BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. William B. Fretz, Jr. Souderton, PA, John P. Freeman Newtown, PA, and The Keystone Equities Group, LP Oaks, PA, Respondents.	DECISION Complaint No. 2010024889501 Dated: December 17, 2015

Respondents William B. Fretz, Jr. and John P. Freeman engaged in business-related conduct that is inconsistent with just and equitable principles of trade, in violation of NASD Rule 2110 and FINRA Rule 2010. Respondents Fretz, Freeman, and the Keystone Equities Group, LP provided misleading information to FINRA, in violation of FINRA Rules 8210 and 2010. Respondent Fretz filed a false Form U4 and failed to update his Form U4, in violation of FINRA Rules 1122 and 2010 and Article V, Section 2 of FINRA's By-Laws. Held, findings and sanctions modified.

Appearances

For the Complainant: Leo F. Orenstein, Esq., Paul M. Schindler, Esq., Jennifer J. Schulp, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondents: Jon-Jorge Aras, Esq., William Uchimoto, Esq.

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Decision

Respondents William B. Fretz, Jr., John P. Freeman, and the Keystone Equities Group, LP ("Keystone" and together, with Fretz and Freeman, "Respondents") appeal a May 30, 2013 Extended Hearing Panel decision pursuant to FINRA Rule 9311. The Extended Hearing Panel found that Fretz and Freeman misused customer funds, made material misrepresentations, and failed to disclose material facts to investors. The Extended Hearing Panel further found that Fretz, Freeman, and Keystone provided misleading information to FINRA during its investigation, and that Fretz willfully filed a false Uniform Application for Securities Industry Registration or Transfer ("Form U4") and failed to amend his Form U4. For their misconduct, the Extended Hearing Panel imposed three separate bars on Fretz and Freeman from associating with any FINRA member in any capacity and fined Keystone $25,000.

The key issue here is whether there has been a violation of just and equitable principles of trade based on Fretz's and Freeman's violation of the fiduciary duties they took on as managers of a private investment fund. We agree with the Extended Hearing Panel's findings of fact. Fretz and Freeman had fiduciary duties to the investors in a private investment fund for which they acted as managers. They violated their fiduciary duties by using the fund's assets to make self-interested loans instead of buying equities, overvalued their contributions to the fund, and loaned money to their struggling broker-dealer to keep it in business.

FINRA Rule 2010 and NASD Rule 2110 impose ethical standards on all FINRA members and associated persons. We find that Fretz and Freeman were entrusted with the money of investors in a private fund and that each breached his fiduciary duty to those investors in misusing that fund's assets. Individuals entrusted to handle investor funds that knowingly mishandle those funds—whether in the context of a broker-dealer business, an asset management context, or in any other business or like relationship—act in a manner wholly inconsistent with FINRA's rules relating to just and equitable principles of trade. We find that Fretz and Freeman acted in precisely this manner and that these acts constitute violations of FINRA's just and equitable principles of trade rule.

I. Background

A. Respondents

Keystone was a privately held broker-dealer and was a FINRA member from 2003 to 2013.[1] During the period from January 2008 to December 2010, it operated one branch office in Oaks, Pennsylvania, and employed approximately five registered representatives, including Fretz and Freeman. Keystone's primary business was providing investment banking services for small and mid-size companies, including raising capital through debt and equity offerings and advising

1 Keystone's FINRA membership was terminated on August 12, 2013 for the failure to pay outstanding fees.

on mergers and acquisitions. Fretz served as Keystone's president, and Freeman served as a director. Keystone's Central Registration Depository ("CRD"®) report identifies only Fretz and Freeman as "direct owners and executive officers of Keystone."

Keystone is owned by Keystone General Partners, Inc., Keystone's general partner and one percent owner, and Keystone Group Holdings, LP ("Keystone Holdings"), Keystone's limited partner and 99 percent owner. Fretz and Freeman each have a 12 to 16 percent ownership interest in Keystone Holdings, along with four other individuals. Keystone is Keystone Holdings' only asset. Keystone had net losses of $644,211 in 2008; $546,543 in 2009; $599,944 in 2010; and $110,827 in 2011. Keystone's audited financial statements for 2010 reflected that its losses raised "substantial concerns about [its] ability to continue as a going concern."

Fretz joined the securities industry in 1987 and began working for Keystone in 2003. At Keystone, he was registered as a general securities representative, general securities principal, equity trader limited representative, financial and operations principal, investment banking limited representative, registered options principal, and general securities sales supervisor.[2] During the relevant period, Fretz had ownership interests in businesses other than Keystone, including Bones Grill (a restaurant), Kelly Builders (a construction company), Star Wine (a wine reviewing competition), 189 Main Street (a commercial property), and KI Real Estate (a commercial real estate company).

Freeman also joined the securities industry in 1987 and began working for Keystone in 2003. At Keystone, he was registered as a general securities representative and investment banking limited representative.[3]

B. Covenant Partners, LP

Covenant Partners, LP ("Covenant") is a private investment limited partnership founded by Fretz and Freeman in 1996 and controlled by Fretz and Freeman throughout the relevant period. Fretz and Freeman describe Covenant as a private equity firm or hedge fund. During the relevant period, Covenant had less than 50 limited partners or investors, including Fretz and Freeman. Most of the investors were friends or family of Fretz and Freeman.

The general partner of Covenant is Covenant Capital Management Partners, LP ("Covenant Capital" or "General Partner"), which has sole responsibility for the management of Covenant's business and investments. The general partner of Covenant Capital is CCM, Inc. ("CCM"), and the limited partners are Fretz and Freeman. Fretz and Freeman each own a 49.5 percent limited partnership interest and CCM owns a one percent interest in Covenant Capital.

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2 Fretz is not currently registered with a FINRA member firm.

3 Freeman is not currently registered with a FINRA member firm.

Freeman is the President and CEO of CCM, and Fretz is a director of CCM.

Covenant was a brokerage customer of Keystone during the relevant period, with Fretz as Covenant's broker of record. Eleven of Covenant's investors also held their Covenant investment in retirement accounts at Keystone. Some Covenant investors also had other brokerage accounts at Keystone.

Covenant was listed as an "affiliate" in Keystone's audited financial statements filed with the Commission and identified as an "Affiliate and Business Partner" on Keystone's website. Covenant and Keystone also shared office space and staff. During the relevant period, Covenant's office address was the same as Keystone's, and Covenant maintained its physical records within the Keystone branch. Fretz used Keystone's email system to communicate with Covenant investors. Barbara Shaffer, an employee and associated person of Keystone, also maintained some of Covenant's books and records, including a check register and a checkbook, and performed administrative tasks on behalf of Covenant, such as preparing promissory notes and communicating with Covenant investors.

II. Procedural History

On August 5, 2011, the Department of Enforcement ("Enforcement") filed the underlying five-cause complaint against Respondents. Enforcement alleged that Fretz and Freeman made improper use of Covenant funds and engaged in unethical conduct, in violation of NASD Rule 2330(a), FINRA Rule 2150(a), NASD Rule 2110, and FINRA Rule 2010. Second, Enforcement also alleged that Fretz and Freeman made misrepresentations and omitted material facts to Covenant investors, in violation of NASD Rule 2110 and FINRA Rule 2010, and that Fretz, Freeman, and Keystone made misleading statements to FINRA, in violation of FINRA Rules 8210 and 2010. Finally, Enforcement alleged that Fretz willfully filed a false Form U4 and failed to amend his Form U4, in violation of FINRA Rules 2010 and 1122 and Article V, Section 2 of FINRA's By-Laws.[4]

After a five-day hearing, the Extended Hearing Panel issued its decision on May 30, 2013. For misusing customer funds and making material misrepresentations, the Extended Hearing Panel barred Fretz and Freeman from associating with any FINRA member firm in any capacity. For providing misleading statements to FINRA, the Extended Hearing Panel imposed additional bars on Fretz and Freeman and fined Keystone $25,000. For his Form U4 violations, the Extended Hearing Panel assessed, but did not impose, a two-year suspension in all capacities and a $50,000 fine against Fretz.

Respondents appealed the Extended Hearing Panel's decision.

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[4] The complaint also alleged that Keystone's brokerage statements were misleading, in violation of NASD Rule 2110 and FINRA Rule 2010. The Extended Hearing Panel dismissed this cause of action.

III. Discussion

A. Fretz and Freeman Engaged in Unethical Conduct

Enforcement alleged various ways in which Fretz and Freeman misused Covenant funds, which Enforcement argued was an improper use of customer funds that violated NASD Rules 2330(a) and 2110 and FINRA Rules 2150(a) and 2010. The Extended Hearing Panel agreed. We modify these findings. While we agree with the Extended Hearing Panel's findings of fact, because we find that Fretz and Freeman engaged in unethical conduct as alleged in the complaint in violation of NASD Rule 2110 and FINRA Rule 2010, we do not further discuss whether the same misconduct also violates NASD Rule 2330(a) and FINRA Rule 2150(a).

NASD Conduct Rule 2110 and FINRA Rule 2010 require members, "in the conduct of [their] business, [to] observe high standards of commercial honor and just and equitable principles of trade."[5] "This general ethical standard . . . is broader and provides more flexibility than prescriptive regulations and legal requirements. NASD Rule 2110 [and FINRA Rule 2010] protect[] investors and the securities industry from dishonest practices that are unfair to investors or hinder the functioning of a free and open market, even though those practices may not be illegal or violate a specific rule or regulation." *Steven Robert Tomlinson*, Exchange Act Release No. 73825, 2014 SEC LEXIS 4908, at *16 n.15 (Dec. 11, 2014). Liability under the rule extends to misconduct related to the business of the member or associated person. *See, e.g., Vail v. SEC*, 101 F.3d 37 (5th Cir. 1966) (affirming registered representative's liability under the predecessor to NASD Rule 2110 for misappropriating funds from the bank account of a political club, of which he was the treasurer). FINRA's just and equitable conduct rule "applies when . . . misconduct reflects on [an] associated person's ability to comply with the regulatory requirements of the securities business and to fulfill his fiduciary duties in handling other people's money." *Daniel E. Manoff*, 55 S.E.C. 1155, 1162 (2002).

For the reasons discussed below, we conclude that Fretz and Freeman, as fiduciaries of Covenant, engaged in business-related misconduct that was inconsistent with just and equitable principles of trade and thus violated NASD Rule 2110 and FINRA Rule 2010.

1. Covenant's Governing Documents

Covenant investors each received a copy of Covenant's Offering Circular and Limited Partnership Agreement. The Offering Circular provides that "[t]he net proceeds of this offering . . . will be invested in securities and other intangible investment instruments." In the "Use of Proceeds" section, it states that offerings "will be invested in securities and otherwise applied to

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[5] FINRA Rule 2010 replaced NASD Rule 2110 on December 15, 2008. *See FINRA Regulatory Notice 08-57*, 2008 FINRA LEXIS 50, at *32-33 (Oct. 2008). NASD Rule 2110 and FINRA Rule 2010 are applicable to associated persons pursuant to NASD Rule 0115(a).

the business and expenses of the Partnership, including management fees to the General Partner, accounting and legal fees and other operating expenses." The Limited Partnership Agreement similarly provides that "[t]he purpose and business of the Partnership generally is to [invest] in Securities and Commodity Interests" and engage in any activity incidental to such investments.

In the section titled "Fiduciary Duties of General Partner," the Offering Circular states that "[a] general partner is accountable to a limited partnership as a fiduciary and consequently must exercise good faith and integrity in handling partnership affairs." In the section titled "Conflicts of Interest," the Offering Circular acknowledges that the General Partner, Fretz, and Freeman may be affected by certain conflicts of interest, but provides that "the General Partner and its Affiliates will take appropriate measures to assure that none of them will unfairly profit from any transaction between any of them and [Covenant]."[6]

2. Covenant's Transfers to Fretz, Freeman, and Their Business Entities

In early 2008, most of Covenant's funds were invested in two direct marketing startups: (1) IXI Corporation ("IXI"), a privately-held data marketing company; and (2) PetFood Direct ("PetFood"), an online seller of pet supplies. From 2008 to 2010, Covenant received approximately $10 million from various sources, including the sale of IXI stock holdings in late October 2009, new investors, loans from third parties, and contributions from Fretz, Freeman, and entities in which they had an interest. Covenant disbursed roughly as much as it took in during this period. Approximately $300,000 was invested in equity investments, $900,000 was used to make arms-length transactions to third parties, and $3.3 million was used to pay off debt, make distributions to investors, and pay professional fees. The remaining funds—approximately $5.4 million gross ($4 million net)—were transferred to Fretz, Freeman, and entities in which they had an interest, including Keystone and Keystone Holdings.[7]

We find that Fretz and Freeman, in their capacity as Covenant's General Partner, characterized transfers from Covenant to themselves and their businesses as loans or distributions in an opportunistic fashion that benefited them to the detriment of Covenant and its investors. Their characterizations disregarded the actual substance of the transfers and changed over time to maximize their personal benefit. We review various transfers that Fretz and Freeman caused Covenant to make to Fretz, Freeman, and Keystone below.

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[6] At the hearing, Fretz and Freeman acknowledged that they had fiduciary obligations to spend Covenant's money for the benefit of investors and to not unfairly profit in their dealings with Covenant.

[7] Respondents acknowledged each of the 188 transfers, including the date, amount transferred, and to whom the transfer was made, that comprised the $5.4 million.

a. Fretz's Use of Account No. 14224

Fretz maintained two personal accounts at Covenant – Account No. 30015, his Covenant capital account, and Account No. 14224, which was titled "Notes Receivable – Bill Fretz." From April 2008 through November 2009, Fretz transferred a total of $2,489,874 from Covenant to himself and his businesses, including Keystone, through Account No. 14224. At the time, Covenant was paying high interest rates on existing debts and borrowing new money at high interest rates. Fretz and Freeman changed the accounting treatment of the transfers from Covenant to Fretz and his businesses, depending on what characterization was most advantageous at the time.

While none of the transfers were evidenced by a promissory note and no interest accrued on Covenant's books and records, Fretz caused the transactions to be characterized as loans at the time they were made. By doing so, Fretz was able to withdraw money from Covenant without diluting his capital account. Thus, when Covenant sold its IXI stock in late October 2009 for a substantial profit, Fretz's capital account was allegedly worth approximately $1.6 million due to his characterization of the transfers as loans rather than approximately $480,000, which would have been the value had the transfers been treated as distributions. Accordingly, when Covenant allocated profits at the end of 2009, Fretz received $600,000 more than the $263,000 he was entitled to had the transfers been accounted for as distributions. Moreover, if the transfers had been accounted for as distributions, Fretz's capital account would have been negative from October 2009 through the remainder of the relevant period.

The record supports Enforcement's contention that Fretz's and Freeman's evolving characterizations of the transfers was intentional. In November 2009, Fretz emailed his accountants, "I didn't take any distributions, only loans from [Covenant] in 2008-2009. I will try to pay off that number before the end of 2009."[8] A year later, in December 2010, Fretz directed his accountants to characterize the transfers as distributions but only after Covenant had allocated the profit from the IXI stock sale: "The money out to me and my related entities all year [2009] needs to be distributions. Because I do want (and need) the IXI profit please take all distributions out as of 10/31/09." At the hearing, Fretz asserted that the transfers from Covenant to Keystone were "all loans," and the transfers to himself and his business were all distributions. He insisted, "Anything to me or my entities, they were not loans. I did not borrow any money from Covenant at all."

As president and general partner of Covenant, Freeman approved the transfers from Covenant to Keystone. In on-the-record testimony in November 2009, Freeman testified that transfers from Covenant to Keystone were distributions to Fretz from his capital account. At the

[8] Two months earlier, however, in response to a FINRA Rule 8210 request, Fretz and Freeman told FINRA that Fretz took a $50,000 distribution from his Covenant capital account on April 29, 2009. We discuss these inconsistencies in more detail as they relate to the third cause of action in Section C.

hearing, however, Freeman testified, "[a]t the time, it was a due from in 2008. And then it became classified as a loan from Covenant to Keystone." Freeman explained that "due from" is "a term that our accountant uses essentially as a placeholder until [the transaction is] classified." He continued, "I think originally, I thought that they were distributions, but they were classified as a due from and then, after consultation with our [accountant], became a loan."

As Enforcement's expert forensic accountant testified, "[A]t the time that money comes out, it's either a loan or distribution. You can't [on] one hand say for the next three months I'm going to call it a distribution, then I'm going to morph it into a loan or vice versa." We, like the Extended Hearing Panel, find Enforcement's expert credible and his testimony persuasive. The record substantiates that $2,489,874 in transfers from Covenant in 2008 and 2009 to Fretz were not bona fide loans. As Enforcement's expert testified, whether a loan is bona fide is determined by objective indicia. Here, the transfers did not bear any traditional trappings of a loan: there was no promissory note, rate of interest, repayment terms, or security.

Moreover, the record conclusively shows that Fretz and Freeman transferred funds from Covenant to Fretz for his personal and business interests, and Fretz unfairly profited as a result. By transferring the money to Fretz, Fretz and Freeman breached their fiduciary duty owed to Covenant investors, and thereby engaged in business-related conduct that is inconsistent with just and equitable principles of trade in violation of NASD Rule 2110 and FINRA Rule 2010.

b. Freeman's Use of the Covenant General Partner Account

During the relevant period, Freeman maintained a balance of less than $10,000 in his Covenant capital account and made no withdrawals from it. In 2008 and 2009, however, Fretz and Freeman transferred approximately $700,000 from Covenant's brokerage and bank accounts to Freeman. They accounted for the transfers as debits to the capital account of the General Partner.

As of January 1, 2008, the General Partner's capital account had a balance of $129,624. By the end of 2009, Fretz and Freeman had transferred $698,471 from the account, including $35,902 in earned management fees, to Freeman, leaving the account with a negative balance of $532,945. At the hearing, Freeman testified that the transfers were redemptions from the General Partner's account.[9] Freeman acknowledged that Covenant borrowed money to fund some of the withdrawals he made. He further testified that, at the time he took these redemptions, he did not "specifically" know how much equity was in the General Partner's account, but he would not want to disburse more than what was in the account because that "would be more than what I was – than I had access to." He testified that, prior to taking money

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9 Freeman's testimony is corroborated by other evidence in the record. Covenant's records also do not provide that the transfers were loans nor do the transfers bear the typical indicia of loans.

from the General Partner's account, he would confer with Fretz, who "was more familiar with the day-to-day accounting of the fund," to confirm that adequate funds were available to support the withdrawal.

Yet the Limited Partnership Agreement prohibited the General Partner from maintaining a negative balance in the General Partner's account.[10] By transferring the money to Freeman, Fretz and Freeman breached their fiduciary duties to Covenant investors, and engaged in business-related conduct that is inconsistent with just and equitable principles of trade in violation of NASD Rule 2110 and FINRA Rule 2010.[11]

c. Covenant's $1.4 Million "Loan" to Keystone

While Fretz and Freeman were transferring funds from Covenant to Keystone, Keystone was struggling to remain afloat. It sustained repeated yearly net losses, and its audited financial statements for 2010 contained a "going concern" clause, indicating the auditors' doubts about Keystone's ability to remain in business. Despite Keystone's precarious financial situation, Fretz and Freeman nonetheless transferred substantial amounts from Covenant to Keystone, both directly and through Keystone Holdings. In all, Fretz and Freeman disbursed $1,178,058 from Covenant's bank and brokerage accounts to Keystone, the majority of which came from Covenant's brokerage account. Shaffer initially characterized these transfers as loans in her check register, but these alleged loans were never formally memorialized. There was no written documentation of the loans, and no rate of interest, repayment schedule, or security or collateral for the supposed loans.

In about April 2011, Fretz and Freeman caused Keystone Holdings to execute a promissory note from Keystone Holdings to Covenant in the amount of $1,410,573. The note was falsely dated December 31, 2010, more than three months before it was actually executed. It provided that principal and interest at 10 percent were due at maturity of the note on December 31, 2012. At the hearing, Freeman testified that the $1.4 million note was created to "document" some of the funds that Freeman and Fretz "were lending to Keystone Equities from Covenant Partners." Freeman also testified he did not know why the note was dated December 31, 2010 when it was created more than three months later.

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10 Specifically, the Limited Partnership Agreement provides that the General Partner's aggregate capital balance will not be less than one percent of the sums of the capital account balances of all limited partners.

11 The Offering Circular and the Limited Partnership Agreement also vest responsibility for Covenant's books and records with the General Partner, and the Limited Partnership Agreement explicitly requires Covenant Capital to make a full accounting and to prepare "audited financial statements" at the end of each fiscal year. It is undisputed that Covenant did not prepare audited financial statements for 2008, 2009, and 2010.

We agree with the Extended Hearing Panel that the $1.4 million note was an "afterthought," and "[t]he circumstances of the creation of the note and the absence of a reasonable explanation for its being post-dated cast serious doubt on Respondents' claim that the note accurately accounts for $1.4 million in transfers to Keystone." The note was created 16 months after some of the transfers, and it was executed at a time when Keystone had a "going concern" clause in its most recent audited financial statements. Moreover, Fretz and Freeman previously described some of the transfers allegedly covered by the note as disbursements when it suited their needs. Not only were Fretz and Freeman unable to offer a reasonable explanation for the timing of the creation of the note, they also were unable to explain why a $1.4 million transfer from Covenant to Keystone Holdings in April 2011, an entity whose only asset was a financially ailing broker-dealer, was in the interests of Covenant investors.

We find that Fretz and Freeman took money out of Covenant to bolster their financially ailing broker-dealer, and there is no evidence that a $1.4 million loan was a good investment for Covenant investors. By transferring the money, Fretz and Freeman breached their fiduciary duties to Covenant investors, and, accordingly, engaged in business-related conduct that is inconsistent with just and equitable principles of trade in violation of NASD Rule 2110 and FINRA Rule 2010.

d. Covenant's Operating Documents Did Not Permit Fretz's and Freeman's Use of Funds

On appeal, Respondents argue that they did not misuse Covenant funds because Fretz and Freeman's actions were consistent with and expressly authorized by Covenant's controlling documents. We disagree.

Respondents argue that the Limited Partnership Agreement "expressly authorizes Respondents to engage in lending and borrowing for Covenant, as well as the ability to pursue a wide array of other investment strategies." They also note that Covenant's Offering Circular provides that its proceeds "will be invested in securities and *otherwise applied to the business and expenses* of the Partnership, including management fees to the General Partner, accounting and legal fees and *other operating costs*" (emphasis in Respondents' brief). The Limited Partnership Agreement, however, expressly limits the General Partner's ability to engage in lending and borrowing to that "incidental" to dealing in securities and commodity interests. From 2008 to 2010, Covenant transferred approximately $5.4 million ($4 million net) to Fretz, Freeman, and their businesses, including the $1.4 million "loan" to Keystone. These transfers cannot be characterized as "incidental," particularly where neither Fretz nor Freeman can explain how these transfers were justifiable expenses or operating costs of Covenant.

Consistent with Covenant's controlling documents, Covenant investor BN testified that he understood that Covenant was investing solely in private companies, like IXI and PetFood. Fretz and Freeman never told BN that Covenant made investments in or loans to entities in which Fretz and Freeman had an interest or loans to Fretz and

Freeman themselves. Although he testified that he probably would not have been concerned if Covenant was lending less than five percent of its portfolio to entities in which Fretz had an interest, when told that more than 50 percent of the money flowing out of Covenant from 2008 to 2010 went to Fretz, Freeman, and their entities, BN said he would be "concerned a lot" and reiterated that he thought that Covenant was "investing purely into these private companies." BN also testified that he did not know that Covenant was lending money to other entities, and noted it was not good investing to loan money at 10 percent while borrowing at substantially higher rates. Other Covenant investors, GW and LF, testified that they, too, were unaware that Fretz and Freeman borrowed money from Covenant for themselves, Keystone, or other business interests.

Respondents' argument on appeal also ignores the "Conflicts of Interest" section of the Offering Circular, which provides that "the General Partner and its Affiliates will take appropriate measures to assure that none of them will unfairly profit from any transaction between any of them and [Covenant]." Both Fretz and Freeman conceded that their fiduciary responsibilities required them to exercise their authority as General Partner for the benefit of Covenant and its investors. Notwithstanding these obligations, when funds were deposited into Covenant, Fretz and Freeman often immediately disbursed money to themselves or entities in which they had an interest, including Keystone. Freeman acknowledged that Covenant did not always seek liquidity for the purpose of benefitting Covenant investors. Covenant obtained some of its funds by borrowing at high interest, and then often would immediately transfer money to Fretz, Freeman, or Fretz's businesses.[12] When asked how it was in the interest of Covenant's investors to borrow money at high interest rates to fund payments to Fretz and Freeman, Freeman testified, "[i]t was in Covenant's best interest because we provided a lot of value to our limited partners and, from time to time, [Covenant] needed liquidity in to satisfy certain things."

We find that Respondents have not offered, and the record does not provide, any credible business justification for the transfer of substantial sums to Fretz, Freeman, and their businesses when the General Partner was obligated to invest the money for the benefit of Covenant investors. Keystone, however, had a dire need for additional money and Fretz and Freeman chose their financial interests over their fiduciary duty to Covenant.

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[12] Freeman acknowledged that Covenant, at times, borrowed capital to fund distributions to him. In one instance, when asked to explain how Covenant investors benefitted from Covenant taking a $100,000 loan and then immediately distributing the proceeds to Fretz, Keystone, and one of Fretz's businesses, Freeman acknowledged that, "[a]t the exact distribution of the funds, there was not a benefit to [Covenant] at that moment." Freeman then attempted to justify the transactions, asserting that Covenant benefited from its use of Keystone's facilities, intellectual capital, and deal flow.

3. Fretz's and Freeman's Failure to Apply the "High Water Mark"

The Extended Hearing Panel found that Fretz and Freeman profited impermissibly by failing to apply applicable provisions of Covenant's governing documents when they allocated profits in 2009 to the General Partner. We agree.

Covenant's Offering Circular and Limited Partnership Agreement provided that, at the end of each fiscal year, the General Partner would receive a 20 percent share of Covenant's profits over five percent but only after investors recouped prior years' losses. As the Offering Circular states, such a requirement "is known in the industry as a 'high water mark.'" The Offering Circular refers to the high water mark in five separate sections, and the Limited Partnership Agreement contains similar language. Covenant's audited financial statements for 2005, 2006, and 2007, which were prepared by a certified public accounting firm ("Accounting Firm")[13] and reviewed and approved by Fretz, also described the General Partner's performance fee as being subject to the high water mark. On March 1, 2012, six months after Enforcement filed the underlying complaint, Fretz and Freeman formally amended the Offering Circular and Limited Partnership Agreement to eliminate the high water mark provisions.

From 2000 through 2008, Covenant sustained repeated yearly net losses. On October 30, 2009, as a result of the sale of Covenant's holdings of IXI stock, Covenant received gross proceeds of approximately $4.4 million. When Fretz and Freeman allocated the 2009 profit, and calculated the General Partner's performance fee, they disregarded the high water mark provisions in Covenant's governing documents, calculating the fee without accounting for the prior years' losses.

At the hearing, Fretz testified that the high water mark "never from the beginning" applied, and he insisted the Covenant investors always understood this. Fretz also testified that MC wrote a letter in 2001 about the inapplicability of the high water mark provision, which Fretz circulated to Covenant investors at the time. Fretz testified that MC wrote an additional letter in 2009 about the inapplicability of the provision, which also was given to Covenant investors. Fretz insisted that, between 2001 and 2009, he and Freeman explained to investors the inapplicability of the high water mark. As a result of MC's "interpretation" and their conversations with the investors, Fretz said he and Freeman "saw no reason to spend a lot of money" to amend Covenant's governing documents. The March 1, 2012 amendment eliminating the high water mark provisions, however, was the fourth amendment to Covenant's governing documents. The documents were previously amended in 1996, 1999, and 2005. None of these amendments, however, mentioned the high water mark. Fretz insisted that these amendments failed to amend the high water mark provisions because "we never had a problem with it whatsoever. Everybody understood."

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[13] Accounting Firm is owned by MC. According to Fretz and Freeman, they repeatedly relied on the advice of accountants at Accounting Firm and particularly MC with respect to bookkeeping at Covenant and Keystone.

The record undermines Fretz's claims. First, MC flatly denied that he prepared a letter in 2001 concerning the high water mark. Further, Accounting Firm's audited financial statements for 2005, 2006, and 2007 specifically reference the high water mark provisions, which is at odds with the alleged 2001 letter prepared by MC that the provisions were inapplicable. Moreover, Respondents failed to introduce any documentary evidence to support the existence of such a letter.[14] Indeed, MC testified that it was not until 2010 that Fretz asked him to prepare an undated letter "[t]o clarify how the . . . rate was going to be calculated."[15]

Second, Freeman's testimony contradicted Fretz's. Freeman testified it "probably" was not until 2009, at the time of IXI stock sale, that he first was told that the high water mark provisions of Covenant's documents would not be applied. Freeman further testified he had no memory of any conversations with Covenant investors about the inapplicability of the high water mark provisions prior to the March 1, 2012 amendment.

Finally, three Covenant investors testified that Fretz and Freeman never informed them that the high water mark provisions were inoperative. Based on the overwhelming evidence, we agree with the Extended Hearing Panel that Fretz was "simply not credible" on this issue.

On appeal, Respondents argue that the Extended Hearing Panel failed to take into account that the March 1, 2012 amendment retroactively "clarifies, ratifies, and codifies" Covenant's governing documents, and more than 70 percent of Covenant investors—20 percent more than required—had agreed to the amendment. The Fourth Amendment, however, provides that it is "effective as of March 1, 2012," years after Covenant's sale of the IXI stock and Fretz and Freeman's 2009 profit allocation, and the Written Consent of Partners in Lieu of Meeting, by which the Covenant investors agreed to the Fourth Amendment, does not state that the high water mark provision would be inapplicable retroactively. Rather, it states that the Fourth Amendment "ratifies, codifies, and provides clarification that the General Partner is and has been entitled to receive" its profit allocation and any unrecouped prior year losses incurred and allocated in previous years "shall not impact or alter" the profit allocation. Even if the Fourth Amendment were retroactive, we agree with the Extended Hearing Panel that, at the time of IXI stock sale, Covenant's governing documents undoubtedly "made the General Partner's performance fee subject to the high water mark provisions."

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[14] Given the record, we agree with the Extended Hearing Panel that Fretz's claim that his prior attorney failed to turn over to FINRA the 2001 letter is "implausible."

[15] On December 10, 2010, Fretz emailed MC, "Here is an example of the letter that I need from you today for FINRA." Fretz included in the email a statement describing the "performance fee" Covenant "will charge limited partners." In a follow up email two days later, Fretz emailed "[t]his may read a bit better" and included a lengthier description of the "performance fee." MC then signed the undated letter.

In sum, we find that when Fretz and Freeman allocated Covenant's 2009 profit, they impermissibly ignored the high water mark provisions of Covenant's governing documents and allocated $374,535 more than what they should have to the General Partner (and themselves) at the expense of the other Covenant investors. By doing so, Fretz and Freeman breached their fiduciary duties to Covenant investors, and violated the ethical requirements of NASD Rule 2110 and FINRA Rule 2010.

4. Overvalued PetFood Stock Contributions

In 2004, Fretz and his immediate family members contributed 123,000 shares of PetFood common stock to Covenant. According to Shaffer's ledger that listed closings for 2004, the contributed stock was valued at $2.00 per share, resulting in a total credit of $246,000 to the capital accounts of Fretz and his family members. Covenant's audited financial statements for 2004, however, valued PetFood common stock at $0.51 per share. The Extended Hearing Panel found that Fretz and his family members' PetFood stock contributions were overvalued. We agree.

On appeal, Respondents argue that Enforcement did not prove what Fretz originally paid for the shares or whether the contributed shares encompassed both common and preferred stock. These arguments are unpersuasive based on the record before us.

Fretz testified that the PetFood shares were valued at $2.00 because he believed that was what he paid, and his accountant, MC, brought it in to Covenant at cost. Fretz further claimed that $2.00 per share "was the cost for everybody originally."[16] MC testified that he believed the $2.00 per share valuation included preferred and common stock, and he would have tracked the cost basis for any limited partner who transferred securities to Covenant.

We agree with the Extended Hearing Panel that MC's testimony about the PetFood stock valuation was "unclear" and agree that he did not substantiate that the $2.00 per share valuation reflected Fretz's cost. Further, Shaffer's records reference only PetFood common stock (not preferred), and Covenant's audited financial statements did not show any PetFood preferred stock holdings, which would be expected if Fretz and his family's transfers to Covenant included preferred stock.[17]

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16 In April 2004, however, Keystone conducted a private placement on behalf of PetFood at $0.32 per share. When asked why he paid $2.00 per share when the same stock was being offered in April 2004 at $0.32 per share, Fretz testified that he was not sure what he paid, and the valuation may have reflected some preferred shares, and MC could explain.

17 Shaffer's records reflect that Fretz and his family members transferred PetFood common stock on February 17, 2004, and December 31, 2004.

By overvaluing the stock, Fretz and his immediate family members increased their ownership interest in Covenant at the expense of other investors whose ownership interests proportionally decreased. Based on Covenant's own valuation, Fretz and his family members' contributions were overvalued by approximately $183,076. By doing so, Fretz breached his fiduciary duties to Covenant investors and engaged in business-related conduct in violation of NASD Rule 2110 and FINRA Rule 2010.

5. <u>Freeman Loan</u>

On July 12, 2004, Freeman borrowed $11,000 from Covenant. This loan was documented by a note. The note provided that Freeman was obligated to pay interest at six six percent annually and that the note matured on July 12, 2005, unless extended by mutual mutual agreement.[18] The parties stipulated that the loan was eventually retired in January 2009, 2009, and Freeman failed to pay any interest on the debt.[19] At the hearing, Freeman could not recall how he repaid the loan, saying the repayment was documented "by an accounting adjustment made to the general partner's account." Regardless of how or if the loan was repaid, we, like the Extended Hearing Panel, find that Freeman's interest free loan was inconsistent with his fiduciary responsibilities to Covenant. Despite the unambiguous terms of the note, Freeman failed to pay any interest on the debt. Accordingly, Freeman unfairly profited from a transaction between himself and Covenant to the detriment of Covenant investors, in violation of his fiduciary duties. Freeman's business-related misconduct violates NASD Rule 2110 and FINRA Rule 2010.

6. <u>Respondents' Other Exculpatory Arguments</u>

Respondents argue that Fretz and Freeman's repeated reclassifications of transfers from Covenant were proper based on a "due-from" accounting convention, and based on their reliance on the advice of their accountant, MC. The record, however, does not support their contentions.

First and foremost, the record shows that Fretz and Freeman recharacterized transfers for self-serving reasons, sometimes years after the actual transaction. Second, as Enforcement's expert forensic accountant credibly testified, the classification of a transfer of funds occurs at the time the money is disbursed. Accordingly, Fretz and Freeman could not morph a distribution

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18 At the time Covenant made this loan to Freeman, Covenant had borrowed funds at 10 percent.

19 At the hearing, Freeman testified that he believed that Covenant's records and the parties' stipulation were inaccurate, and that he had paid interest on the loan. Respondents, however, raised no compelling reason to set aside the stipulation, which is supported by Covenant's records. *See Joseph Abbondante*, 58 S.E.C. 1082, 1088 (2006) ("Stipulated facts serve important policy interests in the adjudicatory process, including playing a key role in promoting timely and efficient litigation; we will honor stipulations in the absence of compelling circumstances.").

into a loan or vice versa. Enforcement's expert further explained that reclassifications are not appropriate for changing a loan to capital or vice versa. Finally, as MC testified and Fretz's emails support, Fretz and Freeman, not MC, directed how transfers were classified. MC credibly testified that he relied on their directives and explained that his accounting firm did not test management assumptions from 2008 to 2010 because it did not prepare audited financials for Covenant.

Respondents also argue that Covenant's federal K-1 tax returns were consistent with respect to Fretz and Freeman's characterization of transfers as loans and disbursements. Enforcement's expert testified, however, that he could not tie Covenant's tax returns to the trial balances, and he was unsure whether the tax returns in the record were actually filed or merely drafts. Ultimately, the expert relied on contemporaneous records, not tax returns which are prepared "after the fact" and "down the road." We, like the Extended Hearing Panel, find the expert's testimony persuasive. The trial balances are the only documents that show how the transfers were treated at the time from an accounting standpoint. And, despite their protestations to the contrary, Respondents repeatedly stated that these trial balances were accurate and final copies.[20]

Enforcement's expert testified that the transfers from Covenant to Fretz, Freeman, and their businesses did not bear the traditional indicia of bona fide loans and should have been treated as distributions. We agree. When the transfers are treated as distributions, Fretz took more money from Covenant than he had in his capital account, and Freeman took more money from the General Partner's account than was in the account. These actions violated their fiduciary duties to Covenant investors.

We find that Fretz and Freeman's disbursements of Covenant funds for their personal and business interests did not benefit Covenant investors and were inconsistent with the fiduciary obligations owed to Covenant investors. This misconduct is inconsistent with just and equitable principles of trade and violates NASD Rule 2110 and FINRA Rule 2010.

B. Fretz and Freeman Made Material Misrepresentations

Enforcement alleged in cause two of the complaint that Fretz and Freeman violated NASD Rule 2110 and FINRA Rule 2010 when they made misrepresentations and omitted material facts to Covenant investors. According to Enforcement, Fretz and Freeman failed to

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[20] At the hearing, Fretz argued that his prior counsel incorrectly stated that Covenant's trial balances were accurate and final copies, and there was a reason she was no longer retained. Given the Extended Hearing Panel's numerous findings discounting Fretz's credibility, the lack of any record evidence supporting Fretz's argument, and Respondents' counsel's repeated assertions concerning the accuracy of these documents, we find that the trial balances are accurate and we rely on them.

observe the high standards of commercial honor and just and equitable principles of trade by failing to disclose to Covenant investors that they transferred money from Covenant to themselves and their business entities, obtained interest-free loans from Covenant, and made a self-interested $1.4 million alleged loan from Covenant to Keystone. Enforcement also alleged that representations in Covenant's governing documents were rendered misleading or false as a result of Fretz and Freeman's failure to apply the high water mark, failure to invest in securities as opposed to making capital withdrawals and self-interested loans, failure to ensure that the General Partner would not unfairly profit, and failure to maintain the appropriate General Partner capital account balance.

As discussed above, we find that Fretz and Freeman, as fiduciaries of Covenant, engaged in business-related misconduct that was inconsistent with just and equitable principles of trade and thus violated NASD Rule 2110 and FINRA Rule 2010. We note that Enforcement's misrepresentations theory identifies the same misconduct that we discussed in cause one. Given the overlap between the two causes, we do not further analyze cause two.

C. Respondents Gave Misleading Responses to FINRA

The Extended Hearing Panel found that Respondents made misstatements to FINRA, in violation of FINRA Rules 8210 and 2010. We affirm the Hearing Panel's findings.

FINRA Rule 8210 requires FINRA members and their associated persons to provide information orally or in writing in response to requests for information issued by FINRA staff with respect to any matter involved in an investigation. The duty of members and their associated persons to cooperate with FINRA investigations and respond fully to Rule 8210 requests is unequivocal. *See Dep't of Enforcement v. Fawcett*, Complaint No. C9A040024, 2007 NASD Discip. LEXIS 2, at *12 (NASD NAC Jan. 8, 2007). "[FINRA's] regulatory mandate is thwarted if respondents can selectively determine which facts to omit." *Dep't of Enforcement v. Duma*, Complaint No. C8A030099, 2005 NASD Discip. LEXIS 46, at *30 (NASD NAC Oct. 27, 2005). Providing false or misleading information to FINRA in the course of an investigation violates NASD Rule 8210. *See Dep't of Enforcement v. Ortiz*, Complaint No. E0220030425-01, 2007 FINRA Discip. LEXIS 3, at *32 (FINRA NAC Oct. 10, 2007), *aff'd*, Exchange Act Release No. 58416, 2008 SEC LEXIS 2401 (Aug. 22, 2008). Such conduct also is inconsistent with just and equitable principles of trade and independently violates NASD Rule 2110 and FINRA Rule 2010. *See Ortiz*, 2007 FINRA Discip. LEXIS 3, at *33 n.26.

We find that Respondents provided false and misleading information, including attaching falsely dated documents, in response to three FINRA information requests.

1. The September 17, 2009 Rule 8210 Request

On September 17, 2009, FINRA issued a Rule 8210 request asking Keystone to provide a bank statement to show the origin of an April 29, 2009 $50,000 deposit into Keystone. FINRA sought to verify that the funds qualified as good capital for net capital purposes. On September 23, 2009, Fretz responded by email on behalf of Keystone. He did not provide the requested bank statement. Instead, he wrote that the funds were a distribution to him from his Covenant capital account and attached a "Distribution Confirmation" signed by Freeman and dated April 29, 2009.

Covenant's quarterly capital account balance sheet for the second quarter of 2009 and Covenant's 2009 trial balance, however, do not reflect an April 29, 2009 distribution to Fretz. Moreover, Shaffer's "Covenant accounting" spreadsheet, on which she typically made contemporaneous entries of transactions, reflected a $50,000 loan from Covenant to Keystone Holdings on April 29.

At the hearing, Freeman offered contradictory testimony. He initially testified that Fretz told him that this transfer and others were distributions. He testified that the Distribution Confirmation was created at Fretz's request after the September 17, 2009 FINRA Rule 8210 request, although he could not remember who created it or whose idea it was to date the confirmation April 29. He also said the form was atypical and not used with any frequency. The next day, Freeman recanted his testimony, and said it was possible that the Distribution Confirmation was created in April 2009. He also claimed that he did not know the Distribution Confirmation would be provided to FINRA.

Fretz, on the other hand, testified that all the money transferred to Keystone was a loan, and he misspoke in his email. He continued, "[A]t that point, I wasn't sure how it was going to be accounted for. I needed to talk to my accountant first. I responded quickly and hastily." When questioned about the April 29, 2009 Distribution Confirmation, which Fretz attached to his supposedly hasty response email, Fretz said it was in Covenant's files at the time of the Rule 8210 request and the transaction "was coded as a distribution," but he "ended up recharacertizing all of this as loans to [Keystone]."

The Extended Hearing Panel concluded that the Distribution Confirmation was falsely dated to make it appear that it had been created contemporaneously with the infusion of $50,000 into Keystone. We agree. With the exception of the Distribution Confirmation, Covenant's books and records reflected that the $50,000 transaction on April 29, 2009 was a loan from Covenant to Keystone Holdings, not a distribution to Fretz from his Covenant capital account. Moreover, if the Distribution Confirmation indeed was created at or around the time of transaction on April 29, 2009, it does not follow that Fretz's response was hastily written and an error because the Distribution Confirmation explicitly provided the transaction was a distribution. Based on the record evidence, we credit Freeman's initial admission that the Distribution Confirmation was created in response to the Rule 8210 request and purposely backdated.

2. <u>The November 4, 2009 Rule 8210 Request</u>

On November 4, 2009, FINRA sent a second Rule 8210 request to Fretz which requested that Keystone provide net capital computations for specific dates and bank statements showing the origin of capital infusions to Keystone. Keystone previously had indicated to FINRA that the infused capital came from Keystone Holdings, which, in turn, received the money from Fretz. Accordingly, FINRA requested copies of Fretz's redacted bank statements to corroborate these representations. On November 24, 2009, Keith Fretz ("K. Fretz"),[21] Fretz's uncle, responded by email on behalf of Keystone, stating that Covenant transferred funds to Keystone Holdings on behalf of Fretz, and "[Keystone Holding] subsequently invested the capital as equity in [Keystone]." K. Fretz attached a November 3, 2009 letter signed by Freeman confirming that Fretz had taken $72,000 in distributions from his personal account with Covenant and transferred the funds to Keystone Holdings.

We find that the November 3, 2009 letter attached to Keystone's Rule 8210 response was falsely dated. On November 23, 2009, K. Fretz emailed Shaffer an unsigned copy of the letter and wrote, "Attached is the text to be put on Covenant letterhead for [Freeman's] signature." At the hearing, Freeman admitted that the letter was atypical but could not recall who composed the letter, when he signed the letter, why the letter was backdated, or who had asked him to sign it but surmised it likely was Fretz or K. Fretz. Freeman also claimed that he did not know at the time that the letter was being provided to FINRA.

Covenant's quarterly capital account balance for the third quarter of 2009 and Covenant's 2009 trial balance did not reflect that Fretz had taken $72,000 in distributions. Moreover, at the same time that Keystone was telling FINRA that Fretz had taken $72,000 in distributions from his personal account with Covenant during the third quarter of 2009, Fretz was telling the exact opposite to his accountant. Specifically, on November 5, 2009—one day after FINRA's Rule 8210 request—Fretz emailed his accountant, "I didn't take distributions only loans from [Covenant] in 2008-2009."[22]

3. <u>The December 1, 2009 Request</u>

Continuing its inquiry into the sources of capital at Keystone, FINRA and Keystone participated in a conference call on December 1, 2009. After the conference call, FINRA sent an email to Fretz and K. Fretz listing the information that they had agreed to provide to FINRA to prove that the capital infusions into Keystone constituted good capital for net capital purposes. Among other things, FINRA requested a signed statement from Fretz "explaining the origin and flow of funds from his personal account at Covenant Partners to [Keystone]" and "[a] financial statement detailing [Fretz's] account value in Covenant."

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[21] K. Fretz was registered with Keystone as a general securities representative. He was not an officer of Keystone.

[22] At the hearing, Fretz claimed this email was "not accurate" because "[t]he accounting firm and myself had determined at the end of 2008 [transfers to him] were all distributions." He continued, "I don't recall this email, and they were always distributions in my mind. I did not take loans from Covenant . . . . I can't explain this email."

On December 4, 2009, Fretz sent a letter to FINRA stating that "the funds that I have invested into [Keystone] have originated from my personal account with [Covenant]. My funds from Covenant have been transferred to [Keystone Holdings], which in turn invests in [Keystone]." In other words, Fretz represented that the origin of the questioned transactions was distributions from his personal account at Covenant. However, less a month earlier, Fretz had specifically told his accountant that he had taken no distributions from Covenant in 2008 to 2009. At the hearing, Fretz testified that at the time he wrote the letter, he believed the transactions were distributions but "[w]e ended up changing it at the end of this year." He did not explain, nor do we think he could offer a plausible explanation, why he told his accountant on November 5 the opposite of what K. Fretz told FINRA in response to the November 4, 2009 request and what he told FINRA in response to the December 1, 2009 request.

In a follow-up letter dated December 16, 2009, Freeman disclosed that, "[a]s of 1 November, 2009, [Fretz's] account value with [Covenant] was in excess of $2,000,000. The funds transferred from [Fretz's personal account at Covenant] to [Keystone] constitute a distribution from [Covenant]. The funds do not constitute a loan to [Fretz] nor to [Keystone]." At the hearing, Freeman testified that Fretz instructed him to respond to FINRA by calculating the value of his account as of November 1, 2009.[23] Freeman acknowledged that he did not make a reasonable effort to determine the value of Fretz's account. Among other things, he did not review Covenant's check register to identify any transfers, and, despite being aware that significant funds were being transferred from Covenant (which he believed at the time were distributions), he nonetheless made no effort to subtract them from Fretz's account value.

4. Respondents' Responses Were Misleading

The Extended Hearing Panel found that Respondents' responses were misleading, and Respondents did not respond to FINRA in good faith. We agree.

On four separate occasions (i.e., September 23, November 24, December 4, and December 16), Respondents unequivocally told FINRA that the origin of capital infusions to Keystone was distributions from Fretz's personal account at Covenant, which he then transferred to Keystone Holdings. Respondents bolstered this assertion by twice attaching falsely dated documents.

Respondents' responses were undoubtedly misleading. Fretz conceded that the September 23, 2009 and November 24, 2009 responses were inaccurate, but asserted that it was not his intention to mislead FINRA, and that the transfers later were recharacterized as loans. Freeman also admitted that, when he provided Fretz's Covenant account value on December 16,

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[23] This date is significant because the IXI transaction occurred just two days prior, at which time Covenant received $4.4 million. Shortly thereafter, Covenant transferred substantial sums to Fretz's businesses.

2009, his response was misleading because he knew that Fretz had made substantial withdrawals from his account after the letter's selected date.

Respondents assert that they made all statements to FINRA in good faith based on their understanding of the transfers at that time the statements were made, and their statements could not have been misleading because they did not know how the transactions ultimately would be characterized. Scienter, however, is not an element of a Rule 8210 violation. *See Howard Brett Berger*, Exchange Act Release No. 58950, 2008 SEC LEXIS 3141, at *39 (Nov. 14, 2008). Moreover, Respondents' assertions are belied by the fact that they submitted falsely dated documents that contradicted Covenant's books and records, and Fretz's contemporaneous instructions to his accountant, for the purpose of misleading FINRA. Even if we were to find that Respondents' notion that belated characterizations of transactions is somehow proper, Respondents' responses nonetheless were misleading because they did not disclose to FINRA their accounting practices or that their characterization of the transfers was not final.[24]

At the hearing, Freeman sought to distance himself from the falsely dated documents, asserting that he did not know that they would be provided to FINRA. His testimony is notable not only for his own contradictory statements, but also for its vagueness and his claimed inability to recall any specifics about the creation of specific documents despite acknowledging that both documents were atypical. Considering Freeman's lack of credibility on a host of other significant issues, we find that Freeman was aware that the documents were provided by Keystone to FINRA, and, thus find him liable for the September 23 and November 24 responses.[25] *See Michael A. Rooms*, 58 S.E.C. 220, 227 (2005) ("Liability under [Rule 8210] may possibly extend to associated persons of a firm who are aware of an 8210 request directed to the firm and seek to falsify or impede the firm's response."), *aff'd*, 444 F.3d 1208 (10th Cir. 2006).

Based on the foregoing, we conclude that Fretz, Freeman, and Keystone provided misleading responses to the September 17 and December 1 requests, and Freeman and Keystone provided a misleading response to the November 4 request, in violation of FINRA Rules 8210 and 2010.[26]

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24 Contrary to Respondents' assertion, Respondents did indeed have a motive to mischaracterize the transactions at issue as unencumbered capital contributions in order to satisfy FINRA's inquires about whether Keystone was operating in compliance with the relevant net capital rules. On the other hand, by classifying the transfers as loans, Fretz improperly inflated his share of IXI profits.

25 As acknowledged by Freeman at the hearing, Freeman's December 16, 2009 response was misleading, for which he is also liable.

26 With respect to Respondents' response to the December 1 request, the Extended Hearing Panel found that Respondents violated FINRA Rule 2010 only because the request did not

[Footnote continued on next page]

D. Fretz Failed to Disclose Material Information on Forms U4

1. Fretz Violated FINRA Rules 1122 and 2010

FINRA Rule 1122 provides that "[n]o . . . person associated with a member shall file with FINRA information with respect to membership or registration which is incomplete or inaccurate so as to be misleading, or which could in any way tend to mislead, or fail to correct such filing after notice thereof," thus requiring associated persons to keep Forms U4 complete and accurate. Similarly, Article V, Section 2(c) of FINRA's By-Laws requires that associated persons keep their Forms U4 "current at all times by supplementary amendments," which must be filed "not later than 30 days after learning of the facts or circumstances giving rise to the amendment." Filing a misleading Form U4 or failing to file a timely amendment to a Form U4 when required, violates the high standards of commercial honor and just and equitable principles of trade to which FINRA holds its members under FINRA Rule 2010. *See Scott Mathis*, Exchange Act Release No. 61120, 2009 SEC LEXIS 4376, at *16 (Dec. 7, 2009), *aff'd*, 671 F.3d 210 (2d Cir. 2012); *Jason A. Craig*, Exchange Act Release No. 59137, 2008 SEC LEXIS 2844, at *8 (Dec. 22, 2008).

Question 14M on the Form U4 asks, "Do you have any unsatisfied judgments or liens against you?" On December 18, 2009, Fretz filed an amendment to his Form U4. Fretz answered "no" to Question 14M even though he was subject to a $131,029 judgment. Between July 2009 and October 2010, eight judgments, totaling more than $2.4 million, were entered against Fretz in Pennsylvania, and all remained outstanding for more than 30 days. Fretz did not amend his Form U4 to disclose these judgments. Fretz admits liability for failing to disclose the eight judgments.

We affirm the Extended Hearing Panel's findings that Fretz violated FINRA Rules 1122 and 2010 and Article V, Section 2(c) of FINRA's By-Laws.

2. Fretz Is Statutorily Disqualified

The complaint alleges that Fretz' violation of FINRA Rules 1122 and 2010 and Article V, Section 2(c) of FINRA's By-Laws was willful. We agree and find that, as a result, Fretz is statutorily disqualified.

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explicitly invoke FINRA Rule 8210. We disagree with this distinction, and find that the response also violated FINRA Rule 8210 because it was part of FINRA's continuing investigation into the sources of capital at Keystone.

Exchange Act Section 3(a)(39)(F) provides that a person who "has willfully made or caused to be made in any application . . . to become associated with a member of a self-regulatory organization . . . any statement which was at the time, and in light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state . . . any material fact which is required to be stated therein," is subject to statutory disqualification." 15 U.S.C. § 78c(a)(39)(F).

To find a willful violation, we must find "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000). "A willfulness finding is predicated on [a person's] intent to commit the act that constitutes the violation– completing the Form U4 inaccurately." *Dep't of Enforcement v. Zdzieblowski*, Complaint No. C8A030062, 2005 NASD Discip. LEXIS 3, at *14 (NASD NAC May 3, 2005). To find that Fretz's actions were willful, we need not find that Fretz intentionally violated FINRA rules or acted with a culpable state of mind, only that he voluntarily provided false answers on the Form U4 or voluntarily omitted to state a material fact. *See Mathis*, 671 F.3d at 216 (holding that the SEC did not abuse its discretion when it concluded that respondent willfully failed to disclose material information because he "voluntarily provided false answers on his Form U4"); *Richard A. Neaton*, Exchange Act Release No. 65598, 2011 SEC LEXIS 3719, at *21-22 (Oct. 20, 2011) (finding that respondent, while aware of his underlying misconduct, voluntarily provided false answers on his Forms U4).

Respondents argue that Fretz was unaware of the judgments against him and did not intentionally fail to disclose them. Respondents' counsel, however, stipulated at the hearing that Fretz was aware of the eight judgments. Further, in their Wells response, Respondents acknowledged that Fretz never amended his Form U4 to disclose the unsatisfied judgments, asserting he did not know that judgments had to be reported. In any event, "[i]t is well established that securities industry professionals must take responsibility for compliance with [Form U4] and cannot be excused for lack of knowledge, understanding or appreciation of its requirements." *Joseph S. Amundsen*, Exchange Act Release No. 69406, 2013 SEC LEXIS 1148, at *31 (Apr. 18, 2013) (internal quotations omitted), *aff'd*, 575 F. App'x 1 (D.C. Cir. 2014). Here, the record conclusively demonstrates that Fretz knew about the eight judgments, yet he voluntarily filed an amendment to his Form U4 containing false information and failed to amend the Forms U4 to disclose the existence of the judgments.

We also find that the information Fretz excluded from his Form U4 was material. In the context of Exchange Act Rule 10b-5, a fact is material if a reasonable investor would view the disclosure of the omitted information as "having significantly altered the 'total mix' of information made available." *Mathis*, 671 F.3d at 219 (internal quotations omitted) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). "Because of the importance that the industry places on full and accurate disclosure of information required by the Form U4, we presume that essentially all the information that is reportable on the Form U4 is material." *Dep't of Enforcement v. Knight*, Complaint No. C10020060, 2004 NASD Discip. LEXIS 5, at *13 (NASD NAC Apr. 27, 2004); *see also Amundsen*, 2013 SEC LEXIS 1148, ay *40.

We find that Fretz's failure to disclose the judgments significantly altered the total mix of information available for a reasonable investor. *See, e.g., Robert D. Tucker*, Exchange Act

Release No. 68210, 2012 SEC LEXIS 3496, at *32 (Nov. 9, 2012) ("[T]he judgments, bankruptcies, and liens [respondents] failed to disclose . . . constituted serious financial problems critical to evaluating [their] fitness to associate in the securities industry.").[27] Therefore, this information constituted material information that should have been disclosed timely on Fretz's Form U4.

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Because we find that Fretz willfully failed to disclose material information on his Form U4, Fretz is statutorily disqualified.

E. Respondents' Jurisdictional Challenge Fails

Respondents contend that FINRA lacks jurisdiction over the conduct alleged in the first, second, and third causes of action because FINRA lacks jurisdiction over hedge funds and their investment managers. We find that Respondents have based their jurisdictional argument on a false premise and conclude that FINRA properly exercised its disciplinary jurisdiction.[28]

We find that Enforcement did not seek to assert jurisdiction over Covenant or Fretz and Freeman in their capacity as investment managers of Covenant. Instead, Enforcement alleged that a FINRA member firm and its associated persons, all of whom have stipulated that they are subject to FINRA's jurisdiction, violated FINRA rules and engaged in conduct subject to discipline by FINRA. We address Respondents' jurisdictional challenge with respect to the first and third causes of action in turn.[29]

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[27] The reasonable investor test asks objectively whether a reasonable investor would view the omissions as material. Therefore, we reject Respondents' argument that the "vast majority of investors were family and friends and not individuals in the industry likely to review his [Form] U4."

[28] Respondents argue that the "[Extended Hearing Panel] concluded that jurisdiction was proper because Keystone and Covenant 'are inextricably connected to each other.'" Respondents misread the Extended Hearing Panel's decision. The Extended Hearing Panel was responding to and rejecting Respondents' claim that the entities were entirely distinct, and then continued that Respondents' "misconduct falls squarely within the traditional scope of FINRA's regulatory mission," analyzing each of the first four causes of action.

[29] Although we dismissed the second cause of action, we address each of Respondents' jurisdictional arguments with respect to the second cause of action as they relate to the first cause of action.

1. <u>Fretz's and Freeman's Unethical Conduct With Respect to Covenant Customer Funds</u>

Respondents argue that the first cause of action should be dismissed because FINRA lacks jurisdiction over Covenant. We find that FINRA properly exercised its jurisdiction with respect to the first cause of action.

We found that Fretz and Freeman breached their fiduciary duties to Covenant investors by misusing Covenant funds in a variety of ways, and thereby engaged in business-related misconduct that is inconsistent with just and equitable principles of trade. "It is well established that FINRA's 'disciplinary authority [under NASD Rule 2110 and FINRA Rule 2010] is broad enough to encompass business-related conduct that is inconsistent with just and equitable principles of trade even if that activity does not involve a security.'" *Blair Alexander West*, Exchange Act Release No. 74030, 2015 SEC LEXIS 102, at *26 (Jan. 9, 2015). As the Commission has explained, "[NASD] Rule 2110 [and FINRA Rule 2010] appl[y] when the misconduct reflects on the associated person's ability to comply with the regulatory requirements of the securities business and to fulfill his fiduciary duties in handling other people's money." *Manoff*, 55 S.E.C. at 1162.

Applying these same principles in *Vail v. SEC*, the Fifth Circuit affirmed FINRA's action against a registered representative who misappropriated funds from the bank account of a political organization for which he was the treasurer. *See Vail v. SEC*, 101 F.3d 37. The court explicitly rejected Vail's jurisdictional challenge, finding that "Vail's position as a fiduciary of the club managing the club's funds constituted business-related conduct" that was subject to FINRA's disciplinary authority under the predecessor to NASD Rule 2110. *Id*.

Nevertheless, Respondents argue that Covenant was a hedge fund and "a pooled investment entity, and its funds should be viewed as Covenant funds, not funds of the individual limited partner." Whether this is true or not, a registered person's misconduct as a fiduciary for a hedge fund is business-related conduct that reflects on his ability to abide by the securities laws. Covenant's status as a hedge fund is not an impediment to a finding of FINRA's disciplinary authority under just and equitable principles of trade for Fretz's and Freeman's breach of their fiduciary duties owed to Covenant and its investors.[30] *See, e.g., Stephen Grivas*, 2015 FINRA Discip. LEXIS 16 (FINRA NAC July 16, 2015) (finding a violation of just and equitable principled where the respondent used the funds of an investment fund he managed to correct his

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[30] Respondents assert that there was no evidence that any Covenant investors, who also were customers of Keystone, "had any claims against Messrs. Fretz and Freeman in the latters' capacity as registered persons of Keystone." Whether the 11 investors had claims against Fretz and Freeman in their capacity as registered persons of Keystone is irrelevant. Rather, the relevant question is whether Fretz and Freeman breached their fiduciary duties owed to Covenant investors, and we find there is conclusive evidence in the record which establishes they did.

broker-dealers net capital deficiencies). Just as Vail was a fiduciary who owed a duty to a political organization, Fretz and Freeman are fiduciaries of Covenant who owed the same duty to Covenant investors, and their misuse of Covenant funds constituted business-related misconduct subject to FINRA's disciplinary authority. Sound logic dictates that FINRA may discipline an associated person for his business-related misconduct that reflects on his willingness to comply with the regulatory requirements of the securities business—whether breaching a fiduciary duty as a club treasurer or as an unregistered investment adviser.

As acknowledged by Respondents, "FINRA's jurisdiction is not based upon the mere existence of securities." Indeed, FINRA has disciplined associated persons under NASD 2110 and FINRA Rule 2010 in many instances for misconduct unrelated to securities. *See, e.g.*, *Dep't of Enforcement v. Golonka*, Complaint No. 2009017439601, 2013 FINRA Discip. LEXIS 5 (FINRA NAC Mar. 4, 2013) (impersonating insurance policy owners in telephone calls to policy issuers to obtain confidential information); *Dep't of Enforcement v. Taylor*, Complaint No. C8A050027, 2007 NASD Discip. LEXIS 11 (NASD NAC Feb. 27, 2007) (submitting false documents to state insurance regulator); *Manoff*, 55 S.E.C. 1155 (unauthorized use of co-worker's credit card numbers); *Dist. Bus. Conduct Comm. v. Kwikkel-Elliott*, Complaint No. C04960004, 1998 NASD Discip. LEXIS 4 (NASD NBCC Jan. 16, 1998) (converting funds from employer by submission of false expense reimbursement requests); *Earnest A. Capriani, Jr.*, 51 S.E.C. 1004 (1994) (converting and misappropriating customer's insurance premiums); *William F. Rembert*, 51 S.E.C. 825 (1993) (submitting falsified customer records resulting in the overpayment of commissions); *DWS Sec. Corp.*, 51 S.E.C. 814 (1993) (making misrepresentations and omitting material facts concerning the use of offering proceeds); *Thomas E. Jackson*, 45 S.E.C. 771 (1975) (forging signatures on insurance applications in order to obtain commissions).

The Commission's holding from 22 years ago that NASD had jurisdiction is equally applicable in this case. *See DWS Sec. Corp.*, 51 S.E.C. at 822. The respondents in that case were officers of the issuers as well as registered person of the broker-dealer that sold the securities. They argued that FINRA had no jurisdiction over their private placement activities. The Commission disagreed, finding that their activities were "inextricably intertwined" and FINRA properly exercised jurisdiction where the respondents controlled the issuer whose funds were dissipated, as well as the broker-dealer involved in the misconduct. *Id.*

Respondents argue that "the existence of a Covenant custodial account at Keystone . . . does not give rise to FINRA jurisdiction over Covenant." We agree. FINRA, however, is not asserting jurisdiction over Covenant. Instead, FINRA is asserting jurisdiction over Fretz and Freeman for their breach of fiduciary obligations owed to Covenant and its investors, many of whom also were customers of Keystone. Their misconduct reflects on their willingness, as associated persons, to comply with the regulatory requirements of the securities business and to fulfill their fiduciary duties in handling other people's money and thus is subject to FINRA's disciplinary authority.

While acknowledging that Covenant limited partnership interests are securities, Respondents argue that FINA lacks jurisdiction because the securities "were not offered or sold by Messrs. Fretz or Freeman through Keystone." Even if the assertion were true,[31] the payment of a commission is not dispositive of the question whether a broker-dealer offered or sold securities or was otherwise involved in a transaction. Moreover, whether or not Fretz and Freeman offered or sold Covenant limited partnership interests "through Keystone," they are nonetheless liable for their unethical conduct.

2. Respondents' Misleading Responses to FINRA

Respondents argue that the third cause of action should be dismissed on "jurisdictional grounds for FINRA's improper use of Rule 8210 pertaining to requests of Covenant's books and records." We disagree and find that the requests were within FINRA's jurisdiction and scope of Rule 8210.

FINRA Rule 8210 requires persons subject to FINRA's jurisdiction to respond to requests for information from FINRA staff "with respect to any matter involved in [an] investigation," and provides FINRA the right to inspect and copy a member or associated person's "books, records, and accounts of such member or person [associated with a member] with respect to any matter involved in the investigation." *See* FINRA Rule 8210(a).[32] FINRA's investigative reach is broad and not limited to only documents and information related to securities. *See North Woodward Financial Corp.*, Exchange Act Release No. 74913, 2015 SEC LEXIS 1867, *14-15 (May 8, 2015); *Dep't of Enforcement v. DiFrancesco*, Complaint No. 2007009848801, 2010 FINRA Discip. LEXIS 37, at *15-16 & n.11 (FINRA NAC Dec. 17, 2010) (collecting cases), *aff'd*, Exchange Act Release No. 66113, 2012 SEC LEXIS 54 (Jan. 6, 2012).

Citing *Jay Alan Ochanpaugh*, Exchange Release No. 54363, 2006 SEC LEXIS 1926 (Aug. 25, 2006), Respondents argue that the Extended Hearing Panel improperly allowed Enforcement to "produce evidence based upon improper access to Covenant books and records that exceeded the scope of Rule 8210." Respondents' reliance on *Ochanpaugh* is misplaced, and Respondents incorrectly surmise that the dispositive issue in *Ochanpaugh* is "*whose* documents are being sought." Rather, the Commission held that an associated person was not required to

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31 In support of their argument, Respondents assert that "Mr. Fretz expressly testified that no commissions were paid to Keystone, himself or Mr. Freeman, in connection with the Covenant limited partner interests." Respondents did not cite any testimony to this effect, and we have found none in the record.

32 FINRA Rule 8210 was amended effective on February 25, 2013. *See FINRA Notice to Members 13-06*, 2013 FINRA LEXIS 8 (Jan. 2013). We apply the version of Rule 8210 that existed at the time of the conduct at issue here.

provide FINRA with documents of a third party when FINRA had not established that the documents were in the associated person's possession and control. *Id.* at *6.

Here, Respondents never claimed that the requested records were not within their possession and control. In fact, the parties stipulated that Fretz and Freeman controlled Covenant, and Respondents in fact produced documents and responded to the requests. *Cf. North Woodward Financial Corp.*, 2015 SEC LEXIS 1867, *14 (rejecting respondents' jurisdictional challenge when FINRA's information requests sought information and documents for associated person's accounts where associated person owned and controlled the money); *Gregory Evan Goldstein*, Exchange Act Release No. 71970, 2014 SEC LEXIS 4625 *13-15 (Apr. 17, 2014) (rejecting respondents' reliance on *Ochanpaugh* when FINRA's information request sought information within the possession and control of an associated person where associated person had an ownership interest in the subject entity); *Dep't of Enforcement v. CMG Institutional Trading, LLC*, Complaint No. E8A20050252, 2008 FINRA Discip. LEXIS 3, at *26-27 (Feb. 20, 2008) (rejecting respondent's jurisdictional challenge where respondent never claimed that the non-regulated entity's records were not within his possession and control, and the record showed the respondent owned and controlled the entity). Moreover, the fact that respondents actually produced some documents and responded to some requests is inconsistent with an argument that the documents were not in the possession, custody and control.

FINRA was not seeking information about Covenant's books and records. Rather, FINRA was investigating the sources of Keystone's capital, and the information requests explicitly sought information related to its investigation. It was entirely proper for Enforcement to investigate the sources of deposits to Keystone to verify they constituted good capital for net capital purposes, and the information requests were directed at legitimate concerns about whether Keystone was in violation of important Commission rules. *See North Woodward Financial Corp.*, 2015 SEC LEXIS 1867, *14 (holding that FINRA's investigation into loans made to associated person by his and his firm's customers was within FINRA's jurisdiction and the scope of Rule 8210 because "the requests probed whether Applicants' conduct contravened the high ethical standards to which all members and associated persons must adhere" irrespective of whether the loans were securities); *Goldstein*, 2014 SEC LEXIS 4625, at *15 (holding that FINRA's investigation into associated person's outside business activity was within FINRA's jurisdiction and scope of Rule 8210); *CMG Institutional Trading, LLC*, 2008 FINRA Discip. LEXIS 3, at *27; *Daniel C. Adams*, 47 S.E.C. 919, 921 (1983) (explaining FINRA's disciplinary authority encompasses non-securities related business activity and the investigation of respondent's solicitation and sale of a tax shelter was properly within FINRA's reach); *Dep't of Enforcement v. Gallagher*, Complaint No. 2008011701203, 2012 FINRA Discip. LEXIS 61, at *17 (FINRA NAC Dec. 12, 2012) (explaining Rule 8210 confers upon FINRA "broad discretion to inquire about any matter involved in a FINRA investigation, complaint, examination, or proceeding").

F. Respondents' Other Procedural Arguments Fail

Respondents make a number of other arguments challenging the fairness of the proceedings against them, and claiming that they were unfairly targeted by FINRA. We have carefully reviewed the record and find no evidence of bias or that Respondents were unfairly targeted. Respondents' arguments have no merit.

First, Respondents question what they suggest was undue delay in the decision to appoint an extended hearing panel to their case. FINRA Rule 9231(c) provides that based on an assessment of the complexity of the issues involved, the likely length of the hearing, and any other relevant factors, the Chief Hearing Officer may designate a matter as an extended hearing to be heard by an extended hearing panel. The rule does not proscribe any particular time period for this determination. The record shows that Respondents were informed that their case was designated as an extended hearing more than a month prior to the commencement of the hearing. Moreover, Respondents do not identify any alleged prejudice they suffered as a result of the timing of the extended hearing determination, and there is no evidence in the record of any harm to Respondents.

Second, Respondents complain about the fact that the Extended Hearing Panel issued its decision ten months after the conclusion of the hearing. There is no FINRA rule, however, that requires the issuance of a decision sooner than ten months, and the time period here does not suggest any bias or prejudice on the part of FINRA. *See, e.g.*, *John Montelbano*, Exchange Act Release No. 45107, 2001 SEC LEXIS 2490, at *8 (Nov. 27, 2001) (rejecting a similar argument where the hearing lasted several days and involved a lengthy record); *Eurrell v. Potts*, 45 S.E.C. 619, 621 (1974) (finding that a 14-month duration before the issuance of a decision did not result in the deprivation of any rights). The timing of the Extended Hearing Panel decision may be attributable to the complexity of the case and length of the hearing. The record reflects five days of hearings and more than 8,000 pages of exhibits. In any event, Respondents do not articulate, and we do not see, any alleged prejudice or harm to Respondents resulting from the timing of the decision.

Finally, Respondents challenge the Extended Hearing Panel's decision to exclude their proposed expert witness, and argue that this decision supports their claim that the Extended Hearing Panel was biased against them. FINRA Rule 9263(a) provides that the Hearing Officer has discretion to exclude all evidence that is irrelevant, unduly repetitious, or unduly prejudicial. A Hearing Officer has broad discretion to accept or reject evidence, which we review only for an abuse of discretion, and the burden on a complaining party is heavy. *See Dep't of Enforcement v. Strong*, Complaint No. E8A2003091501, 2008 FINRA Discip. LEXIS 19, at *17-18 (FINRA NAC Aug. 13, 2008).

Respondents argue that their expert was a former enforcement director who would have testified that he never would have investigated Respondents' misconduct or brought charges because the misconduct did not involve the activities of a broker-dealer. In essence, Respondents' proposed expert would have addressed FINRA's jurisdiction to investigate and bring charges with respect to Respondents' misconduct. Jurisdiction, however, is a legal conclusion and, accordingly, is not properly the subject of expert testimony. *Dep't of Enforcement v. Fiero*, Complaint No. CAF980002, 2002 NASD Discip. LEXIS 16, *90 (NASD NAC Oct. 28, 2002). Moreover, as discussed above, there is no question that FINRA had the jurisdiction to investigate and file a complaint for Respondents' business-related ethical violations. We find that the Extended Hearing Panel did not abuse its discretion in excluding Respondents' expert.

V. Sanctions

The Extended Hearing Panel imposed three separate bars on Fretz and Freeman from associating with any FINRA member in any capacity and fined Keystone $25,000. After an independent review of the record, we modify these sanctions.

A. Fretz's and Freeman's Violation of Just and Equitable Principles of Trade

We find that Fretz and Freeman engaged in business-related conduct that is inconsistent with just and equitable principles of trade in violation of NASD Rule 2110 and FINRA Rule 2010. In assessing sanctions, we consider FINRA's Sanction Guidelines ("Guidelines"), including the Principal Considerations in Determining Sanctions and any other case-specific factors.[33] The Guidelines do not specifically address the misconduct at issue, so we apply the Principal Considerations. Based upon the Principal Considerations, we find numerous aggravating factors.

As fiduciaries of Covenant, Fretz and Freeman acted as the custodians of Covenant investors' money and were obligated to exercise good faith and integrity in handling Covenant affairs. The overwhelming evidence establishes that they failed to do so, engaging in a myriad of acts of self-dealing and unethical conduct.[34] Fretz and Freeman's misconduct involved many instances of the misuse of large amounts of money over an extended period of time. Fretz and Freeman used Covenant's assets to fund their failing broker-dealer and their personal lifestyles at the expense of Covenant investors. In order to enable their misconduct, they characterized disbursements from Covenant to themselves and their business in an opportunistic fashion that solely benefited them to the detriment of Covenant investors to whom they owed fiduciary responsibilities.[35] Fretz and Freeman unfairly profited as a result of each of their acts of misconduct, including transferring funds from Covenant to themselves and their business entities (including Keystone), taking amounts in excess of the capital account of the General Partner, failing to apply the high water mark in Covenant's governing documents, overvaluing stock contributions, and failing to pay interest on a personal loan from Covenant. All these factors support a stringent sanction against Fretz and Freeman.

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[33] *See also FINRA Sanction Guidelines*, 33 (2013). We apply the applicable FINRA Guidelines in place at the time of this appeal.

[34] *Id.* at 6-7 (Principal Considerations in Determining Sanctions, No. 8, 9, 17).

[35] *Id.* at 6-7 (Principal Considerations in Determining Sanctions, No. 11, 17).

Furthermore, the record supports that their misconduct was intentional.[36] We agree with the Extended Hearing Panel that the shifting, confusing, and contradictory characterizations Freeman and Fretz gave the transfers were intended to obfuscate and conceal their activity. Among other things, Fretz purposefully characterized his disbursements from Covenant to himself and his businesses to maximize his allocation of the IXI stock profit, specifically telling his accountant to classify transfers to him as distributions but only after the allocation. Fretz and Freeman also deliberately transferred substantial amounts from Covenant to Keystone to prop up their struggling broker-dealer, classifying the transfers as it suited their needs at the time, and then later documenting the transfers as a $1.4 million loan, despite the fact that there were no written terms for the loan, no interest rate, and no collateral.

It is further aggravating that Fretz and Freeman attempted to conceal their misconduct from both Covenant investors and FINRA.[37] When FINRA began investigating the sources of funds deposited at Keystone to verify that they constituted good capital for net capital purposes, Fretz and Freeman provided falsified documents and misleading responses. Fretz and Freeman also failed to disclose to Covenant investors, including 11 who were Keystone customers, that they were disbursing millions of dollars of Covenant investors' funds to themselves and Keystone. Fretz and Freeman did not procure or provide audited financial statements for Covenant during the relevant period, despite this requirement in Covenant's governing documents,[38] thereby keeping investors unaware of Fretz's and Freeman's activities. Although Covenant investors received Covenant's federal K-1 tax returns, these documents did not include disclosures about Covenant's investments nor did they show how the transfers from Covenant were treated at the time from an accounting standpoint. Covenant investor BN testified he believed that Covenant invested only in private companies, and other Covenant investors testified that they were unaware that Fretz and Freeman borrowed money from Covenant for themselves, Keystone, or other business interests. All three investors also testified that they were never told that Fretz and Freeman were not applying the high water mark provisions of Covenant's governing documents.

We also find it aggravating that Fretz and Freeman have not accepted responsibility for their misconduct.[39] For example, Fretz testified that he did not have a duty to tell Covenant investors that he "was using Covenant funds to keep Keystone in business," insisting that it was

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36 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 13).

37 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 10).

38 It is undisputed that that Fretz and Freeman never amended Covenant's governing documents to remove the requirement. At the hearing, Fretz explained that Covenant stopped doing audited financial statements because it was too expensive, and he told all the "significant shareholders" of Covenant.

39 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 2).

not material. He further testified that it was in Covenant investors' interests to prop up Keystone because Keystone would be able to facilitate deals for Covenant in the future. Likewise, Freeman testified that Covenant derived a lot of benefit from Keystone "from a management point of view, from operations, from shared services, from the ability to sources deals." Freeman also testified that it was in Covenant's interest to borrow money at high rates of interest to fund payments to himself and Fretz because "we provided a lot of value to our limited partners and, from time to time, [Covenant] needed liquidity to in order satisfy certain things." The record simply does not support any credible business justification for the transfer of substantial sums to Fretz, Freeman, and their businesses when the General Partner was obligated to invest the money for the benefit of Covenant investors. And we find Fretz's and Freeman's refusal to acknowledge that their actions unfairly benefited their companies, including Keystone, at the expense of Covenant and its investors to be highly disconcerting.

We reject Respondents' suggestion that we consider their lack of previous disciplinary history or the absence of customer complaints as mitigating. *See Dep't of Enforcement v. Craig*, Complaint No. E8A2004095901, 2007 FINRA Discip. LEXIS 16, at *24 (FINRA NAC Dec. 27, 2007) (rejecting argument that absence of disciplinary history and prior customer complaints deserved mitigation), *aff'd*, Exchange Act Release No. 59137, 2008 SEC LEXIS 2844. In fact, we note that the lack of investor complaints could very well be attributed to the fact that investors were unaware of Fretz's and Freeman's self-dealing, as corroborated by the investors' testimony, and the lack of audited financial statements.

Fretz and Freeman demonstrated a serious misunderstanding of the fiduciary obligations they subjected themselves to as officers of Covenant, and their misconduct reveals a troubling disregard for fundamental principles of the securities industry. Taking into consideration the egregiousness of their misconduct, the presence of numerous aggravating factors, and the absence of mitigating circumstances, we find that they pose a danger to the investing public. We find that barring them in all capacities is necessary to deter them and others similarly situated from engaging in similar misconduct. Therefore, we bar Fretz and Freeman from associating with any FINRA member firm in any capacity for their misconduct that violated just and equitable principles of trade.

B. Respondents' FINRA Rule 8210 Violations

The Extended Hearing Panel barred Fretz and Freeman and fined Keystone $25,000 for their violations of FINRA Rules 8210 and 2010. We affirm this sanction with respect to Fretz and Freeman, and increase the sanction with respect to Keystone.

Absent mitigating circumstances, a bar should be the standard sanction for failing to respond truthfully to FINRA. *See Ortiz*, 2007 FINRA Discip. LEXIS 3, at *43. If there are mitigating factors present, adjudicators should consider suspending the individual in any or all capacities for up to two years.[40] In the case of a firm, the Guidelines state that, in egregious

[40] *Guidelines*, at 33.

cases, adjudicators should consider expulsion. If there are mitigating factors present, adjudicators should consider suspending the firm with respect to any or all activities or functions for up to two years.[41] The Guidelines instruct adjudicators to consider, in addition to the principal considerations and general principles applicable to all violations, the importance of the information requested as viewed from FINRA's perspective.[42]

Respondents repeatedly made false and misleading statements to FINRA. Both Fretz and Freeman made or were involved in the preparation of Keystone's responses to FINRA's requests and directly or indirectly provided falsely dated documents to FINRA. The information sought by FINRA related to its investigation into net capital at Keystone and compliance with important Commission rules. Respondents frustrated FINRA's important investigation with repeated false statements to FINRA's numerous requests.[43] Indeed, the four misleading responses provided by Respondents impeded FINRA's investigation and made it more difficult for FINRA to determine the nature of transfers from Fretz to Keystone, and the source from which Fretz received the money to transfer to Keystone. We reject Respondents' attempt to mitigate their misconduct by asserting they never intended to mislead FINRA. We find that the evidence belies their assertion. Respondents' misrepresentations were intentional, and they demonstrated a pattern of obstruction and prolonged delay.

We find that Respondents' numerous false statements to FINRA were egregious, and that there are no applicable mitigating factors. Respondents made misleading statements and backdated documents in an effort to conceal their misconduct and mislead FINRA. Fretz and Freeman are the only officers at Keystone and effectively controlled the firm. Accordingly, their misconduct is imputed to Keystone, and there is no mitigation for a member firm based on shared ownership with other parties.

Considering the egregiousness of the misconduct, including two falsified documents and four misleading responses, we find that a $25,000 fine is inadequate to address the misconduct at issue. Anything short of an expulsion of Keystone and a bar of Fretz and Freeman would be insufficient to remedy Respondents' misconduct and to deter others from engaging in future misconduct. *See Ortiz*, 2008 SEC LEXIS 2401, at *32 ("Because of the risk of harm to investors and the markets posed by such misconduct, we conclude that the failure to provide truthful responses to requests for information renders the violator presumptively unfit for employment in the securities industry."). We therefore bar Fretz and Freeman in all capacities and expel Keystone from FINRA membership for their misleading statements to FINRA.

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[41] *Id.*

[42] *Id.*

[43] *See id.* at 7 (Principal Considerations in Determining Sanctions, No. 12).

C. Fretz’s Form U4 Violations

The Extended Hearing Panel assessed, but, in light of the bars, declined to impose a two-year suspension and $50,000 fine against Fretz for his Form U4 violations. We affirm this sanction.

The Guidelines for misconduct involving the failure to file or filing false, misleading, or inaccurate Form U4’s or amendments recommend a fine of between $2,500 and $50,000 and direct us to consider suspending the individual for five to 30 business days.[44] In egregious cases, such as those involving repeated failures to file, untimely filings, or false, inaccurate, or misleading filings, the Guidelines recommend considering a longer suspension of up to two years or a bar.[45] In evaluating the appropriate sanctions, the Guidelines provide three principal considerations specific to Form U4 violations, only one of which—the nature and significance of the information at issue—is relevant here.[46] The Extended Hearing Panel concluded that Fretz’s misconduct was egregious. We agree.

First, we consider the nature of the information that Respondents failed to disclose. Fretz filed a false Form U4, in which he failed to disclose an unsatisfied $131,029 judgment, and failed to amend his Form U4 to disclose an additional seven judgments. The eight judgments totaled more than $2.4 million. Respondents argue that there was no evidence that the judgments were significant to the nature of Fretz’s conduct at Covenant or Keystone. We disagree. The judgments implicate Fretz’s financial stability, judgment, and ability to manage his finances. Such serious financial issues “raise concerns about whether [respondents] could responsibly manage [their] own financial affairs, and ultimately cast doubt on [their] ability to provide trustworthy financial advice and services to investors relying on [respondents] to act on their behalf.” *Tucker*, 2012 SEC LEXIS 3496, at *32 (citing *Scott Mathis*, Exchange Act Release No. 61120, 2009 SEC LEXIS 4376, at *29 (Dec. 7, 2009), *aff’d*, 671 F.3d 210 (2d Cir. 2012)).

Respondents argue that Fretz did not act intentionally. At a minimum, we find that Fretz’s misconduct was reckless. Fretz’s misconduct spanned more than three years, a

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44 *Guidelines* at 69.

45 *Id*. at 70.

46 *Id*. at 69 (Principal Considerations in Determining Sanctions, No. 1). Respondents’ failures to disclose information in this case do not implicate the other two principal considerations applicable to Form U4 violations: whether the failure resulted in a statutorily disqualified individual becoming or remaining associated with a firm; and whether a firm’s misconduct resulted in harm to a registered person, another member firm, or any person or entity. *Id*. Because these considerations do not apply, we do not consider them either aggravating or mitigating.

significant period of time, and involved numerous acts and a pattern of misconduct.[47] As the principal at Keystone responsible for registration and disclosure issues, we find that his misconduct is particularly flagrant.

Moreover, as of the hearing, in addition to the eight judgments alleged in the complaint, nine more judgments were entered against Fretz, only one of which he timely disclosed. Respondents' counsel stipulated that Fretz was aware of two of these judgments, one of which was disclosed. For the remaining seven judgments, counsel stipulated that Fretz was aware of the actions but not the existence of a final judgment. Fretz's assertions ring hollow. Not only was he served with the other seven judgments, but Enforcement included them in its exhibits and referenced them in its pre-hearing brief, which was filed a month prior to the hearing. Despite being repeatedly made aware of the existence of the additional judgments, Fretz did not amend his Form U4 until the third day of the hearing. We find that Fretz's continued failures with respect to his Form U4 disclosures to be highly aggravating.

Respondents argue that, because the vast majority of Fretz's investors were friends and family and not individuals likely to review his Form U4, there was no harm to investors. As an initial matter, we note that the lack of customer harm is not mitigating. Besides investors, who have access to certain disclosures on FINRA's BrokerCheck, the Form U4 also is used by all self-regulatory organizations (including FINRA), state regulators, and broker-dealers to determine and monitor the fitness of securities professionals. *See Rosario R. Ruggiero*, 52 S.E.C. 725, 728 (1996). True and complete answers to Form U4 questions are "essential to a meaningful system of self-regulation" and "vital to determining the fitness of an applicant for registration as a securities professional." *Craig*, 2007 FINRA Discip. LEXIS 16, at *25.

We agree with the Extended Hearing Panel that Fretz's misconduct was egregious. His continued misconduct after Enforcement filed this complaint further demonstrates his complete disregard for the disclosure required by FINRA rules and the Form U4 and warrants significant sanctions.[48] We agree with the Extended Hearing Panel that a $50,000 fine and two-year suspension is all capacities—which is consistent with the Guidelines—are appropriate sanctions and best serve to protect the investing public and deter others from failing to disclose material information when seeking registration through a FINRA member. In light of the bars, however, we decline to impose these sanctions.

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[47] *See Guidelines* at 6-7. (Principal Considerations in Determining Sanctions, No. 8, 9, 13).

[48] *See id.* at 7 (Principal Considerations in Determining Sanctions, No. 13).

VI. Conclusion

Fretz and Freeman engaged in business-related conduct that was inconsistent with just and equitable principles of trade in violation of NASD Rule 2110 and FINRA Rule 2010. Fretz, Freeman, and Keystone also provided misleading information to FINRA, in violation of FINRA Rules 8210 and 2010, and Fretz willfully filed a false Form U4 and failed to amend his Form U4, in violation of FINRA Rules 1122 and 2010 and Article V, Section 2 of FINRA's By-Laws. For their misconduct, we impose two bars on Fretz and Freeman from associating with any FINRA member in any capacity and expel Keystone from FINRA membership, effective upon service of this decision. Fretz is also statutorily disqualified for his willful Form U4 violations. We also impose appeal costs of $1,502.20.

On Behalf of the National Adjudicatory Council,

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Marcia E. Asquith,
Senior Vice President and Corporate Secretary