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8 Attorneys for Complainant

9 BEFORE THE DEPARTMENT OF CORPORATIONS
10 OF THE STATE OF CALIFORNIA
11

12	In the Matter of)	FILE NO. 925-2651
13)	
14	THE CALIFORNIA CORPORATIONS)	STATEMENT IN SUPPORT OF ORDER
15	COMMISSIONER,)	LEVYING ADMINISTRATIVE PENALTIES
16)	PURSUANT TO CORPORATIONS CODE
17	Complainant,)	SECTION 25252
18)	
19	v.)	
20)	
21	WHITCRAFT CAPITAL MANAGEMENT,)	
22	INC.,)	
23)	
24	Respondent.)	
25)	
26)	
27)	
28)	

22 Wayne Strumpfer, Acting California Corporations Commissioner ("Commissioner") of the
23 Department of Corporations ("Department") alleges and charges as follows:

- 24 1. Whitcraft Capital Management, Inc. ("Whitcraft") holds a valid and unrevoked
25 investment adviser certificate issued by the Commissioner pursuant to Corporations Code section
26 25230 on July 25, 1997. Whitcraft's investment adviser business is located at 660 Rhodes, Palo
27 Alto, California 94303-3032, and formerly was located at 213 Garnet Avenue, San Carlos,
28 California 94070.

1 2. On February 26, 1999, December 11, 2002 and on August 27, 2003, the Department
2 commenced three separate regulatory examinations of Whitcraft’s investment adviser business. The
3 examinations revealed the same violations of the books and records provisions of the Corporate
4 Securities Law of 1968, Corporations Code section 25000 et seq., and the regulations thereunder
5 found at California Code of Regulations, title 10, section 260.000 et seq.

6 3. These violations consisted of Whitcraft’s failure to keep true, accurate and current
7 books and records, including: 1) failing to maintain an accounting system; and 2) failing to file
8 annual financial reports. The books and records requirements provide the Department with a
9 regulatory mechanism to validate a firm's liquidity and financial integrity on a monthly basis to
10 ensure that licensees maintain the necessary net capital for the protection of the public. Whitcraft’s
11 failure to keep true, accurate and current books and records prevents the Department from
12 determining as part of its regulatory examination, whether it meets the capital requirements imposed
13 by the Corporations Code and the regulations enacted thereunder.

14 4. Corporations Code section 25241 provides that investment advisers are required to
15 maintain books and records that are subject to examinations by the Commissioner. Section 25241
16 provides, in relevant part, as follows:

17 (a) Every...investment adviser licensed under Section 25230 shall make and
18 keep accounts, correspondence, memorandums, papers, books, and other
19 records and shall file financial and other reports as the commissioner by
20 rule requires, subject to the limitations of . . . Section 222 of the Investment
21 Advisers Act of 1940 with respect to investment advisers.

22 (b) All records so required shall be preserved for the time specified in the rule.

23 (c) All records referred to in this section are subject at any time and from time
24 to time to reasonable periodic, special, or other examinations by the
25 commissioner, within or without this state, as the commissioner deems
26 necessary or appropriate in the public interest or for the protection of
27 investors.

28 5. California Code of Regulations, title 10, section 260.241.3 sets forth the specific
books and records, which are required to be maintained by investment advisers. Section 260.241.3
provides in relevant part:

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(a) Every licensed investment adviser shall make and keep true, accurate and current the following books and records relating to such person's investment advisory business:

- (1) A journal or journals, including cash receipts and disbursements records, and any other records of original entry forming the basis of entries in any ledger.
- (2) General and auxiliary ledgers (or other comparable records) reflecting asset, liability, reserve, capital, income and expense accounts.
- (4) All check books, bank statements, cancelled checks and cash reconciliations of the investment adviser.
- (5) All bills or statements (or copies thereof), paid or unpaid, relating to the business of the investment adviser as such.
- (6) All trial balances, financial statements, worksheets that contain computations of minimum financial requirements required under Section 260.237.1 or Section 260.237.2, as applicable, of these rules, and internal audit working papers relating to the business of such investment adviser.

(c) Every licensed investment adviser who renders any investment supervisory or management service to any client shall, with respect to the portfolio being supervised or managed and to the extent that the information is reasonably available to or obtainable by the investment adviser, make and keep true, accurate and current:

- (1) Records showing separately for each such client the securities purchased and sold, and the date, amount and price of each such purchase or sale.
- (2) For each security in which any such client has a current position, information from which the investment adviser can promptly furnish the name of each such client, and the current amount of the interest of such client.

(e) All books and records required to be made under the provisions of subsections (a) to (c)(1), inclusive, of this section shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser.

(j) Any investment adviser who is subject to the minimum financial requirements of Section 260.237.1 or Section 260.237.2, as applicable, shall, in addition to the records otherwise required under this section, maintain a record of the proof of money balances of all ledger accounts in

1 the form of trial balances and a record of the computations of net capitals
2 and aggregate indebtedness pursuant to Section 260.237.1 of these rules or
3 minimum net worth pursuant to Section 230.237.2 of these rules (as of the
4 trial balance date). The trial balances and computations shall be prepared
5 currently at least once a month.

6 6. The Department's examiner found during all three regulatory examinations that
7 Whitcraft did not maintain proper books and records as set forth above. Specifically, Whitcraft
8 failed to maintain journals, general ledgers, financial statements, bank statements, trial balances,
9 income statements, balance sheets, and cash reconciliation on all cash accounts. Furthermore,
10 balance sheets, journals, and trial balances were not prepared on a monthly basis, nor were bank
11 statements and cash reconciliations furnished to the Department. Whitcraft, therefore, failed to
12 maintain proper books and records as required by and in violation of California Code of Regulations,
13 title 10, section 260.241.3.

14 7. During the regulatory examination conducted by the Department on December 11,
15 2002, Whitcraft explained that it could not show the examiner its books and records because they
16 were located somewhere other than at its principal place of business. Under section 260.241.4(a) of
17 the California Code of Regulations, title 10, "...each licensed investment adviser shall, upon any
18 change in the information contained in its application for a certificate...promptly file an amendment
19 to such application setting forth the changed information (and in any event within 30 days after the
20 change occurs)." According to the application for an investment adviser certificate, the Form ADV,
21 Part 1, Page 1, Item 3A, 3B, and 3C, Whitcraft is required to disclose the name, address, business
22 hours, and telephone number of the entity where its books and records are kept. Whitcraft never
23 filed an amendment to its Form ADV to reflect the new location of its books and records in violation
24 of section 260.241.3, although by letter dated May 15, 2005 it had indicated it would do so.

25 8. Whitcraft's Investment Advisory Agreement with its clients indicates that it has a
26 limited power of attorney to execute transactions on behalf of its clients. Therefore, Whitcraft is
27 subject to the capital requirements of California Code of Regulations, title 10, section 260.237.1
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1 prior to April 3, 2003 and section 260.237.2 thereafter.¹ Under section 260.237.1:

2 An investment Adviser licensed prior to 03/01/03 may comply with either the
3 minimum financial requirements in this section or in Section 260.237.2 until
4 January 1, 2005, at which time this section shall become inoperative and an
5 investment adviser shall comply with the minimum financial requirements in
6 Section 260.237.2

6 (a) No investment adviser who has any power of attorney from any
7 investment advisory client to execute transactions...shall permit its total
8 aggregate indebtedness to exceed 500% of its tangible net capital or
9 permit its current aggregate indebtedness to exceed its current net capital;
10 and,

10 (2) If the investment adviser has any power of attorney from any
11 investment advisory client to execute transactions and does not have
12 regular or periodic custody or possession of any of its investment
13 advisory clients' securities or funds, except the receipt of prepaid
14 subscriptions for periodic publications, or other investment advisory
15 services, it shall at all times have and maintain tangible net capital of
16 not less than \$5,000.00;...

14 9. Prior to April 3, 2003, Whitcraft was required to meet the capital requirements of
15 section 260.237.1, subsection (a)(2). Furthermore, subsection (c) of section 260.237.1 provided, and
16 currently provides, that for purposes of section 260.237.1, subsection (a), all financial information
17 shall be determined in accordance with generally accepted accounting principles.

18 10. California Code of Regulations, title 10, section 260.237.2 provides in relevant part:

19 (a) Every investment adviser who has custody of client funds or securities
20 shall maintain at all times a minimum net worth of \$35,000, and every
21 investment adviser who has discretionary authority over client funds or
22 securities but does not have custody of client funds or securities shall
23 maintain at all times a minimum net worth of \$10,000.

23 After April 3, 2003, Whitcraft was required to comply with either the minimum financial
24 requirements found in section 260.237.1, or those in section 260.237.2 until January 1, 2005, at
25 which time section 260.237.1 became inoperative. Section 260.237.2, subsection (d) also provides
26 that a licensee's net worth shall be determined by generally accepted accounting principles.

27 _____
28 ¹ Various provisions of the California Code of Regulations were amended and became effective April 3, 2003. This
action seeks an order based on violations under the rules in effect both prior and subsequent to the amendments.

1 11. Whitcraft has not complied with either section 260.237.1 or 260.237.2 during the
2 relevant time period. During the examinations, Whitcraft was unable to provide the evidence that it
3 maintained tangible net capital of not less than \$5,000, nor was it able to show a record of the
4 computations of net capitals and aggregate indebtedness or the amount of its minimum net worth
5 because it lacked sufficient books and records. Whitcraft ultimately failed to prove its compliance
6 with sections 260.237.1 and/or 260.237.2 when it failed to file its annual financial reports for years
7 1999, 2000, 2001, 2002, 2003, 2004, and 2005 pursuant to California Code of Regulations, title 10,
8 section 260.241.2, subsection (a).

9 12. Under section 260.241.2, subsection (a), certain investment advisers are required to
10 file an annual report.² Section 260.241.2 provides in relevant part:

11 (a) General Rule. Subject to the provisions of Subsection (c) of this section,
12 ...every licensed investment adviser subject to the provisions of Section
13 260.237.1 or Section 260.237.2, as applicable, of these rules, shall file an
14 annual financial report containing the information required by a form or
15 forms to be supplied or approved by the Commissioner, as follows:

16 (2) The annual report for investment advisers shall contain a Statement of
17 Financial Condition. Supporting schedules shall contain computations
18 of net capitals, aggregate indebtedness and ratios required under
19 Section 260.237.1 and the certificate of the accountant required under
20 subsection (e) of Section 260.237 of these rules.

21 13. Section 260.241.2 subsection (b) also requires that the investment adviser submit
22 verifications of its reports, stating:

23 “Attached to each financial report filed pursuant to subsection (a) of this section
24 shall be a verification that, to the best knowledge and belief or the person making
25 the verification, (1) the financial statements and supporting schedules are true
26 and correct, and (2)...if the...investment adviser...is a...corporation, [the
27 verification shall be made by]...a duly authorized officer.”

28 14. As of December 31, 1999, Whitcraft has failed to submit any annual financial reports
or verifications in violation of section 260.241.2, subsections (a)(2) and (b).

² Prior to April 3, 2003, section 260.241.2(a)(5) required the annual financial report to be submitted within 60 days of the investment adviser’s fiscal year-end. Currently, annual financial reports under 260.241.2(a)(5) must be filed within 90 days of the investment adviser’s fiscal year-end.

1 15. The Department also found billing discrepancies during the regulatory examination of
2 Whitcraft on December 11, 2002. Whitcraft explained to the Department by letter dated May 11,
3 2003 and again on August 27, 2003 that the excess fees it has charged its clients were a result of an
4 increase in Whitcraft’s annual fees but which were never written in a contract signed by its clients.

5 16. California Corporations Code section 25238 provides in relevant part: “No
6 investment adviser...shall engage in investment advisory activities, or attempt to engage in
7 investment advisory activities...in contradiction of such rules as the commissioner may prescribe
8 designed to promote fair, equitable, and ethical principles.” California Code of Regulations, title 10,
9 section 260.238 provides in relevant part:

10 The following activities do not promote “fair, equitable or ethical principles,” as
11 that phrase is used in Section 25238 of the Code.

- 12 (n) Entering into, extending or renewing any investment advisory
13 contract, other than a contract for impersonal advisory services, unless
14 such contract is in writing and discloses, in substance, the services to
15 be provided, the term of the contract, the advisory fee or the formula
16 for computing the fee the amount or the manner of calculation of the
17 amount of the prepaid fee to be returned in the event of contract
18 termination or nonperformance, whether the contract grants
19 discretionary power to the adviser or its representatives.
- 20 (o) Making any untrue statement of a material fact or omitting a
21 statement of material fact necessary in order to make the statements
22 made, in light of the circumstances under which they are made, not
23 misleading in the solicitation of advisory clients.

24 17. By failing to obtain a written contract on behalf of its clients authorizing Whitcraft to
25 charge an excess fee for its advisory services, Whitcraft has violated Section 25238 of the
26 Corporations Code as defined in the California Code of Regulations, title 10, section 260.238
27 subsections (n) and (o).

28 18. Corporations Code section 25252, which became effective January 1, 1999,
authorizes the Commissioner to issue an order levying administrative penalties against any
investment adviser for willful violations of any provision of the Corporations Code and any rules
promulgated thereunder. Specifically, section 25252 provides, in relevant part:

1 The Commissioner may, after appropriate notice and opportunity for hearing, by orders, levy
2 administrative penalties as follows:

- 3 (b) Any broker-dealer or investment adviser that willfully violates any provision of this
4 division to which it is subject, or that willfully violates any rule or order adopted or
5 issued pursuant to this division and to which it is subject, is liable for administrative
6 penalties of not more than five thousand dollars (\$5,000) for the first violation, not
more than ten thousand dollars (\$10,000) for the second violation, and not more than
fifteen thousand dollars (\$15,000) for each subsequent violation.

7 19. Whitcraft has willfully violated the books and records provisions of the Corporate
8 Securities Law of 1968, Corporations Code section 25000 et seq., and the regulations thereunder.
9 On February 20, 2003, the Department sent Whitcraft a regulatory letter notifying it of the various
10 violations discovered during the second examination conducted on December 11, 2002 pursuant to
11 Corporations Code section 25241, including violations of California Code of Regulations, title 10,
12 sections 260.241.2 for annual reports and 260.241.3 for books and records. The Department's letter
13 reminded Whitcraft that the same violations were first brought to its attention in the 1999
14 examination and in the Department's regulatory letter to Whitcraft dated March 22, 1999. The
15 Department's letter requested that Whitcraft submit the required records above and to provide written
16 assurances that annual reports would be filed on a timely basis in the future, that it will maintain
17 books and records adequately on a monthly basis, and that monthly computations will be performed
18 and maintained in the future. Whitcraft responded to the Department by letter dated May 15, 2003
19 in which it apologized for the delay and said that its accountant was on vacation and that she would
20 be back by Memorial Day, at which time the financial documents would be completed and
21 forwarded to the Department. The Department placed a follow-up call to Whitcraft on May 28,
22 2003, at which time a message was left asking that it return the call. However, no records were
23 received.

24 20. Therefore, on August 27, 2003 a third regulatory examination of Whitcraft was
25 conducted unannounced. Immediately after the examination, Whitcraft replied to the Department by
26 letter dated August 27, 2003 stating that its books were not available for review, were being worked
27 on by its accountant, and would be complete and available for review on or before October 1, 2003.
28 The Department sent Whitcraft a regulatory letter on October 1, 2003 detailing the results of the

1 August 27, 2003 examination. Again, Whitcraft was informed of the violations for sections
2 260.241.2 and 260.241.3 of the California Code of Regulations and was reminded that these
3 deficiencies were discussed earlier in the Department's regulatory letters of March 22, 1999 and
4 February 20, 2003. Whitcraft again was asked to provide the same written assurances along with an
5 explanation as to why these deficiencies have not yet been corrected. Whitcraft did not respond.

6 21. On November 17, 2003, the Department sent Mr. Whitcraft a delinquent response
7 letter requesting a response to the October 1, 2003 regulatory letter, which was included, within ten
8 (10) days of receipt of the letter. On December 11, 2003, Whitcraft wrote that it had not received the
9 regulatory letter dated October 1, 2003, but that it was working diligently to supply the Department
10 with all the information requested and should be able to satisfy the bulk of it as soon as possible.

11 22. On January 27, 2004, the Department sent Whitcraft another delinquent response
12 letter outlining the regulations that were being violated and asking Whitcraft for a response with the
13 required documents and written assurances within ten (10) days. On May 3, 2004, Whitcraft
14 responded by letter stating that the documents will be provided shortly after May 24th, when its
15 President, Jonathan Whitcraft returns.

16 23. The Department sent a final delinquent response letter to Whitcraft dated September
17 10, 2004 following up on its letters of October 1, 2003, November 17, 2003, and January 27, 2004
18 detailing the reoccurring violations of regulations 260.241.2 for reports and 260.241.3 for books and
19 records, and the Department's inability to confirm compliance with regulation 260.237.1/260.237.2
20 for net capital requirements. Again, the Department asked for the required records and reports,
21 along with written assurances, and explanations as to why the deficiencies have not been corrected
22 although they have repeatedly been brought to Whitcraft's attention. Whitcraft responded by letter
23 dated September 21, 2004 stating that it was putting together the requested information as of July 31,
24 2004 and that the information would be delivered to the Department within the next few days. Still,
25 no records from Whitcraft were received by the Department.

26 24. On December 19, 2004, the Department placed a call to Whitcraft, at which time Mr.
27 Whitcraft stated that he was still working on the financial books and records and that they should be
28 ready soon. Mr. Whitcraft was asked to put that promise in writing and he stated that he would fax

1 the response right away. On December 22, 2004, Whitcraft faxed the Department a letter stating
2 that the required records and reports through 2004 will be delivered to the Department by the end of
3 January 2005. To date, no records or reports have been received by Whitcraft since 1999.

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5 25. By reason of the foregoing, Whitcraft has willfully violated California Code of
6 Regulations, title 10, section 260.241.2, subsections (a) and (b), section 260.241.3, subsections (a),
7 (c), (e), and (j), section 260.241.4(a), and section 260.238 subsections (n) and (o) justifying the
8 imposition of administrative penalties. Whitcraft, as a licensee, was obligated to have knowledge of,
9 and to comply with, the provisions of the Corporations Code and the regulations thereunder to
10 maintain its investment adviser certificate.

11 26. Therefore, pursuant to Corporations Code section 25252, the Commissioner seeks
12 administrative penalties against Whitcraft Capital Management Inc. for its failure to: 1) Maintain on
13 a monthly basis since 1999 proper books and records including journals, general ledgers, financial
14 statements, bank statements, trial balances, income statements, balance sheets, and cash
15 reconciliation on all cash accounts in willful violation of California Code of Regulations, title 10,
16 section 260.241.3, subsections (a), (c), (e) and (j), in the amount of \$20,000.00; 2) File the required
17 annual financial reports since 1999 in willful violation of California Code of Regulations, title 10,
18 section 260.241.2, subsections (a) and (b) in the amount of \$10,000.00; 3) Failing to disclose on its
19 Form ADV the location of its books and records in willful violation of 260.241.4(a) in the amount of
20 \$5,000.00; and 4) Charging clients fees for investment advisory services without permission
21 pursuant to a written contract in willful violation of section 260.238(n) and (o) in the amount of
22 \$10,000.00.

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WHEREFORE, good cause showing, and pursuant to Corporations Code section 25252, the California Corporations Commissioner prays for an order levying administrative penalties for a total of \$45,000.00.

Dated: June 6, 2006

WAYNE STRUMPFER
Acting California Corporations Commissioner

By: _____
LINDSAY HERRICK
Corporations Counsel
Enforcement Division