FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. WILLIAM B. FRETZ, JR. (CRD No. 1545760), JOHN P. FREEMAN (CRD No. 1651569), and THE KEYSTONE EQUITIES GROUP, LP (CRD No. 127529), Respondents.	Disciplinary Proceeding No. 2010024889501 Hearing Officer–MC **EXTENDED HEARING PANEL DECISION** May 30, 2013

Respondents William B. Fretz, Jr. and John P. Freeman misused customer funds in violation of NASD Rules 2330(a) and 2110, and FINRA Rules 2150(a) and 2010, and made misrepresentations and omissions of material fact to investors, 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. For their misconduct, Fretz and Freeman are barred from associating with any FINRA member firm in any capacity, and The Keystone Equities Group is fined $25,000.

The Keystone Equities Group is not liable for providing misleading brokerage statements to 11 customers.

Appearances

Jeffrey Pariser, Esq., Paul M. Schindler, Esq., and Jennifer Schulp, Esq., for the Department of Enforcement.

Mu'min F. Islam, Esq., MFI Law Group, PLLC, and William W. Uchimoto, Esq., Stevens & Lee, PC, for Respondents.

DECISION

I. INTRODUCTION

This case grew from what began as a routine FINRA inquiry into the source of a $50,000 deposit to a FINRA member firm, The Keystone Equity Group, LP ("Keystone"). Pursuing their inquiry to determine whether the deposit conformed to FINRA's net capital requirements, the examiners unexpectedly discovered evidence of numerous, large, puzzling transfers of funds. As the examiners followed the money to answer the questions raised by these transfers, their routine net capital inquiry developed into an investigation into a completely different set of FINRA rule violations. The investigation produced the Complaint in this case, charging Respondents with repeated and pervasive misuse of customer funds, misrepresentations and omissions of material facts in the sales of securities, and other violations.

The first issue the case presents is jurisdictional. Respondents challenge FINRA's jurisdiction over the conduct alleged in the first four causes of action and insist that these charges must be dismissed. The second issue, central to the allegations against them, is whether the two individual respondents, William B. Fretz and John P. Freeman, misused millions of dollars from the funds of Covenant Partners, LP ("Covenant"), a limited partnership they control, by funneling the money through Keystone, which was struggling financially, to prop it up and to benefit themselves.

For the reasons set forth below, the Extended Hearing Panel rejects Respondents' overarching objection to FINRA's jurisdiction and decides the central issue against Fretz and Freeman. We conclude that they misused approximately $5 million of Covenant's funds over a period of years and engaged in other serious misconduct.

We also conclude that Fretz and Freeman made misrepresentations and omissions of material fact to investors; that the three Respondents provided misleading information in

response to FINRA's requests for information; and that Fretz filed a false Form U4 and failed to update his Form U4 to reflect numerous judgments that had been filed against him. However, we dismiss the allegation that Keystone provided misleading brokerage statements to customers.

II. FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. Background

1. Respondents

Keystone, a FINRA member since 2003, is a privately held broker-dealer with one branch office in Oaks, Pennsylvania. Fretz and Freeman are both principals of Keystone,[1] which they operate and control. Each has a 12 percent ownership interest in Keystone through Keystone Group Holdings, LP ("Holdings"), a holding company whose only asset is Keystone.[2] Keystone provides investment banking services to small and medium-sized companies.[3] From January 2008 through December 2010 (the "Relevant Period"), Keystone employed three registered representatives in addition to Fretz and Freeman.[4]

Fretz has extensive experience in the securities industry. He first registered with FINRA in 1987 and has worked at Keystone since 2003. At Keystone, Fretz holds eight registrations: Series 7, General Securities Representative; Series 24, General Securities Principal; Series 55, Equity Trader; Series 27, Financial and Operations Principal; Series 79, Investment Banking Representative; Series 4, Registered Operations Principal; and Series 9 and 10, General Securities Sales Supervisor.[5]

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[1] Stipulation ("Stip.") 1.

[2] Tr. 263. Fretz and Freeman share ownership of Holdings with six others. Tr. 247-48, 263.

[3] Stip. 7.

[4] Stip. 4.

[5] Stip. 2.

Freeman, too, registered first with FINRA in 1987 and has worked at Keystone since 2003. He holds two registrations: Series 7 and 79.[6]

2. Covenant Partners

Fretz and Freeman founded Covenant in 1996. It is a private investment limited partnership that they control. Fretz and Freeman describe Covenant as a private equity firm or hedge fund.[7] They each own one half of Covenant Capital Management ("CCM"), Covenant's General Partner.[8] Through CCM, Fretz and Freeman manage Covenant's affairs and its funds. Fretz and Freeman each acquired limited partnership interests in Covenant, and sold limited partnership interests to friends and family members who comprise most of Covenant's approximately 40 investors. During the Relevant Period, 11 limited partners held their Covenant interests in retirement accounts at Keystone, and were customers of the firm.[9]

B. Respondents' Jurisdictional Challenge

Respondents vigorously argue that FINRA has no jurisdiction over the misconduct alleged in the first four causes of action because the subject matter relates to Fretz's and Freeman's management of Covenant funds.[10] Respondents contend that Covenant is an entity separate and apart from Keystone, a hedge fund outside of FINRA's regulatory scope.[11] From this predicate Respondents argue that:

- the allegations of misuse of funds in the first cause of action are beyond FINRA's authority because they arise from FINRA's improper and "exhaustive review" of

[6] Stip. 3.

[7] Stip. 12.

[8] Stip. 11.

[9] Stip. 18.

[10] Respondents stipulate that FINRA has personal jurisdiction over them for the purposes of this disciplinary proceeding. Stips. 2, 3, 5.

[11] Respondents' Br. 3, 5, 8-9.

hedge fund books and records, and relate to the hedge fund's operations, accounting practices, disbursements, and profit allocations;[12]

- the allegations of misrepresentations and omissions in the second cause of action are outside of FINRA's purview because they concern the hedge fund's offering circular and partnership agreement, matters solely pertaining to the hedge fund;[13]
- the allegations of misleading statements to FINRA in the third cause of action are beyond the scope of FINRA's authority under Rule 8210 because they concern information FINRA obtained from the hedge fund's books and records and relate to Respondents' documentation of hedge fund disbursements;[14] and
- the allegation that Keystone sent customers misleading brokerage account statements in the fourth cause of action is outside FINRA's authority because the account statements came from Covenant.[15]

With regard to the second cause of action, alleging Respondents provided misleading responses to FINRA information requests, Respondents raise separate, additional arguments. First, they claim that the second cause of action represents a misapplication of the "just and equitable" business conduct requirements of NASD Rule 2110 and FINRA Rule 2010. Respondents argue that because they did not act in bad faith, just and equitable business conduct principles simply do not apply to their private contract obligations to Covenant as defined by its

[12] *Id.* at 5.

[13] *Id.*

[14] *Id.* at 9-10.

[15] *Id.* at 5.

limited partnership agreement and offering circular.[16] Second, Respondents contend that FINRA lacked authority to inspect Covenant's books and records and demand information and documents under Rule 8210, as it did in this case, because Rule 8210 only permits FINRA to inspect the books and records of a member or associated person, and Covenant is neither.[17]

We reject Respondents' jurisdictional challenges for the reasons discussed below.

1. The Facts Do Not Support The "Separate Entity" Predicate For Respondents' Jurisdictional Challenge

First, contrary to Respondents' claim, Covenant and Keystone are not entirely distinct, unaffiliated legal entities with separate books and records. Rather, Keystone and Covenant, through Fretz and Freeman, are inextricably connected to each other. The two entities share office space, equipment, and personnel. Covenant's office address is the same as Keystone's and, during the Relevant Period, Fretz's assistant and Keystone employee, Barbara Shaffer, maintained Covenant's books and records, including a checkbook and check register, at that address.[18] Fretz used Keystone's email system to communicate with Covenant investors.[19] Keystone itself referred to Covenant as an affiliate; its website described Covenant as an "Affiliate and Business Partner" of the firm.[20] In audited financial statements filed with the SEC, Keystone made similar references to Covenant as its "affiliate."[21]

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[16] Respondents' Post-Hearing Br. 22-23 (*citing Dep't of Enforcement v. Shvarts*, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *13-14 (N.A.C. June 2, 2000) (*quoting Samuel B. Franklin & Co.*, 38 S.E.C. 113, 116 (1957)). *Franklin* concerns a complaint by an NASD member firm that another member firm failed to perform a contractual obligation to make good delivery of purchased stock.

[17] Respondents' Br. 12-16 (*citing Jay Alan Ochanpaugh*, Exchange Act Rel. No. 54363, 2006 SEC LEXIS 1926 (Aug. 25, 2006)).

[18] Tr. 156-57.

[19] Tr. 158.

[20] Stip. 15.

[21] CX-346, CX-63.

The two entities are under common control. As stated above, Fretz and Freeman control both: Fretz is President of Keystone, Freeman is a Director, and the two of them are Keystone's control persons.[22] Through CCM, Covenant's General Partner, they also own and control Covenant. Covenant is a brokerage customer of Keystone, holds a brokerage account at the firm, and Fretz is Covenant's broker of record.[23] During the Relevant Period, 11 of Covenant's limited partners held their Covenant investments in qualified retirement accounts at Keystone, and were therefore Keystone customers, and other Covenant investors had regular brokerage accounts at Keystone.[24]

Significantly, at the hearing, Fretz and Freeman emphasized that the close relationship between Keystone and Covenant is one of the signal attractions of investment in Covenant; indeed, they described the broker-dealer as essential to Covenant's operation. Freeman testified that Covenant benefits from use of Keystone's facilities, Keystone's "intellectual capital," and the firm's "deal flow."[25] Fretz testified that during the Relevant Period Covenant's investments "came directly from Keystone ... [Keystone] gives Covenant Partners a lot of opportunity .... Frankly, that's why a lot of people love investing in Covenant because they knew we saw a lot of things earlier and gave us great opportunity."[26]

2. FINRA's Conduct Rules Prohibit Respondents' Misconduct

Second, the nature of Respondents' misconduct falls squarely within the traditional scope of FINRA's regulatory mission. The first cause of action alleges that Fretz and Freeman misused customer funds. Misuse of customer funds is expressly prohibited by NASD Rule 2330(a) and

[22] Tr. 447-48; CX-11, at 3.

[23] Tr. 154.

[24] Stips. 18, 29.

[25] Tr. 799-800.

[26] Tr. 237-38. Respondents' accountant, Mark Carrow, echoed these sentiments, testifying that Keystone is "a great source of ideas" and that Covenant's "profitability ... came from the broker dealer." Tr. 1891-92.

FINRA Rule 2150. Of the $5 million Fretz and Freeman improperly took from Covenant, they disbursed most of it—$4.26 million—through Covenant's Keystone brokerage account.[27] Although Respondents describe these transfers as disbursements of a hedge fund, they are properly viewed as transfers of a broker-dealer's customer funds at the direction of registered persons through a brokerage account of a member firm. As such, the Panel finds that FINRA's exercise of jurisdiction to monitor and investigate the transfers is entirely proper.

Similarly, Respondents' arguments as to the second cause of action miss the mark. The second cause of action charges Fretz and Freeman with violations of NASD Rule 2110 and FINRA Rule 2010[28] for failing to inform Covenant investors of the use to which they put Covenant's funds, and for omissions and misrepresentations in the Covenant Limited Partnership Agreement and Offering Circular Fretz and Freeman gave to investors. Respondents argue that this alleged misconduct does not involve securities business activity because it concerns the hedge fund, and claim that here FINRA is seeking improperly to extend its authority to pass judgment on Respondents' "contract obligations." But Covenant limited partnership interests are securities.[29] Therefore, misrepresentations and omissions made in the materials Fretz and Freeman used to offer and sell Covenant partnership interests are securities-related and thus clearly within FINRA's jurisdiction. By pursuing this charge, Enforcement is not seeking to

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[27] CX-20, CX-279, Figure 2 at 11.

[28] As of July 30, 2007, NASD consolidated with the member regulation and enforcement functions of NYSE Regulation and began operating under a new corporate name, the Financial Industry Regulatory Authority (FINRA). References in this decision to FINRA include, where appropriate, NASD. Following consolidation, FINRA began developing a new FINRA Consolidated Rulebook. The first phase of the new consolidated rules became effective on December 15, 2008. *See* Regulatory Notice 08-57 (Oct. 2008). This decision refers to and relies on the conduct rules that were in effect at the time of the misconduct described in the Complaint. The applicable rules are available at www.finra.org/rules. In this case, the Relevant Period begins when NASD Rules were effective and ends after the adoption of FINRA Rules. However, FINRA Rule 2010 is identical to its predecessor, NASD Rule 2110.

[29] The Offering Circular describes the partnership interests as securities, (CX-64, at 1), and limited partnerships have long been held to be investment contracts, and thus securities. *Williamson v. Tucker*, 645 F.2d 404, 423 (5th Cir. 1981).

extend "just and ethical" business conduct principles to private contract obligations, but is applying them to traditional business-related conduct.[30] And because Fretz and Freeman act as Covenant's General Partner, they owe fiduciary obligations to the limited partners requiring them to disclose the use to which they put the limited partners' funds.[31]

Finally, the fourth cause of action concerns misleading monthly statements Keystone allegedly sent to its customers holding qualified retirement accounts at the firm, a matter also clearly within FINRA's authority to review and regulate. Simply because Covenant initially generated the statements does not undermine FINRA's authority to review them.

3. FINRA Sought Production Of Documents In Respondents' Possession And Control

As for the third cause of action, relating to FINRA's requests for information, there can be no dispute that Fretz and Freeman, as registered persons, and Keystone, as a FINRA member firm, are required to respond to FINRA staff requests for information they possess. It is a fundamental proposition that because FINRA lacks subpoena power, it must rely on information requests pursuant to Rule 8210 to fulfill its regulatory responsibility to police the activities of members and associated persons. "The rule is at the heart of the self-regulatory system for the securities industry" and is "unequivocal" in its imposition of the obligation to comply with information requests.[32] In this case, as noted above, the requests for information were directed to Respondents, directing them to produce records in their possession, and originally concerned capital infusions into FINRA member firm Keystone by Covenant.

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[30] *See, e.g., John M.E. Saad*, Exchange Act Rel. No. 62178, 2010 SEC LEXIS 1761, at *13 (May 26, 2010); *Dep't of Enforcement v. Shvarts*, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *18 (N.A.C. June 2, 2000).

[31] *Saad*, 2010 SEC LEXIS 1761, at *13 & n.5; *Vail v. SEC*, 101 F.3d 37, 39 (5th Cir. 1996).

[32] *Howard Brett Berger*, Exchange Act Rel. No. 58950, 2008 SEC LEXIS 3141, at *13 (Nov. 14, 2008).

Respondents' claim that the documents FINRA sought were hedge fund records and, as such, constituted third-party records beyond the reach of Rule 8210, is ill-founded. To support this claim, Respondents rely on their reading of a single case, *Jay Alan Ochanpaugh.*[33] The case is factually distinguishable, however, and Respondents misapply it.

In *Ochanpaugh*, the respondent objected to a Rule 8210 request that he produce third-party checks written on a bank account of a church of which he was the president. The respondent protested that the records sought by the Rule 8210 request were not his books and records and therefore were beyond the scope of NASD's authority to obtain them under Rule 8210. The Securities and Exchange Commission agreed, stating that although precedent supports a "broad interpretation" of Rule 8210, its scope "does have limits."[34] The Commission found that NASD failed to establish that the respondent possessed and controlled the third-party documents requested, and had not shown that the request was for "books, records, and accounts" of a member or associated person, and therefore within the scope of Rule 8210.[35]

Ochanpaugh is distinguishable for two reasons. First, in making the information requests here, FINRA sought information about the origin of funds disbursed from Covenant to a FINRA member firm. The requests all related to the FINRA staff's original inquiry into whether infusions of cash into Keystone constituted "good capital."[36] Even if the records produced were not, strictly considered, "firm" records, they related directly to firm business. Second, unlike

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[33] Exchange Act Rel. No. 54363, 2006 SEC LEXIS 1926 (Aug. 25, 2006).

[34] *Id.* at *13.

[35] *Id.* at *23-24.

[36] CX-281 (September 17, 2009 Rule 8210 request for a copy of a bank statement showing the origin of a $50,000 deposit into Keystone on April 29, 2009), CX-283 (November 4, 2009 Rule 8210 request for evidence of capital deposited into Keystone in third quarter of 2009), CX-286 (December 1, 2009 FINRA email request for a statement on Keystone letterhead explaining the origin of funds from Fretz's Covenant account to Keystone, a financial statement showing the value of Fretz's Covenant account, and a written statement from Covenant confirming the funds deposited into Keystone were not a loan to Fretz or Keystone).

Ochanpaugh, Fretz and Freeman had possession and control over the documents, and were easily able to produce them.

For all of these reasons, the Panel denies Respondents' challenges to FINRA's jurisdiction.

C. Fretz And Freeman Misused Covenant's Funds (Cause One)

As owners of CCM, Covenant's General Partner, Fretz and Freeman together control Covenant.[37] They exercise broad discretion to make management decisions for Covenant, including investing, lending, and borrowing funds on its behalf. However, although their discretion is considerable, it is not unlimited.

Covenant's Offering Circular and Limited Partnership Agreement, which define the duties and responsibilities of the General Partner, prescribe how partnership funds are to be used.[38] The Offering Circular requires that Covenant proceeds "will be invested in *securities* and otherwise applied to the business and expenses of the Partnership."[39] The Limited Partnership Agreement declares that the "purpose and business of the Partnership generally is to acquire, purchase, invest in, hold for investment, own, exchange, assign, sell or otherwise dispose of, trade in … or otherwise deal in Securities and Commodity Interests … including, without limitation, borrowing and lending Securities, Commodity Interests and funds."[40] The Limited Partnership agreement states, "'Securities' means securities, repurchase agreements and other intangible investment instruments and vehicles of every kind and nature."[41]

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[37] Stip. 11; Tr. 743.

[38] CX-64, CX-65.

[39] CX-64, at 19 (emphasis added).

[40] CX-65, at 15 ¶ 6.

[41] CX-65, at 14 ¶ 5.29.

As the persons controlling the General Partner, Fretz and Freeman assumed fiduciary obligations to Covenant and its limited partners. The Offering Circular states that the General Partner is a "fiduciary and consequently must exercise good faith and integrity in handling partnership affairs"[42] and requires the General Partner to ensure that it does not "unfairly profit from any transaction" with Covenant.[43]

At the hearing, Fretz and Freeman conceded that their fiduciary responsibilities required them to exercise their authority for the benefit of Covenant and its investors. Fretz, when asked if he understood he owed the duty of a fiduciary to Covenant investors, answered, "Oh, yes, sir." When questioned whether he understood he was required to exercise "good faith and integrity" on behalf of Covenant, Fretz emphatically asserted, "Absolutely. Always did."[44] Similarly, Freeman testified that decisions to invest, borrow, or lend money on behalf of Covenant had to be for the benefit of investors.[45]

At the outset of the Relevant Period, Covenant's funds were for the most part invested in two companies: IXI Corporation, a data marketing company, and PetFoodDirect, an internet pet supply company.[46] As these were illiquid investments, according to Freeman, Covenant lacked cash to permit withdrawals that Fretz and Freeman wished to make. Therefore they needed to attract new investments in Covenant, or borrow funds on behalf of Covenant, to be able to withdraw cash.[47]

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[42] CX-64, at 25.

[43] *Id.*

[44] Tr. 162.

[45] Tr. 743-44.

[46] CX-104, at 4.

[47] Tr. 780-81.

From 2008 through 2010, almost $10 million flowed into Covenant.[48] The sources of funds included: sales of a stock holding in November 2009, new investments, loans from third parties, and contributions from Freeman, and Fretz and his business entities.[49] During that time, Covenant disbursed roughly as much as it took in. But despite the Offering Circular's directive that they invest Covenant proceeds in securities, Fretz and Freeman placed only a small fraction —approximately $300,000—of Covenant's funds into equity investments.[50] In contrast, approximately $5.4 million gross, and $4 million net,[51] went to Freeman, to Fretz and his companies, and to Keystone.[52] As the persons in charge of Covenant's operations, Fretz and Freeman misused the funds in six ways, by:

- Causing Covenant to disburse a total of $2.5 million to Fretz in a series of transactions extending from 2008 through 2009;
- Causing Covenant to make a series of transfers in 2008 and 2009 to Freeman that caused deficits in Covenant's General Partner account, effectively providing Freeman over $500,000;
- Issuing a $1.4 million promissory note documenting a "loan" from Covenant to Holdings at the end of 2010;
- Making an excessive profit allocation of almost $400,000 to the General Partner's account—*i.e.*, to themselves—from Covenant's sale of IXI stock in late 2009;
- Inflating the value of stock contributions Fretz made to Covenant in 2004 by approximately $183,000; and
- Causing Covenant to make an $11,000 "short term" interest-free loan to Freeman in 2004 that was not "retired" until 2009.

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[48] Tr. 1181.

[49] Tr. 1198-99; CX-4, at 2.

[50] Tr. 1192-93, 1195.

[51] Tr. 1180.

[52] Tr. 1180-81, 1192; CX-1, CX-2; Stip. 19. Funds disbursed to Holdings went to Keystone, as Fretz testified: "[T]he holding company was where the money went to. And then the holding company downstreams to the broker/dealer." Tr. 614, 618.

The misuse of funds is set forth in detail below.

1. The $2.5 Million In Transfers To Fretz

During 2008 and 2009, Fretz and Freeman made numerous transfers to and from Fretz's Covenant accounts.[53] In 2008, Fretz disbursed a total of $505,058 to himself and his businesses;[54] in 2009, Fretz disbursed an additional $1,984,816, bringing the total payments to himself and his businesses to $2,489,874.[55] According to Enforcement's accounting, during the Relevant Period, Fretz's withdrawals exceeded the equity in his capital account by $1,874,046; in other words, Fretz withdrew almost $2 million more from Covenant than he was entitled to distribute and use for his own purposes.[56]

Over time, Fretz and Freeman have characterized these transfers inconsistently, sometimes describing them as loans and other times as distributions, depending on which description best suited their purposes at the moment. Enforcement argues that they did so in order to manipulate Covenant's accounting to maximize gains to them and to disguise the fact that the withdrawals exceeded the capital available in Fretz's account.[57] We find that the shifting, confusing, and contradictory characterizations Freeman and Fretz gave the transfers were intended to obfuscate and conceal their activity, and constitute evidence of their knowing engagement in a pattern of misuse of the funds.

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[53] Fretz's two principal Covenant accounts are his capital account, No. 30015, and a second account, No. 14224, labeled "notes Receivable – Bill Fretz" on Covenant's books. CX-279, at 12.

[54] Stip. 21.

[55] CX-7, CX-69, CX- 70; Compl. ¶¶ 53, 55; Answer ¶¶ 53, 55. During the Relevant Period, Fretz, his business entities, and Freeman transferred $1,421,899 to Covenant. Of that amount, only $12,100 came from Freeman. CX-20, Attachment B; Tr. 1167-68, 1345.

[56] As a limited partner, Fretz was entitled by Covenant's governing documents to withdraw his capital. However, from October 2009 through December 2010, Fretz's capital account, FINRA examiners found, was negative. CX-7, at 1-3. As General Partner, Fretz was entitled to invest Covenant capital on behalf, and for the benefit, of Covenant investors.

[57] Enforcement's Post-Hearing Br. ¶¶ 62, 75-77.

a. Fretz And Freeman Accounted For The Transfers Inconsistently

At the hearing, Fretz distinguished transfers of funds to Keystone from transfers to himself and his businesses. He claimed that the transfers from Covenant to Keystone were "all loans."[58] The transfers to himself and his businesses, he insisted, were all *distributions* he was entitled to make to himself. He stated, "Anything to me or my entities, they were not loans. I did not borrow any money from Covenant at all." For example, Fretz testified unambiguously that a $50,000 transfer of funds from Covenant to Keystone in a check he wrote on April 29, 2009, "was a loan; it was not a distribution."[59]

But in September 2009, just a few months after Fretz wrote this check, in response to a FINRA Rule 8210 request, Fretz and Freeman said the opposite. Fretz wrote to FINRA, "The funds were a distribution to me." He enclosed a letter Freeman signed, titled "Distribution Confirmation," purporting to document that the transfer to Keystone was a distribution Fretz was entitled to take from his Covenant capital account.[60]

However, shortly after making these unequivocal representations to FINRA, Fretz told his accountant something quite different. On November 5, 2009, Fretz sent an email directing the accountant to consider *all* disbursements from Covenant to him as loans: "I didn't take any distributions, only loans from the partnership in 2008-2009. I will try to pay off that number before the end of 2009."[61]

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[58] Tr. 306-07.

[59] Tr. 615.

[60] CX-281, CX-282. On the final day of the hearing, Fretz testified that at the time FINRA asked him about the transfer, he "fully believed in good faith that ... [it] was a distribution." Tr. 1960-61.

[61] Tr. 308. When confronted with this email at the hearing, Fretz claimed the 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 then insisted, "I don't recall this E-mail, and they were always distributions in my mind. I did not take loans from Covenant .... I can't explain this E-mail." He then attempted to explain that "I think what I might have been saying" was that the term he "should have used here is 'due from'" because, according to his accountant, "throughout the year everything is characterized as due from" until, at the end of the year, it becomes a distribution. Tr. 309-10.

Fretz had a reason to tell his accountant in late 2009 that all of his transfers of funds from Covenant were loans. Doing so helped him reap a significant profit.

At the end of October 2009, Covenant sold its IXI Corporation stock, one of its two major stock holdings.[62] The partnership's sizable profits from the IXI sale were allocated to Covenant investors in proportion to the funds in their capital accounts in the last quarter of 2009. Distributions deplete a capital account, but loans do not.[63]

If Fretz's transfers were distributions, they would have substantially depleted the balance in his capital account at the beginning of the last quarter of 2009.[64] Characterized as "loans," the transfers did not reduce the value attributed to Fretz's capital account. This meant Fretz was able to claim a share of the IXI stock sale profits based upon a $1.6 million valuation of his capital account. As a result, Fretz received approximately $900,000 from the stock sale. He would have been entitled to far less—$263,000—if the transfers had been treated as distributions.[65]

Other Covenant investors did not receive such favorable treatment in the allocation of their portion of the stock sale profits.[66]

Freeman, too, has shifted his characterization of transfers of funds from Covenant to Fretz, Fretz's businesses, and to Keystone. As president and General Partner of Covenant, Freeman approved the transfers.[67] In on-the-record testimony Freeman gave in November 2010,

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[62] Tr. 357-58, 361.

[63] As expressed in the report of Enforcement's expert accountant, Bruce. G. Dubinsky, "Both allocation of profits and withdrawal of capital from the partnership serve to reduce the partner's ownership share in the partnership, as denoted in their capital account balance. A loan, however, does not reduce a partner's capital account, rather it is recorded as a loan receivable (an asset) of the partnership." CX-279, at 16 ¶ 34.

[64] Tr. 1221, 1231-32; CX-7, at 2-3.

[65] CX-91, CX-7; Tr. 1227-28.

[66] Tr. 1534-36, 1840-41.

[67] Tr. 817.

he said that disbursements from Covenant to Keystone were distributions to Fretz from his capital account, and that is how he viewed them at the time he approved the transfers.[68] However, at the hearing he stated that although he thought the transfers were distributions at the time, subsequently he came to conclude they were loans. Why? Because after they were made "they were classified as a due from and then, after consultation with our accountant, became a loan."[69] Freeman explained that "due from" is a "placeholder" used by the accountant "until it's classified."[70] Thus, in sum, Freeman called the transfers distributions in the "Distribution Confirmation" he signed, and in his on-the-record testimony, but claimed at the hearing that they were loans because the accountant later said so.

b. The Transfers Were Distributions

There are objective indicia that can determine whether a transaction is a bona fide loan or a distribution. A promissory note, rate of interest, repayment terms, and security are traditional trappings of a loan. Fretz's and Freeman's transfers of Covenant funds to themselves were devoid of these trappings: there were no notes recording a "debt"; no arm's length rate of interest; no fixed maturity date; no repayment schedule; no evidence of an expectation of repayment; and no security or collateral.[71] When a transfer is a loan, the obligation to repay coincides in time with the withdrawal of the funds.[72] Covenant was no stranger to traditional loans and was party to a number of them, as borrower and lender, documented by promissory

[68] Tr. 818-19, 823.

[69] Tr. 814.

[70] Tr. 815. However, Freeman gave on-the-record testimony in November 2010 in which he stated the transfers from Covenant to Keystone were distributions from Fretz's capital account. Tr. 818-19, 823.

[71] Tr. 1668-72; CX-279, at 17 ¶ 36.

[72] Tr. 1672-73.

notes and customary terms of repayment.[73] But these indicia are entirely absent from Fretz's 2008-2009 withdrawals of funds from Covenant.

These facts lead inexorably to the conclusion that the $2,489,874 in transfers to Fretz from Covenant in 2008 and 2009 were not bona fide loans. The evidence shows that Fretz and Freeman characterized the transfers however best served their purposes at the time. In the end, regardless of what label Fretz and Freeman use, Fretz and Freeman disbursed Covenant funds for Fretz to use for his personal and business interests. Thus the disbursements were inconsistent with Fretz's and Freeman's fiduciary obligations to Covenant's investors, and violated NASD Rules 2330(a) and 2110, and FINRA Rules 2150(a) and 2010.

2. The Transfers To Freeman

During the Relevant Period, Freeman maintained a balance of less than $10,000 in his Covenant capital account, an IRA account. He made no withdrawals from it.[74] However, in 2008 and 2009, Fretz and Freeman transferred significant sums from Covenant's brokerage and bank accounts to Freeman.[75] They accounted for the transfers as debits to the General Partner's account.[76] Fretz testified that the transfers totaled approximately $700,000.[77]

On January 1, 2008, the General Partner's account had a balance of $129,624.[78] According to Enforcement's unchallenged calculations, by the end of 2009, Fretz and Freeman had transferred $698,471 from the account, including $35,902 in earned management fees, to

[73] CX-136, CX-5 (Covenant loans 2004-2010).

[74] Tr. 772.

[75] Stip. 23.

[76] Stip. 24.

[77] Tr. 769.

[78] CX-69 (Account No. 30001).

Freeman, which left the account with a negative balance of $532,945.[79] Freeman's withdrawals in 2010 again took the account negative.[80] The transfers were not accounted for as loans, and bore none of the hallmarks of bona fide loans. These distributions constituted a misuse of partnership funds by Freeman, as alleged, in violation of NASD Rules 2330(a) and 2110, and FINRA Rules 2150(a) and 2010.

3. The $1.4 Million "Loan"

During the Relevant Period, Keystone's financial condition was precarious, and this affected Fretz's and Freeman's financial well-being.[81] In 2008, Keystone sustained net losses of over $600,000; in 2009, over $546,000; and in 2010, almost $600,000.[82] Keystone's 2010 audited financial statements contained a "going concern" clause, certifying the auditors' doubts about the company's ability to stay in business.[83]

Fretz and Freeman transferred substantial amounts from Covenant to Keystone, both directly and through Holdings. For example, on May 30, 2008, an investor committed $40,000 to Covenant, and on June 6, 2008, Covenant transferred slightly more than $30,000 to Holdings. On June 23, 2008, when an investor put $17,000 into Covenant, Covenant immediately transferred $20,000 to Keystone. On June 30, 2008, an investor placed $150,000 into Covenant, and Covenant transferred $75,000 to Holdings.[84] During the Relevant Period, Fretz and Freeman disbursed $1,178,058 from Covenant's bank and brokerage accounts to Keystone.[85]

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[79] CX-68.

[80] CX-72.

[81] Stip. 8; Tr. 907.

[82] Stip. 10; CX-60 – CX-62.

[83] CX-62, at 10; Tr. 258-59.

[84] CX-2, at 1.

[85] CX-279, at 11. The transfers totaled over $510,000 in 2008; over $480,000 in 2009; and over $180,000 in 2010. Most of the funds to Keystone came from Covenant's brokerage account.

Fretz and Freeman subsequently attempted to make it appear that the disbursements they made from Covenant to Keystone were legitimate loans of partnership funds. [86] They argue that the transfers were bona fide loans because they "were subsequently evidenced by a promissory note" and were initially characterized as loans by Keystone bookkeeper Barbara Shaffer in her check register notes.[87]

The "promissory note" was an afterthought. Fretz and Freeman created the promissory note in order to make it appear that the disbursements to Keystone were a "loan," by committing Keystone to repay $1,410,573 to Covenant, at 10 percent interest, due on December 31, 2012.[88] The promissory note is dated December 31, 2010. However, it was created and signed by Freeman in April 2011.

When he testified, Freeman claimed that he had no idea why the note was dated December 31, 2010, when it was created over three months later.[89] He testified that the note was created to "document" some of the funds Freeman and Fretz "were lending to Keystone Equities from Covenant Partners" during the Relevant Period[90] and used to operate Keystone.

The 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.[91] The note was created 16 months after many of the transfers,[92] to memorialize transactions that Fretz and Freeman had previously described as

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[86] Tr. 879.

[87] Respondents' Post-Hearing Br. 18-19.

[88] Stip. 22.

[89] Tr. 876-77.

[90] Tr. 877; Stip. 22.

[91] Enforcement's expert testified that the ability of a borrower to repay a loan is a factor to consider in assessing the legitimacy of the characterization of a transaction as a loan. Tr. 1695.

[92] CX-279, at 12 ¶ 28.

distributions.[93] As Enforcement's expert forensic accountant testified, "at 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."[94]

The evidence reveals the note to be a clumsy effort by Fretz and Freeman to retroactively change the accounting record of their misuse of Covenant funds. The promissory note does not alter the fact that the disbursements of $1.4 million to Keystone were infusions of cash into their financially ailing broker-dealer. As such, the transfers were impermissible under Covenant's governing documents, and a misuse of Covenant funds.[95]

4. The Profit Allocation Of The IXI Stock Sale And The "High Water Mark"

From 2000 through 2008, Covenant lost money.[96] However, on October 30, 2009, as a result of the sale of Covenant's holdings of IXI Corporation stock, Covenant took in approximately $4.4 million, making 2009 Covenant's first profitable year in almost a decade.[97] When Fretz and Freeman set out to allocate the 2009 profit, and to calculate the performance fee to be paid to them through the General Partner, they did so improperly. As a result, they profited impermissibly by disregarding the binding requirements of Covenant's governing documents. Doing so violated their fiduciary duties to Covenant's limited partners and constituted a misuse of partnership funds.

Covenant's Offering Circular and the Limited Partnership Agreement prescribe the manner by which the General Partner is to determine its share of partnership profits, including its

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[93] Tr. 1669-70.

[94] Tr. 1673.

[95] Enforcement's Post-Hearing Br. ¶¶ 82-85. When the promissory note was created, Keystone was operating under a "going concern" clause. Tr. 845-46. Keystone had net losses of $644,211 in 2008; $546,543 in 2009; and $599,944 in 2010. Stips. 8-9.

[96] CX-92.

[97] Tr. 803-04; CX-78, at 9.

performance fee.[98] The documents state that at the end of each fiscal year, the General Partner is to receive a 20 percent share of the profits earned by each limited partner, but that this allocation should be calculated only after each limited partner recovers any losses suffered in the prior fiscal period. The Offering Circular states that this provision "is known in the industry as a 'high-water mark.'"[99] The Offering Circular refers to the high water mark in five separate sections of its text.[100]

Despite the clarity with which the Offering Circular adopts the high water mark, Fretz and Freeman contend that they and the limited partners never intended to employ it when allocating profits. According to Fretz, the lawyers responsible for including the high water mark language "missed the idea of what we were looking to do"[101] and failed to capture "the essence of what our limiteds had wanted."[102] Thus, according to Fretz, the high water mark was "never, from the beginning" meant to be applied, and he insisted that the investors understood this.[103] Consequently, Fretz and Freeman simply disregarded the high water mark provisions when they allocated Covenant profits and calculated the performance fee they paid themselves as General Partner.

Fretz testified that many years ago, in 2001, Covenant's accountant, Mark Carrow, drafted a letter essentially eliminating the high water mark and explaining how he and Freeman would determine the General Partner's profit allocation and performance fee. Fretz testified that

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[98] CX-64, at 20, CX-65, at 21.

[99] CX-64, at 20. The Offering Circular explains, "A high-water mark simply means that if a Limited Partner has a Loss in any period followed by a Profit, there will not be a Profit Allocation to the General Partner until the Loss has been fully recouped." CX-64, at 8.

[100] CX-64, at 7, 13, 20, 28.

[101] Tr. 541.

[102] Tr. 542.

[103] Tr. 543.

all the limited partners received a copy of the letter in 2001.[104] Thereafter, according to Fretz, he and Freeman explained this to subsequent Covenant investors. Fretz insisted that this was "always the way the fund was managed, handled, and accounted for."[105] In 2009, Fretz claimed, Carrow redrafted the 2001 letter, and all Covenant investors received it.[106]

It was not until 2012, however, that Fretz and Freeman formally amended the Offering Circular and Limited Partnership Agreement to eliminate the high water mark provisions retroactively, effective March 1, 2012.[107] According to Freeman, the amendment came about as a result of FINRA's investigation when "it was pointed out that this was an area that needed to be updated."[108] Fretz claimed that he and Freeman had not made the amendment earlier because they felt there was no need to "go back and spend money to change the document at that point" since Carrow had provided his written "interpretation" in 2001 and "talking to the limiteds about it was adequate."[109]

The 2012 amendment was the fourth amendment Fretz and Freeman made to Covenant's governing documents. They made the previous three amendments in 1996, 1999, and 2005. None of those mentioned the high water mark. According to Fretz, this was because "[e]verybody understood" that the high water mark was inoperative.[110] In the meantime, Covenant's financial statements issued in 2005, 2006, and 2007, all prepared by Carrow and reviewed and approved by Fretz, described the General Partner's performance fee as being subject to the high water

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[104] Tr. 541, 544.

[105] Tr. 544.

[106] Tr. 543-44.

[107] CX-66; Stip. 26.

[108] Tr. 865-66.

[109] Tr. 541-42.

[110] Tr. 558-59.

mark. Fretz could not explain why, if the high water mark was "inoperative," the statements did not say so. [111]

Carrow contradicted Fretz's testimony about the 2001 letter. Carrow flatly denied preparing a letter in 2001 to inform investors that the high water mark did not apply. He denied sending any communication to Covenant investors about the high water mark.[112] The Panel credits Carrow's testimony on this issue in part because there is no documentary evidence of a letter about the performance fee in 2001. Notably, when asked for corroborating documentation, Fretz claimed, implausibly, that he had provided the 2001 letter to a previous attorney who no longer represented him, and that she neglected to turn it over to FINRA.[113]

Carrow testified that it was not until 2010 that Fretz asked him to prepare a letter "[t]o clarify how the ... rate was going to be calculated."[114] Fretz sent Carrow an email on December 10, 2010, stating "Here is an example of the letter that I need from you today for FINRA." Fretz included in the email a draft statement describing the "performance fee" Covenant "will charge limited partners."[115] Fretz followed up two days later in a second email with a revision, advising Carrow "[t]his may read a bit better," containing a lengthier description of the "performance fee."[116] Then, at Fretz's instruction, Carrow wrote and signed the undated letter.[117]

Freeman's testimony also contradicted Fretz. Freeman testified it was "probably" not until 2009, at the time of the calculation of the 2009 profit allocation, that he first learned of a

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[111] Tr. 549-54.

[112] Tr. 1850.

[113] Tr. 543-44.

[114] Tr. 1852-53. Carrow's 2010 letter is undated. RX-1, at 122. It states that its purpose is to "clarify the terms of the Partnership's Incentive Allocation (the General Partner performance share)." RX-1, at 122.

[115] CX-358, at 1.

[116] CX-358, at 2.

[117] Tr. 1851-52; RX-1, at 122.

decision not to use the high water mark.[118] Freeman recalled no previous discussions with Covenant investors concerning the inapplicability of the high water mark provision in Covenant's Offering Circular.[119]

Furthermore, the three investors who provided information about the matter all stated, contrary to Fretz's claims, that Freeman and Fretz never discussed the high water mark provisions with them, and did not inform them that the provisions in the Offering Circular and Partnership Agreement were inoperative.[120]

Thus, the evidence establishes that there was no Carrow letter in 2001, and that during the Relevant Period Fretz and Freeman did not notify Covenant investors that the General Partner was going to disregard the high water mark provisions of the Offering Circular and Limited Partnership Agreement. Rather, the evidence shows that Fretz, responding to FINRA questions about whether he used the high water mark to calculate the General Partner's 2009 profit allocation, directed Carrow to write a letter he needed "for FINRA" in December 2010.

The Panel finds, based on the substance of his testimony, his demeanor at the hearing, and the documentary evidence undermining his contentions, that Fretz is simply not credible on this issue.

During the Relevant Period, Covenant's governing documents made the General Partner's performance fee subject to the high water mark provisions. When Fretz and Freeman allocated the substantial profits from the IXI sale in 2009, they should have done so by applying the high water mark provisions, consistent with the governing documents and the rightful

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[118] Tr. 860-61.

[119] Tr. 862-63.

[120] Tr. 1630; CX-309, at 43-44 (Fretz and Freeman did not discuss profit allocation), CX-310, at 17-18 (Fretz and Freeman never discussed high water mark).

expectations of Covenant investors. By not doing so, they allocated $374,535 more than what they should have to the General Partner and, thereby, to themselves.[121]

5. The Overvalued Stock Contributions

In 2004, Fretz and his immediate family members contributed 123,000 shares of PetFoodDirect common stock to Covenant.[122] Fretz valued the contributions at $2.00 per share, resulting in a credit of $246,000 to his capital accounts and the capital accounts of those family members from whom the contributions came.[123]

Fretz claimed that $2.00 per share "was the cost for everybody originally." When told that PetFoodDirect conducted a private placement in April 2004 at $0.32 per share,[124] he then testified that he was "not sure" what he had paid for the shares.[125]

When Fretz contributed his and his family's PetFoodDirect shares into Covenant, Covenant's audited financial statement, prepared by Carrow, valued the several million shares of PetFoodDirect that Covenant already owned at $0.51 per share, approximately one quarter of the

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[121] CX-6, CX-92.

[122] Tr. 563-68, 1207; CX-74.

[123] Tr. 1207-08, 1210-11; CX-7, at 4-5, CX-74. Fretz testified that Carrow was responsible for his decision to contribute the PetFoodDirect shares to Covenant. According to Fretz, Carrow asked why he was holding the shares "outside the fund," suggested he contribute them to Covenant, and consequently Fretz contributed his family's shares to the partnership. He claimed he believed that the shares were valued at $2.00 by Carrow, who told him he valued the shares at cost. Tr. 564-65. Carrow's testimony about PetFoodDirect, taken as a whole, was unclear. However, Carrow did not substantiate Fretz's claims that he suggested that Fretz contribute the PetFoodDirect shares to Covenant, and valued the shares at $2.00 because that was Fretz's cost. At one point, Carrow stated he valued the shares at $2.00 based upon the cost of the shares when acquired in 1999 and for tax purposes, and would not change that valuation without a realized profit or loss from the sale of the shares. Tr. 1879-81, 1896. At another point, Carrow testified that "for years" he tracked Covenant's assets on a "book basis, fair market value, [and] tax basis." Tr. 1835. He stated that "if there is impairment of the asset, you take it down" for the purpose of accounting for the capital balance, although not for tax purposes. For tax purposes, Carrow testified, a change in value of the asset is not recorded until a sale of the asset, when there is a realized gain or loss. Tr. 1835-36. Because of the cost of multiple tracking, Carrow stated he persuaded Covenant management to agree that he would track the "book basis" of Covenant assets in preparing Covenant's annual Schedule K-1s. Tr. 1836. On Covenant's spreadsheets or trial balances, however, Carrow testified that "for the most part," he valued Covenant capital accounts "on a book basis, fair market value." Tr. 1838.

[124] Tr. 570-72.

[125] Tr. 572.

value Fretz gave them.[126] Enforcement argues that Fretz should have valued the shares at the level reflected in Covenant's books.[127] The Panel agrees.

When Fretz contributed the PetFoodDirect shares to Covenant, other Covenant investors acquired an interest in them. By valuing them at $2.00 per share, Fretz caused Covenant investors to overpay his and his family's accounts for Covenant's acquisition of the shares. At the time, Fretz's capital account received a credit of $67,000, based on the $2.00 per share price, when it would have received a credit of only $17,000 at the $0.51 per share price. Thus, Fretz realized a $67,000 gain from contributing the PetFoodDirect shares. Had the shares been valued at $0.51, he would have realized a gain of only $17,000.[128] Given his fiduciary duties to Covenant and its limited partners, which he acknowledges,[129] Fretz had an obligation not to profit unfairly, to the detriment of the limited partners, as he did when he contributed his family's 123,000 shares, and overvalued them by over $183,000.[130]

6. The Freeman Loan

Freeman borrowed $11,000 from Covenant on July 12, 2004.[131] For this transaction, a note documents the loan. The loan terms include interest at six percent annually and a maturity date of one year, on July 12, 2005, unless extended by mutual agreement.[132]

At the same time Covenant gave Freeman a six percent loan, Covenant borrowed funds for itself at a ten percent interest rate.[133] When asked if he believed it was in the best interests of

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[126] CX-101, at 4.

[127] Tr. 2044.

[128] Tr. 1240-46.

[129] Tr. 162.

[130] Tr. 1238; CX-74, at 21, CX-7, at 4-5. The total overvaluation is the difference between the value of the 123,000 shares at $2.00 per share and at $0.51 per share. Enforcement calculates the total overvaluation at $183,076.

[131] Tr. 900.

[132] CX-129.

Covenant investors to lend him money at six percent, while Covenant was borrowing at ten percent, Freeman answered, ambiguously, "I thought it was a fair loan, yes."[134] When asked how he justified the loan as a prudent use of Covenant's funds, Freeman did not provide a coherent answer, saying, vaguely, "It's a short-term loan at having partners make money."[135]

Freeman's concept of "short term" is expansive. He could not remember when he repaid the loan.[136] He testified that he could have done so in 2008, because at that time he "had plenty of money in the general partner's account."[137] Freeman also could not recall how he repaid the loan, saying the repayment was documented by "an accounting adjustment made to the general partner's account."[138] A Covenant trial balance reflects simply that the loan was "retired" in January 2009.[139] The trial balance also reflects that, as of December 2010, Freeman had paid no interest on the loan.[140] He was unable to explain why it took four and a half years to "retire" this "short term" loan.[141]

However, Freeman admitted that Keystone's problems affected his financial condition beginning in 2008, and caused him to withdraw Covenant funds during the Relevant Period.[142] The evidence documents Freeman's financial difficulties. In June 2009, he notified Fretz that a

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[133] Tr. 901.

[134] Tr. 902.

[135] Tr. 903. In an on-the-record interview prior to the hearing, when he was asked "can you tell me why you think it is a prudent use of Covenant's money to lend it to you at 6 percent when it is borrowing money from other people at a higher rate?" Freeman answered, "No." Tr. 902-03.

[136] Tr. 903.

[137] Tr. 904.

[138] *Id.*

[139] Tr. 905.

[140] CX-71; Stip. 27. Freeman testified that he believed the trial balance and stipulation are inaccurate, and that he has paid interest on the 2005 loan. Tr. 906.

[141] Tr. 906-07.

[142] Tr. 907.

check he had written from Covenant "is going to bounce again."[143] In August 2009, he wrote Fretz an email about his concern over being able to cover a $15,000 check drawn on his Covenant account, saying "I will make sure that I have funds in Covenant's account during the next couple days to cover it," and that "I am 2 months behind on everything."[144] When asked how he endeavored to ensure that he would have adequate funds in his Covenant account, Freeman, revealingly, testified that he would solicit new investors or borrow the money.[145]

Freeman's interest free "loan" from Covenant, which the evidence suggests he may not yet have repaid, was inconsistent with his fiduciary responsibilities to Covenant and its limited partners, and constituted a misuse of Covenant funds.

D. Fretz And Freeman Made Material Misrepresentations (Cause Two)

The second cause of action alleges that in Covenant's Limited Partnership Agreement and the Offering Circular, Fretz and Freeman failed to disclose the transfers of Covenant funds to themselves and their business interests, including Keystone, in violation of their fiduciary responsibilities. As noted above, Fretz and Freeman founded Covenant. They were responsible for the Limited Partnership Agreement and Offering Circular and provided copies to limited partners. In those documents, Fretz and Freeman represented that Covenant would use investor money to purchase securities and other appropriate investments.[146] Fretz and Freeman instead used investor money for their interests, to infuse cash into Keystone, to lend to themselves, or to support Fretz's other business concerns. When Fretz and Freeman distributed the Limited

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[143] *Id.*; CX-321.

[144] CX-322.

[145] Tr. 908-09. Freeman continued to ask Fretz for help in covering the $15,000. CX-323; Tr. 909. The problem persisted into August 2009, when his wife invested her IRA account into Covenant, and Freeman directed Fretz to wire the funds to him immediately upon deposit. Tr. 909-10; CX-324.

[146] CX-64, CX-65.

Partnership Agreement and Offering Circular, they made material misrepresentations and omitted material facts.

The testimony of investor BN is illustrative. BN testified that he believed Covenant's—and his—funds were being invested in private companies such as IXI, and he was unaware that Fretz and Freeman were transferring substantial sums to Keystone.[147] When BN, himself a securities professional registered with FINRA,[148] learned that Fretz and Freeman "loaned" Keystone over a million dollars in Covenant funds, he unhesitatingly characterized the loans as "significant" and stated that he had not anticipated this would be the use to which his funds would be put.[149] In his view, he would not want to lend his invested funds unless, in return, the loan earned a "pretty significant percentage."[150] Covenant investors GW and LF, in on-the-record interviews, testified that they were unaware that Fretz and Freeman borrowed money from Covenant for themselves, Keystone, or other business interests.[151]

BN, GW, and LF all were also unaware that Fretz and Freeman were not utilizing the high water mark in calculating their performance fees. They never agreed that Fretz and Freeman could disregard the high water mark provisions in Covenant's governing documents, as Fretz falsely claimed.[152]

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[147] Tr. 1620-30, 1639.

[148] Tr. 1612-13.

[149] Tr. 1639-41.

[150] Tr. 1639.

[151] CX-310, at 15-16, CX-309, at 43-44.

[152] Tr. 1629-30; CX-309, at 42-44, CX-310, at 17-18.

When he testified, Fretz acknowledged that he did not inform Covenant's investors that he was disbursing Covenant funds to Keystone, and to his business concerns; indeed, he stated that he had no obligation to do so.[153]

We disagree and find that Fretz and Freeman had an obligation to disclose to Covenant investors the fact that they were disbursing substantial sums of Covenant funds to themselves, Keystone, and Fretz's businesses. We find that these disbursements were, by their size and nature, material. Misuse is always material but even if the disbursements were arguably not misuses of investor funds, they still should have been disclosed. Certainly investor BN's testimony supports the conclusion that he reasonably deemed the fact of the disbursements to have been material, and to be information he wanted to know.[154]

We find that the disbursements were inconsistent with the provisions of Covenant's Limited Partnership Agreement and Offering Circular which, uncorrected by disclosures from Freeman and Fretz, were themselves materially misleading. We find therefore that through Covenant's governing documents, Fretz and Freeman made material misrepresentations to Covenant investors about the use to which invested funds would be put. It is "axiomatic" that for a registered person to make material misrepresentations or omissions to customers is to engage in unethical conduct. [155] Fretz and Freeman are therefore liable for unethical conduct, and for violating FINRA Rule 2010 as charged in the Complaint's second cause of action.

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[153] Tr. 246-47.

[154] Facts are material if a reasonable investor would consider them important in making an investment decision. *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1466 (2d Cir. 1996); *SEC v. Rogers*, 790 F.2d 1450, 1458 (9th Cir. 1986).

[155] *Dep't of Enforcement v. Timberlake*, No. C07010099, 2004 NASD Discip. LEXIS 11, at *16 (N.A.C. Aug. 6, 2004) (*citing Ramiro Jose Sugranes*, 52 S.E.C. 156, 157 (1995)).

E. Respondents Gave Misleading Responses To FINRA (Cause Three)

The third cause of action alleges that Respondents made misleading statements to FINRA, in violation of FINRA Rules 8210 and 2010. It identifies three separate instances, in September, November, and December 2009, when Respondents represented that payments to Keystone from Covenant were distributions from Fretz's capital account when, in fact, the payments were recorded as loans on Covenant's books and records. The cause of action also alleges that on a fourth occasion, on December 16, 2009, Freeman provided misleading information to FINRA by overstating the value of Fretz's account at Covenant.

1. The September 17, 2009 Rule 8210 Request

On September 17, 2009, FINRA issued the Rule 8210 request to Fretz that launched the investigation in this case. FINRA asked Keystone to provide a bank statement to show the origin of a $50,000 deposit into the firm on April 29, 2009.[156] Keystone did not provide the statement. Instead, as noted above, Fretz responded on Keystone's behalf by email on September 23, 2009, stating that the funds were a distribution from his Covenant capital account, and attaching a document titled "Distribution Confirmation" signed by Freeman, dated April 29, 2009.[157] The date was misleading. Freeman testified that Fretz asked him to prepare the Distribution Confirmation after the September 17 request, not months earlier on April 29, 2009, when Fretz transferred the funds to Keystone.[158] The letter was, therefore, falsely dated, to make it appear that it had been created contemporaneously with the infusion of $50,000 into Keystone.

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[156] CX-281.

[157] CX-282.

[158] Tr. 870-75. Freeman's testimony was at times contradictory. Initially, he testified that Fretz told him this transfer, and others, were distributions. He admitted that the distribution confirmation was backdated. Tr. 825, 872. On the following day, Freeman testified that he was confused when he gave this testimony. Tr. 931. He testified that he did not know when the letter dated April 29 was created, and claimed that it was possible it was created in April 2009. Tr. 941-942.

The transfer was not recorded as a distribution in Covenant's quarterly capital account balance for the second quarter of 2009,[159] nor was it accounted for in Covenant's 2009 trial balance as a distribution.[160] Thus, there is no evidence that the $50,000 deposit to Keystone consisted of a distribution from Fretz's Covenant capital account.[161] The spreadsheet maintained by Keystone employee and bookkeeper Barbara Shaffer, which she called "Covenant accounting," on which she made contemporaneous entries to document transfers, labels the $50,000 to Keystone as a "loan."[162]

Enforcement argues that Fretz and Freeman knew or should have known that the transfer was recorded as a loan in Covenant's records, and that they therefore gave a false response to FINRA's September 17, 2009 Rule 8210 information request when they described it as a distribution.

2. The November 4, 2009 Rule 8210 Request

On November 4, 2009, FINRA issued another Rule 8210 request to Fretz. This one asked him to produce (i) bank statements reflecting the source of four transfers of funds to Keystone in the third quarter of 2009; and (ii) the firm's net capital computations for the dates of the capital infusions.[163] Instead, Fretz's uncle[164] responded by email on behalf of Keystone on November 24, 2009, and attached a letter signed by Freeman. The letter, dated November 3, 2009, addressed to Fretz, purports to "confirm transfers from [Fretz's] personal account with Covenant for a total of

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[159] CX-312, at 8; Tr. 1544-46.

[160] CX-70; Tr. 1547-48.

[161] The 2009 Covenant trial balance shows, instead, $126,000 accounted for in April 2009 in the "Notes Receivable – Bill Fretz" account. CX-70.

[162] CX-74, at 58; Tr. 1020-22. Shaffer testified she tried to keep the spreadsheet accurate, that Fretz and Freeman knew she kept it, and often relied on Fretz to be able to characterize the nature of a transfer. Tr. 1022-25.

[163] CX-283.

[164] Fretz's uncle, Keith Fretz, is a Keystone employee. Tr. 618.

$72,000, representing a distribution from [Fretz's] capital account in Covenant" in the third quarter of 2009.[165]

Freeman's testimony about the letter was remarkable for its vagueness. The only fact he recalled was that when he was asked to sign it, he did so.[166] He could not recall anything about the creation of the letter. He admitted it was an unusual letter, and stated that he did not write letters like it "every day."[167] Despite the unusual nature of the letter, Freeman could not remember if he composed it, who asked him to sign it, why it was backdated, or whether he consulted Covenant's records to determine if the letter was accurate. He testified that he did not even know whether, at the time, he was aware the letter was going to be given to FINRA.[168]

The letter Freeman signed was falsely dated. On November 23, 2009, Fretz's uncle sent an email to Barbara Shaffer stating, "Attached is text to be put on Covenant letterhead for [Freeman's] signature."[169] The letter Freeman signed, which was prepared after the email, was dated November 3, 20 days before the email. Once again, Fretz and Freeman responded to a FINRA request for information by producing a document with a fabricated date.

Covenant's quarterly capital account balance for the third quarter of 2009, and Covenant's 2009 trial balance for the same period, show no distributions of capital from Fretz's account.[170] As noted above, in an email dated November 5, 2009, in a period when Fretz was telling FINRA the cash infusions into Keystone were from his Covenant capital distributions, he

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[165] CX-285, at 2.

[166] Tr. 881.

[167] Tr. 886.

[168] Tr. 880-85.

[169] CX-284.

[170] CX-312, at 9, CX-70, at 2; Tr. 1550-53.

instructed his accountant that he took no distributions, only loans, from Covenant in 2009.[171] Fretz's November 5 email directly contradicts Freeman's letter. Based upon these facts, Enforcement argues that the November 24, 2009 response to FINRA was inaccurate.[172]

3. The December 1, 2009 FINRA Request for Information

On December 1, 2009, FINRA sent an email to Keystone requesting a signed statement from Fretz explaining transfers of funds from his personal account at Covenant to Keystone. This request did not invoke Rule 8210. Fretz replied by letter dated December 14, 2009, stating that he had "invested" funds from his personal Covenant account into Keystone.[173] Enforcement charges this letter was inaccurate because Covenant's trial balance and Fretz's November 5, 2009 email to his accountant characterize the transfers as a loan.[174]

The December 1, 2009 information request also asked Keystone for a financial statement detailing Fretz's Covenant fund account value. Freeman provided a second response to the request, a letter dated December 16, 2009. In it, he asserted that Fretz's Covenant account value exceeded $2 million, and that the amounts transferred to Keystone were distributions, not loans.[175] Enforcement argues that, regardless of whether the transfers to Fretz were distributions or loans, the value of his capital account was substantially less than $2 million.[176]

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[171] CX-315.

[172] Enforcement's Post-Hearing Br. ¶ 103; Tr. 1553.

[173] CX-287.

[174] Enforcement's Post-Hearing Br. ¶ 103.

[175] CX-288.

[176] Enforcement's Post-Hearing Br. ¶¶ 23-24; CX-70 (Covenant trial balance for 2009, showing final balance Dec. 31, 2009, for Fretz's capital account, No. 30015 of $886,590); as noted above, if the transfers in Account No. 14224 were treated as distributions, Fretz's capital account at year's end in 2009 would have been approximately $480,000; treating the transfers as loans, Fretz was able to allocate profits in 2009 to himself as if his capital account were worth approximately $1.6 million (CX-91, CX-7, at 3).

Freeman testified that Fretz instructed him to respond to this FINRA information request by calculating his Covenant account value as of November 1, 2009.[177] Freeman conceded that when preparing his assessment he reviewed account documents that were nearly a year old and did not bring them current.[178] Because he knew that Fretz moved funds from Covenant after November 1, 2009, Freeman agreed, reluctantly, that his response may have been misleading.[179]

4. The Responses Were Misleading

Enforcement argues that these four responses were inaccurate, misleading, and hindered FINRA's investigation into the source and nature of the transfers from Fretz to Keystone.[180]

Respondents claim that they provided the information to FINRA in good faith, relying upon the information available to them at the time, including the April 29, 2009 Distribution Confirmation. Respondents contend that because they engaged in no "collusion to provide inaccurate responses," acted in good faith on their beliefs at the time, and responded accurately to the best of their knowledge, they did not violate FINRA Rules 8210 and 2010.[181]

We find that Respondents did not respond to FINRA in good faith. Their responses may have been partially accurate to the extent they described certain transfers as distributions because, as set forth above, the transfers to Keystone lacked indicia that they were loans. But we must consider the evidence of Respondents' intent when they made the responses and the context in which they did so.

At the very least, Respondents should have revealed that Covenant books did not record the transfers as distributions, but as loans, in contradiction to Respondents' representations. Fretz

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[177] Tr. 887, 936.

[178] Tr. 890-94, 977-78.

[179] Tr. 895-99.

[180] Enforcement's Post-Hearing Br. ¶¶ 94-113.

[181] Respondents' Post-Hearing Br. 28-31.

was not acting in good faith when he attested to FINRA that the transfers were distributions while, at the same time, he was telling his accountant that he took no distributions, "only loans," in 2009. And Fretz and Freeman did not act in good faith, but consciously sought to mislead FINRA, when they created falsely dated documents purporting to corroborate their answers to FINRA's inquiries.

Respondents thus fell far short of the well-established requirement of members and associated persons to provide accurate, not misleading, information in connection with an examination or investigation.[182]

As for Freeman's valuation of Fretz's Covenant account, it, too, failed to meet the fundamental requirement of associated persons to respond truthfully and accurately to FINRA information requests. Even Freeman conceded that his calculation of Fretz's Covenant account value "may" have been misleading. It was, as shown above. It, therefore, violated FINRA Rule 2010.

In sum, therefore, the Extended Hearing Panel concludes that Fretz and Keystone violated FINRA Rules 8210 and 2010 by the misleading nature of their response to FINRA's September 17, 2009 Rule 8210 information request; Fretz, Freeman, and Keystone violated Rules 8210 and 2010 by the misleading nature of their response to FINRA's November 4, 2009 information request; and Fretz, Freeman, and Keystone violated Rule 2010 by the misleading nature of their responses to FINRA's December 1, 2009 information request.

F. Keystone's Brokerage Account Statements (Cause Four)

The Complaint's fourth cause of action is directed solely at Respondent Keystone. It alleges that Keystone violated NASD Rule 2110 and FINRA Rule 2010 by sending misleading

[182] *Dep't of Enforcement v. Rogala*, No. C8A030089, 2005 NASD Discip. LEXIS 44, at *21 (N.A.C. Oct. 11, 2005).

monthly brokerage account statements to approximately 11 of its customers who had invested in Covenant through their qualified retirement accounts. Each statement represented the value of the customers' Covenant investments obtained from Keystone's clearing firm, which obtained the value from Keystone's employees or from a third-party pricing service which, in turn, obtained the value from Keystone's Barbara Shaffer.[183]

Shaffer has worked for Fretz for 17 years at Keystone, through which she is registered with FINRA.[184] During the Relevant Period, she was responsible for "operations and administration" at Keystone.[185] In performing her responsibilities, she was the contact person for Keystone's clearing firm, Pershing LLC,[186] and for an outside company providing valuations of Keystone brokerage accounts to Pershing.[187]

Shaffer instructed the outside company that the valuation of investors' Covenant investments should remain at $1.00 per share, reflecting the value of the investors' initial investments.[188] Shaffer did so because limited partnerships are difficult to value. After discussing the matter with Pershing, Schaffer concluded this was reasonable, because the investors could compare their statements to the valuation in the K-1s they received at year's end, which provided them with the accountant's annual estimated value of their Covenant holdings.[189] Thus, the

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[183] Stip. 32.

[184] She currently holds Series 7, 24, and 63 licenses. Tr. 1004, 1008.

[185] Tr. 1014-15.

[186] Stip. 32; Tr. 1014.

[187] Stip. 32; Tr. 1039.

[188] Tr. 1040-41, 1045; CX-298 – CX-308. Fretz testified that Shaffer did this without his knowledge, although he felt "it was nice to know your cost basis in the fund and put it against your K-1." Tr. 588. Because "all the investors were supremely aware" of how this was being done, Fretz supported Shaffer's approach, although he would have simply given a zero valuation instead of carrying it at the $1 cost basis. Tr. 589-91.

[189] Tr. 1045-46.

account statements did not reflect the actual, current value of the accounts.[190] This is the basis for Enforcement's contention that the statements were misleading.

However, there is no evidence that the statements were in fact misleading, and nothing to suggest that any of the 11 account holders were misled. The sole account holder who testified at the hearing stated that he relied on the valuation in the K-1 that the Covenant accountant sent him at the end of each year.[191]

The account statements' valuation of the account holders' investments remained consistent throughout the Relevant Period. Shaffer's testimony revealed no design on her or Keystone's part to mislead or to deceive the account holders. Rather, we find that her testimony reflected a practical, albeit not ideal, resolution of the problem of how to put an accurate monthly value on the accounts. Keystone did not perform monthly valuations, but instead relied on the annual preparation of K-1s to inform account holders of their account values for tax purposes. This is not a case in which Keystone, to gain some advantage, attempted to fool its account holders into believing their accounts held an inflated value.

For all of these reasons, the Panel finds that there is insufficient evidence that Keystone, through Shaffer, acted unethically in its preparation of the monthly account statements for the 11 account holders. We therefore conclude that there is insufficient evidence to support the allegations in the fourth cause of action, alleging that Keystone issued misleading brokerage account statements in violation of NASD Rule 2110 and FINRA Rule 2010. The fourth cause of action is, therefore, dismissed.

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[190] Stip. 33.

[191] Tr. 1624, 1636-37.

G. Fretz's Forms U4 (Cause Five)

FINRA's By-Laws require that every registration application must be "kept current at all times by supplementary amendments."[192] FINRA Rule 1122 states, in its entirety:

> No member or 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.

On December 18, 2009, Fretz answered "no" to the relevant question on his Form U4 which asked if there were any unsatisfied judgments or liens filed against him.[193] His answer was incorrect. At the time, he had an outstanding unsatisfied judgment in the amount of $131,029.[194] Between July 2009 and October 2010, eight judgments, for more than $2.4 million, were entered against Fretz in Pennsylvania, and all remained unsatisfied for more than 30 days.[195] Fretz did not amend his Form U4 to show the judgments. He claimed that he was then unaware that he was required to report judgments and liens because he was under the mistaken impression that he needed only to report a bankruptcy.[196] Fretz admits responsibility for failing to disclose the eight judgments as charged in the Complaint, and for violating FINRA Rules 1122 and 2010, and Article V, Section 2 of FINRA's By-Laws.[197]

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[192] Article V, Section 2, FINRA By-Laws.

[193] CX-274, at 17.

[194] CX-8.

[195] CX-8; Compl. ¶¶ 156-62; Answer ¶¶ 156-62.

[196] Tr. 130-31.

[197] Compl. ¶ 162; Answer ¶ 162; Respondents' Post-Hearing Br. 31.

III. SANCTIONS

A. The Parties' Recommendations

1. Enforcement

Enforcement recommends that the Extended Hearing Panel bar Fretz and Freeman for (i) misusing customer funds, in violation of NASD Rules 2330(a) and 2110, and FINRA Rules 2150(a) and 2010; (ii) making misrepresentations and omissions of material facts to Covenant investors, in violation of NASD Rule 2110 and FINRA Rule 2010; and (iii) producing false and inaccurate responses to requests for information, in violation of FINRA Rules 8210 and 2010. With regard to Fretz's Form U4 violations of FINRA Rules 1122 and 2010, Enforcement argues they are egregious and recommends a two-year suspension in all capacities and a fine of $50,000.

As for Keystone, Enforcement recommends that we expel the firm for its false and inaccurate responses to FINRA requests for information.

Enforcement argues that such severe sanctions are proper because Respondents have not accepted any responsibility for their misconduct and have not taken corrective measures; have made no attempt to return misused funds to Covenant; have engaged intentionally in a lengthy pattern of misconduct extending over three years during which they misused millions of dollars; have attempted to conceal their misconduct from FINRA; and have benefitted directly from their misconduct.

Should the Panel decline to impose the bars and expulsion, Enforcement urges the Panel to impose lengthy suspensions, fines, and order them to pay restitution.[198]

[198] Enforcement calculates restitution, if ordered, should total $2,731,543 plus interest. Enforcement's Post-Hearing Br. ¶ 47.

2. Respondents

Not unexpectedly, Respondents ask that we impose, at most, "no more than a minor monetary sanction." They base this request in part on their contention that the evidence does not show they misused customer funds. They also urge us to consider in mitigation that "Respondents' securities history and prior compliance with FINRA Rules," that Respondents "have never had any enforcement actions against them," and that there is no evidence "that Respondents have a history of failing to abide by FINRA Rules, or possess an inability to adhere to these rules moving forward."[199]

For the Form U4 violations, Respondents note in mitigation that Fretz accepts responsibility for his mistake. Arguing that there is no evidence that the information Fretz neglected to include in Form U4 amendments was significant, and no harm resulted, Respondents recommend that we should impose a fine no greater than $2,500.[200]

For the Rule 8210 and 2010 violations, Respondents recommend that we find it to be a mitigating circumstance that FINRA was seeking information to determine whether deposits to Keystone constituted "good capital," or whether the firm might have had a net capital violation. Respondents contend this is mitigating because whether they characterized the deposits as loans or distributions was immaterial to FINRA's inquiry.[201] Under the circumstances, including Respondents' "limited accounting processes" and the fact that Fretz did not review the information requests with his accountant, but instead relied on the limited available records,

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[199] Respondents' Post-Hearing Br. 31.

[200] *Id.* at 32.

[201] *Id.* at 33-34.

Respondents maintain that their responses to FINRA information requests were "reasonable" and not false.[202]

B. Misuse Of Funds By Fretz And Freeman (Cause One)

For misuse or conversion of customer funds, FINRA's Sanction Guidelines state that "a bar is standard."[203] It is well established that misusing customer funds is "among the most grave violations" a registered person may commit and, by its nature, "is extremely serious and patently antithetical to the 'high standards of commercial honor and just and equitable principles of trade' that [FINRA] seeks to promote."[204] As such, in the absence of mitigating factors, misuse of customer funds by a respondent poses so substantial a risk to investors "as to render the violator unfit for employment in the securities industry."[205]

Here, the evidence shows that Fretz and Freeman made use of Covenant's funds as they deemed fit for their own benefit, instead of for the benefit of Covenant and its investors, to whom they owed fiduciary responsibilities.

There are a number of aggravating factors. Fretz's and Freeman's insistence that the evidence does not establish that they misused Covenant funds is, implicitly, a refusal by Fretz and Freeman to accept responsibility for their misconduct.[206] The misuse occurred over an extended period,[207] and was intentional and deliberate, not the product of mistake or hasty misjudgment.[208] Fretz and Freeman sought to conceal their misuse by accounting for the funds in

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[202] Respondents' Post-Hearing Br. 34.

[203] FINRA Sanction Guidelines 36 (2011).

[204] *John Edward Mullins*, Exchange Act Rel. No. 66373, 2012 SEC LEXIS 464, at *42, *73 (*quoting Wheaton D. Blanchard*, 46 S.E.C. 365, 366 (1976)).

[205] *Id.* at *74 (*quoting Charles C. Fawcett IV*, Exchange Act Rel. No. 56770 (Nov. 8, 2007), 91 SEC Docket 3147, 3157 n.27).

[206] *Id.* at 6 (Principal Consideration No. 2).

[207] *Id.* at 6 (Principal Considerations Nos. 8, 9).

[208] *Id.* at 7 (Principal Consideration No. 13).

a misleading manner, and their answers to FINRA inquiries about the disbursements were further attempts to conceal the truth.[209] Their goal was to realize personal gain, directly by making personal use of funds, and indirectly by using funds to prop up Keystone.[210]

We discern no mitigating circumstances and reject Respondents' suggestion that we consider the lack of previous disciplinary history. As the Guidelines make clear, and precedent underscores, "while the existence of a disciplinary history is an aggravating factor when determining the appropriate sanction, its absence is not mitigating."[211]

The Panel has taken all of these factors into consideration. We conclude that the seriousness of the misconduct, the absence of mitigating circumstances, and the presence of aggravating factors, considered together, require us to impose bars in order to deter future similar misconduct and to promote the general goal of improving business standards in the securities industry. Therefore, we bar Fretz and Freeman from associating with any FINRA member firm in any capacity for misusing customer funds, in violation of NASD Rules 2330(a) and 2110, and FINRA Rules 2150(a) and 2010).

C. Misrepresentations Of Material Facts And Failures To Disclose Material Facts (Cause Two)

In egregious cases, for intentional or reckless misrepresentations of material facts, or failure to disclose material facts, the Sanction Guidelines recommend consideration of a bar.[212]

As set forth above, Fretz and Freeman, founders of Covenant, are directly responsible for the representations in Covenant's Limited Partnership Agreement and Offering Circular, which they circulated to all Covenant investors. Those governing documents laid out precise

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[209] *Guidelines* at 6 (Principal Consideration No. 10).

[210] *Id.* at 7 (Principal Consideration No. 17).

[211] *Id.* at 6 (Principal Consideration No. 1 n.1 (*citing Rooms v. SEC*, 444 F.3d 1208, 1214-15 (10th Cir. 2006)).

[212] *Id.* at 88.

requirements for the General Partner. Through the documents, Fretz and Freeman represented that the General Partner would invest Covenant funds in securities and fulfill their fiduciary obligations to the limited partners. Fretz and Freeman failed to do so, rendering the representations in the governing documents materially false and misleading. The governing documents also repeatedly represented that, in their General Partner role, Fretz and Freeman would calculate their management or performance fee based upon a high water mark. They disregarded the high water mark, again rendering the governing documents materially misleading. And, as set forth above, Fretz and Freeman 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 to Keystone. These omissions were clearly material, and certainly egregious, because they allowed Fretz and Freeman to treat Covenant as their personal bank for a period of years.

These false representations and omissions were not inadvertent. Rather, they were intentional and persistent. We therefore find it necessary to bar Fretz and Freeman from associating with any FINRA member firm in any capacity for making material misrepresentations, and for failing to disclose material facts, in violation of NASD Rule 2110 and FINRA Rule 2010.

D. Misleading Statements To FINRA (Cause Three)

The Sanction Guidelines recommend a fine of $25,000 to $50,000 for failing to respond, or failing to respond truthfully, to a request for information issued pursuant to Rule 8210.[213] Fretz and Freeman repeatedly responded in a misleading fashion to FINRA requests for information about transfers of funds from Covenant to Keystone. By fabricating documents purporting to

[213] *Guidelines* at 33.

corroborate their responses, the Panel finds that Fretz and Freeman aggravated their misconduct and made it egregious. For doing so, we bar Fretz and Freeman from associating with any FINRA member firm in any capacity.

With regard to Keystone, the relevant factors are different. In this case, Fretz and Freeman controlled Keystone's responses. Other Keystone employees were implicated in the responses to FINRA's information requests, but they were acting at the behest of Fretz and Freeman. Therefore, although we find the misleading statements of Fretz and Freeman to be sufficiently egregious to require a bar, we do not agree with Enforcement's recommendation that Keystone's role in providing misleading responses to FINRA requires expulsion of the firm. While Fretz and Freeman control Keystone, they share ownership of the firm with others. To expel Keystone would be to impose sanctions on others for conduct for which Fretz and Freeman are primarily responsible. Therefore, the Extended Hearing Panel concludes that a fine of $25,000 on Keystone suffices to achieve the remedial goal of deterring future misconduct by Keystone, without imposing a punitive sanction, consistent with the guidance that the Guidelines provide.[214]

E. Fretz's Form U4 Violations (Cause Five)

The Sanction Guidelines recommend a fine of $2,500 to $50,000, and a suspension of five to 30 days, for filing a false or misleading Form U4, or failing to file an amendment.[215] In egregious cases, the Guidelines recommend consideration of suspension for up to two years, or a bar.[216]

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[214] *Guidelines* at 2.

[215] *Id.* at 69.

[216] *Id.* at 70.

Enforcement deems Fretz's U4 violations to be egregious. We agree. Despite Fretz's disclaimers, his failures to amend his Form U4 to reflect judgments and liens against him were willful. Furthermore, the information he failed to disclose involved numerous judgments for substantial sums. He initially failed to disclose an unsatisfied judgment in the amount of $131,029 and subsequently failed to amend his Form U4 to reflect eight judgments, for more than $2.4 million. These failures were not minor and aberrational, and the result was that Fretz's Form U4 failed to inform anyone reviewing it of his sizable debts.

However, in light of the bars we have imposed upon Fretz, we do not find it necessary to impose an additional penalty for his Form U4 violations. Were we to do so, we agree with Enforcement's recommendation that a suspension for two years in all capacities, and a fine of $50,000, would be appropriately remedial and sufficient to deter Fretz, and others similarly situated, from such misconduct.

IV. CONCLUSION

For misusing customer funds, in violation of NASD Rules 2330(a) and 2110, and FINRA Rules 2150(a) and 2010, the Extended Hearing Panel bars Respondents William B. Fretz, Jr., and John P. Freeman from associating with any FINRA member firm in any capacity.

For making material misrepresentations to investors, and failing to inform them of material facts, in violation of NASD Rule 2110 and FINRA Rule 2010, the Extended Hearing Panel bars Respondents William B. Fretz, Jr., and John P. Freeman from associating with any FINRA member firm in any capacity.

For providing misleading information to FINRA, in violation of FINRA Rules 8210 and 2010, the Extended Hearing Panel bars Respondents William B. Fretz, Jr., and John P. Freeman from associating with any FINRA member firm in any capacity, and fines Respondent The Keystone Equities Group, LP, in the amount of $25,000.

Because of the bars we have imposed, the Extended Hearing Panel will not impose any further penalty upon Respondent William B. Fretz, Jr., for willfully filing a false Form U4 and failing to amend his Form U4, in violation of FINRA Rules 1122 and 2010.

If this decision becomes FINRA's final action in this disciplinary proceeding, the bars shall become effective immediately. [217]

EXTENDED HEARING PANEL.

By: Matthew Campbell
Hearing Officer

Copies to:

William B. Fretz, Jr. *(via overnight courier and first-class mail)*
John P. Freeman *(via overnight courier and first-class mail)*
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Paul M. Schindler, Esq. (*via electronic mail*)
Jennifer J. Schulp, Esq. (*via electronic mail*)

[217] The Extended Hearing Panel has considered and rejects without discussion all other arguments of the parties.