceeds. *See SEC v. Byers*, 637 F. Supp. 2d at 177 (ruling that *pro rata* plan is appropriate where there is commingling and similarly situated victims).

Although defendants' fraud was pervasive, the Amended Joint Plan recognizes that extraneous business developments might also contribute to an investor's losses. The Amended Joint Plan therefore limits an investor's potential recovery for investments in a pre-IPO company that failed for business reasons, while still assuring every defrauded investor at least a claim to a modest distribution from the receivership estate.

When the receivership is ready to make its initial distributions pursuant to the Amended Joint Plan, the distribution agent will set a "record date" for final claims. Amended Joint Plan at 8. On the record date, claims for investments in companies that have become worthless due to business reasons will be deemed "Rescission Claims," and the principal amount of claims in such failed investments will be reduced to 25% to 30% of the initial gross investments in those failed companies. *Id.* To recover upon a "Rescission Claim," the investor must be a "Rescission Claimant," who is defined to be an investor who holds only failed companies – i.e., Rescission Claims - as of the record date. *Id*. These Rescission Claimants may seek a *pro rata* distribution for their Rescission Claims, which will be 25% to 30% of their initial investments. *Id.* By comparison, investors who have investments in failed companies and in still active companies on the record date may seek a *pro rata* distribution based upon their principal out of pocket investment in the still active companies, but not in any of the failed companies.

This structure assures that every defrauded investor may seek a distribution. Investors whose intended purchases are only failed investments may seek a 25% to 30% *pro rata* recovery on their investments. Investors whose intended purchases are both failed and active companies may seek a *pro rata* recovery on the principal amount of their investment in the active companies. Investors with only still active companies may seek a *pro rata* recovery on the full principal amount of their

investments because all of their investments might still generate a return.[2]

D. An Investment Banker Should Be Retained to Assess Potential Pre-IPO Share Sales and Early Distributions to Opt-out Investors.

The Amended Joint Plan includes the retention of an investment banker: Marc Winthrop and Oxis Capital. An investment banker is needed to advise the Court of the best way to derive value from the receivership's pre-IPO share holdings. Amended Joint Plan at 8. Mr. Winthrop previously submitted a report stating that holdings in some companies should be held in anticipation of potential liquidity events.[3] The Amended Joint Plan provides, based upon input by an investment banker, for the orderly sale of the pre-IPO shares and financial interests held by the receivership entities, which could include holding the pre-IPO shares and financial interests for a period of time to maximize value. Amended Joint Plan at 11. If there are surplus shares for a particular company, or concerns about the future value of a company, the Receiver and the investment banker may, with court approval, negotiate the sale of shares in those companies to provide liquidity for the receivership and raise distribution proceeds.

If the Court authorizes holding the receivership's portfolio of pre-IPO shares and financial interests for a period exceeding two years, the Amended Joint Plan provides that the Court will also create a mechanism for investors and certain creditors to elect an early payment at 25% to 30% of the

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[2] Jawbone, Badgeville, ODesk Corporation, Virtual Instruments and Jumio failed before the receivership began on October 11, 2016. If the holder of those investments is a Rescission Claimant who has no other active investments (or only post-receivership failed investments) on the record date, that holder may seek a 25% to 30% *pro rata* distribution from available assets for their discounted claim. *Id.* Based upon the Claims Validation Summary, the current Rescission Claims for pre-receivership failed companies is $359,257, and the Rescission Claimants for these investments may seek a minimum (25%) claim for $89,814. Similarly, after the receivership began in October 2016, Glam Media, Inc., Practice Fusion, Inc. and Candi Controls, Inc. failed or became essentially worthless. If the holder of these investments has no other active or successful investments on the record date, that holder may submit a Rescission Claim for 25% to 30% of the principal amount of their investments. The total current amount of Rescission Claims for pre- and post-receivership failed companies is $622,659, with total minimum 25% claim of $155,665.

[3] On February 9, 2018, the Court ordered the parties to negotiate the selection and retention of an investment banker. Minute Order dated February 9, 2018 (ECF 309). Mr. Winthrop is prepared to negotiate an arrangement to provide periodic updates of his report. He is also prepared to negotiate an arrangement to negotiate the sale of a portion of the receivership's holdings of pre-IPO shares.

claim amount (depending upon the amount of such claims and the money available to pay such claims). An early payment is not guaranteed, and will only be made if feasible after consultation with a retained financial professional and final court approval of the amounts and payees. *See* Amended Joint Plan at 8, 13 (describing early claim process for "Early Election Claimants").

From the parties' discussions with Mr. Winthrop, the SEC and Receiver understand that it may be feasible to sell a portion of the receivership's portfolio to secondary market investors through an appropriately structured sale. Mr. Winthrop recommended soliciting offers to purchase shares at a particular price for the portion being offered. Mr. Winthrop has provided a fee proposal for such sales that would be acceptable to the SEC and Receiver, if approved by the Court.

E. The Amended Joint Plan Addresses Shortfalls and Authorizes Supplemental Distributions.

The Amended Joint Plan provides flexibility in making distributions. First, it addresses the risk of shortfalls in various pre-IPO companies. As previously described to the Court, if Equity Acquisition Corporation ("EAC") fails to deliver shares owed to the receivership, or if certain parties to forward contracts fail to deliver the shares promised to Clear Sailing, there will be new or additional shortfalls in the shares owed to investors. *See* Order on Shortfall Motion and Investor/Creditor Status at 14-16 (ECF 385). By using a consolidated *pro rata* approach, the Amended Joint Plan authorizes distributions even if the receivership is unable to recover all of the shares owed. Even if the total dollar amount of future distributions is reduced because the receivership cannot recover some shares, the Receiver will still be able to make a *pro rata* distribution using the available proceeds from selling the remaining shares.

In addition, if there is a very successful liquidity event that generates sufficient proceeds to satisfy all of the receivership's administrative, investor and creditor claims, the Amended Joint Plan provides for a discretionary third supplemental distribution of excess proceeds. Amended Joint Plant at 14. For the third distribution, the Receiver may recommend to the Court that the excess proceeds be used to make additional payments to investors in companies that had very successful liquidity events, to pay some or all of the court awarded interest and attorneys' fees for Global Generation and Progresso Ventures and to satisfy unpaid federal or state tax liabilities. *Id.*

Further, the Receiver may recommend, as a matter of fairness, that investors who received reduced distributions as Rescission Claimants, as early opt-out investors, or as investors who held mostly failed investments on the record date should receive some type of additional distribution. The overarching goal of the third distribution, if any, is to provide a flexible mechanism for being fair and reasonable to investors in successful companies, to unsecured judgment creditors such as Global Generation and Progresso Ventures, and to investors who received less than their principal investment amount in earlier distributions.[4]

II. The Court Should Reject the Investor Group's Alternative Plan: It is Not Fair or Reasonable; Eliminates the Receivership's Vital Protections; and Has Tainted Insider Joshua Cilano Taking Control.

A. The Investor Group's Alternative Plan is Neither Fair Nor Reasonable.

For any plan of distribution to be approved, it must be both "fair and reasonable." *SEC v. Wang*, 944 F.2d 80, 85 (2d Cir. 1991) (a court may approve a plan of distribution that is "fair and reasonable"). The Alternative Plan fails to deliver on the first requirement as it denies similarly defrauded investors any opportunity for recovery. The only investors who recover under the Alternative Plan are those who intended to purchase shares in a company that eventually has a liquidity event; all other investors receive nothing. The Alternative Plan gives further life to defendants' Ponzi scheme, and to the rampant commingling, by limiting an investor's distribution to only shares in the particular pre-IPO company in which they believed they invested, ignoring the plain fact that money from other investors was likely used to purchase those shares. The SEC is unaware of a single case approving an unfair distribution structure, such as the Investor Group's Alternative Plan, whereby defrauded investors are deliberately excluded from any recovery from the receivership estate. *See SEC v. Byers*, *supra*, 637 F. Supp. 2d at 176-77 (stating that "pro rata distributions are the most fair and most favored in receivership cases" and that in the event of commingling, a tracing analysis "has been almost universally rejected by courts as inequitable").

The Alternative Plan moreover injects new sources of unfairness by proposing a flawed

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[4] The SEC obtained a $500,000 disgorgement payment from relief defendant Anne Bivona. This amount is being held in a separate account by the Receiver, and the SEC will provide a future recommendation for the use of those segregated funds.

method for handling share shortfalls. In meet and confer exchanges, the Investor Group's counsel indicated that if there was a shortfall in the number of shares for investors in a particular company, those investors would bear all of the losses related to that shortfall. For example, if there was a 25% shortfall in the number of necessary shares for Company X because a forward contract was not honored, then the shortfall would be covered only to the extent of management fees for Company X's shares. Hence, if the management fees constituted 8% of those shares, then investors in Company X's shares would suffer the entire 17% loss in available shares (25% shortfall – 8% management fees) even if such investors were not told that they were investing in risky forward contract shares. As a result, these investors must unfairly bear the entire burden of defendants' fraud.

The Alternative Plan furthermore unfairly limits any recovery by Global Generation, Progresso Ventures and the remaining Square investors to money raised from management fees and any share surpluses. The Alternative Plan proposes to use proceeds from management fees and share surpluses to pay, first, outstanding administrative claims. Any remaining proceeds will then be used to pay, second, expenses for operating the FMOF, NYPA and SRA Funds, including the oversight officer's fees. Only if fees remain after those two categories will Global Generation, Progresso Ventures and the remaining Square investors receive, third, a *pro rata* distribution from the remaining balance of management fees and share surpluses. Because the accumulated management fees might be largely consumed for administrative and management claims, there is a significant risk that Global Generation, Progresso Ventures and remaining Square investors will not receive distributions equal to their *pro rata* share of investor and unsecured creditor losses. By comparison, the Amended Joint Plan provides for *pro rata* distributions on an equal basis. [5]

B. The Receivership Structure is Necessary to Protect Victims and Execute an Equitable Distribution.

On October 11, 2016, the Court approved the Stipulated Order for Appointment of Receiver

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[5] The Investor Group's reliance upon management fees to cover expenses and pay unsecured creditor adds a new level of unfairness. Many investors negotiated reduced management fees and carried interest fees. This means that some investors will pay more than other investors through management fees to cover operating expenses and to compensate unsecured creditors even if defendants defrauded both groups of investors in the same way.

("Receivership Order"). ECF 142. The Receivership Order provides important protections for investors and creditors by staying litigation against the receivership entities to prevent the dissipation and seizure of assets. *Id.* at 9-10. The Order requires quarterly reports from the Receiver and Court approval of all fees paid to the Receiver and to the Receivers' professionals. *Id.* at 13-16. The Court appointed a Receiver who answers to the Court and owes a fiduciary duty to investors, creditors and the receivership estate. *E.g.*, *Quilling v. Trade Partners, Inc.*, 2006 WL 1134227 at *1 (W.D. Mich. April 26, 2006). The Receiver gathers, preserves and manages assets by and for the receivership estate. Receivership Order at 2-4. As part of its duties, the Receiver can propose and implement a distribution plan under the supervision of the Court, and may prosecute and defend claims on the receivership's behalf. *Id.* at 11-12, 13.[6]

However, the Investor Group proposes to terminate the receivership and to have defendants' insider, Joshua Cilano, operate and manage the receivership estate assets without the protections of a Receiver and the Receivership Order. By terminating the receivership prematurely, the Investor Group's proposal ignores the actions by former management that resulted in the appointment of the Receiver, including the prior mismanagement and poor record keeping. Indeed, their proposal returns the investments to the status quo pre-receivership, complete with a former employee at the helm. Further, the proposed premature termination of the receivership ignores the continued need for the protections under the Court's Receivership Order including the stay of litigation against the receivership and the Receiver's pursuit of actions that will benefit the receivership estate.[7]

C. Tainted Insider, Joshua Cilano, Should Be Disqualified From Taking Control.

An independent reason for rejecting the Alternative Plan is its choice of leader: tainted,

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[6] Except for selling shares that are publicly traded, the Receiver may not dispose of assets without the Court's approval. *Id.* at 10.

[7] If the stay were terminated, investors and creditors might file claims and seek to attach assets in the possession of the Funds or Clear Sailing, thereby creating a rush to the courthouse. During the second meet and confer session regarding the amended plans, the Investor Group's only stated reason for terminating the receivership was its objection to Sherwood Partners' performance as a receiver. The SEC then asked the Investor Group whether it would agree to keep the Receivership Order in place if the Court were to select a new receiver to replace Sherwood Partners. The Investor Group subsequently advised all counsel that it would still seek to end the receivership, and this response renders disingenuous the Investor Group's stated reason for terminating the receivership.

conflicted insider, Joshua Cilano, who has already profited handsomely from defendant Saddle River Advisors' fraud and stands to reap outsized additional unjustified profits if the Court adopts the Alternative Plan. Mr. Cilano, the second largest salesperson for Saddle River Advisors, sold pre-IPO shares to investors from mid-2014 through 2015, while receiving $674,634 in commissions. SEC Reply in Support of Joint Distribution Plan at 2 (ECF 238); Supporting Declaration of M. Monica Ip at ¶¶ 1-6 and Ex. 1 (ECF 239); Supporting Declaration of John S. Yun at Ex. 3 (ECF 240).

More than a year ago, the Court granted the SEC's and Receiver's request to exclude insiders from the receivership recovery. Order Regarding Preliminary Findings Related to Proposed Joint Distribution Plan at 28 (ECF 246). In language that is eerily reminiscent of Mr. Cilano's position here, the Court cited an Eleventh Circuit decision that affirmed the exclusion of a sales agent who had '"put a great deal of effort into promoting and marketing [defendant's] products' and who had "received at least $660,000 in commissions' based on his role." ECF 246 at 24 (quoting *SEC v. Pension Fund of Am. L.C.*, 377 Fed. Appx. 957, 963 (11th Cir. May 6, 2010)). This Court further noted that equity required denying the claims because it would be "inconsistent with the equitable distribution" to reduce the total potential recovery of the [victims] by compensating a former [sales agent] . . . in furtherance of the fraudulent scheme that caused the losses at issue." *Id.* Accordingly, because of his role as a lead salesperson for Saddle River Advisors during the fraudulent scheme, it is doubtful that Joshua Cilano would ever be permitted to recover any money from the receivership on top of the approximately $675,000 in commissions that he previously received. Any person barred from recovery because of his role with the fraudulent enterprise is likewise disqualified from running the day-to-day operations of what remains of that enterprise.

Compounding the impropriety of placing Mr. Cilano at the helm is his proposed sweetheart compensation package, which disregards the fraud on investors and provides Mr. Cilano with a path for additional windfall profits. Mr. Cilano should not be compensated through management fees that were agreed to by investors and claimed by defendants and insiders as part of the fraudulent scheme. *See SEC v. Byers*, *supra*, 637 F. Supp. 2d at 178, 184 (distribution plan barred payments to insiders). Further, Cilano seeks to be compensated without showing that he performed actual services meriting fees, and without seeking court approval. In addition, Mr. Cilano previously declared that "receipt of

the applicable management fees on a going forward basis will allow me to satisfy the SRA Funds' broker obligations that remain outstanding." Declaration of Joshua Cilano at ¶ 18 (ECF 251-1). Mr. Cilano's statement is not consistent with an impartial fiduciary's. Instead, Mr. Cilano leaves open the possibility that he will share future fees with insiders who should receive nothing from the receivership or that he has undisclosed conflicts of interests.

The Investor Group's eleventh-hour proposal to add another layer of oversight does not solve the problems associated with appointing Mr. Cilano as the new manager. The Investor Group adds unnecessary administrative costs by proposing Ms. Susan Uecker as an oversight officer, and thereby tacitly admits that Mr. Cilano is conflicted. Ms. Uecker's limited duties under the Alternative Plan would, in any event, prevent her from providing the necessary oversight. Her duties only include reporting twice a year to the Court and approving or signing checks. Moreover, the Investor Group proposes operating the Funds pursuant to the former management and operating agreements, but Ms. Uecker does not have any experience operating an investment advisory firm or pooled investment fund, and has not served in a compliance or legal capacity with a broker-dealer or investment adviser. Rather than mitigate Mr. Cilano's conflicts of interest, the proposed additional layer would only waste receivership assets. In any event, selection of any new manager or oversight officer should be through an open and transparent judicial approval process.

CONCLUSION

For the foregoing reasons, the Court should adopt the Receiver's and the SEC's Amended Joint Plan and reject the Investor Group's Alternative Plan.

Dated: September 28, 2018

Respectfully submitted,

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