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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)	CASE NO.
)	
13 THE CALIFORNIA CORPORATIONS)	FILE NO. 923-3091
14 COMMISSIONER,)	
)	STATEMENT IN SUPPORT OF ORDER TO
15 Complainant,)	DISCONTINUE VIOLATIONS PURSUANT
)	TO CORPORATIONS CODE SECTION 25249
16 v.)	AND COMMISSIONER'S INTENTION TO
)	MAKE ORDER FINAL
17 RHODES INVESTMENT ADVISORY)	
18 (JAMES ERNEST RHODES DBA),)	
)	
19 Respondent.)	
)	
20)	
21)	

22 Demetrios A. Boutris, the California Corporations Commissioner ("Commissioner") of the
23 Department of Corporations ("Department") alleges and charges as follows:

24 1. Rhodes Investment Advisory (James Ernest Rhodes DBA) ("RIA") holds a valid and
25 unrevoked investment adviser certificate issued by the Commissioner on July 10, 1995 pursuant to
26 Corporations Code section 25230. RIA is an investment adviser business located at 1221 State
27 Street, El Centro, California 92243. RIA is a sole proprietorship. James Ernest Rhodes is RIA'S
28 sole proprietor.

1 2. On or about April 7, 2003, the Commissioner commenced a regulatory examination of
2 RIA. The examination revealed violations of the reporting provisions of the Corporate Securities
3 Law of 1968 ("CSL")(Corp. Code § 25000 et seq.) and the regulations thereunder found at
4 California Code of Regulations, title 10, ("CCR") (§ 260.000 et seq.).

5 3. These violations consisted of RIA'S failure to file annual financial reports with the
6 Commissioner within 60 days of the end of RIA'S fiscal year. RIA'S fiscal year ends in December.
7 The annual report filing requirement provides the Department with a regulatory mechanism to
8 validate a firm's liquidity and financial integrity on a yearly basis to ensure that licensees maintain
9 the necessary net capital for the protection of the public.

10 4. Corporations Code section 25241 provides that investment advisers are required to
11 maintain books and records that are subject to examination by, and to file such reports as required
12 by, the Commissioner. Corporations Code section 25241 provides, in relevant part, as follows:

13 [E]very investment adviser licensed under Section 25230 shall make and keep such
14 accounts, correspondence, memoranda, papers, books, and other records and shall file such
15 financial and other reports as the commissioner by rule requires....

16 5. CCR section 260.241.2 requires the filing of an annual report by certain investment
17 advisers. Prior to April 3, 2003¹, subdivision (a)(2) of CCR section 260.241.2, provided as follows:

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

22 ...
23 (2) The annual report for investment advisers shall contain a Statement of Financial
24 Condition. Supporting schedules shall contain computations of net capitals, aggregate
25 indebtedness and ratios required under Section 260.237.1 and the certificate of the accountant
26 required under subsection (c) of Section 260.237 of these rules.

27 6. Prior to April 3, 2003, CCR section 260.237.1 set forth the capital requirements for
28 investment advisers. Subdivision (a)(2) of CCR section 260.237.1 provided, in relevant part, as
follows:

¹ Various provisions of the CCR were amended and became effective April 3, 2003. This administrative action is based on violations that occurred under statutes and rules prior to the effective date of the amendments.

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

5 ...
6 (2) If the investment adviser has any power of attorney from any investment advisory client
7 to execute transactions and does not have regular or periodic custody or possession of any of
8 its investment advisory clients' securities or funds, except the receipt of prepaid subscriptions
9 for periodic publications, or other investment advisory services, it shall at all times have and
10 maintain tangible net capital of not less than \$5,000....

11 Subdivision (c) of CCR section 260.237.1 provided that for purposes of CCR section
12 260.237.1(a), all financial information shall be determined in accordance with generally accepted
13 accounting principles.

14 7. The Department's examiner found during the regulatory exam on April 7, 2003, that
15 RIA had discretionary power to execute transactions in the brokerage accounts of its investment
16 adviser clients. Therefore, prior to April 3, 2003, RIA was required to meet the capital requirements
17 provided for under CCR section 260.237.1(a)(2) and to show proof of compliance with this
18 regulation by filing annual financial reports required by CCR section 260.241.2. At the time of the
19 April 7, 2003, examination, RIA had failed to submit its annual financial statements for the years
20 1998 through 2002, in violation of CCR section 260.241.2(a). As a result of RIA'S violation of
21 CCR section 260.241.2(a), the Department was unable to determine, at the end of RIA'S fiscal year,
22 if the firm was in compliance with the net capital requirements of CCR section 260.237.1.

23 8. On May 9, 2003, the Department sent RIA a regulatory letter notifying the firm of the
24 exceptions discovered during the April 7, 2003 examination, including the violation of CCR section
25 260.241.2(a). Mr. Rhodes responded on behalf of RIA by letter on May 21, 2003. In this letter, Mr.
26 Rhodes claimed that he failed to submit timely annual financial reports because he did not
27 understand the requirement to file them. However, he stated that they would be timely filed in the
28 future, since they had "...been added to the firm's year-end task list."

9. A prior regulatory examination of RIA conducted by the Department on April 11,
1997 revealed, in part, the same failure to file an annual financial report. On April 18, 1997, the
Department sent a letter notifying RIA of its failure to file its annual financial report for 1996, in

1 violation of CCR section 260.241.2(a). Mr. Rhodes replied by letter dated May 7, 1997, stating that
2 all the deficiencies noted in the Department's April 18, 1997 letter, including the late filing of the
3 annual financial report, would be corrected. Mr. Rhodes submitted a second letter to the
4 Department, dated May 14, 1997, that stated in part "In the future annual financial reports will be
5 filed in a timely manner."

6 10. Corporations Code section 25249, which became effective January 1, 1999,
7 authorizes the Commissioner to issue an order directing any investment adviser to discontinue any
8 violation of any provision of the CSL and any rules promulgated thereunder. Specifically,
9 Corporations Code section 25249 provides, in relevant part:

10 If, after examination or investigation, the commissioner has reasonable grounds to believe
11 that any...investment adviser has violated any law or rule binding upon it, the commissioner
12 shall, by written order addressed to the...investment adviser, direct the discontinuance of the
13 violation. The order shall be effective immediately, but shall not become final except in
14 accordance with the provisions of Section 25251.

15 11. Corporations Code section 25251 provides:

16 (a) No order issued pursuant to Section 25249 or 25250 may become final except after notice
17 to the affected broker-dealer or investment adviser of the commissioner's intention to make
18 the order final and the reasons for the finding. The commissioner shall also notify the
19 broker-dealer or investment adviser that upon receiving a request the matter shall be set for
20 hearing to commence within 15 business days after the receipt of the request. The broker-
21 dealer or investment adviser may consent to have the hearing commence at a later date. If no
22 hearing is requested within 30 days after the mailing or service of the required notice, and
23 none is ordered by the commissioner, the order may become final without a hearing and the
24 broker-dealer or investment adviser shall immediately discontinue the practices named in the
25 order. If a hearing is requested or ordered, it shall be held in accordance with the provisions
26 of the Administrative Procedure Act (Chapter 5 (commencing with Section 11500) of Part 1
27 of Division 3 of Title 2 of the Government Code) and the commissioner shall have all of the
28 powers granted under that act. If, upon the conclusion of the hearing, it appears to the
29 commissioner that the broker-dealer or investment adviser is conducting business in an
30 unsafe or injurious manner or is violating any law of this state, or any rule binding upon it,
31 the commissioner shall make the order of discontinuance final and the broker-dealer or
32 investment adviser shall immediately discontinue the practices named in the order.

33 (b) The broker-dealer or investment adviser may within 10 days after an order is made final
34 commence an action to restrain enforcement of the order. If the enforcement of the order is
35 not enjoined within 10 days by the court in which the action is brought, the broker-dealer or
36 investment adviser shall comply with the order.

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12. By reason of the foregoing, RIA has willfully violated Corporations Code section 25241 and CCR section 260.241.2(a), justifying the issuance of an Order to Discontinue Violations. RIA, as a licensee, was obligated to have knowledge of, and to comply with, the provisions of the CSL and the regulations thereunder to maintain its investment adviser certificate. Furthermore, on April 18, 1997, the Department notified RIA of the annual financial report filing requirement. RIA has continued to violate both Corporations Code section 25241 and CCR section 260.241.2, despite the Department's actual notification and Mr. Rhodes's assurances of future compliance.

13. Therefore, pursuant to Corporations Code section 25249, the Commissioner has issued an order directing RIA to discontinue violating Corporations Code section 25241 and CCR section 260.241.2(a).

WHEREFORE, good cause showing, and pursuant to Corporations Code section 25251, the California Corporations Commissioner hereby notifies RIA of his intention to make final the Order to Discontinue Violations Pursuant to Corporations Code Section 25249 issued on November 19, 2003.

Dated: November 19, 2003

DEMETRIOS A. BOUTRIS
California Corporations Commissioner

By: _____
NICHOLAS LANZA
Senior Corporations Counsel
Enforcement and Legal Services Division