

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

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AUG 20 2007

MICHAEL W. DOBBINS
CLERK, U.S. DISTRICT COURT

UNITED STATES SECURITIES
AND EXCHANGE COMMISSION,

Plaintiff,

v.

SENTINEL MANAGEMENT GROUP, INC.

Defendant.

JUDGE KOCORAS

CASE NO.

JURY DEMANDED

MAGISTRATE JUDGE MASON

07C

4684

COMPLAINT

Plaintiff United States Securities and Exchange Commission (“SEC” or “Commission”) alleges as follows:

NATURE OF THE ACTION

1. This action involves the ongoing fraud and misappropriation and misuse of client assets by the investment advisory firm Sentinel Management Group, Inc. (“Sentinel” or “Defendant”). Sentinel, which claims to have \$1.2 billion in assets under management, defrauded its clients by improperly commingling, misappropriating and leveraging their securities without their knowledge in violation of the Investment Advisers Act of 1940, (“Advisers Act”).

2. Sentinel’s fraudulent conduct has placed its clients at risk of serious and irreparable loss. Among its improper activities, Sentinel transferred at least \$460 million in securities from client investment accounts to Sentinel’s proprietary “house” account. Sentinel also used securities from client accounts as collateral to obtain a \$321 million line of credit as

well as additional leveraged financing. The bank that extended the \$321 million line of credit to Sentinel informed Sentinel that it is in default under the credit agreement and therefore the bank intends to sell securities currently sitting in Sentinel's "house" account that were pledged as collateral for the loan beginning as soon as August 22, 2007. The securities to be sold may include securities that were fraudulently transferred to the "house" account from client accounts. At the very least, Sentinel has not kept accurate books and records, required to be kept under the federal securities laws, necessary to verify the ownership of the securities in its client and "house" accounts and to prevent the firm from selling assets that it is not entitled to sell and distributing the sale proceeds persons not entitled to receive them.

3. Sentinel did not disclose to its clients its practices of commingling, transferring and misappropriating their assets, or inform them that their investment portfolios were highly-leveraged as a result of Sentinel's financing activities. To the contrary, Sentinel provided its clients with daily account statements that did not reflect the improper activities.

4. Through the activities alleged in this Complaint, Sentinel has, and unless enjoined, will continue to, directly and indirectly, engage in transactions, acts, practices or courses of business which are violations of Sections 206(1), 206(2) and 206(4) of the Advisers Act [15 U.S.C. § 80b-6(1), 80b-6(2) and 80b-6(4)], and Rule 206 (4)-2 promulgated thereunder [17 C.F.R. 275.206(4)-2].

JURISDICTION AND VENUE

5. The SEC brings this action pursuant to the authority conferred upon it by Section 209(d) of the Investment Advisers Act of 1940 (the "Advisers Act") [15 U.S.C. § 80b-9(d)].

6. This Court has jurisdiction pursuant to Section 214 of the Investment Advisers Act of 1940 [15 U.S.C. § 80b-14] and 28 U.S.C. § 1331.

7. Venue is proper in this Court pursuant to Section 214 of the Advisers Act [15 U.S.C. § 80b-14].

8. The acts, practices and courses of business constituting the violations alleged herein occurred within the jurisdiction of the United States District Court for the Northern District of Illinois and elsewhere.

9. Defendants, directly and indirectly, have made, and are making, use of the means and instrumentalities of interstate commerce and of the mails in connection with the acts, practices and courses of business alleged herein in the Northern District of Illinois and elsewhere.

DEFENDANT

10. Sentinel, an Illinois corporation headquartered in Northbrook, Illinois, provides investment advisory and discretionary money management services to various types of client clients, including financial institutions, private investment firms, pension funds and individuals. Sentinel is an investment adviser registered with the SEC and a futures commission merchant (“FCM”) registered with the Commodity Futures Trading Commission (“CFTC”). It is also a member of National Futures Association (“NFA”), a self-regulatory organization. As of August 13, 2007, Sentinel claimed to have \$1.2 billion of client interests in assets under management.

FACTS

11. Sentinel is a registered investment adviser that primarily manages investments of short-term cash for various advisory clients, including FCMs, hedge funds, financial institutions, pension funds, and individuals. Sentinel’s website claims that since 1979, Sentinel has “never lost a dime of client funds, or delayed even one day in returning the full amount of a client’s cash regardless of prevailing market conditions.” Additionally, Sentinel states that it “buys only the

highest quality and most liquid securities.” Sentinel’s objective “is to achieve the highest yield consistent with preservation of principal and daily liquidity, not simply the highest yield.” As of August 13, 2007, Sentinel claimed to have \$1.2 billion of client assets under management.

12. On August 13, 2007, Sentinel sent a letter to clients announcing that it was halting all redemptions due to the “liquidity crisis” in the credit markets. In the letter, Sentinel represented that the “liquidity crisis” prevented Sentinel from meeting redemption requests “without selling securities at deep discounts to their fair value and therefore causing unnecessary losses” to clients.

13. Sentinel’s explanation of its redemption suspension was false and misleading. As described below, for a period of at least several months up to and including the week of August 13, 2007, Sentinel’s advisory clients suffered undisclosed losses and risks of losses due to Sentinel’s undisclosed use of leverage and commingling and misappropriation of clients’ securities. As of August 13, 2007, the account statements Sentinel provided to clients listed hundreds of millions of dollars in securities that were not held by Sentinel at all, were held by Sentinel and treated as its own assets, or were pledged as collateral for loans extended to Sentinel.

A. The Programs

14. Sentinel offered clients the opportunity to participate in a variety of investment programs, each of which had its own investment policy designed to meet the requirements and preferences of different types of clients. Regardless of which investment program a particular client chose, Sentinel had the general practice of pooling the client’s assets with those of similar types of clients in one of three segregated client custodial accounts held at the Bank of New York. The accounts were referred to within Sentinel as Seg 1, Seg 2 and Seg 3.

15. Seg 1 contained assets of registered FCMs with only domestic customer deposits. FCMs are futures brokers that are members of the NFA and investments are subject to the rules of the CFTC. The customer deposit accounts are required to adhere to strict investment standards embodied in Rule 1.25 promulgated under the Commodities Futures Trading Act and are commonly referred to as “125 accounts.” Seg 2 contained assets of FCMs with foreign customer deposits. Seg 3 contained assets of all other types of clients, including hedge funds, trust accounts, endowments and individuals.

16. Under Rule 206(4)-2 promulgated under the Advisers Act, a registered investment adviser such as Sentinel is not allowed to have custody of any client funds or securities unless, among other requirements, the funds and securities are held in segregated accounts that hold only clients’ funds and securities. Sentinel routinely violated this requirement, by commingling and transferring client funds and securities between the various client segregated accounts and between client accounts and a “house” account, which also contained securities which Sentinel claimed it owned.

B. Sentinel’s Representations to Clients

17. Sentinel made written representations to its clients through at least four means: an advisory agreement with clients; client account statements provided daily to clients; its investment policies on Sentinel’s website; and Part II of Sentinel’s Form ADV filed with the Commission.

18. From at least July 2005, in its standard investment advisory agreement with clients, Sentinel represented that the clients in each segregated portfolio owned an indirect, pro rata interest in their particular segregated investment portfolio. The Agreement also provided discretionary authority to Sentinel to buy and sell securities without requesting authority from

clients before executing the trades. The Agreement often had an Addendum specifying the investment policy that was to be used to invest the client's funds. For example, the Addendum for the largest client in Seg 3 stated that its funds would be invested consistent with the limitations of CFTC Rule 1.25. This rule restricted investments to highly-rated debt instruments and other highly rated and relatively liquid investments.

19. The version of the Agreement provided to clients prior to 2005 did not state that any form of leverage would be utilized by Sentinel in managing the clients' accounts. At some point in late 2004 or early 2005, Sentinel typically added to the Agreement a provision allowing the use of leverage, but did not disclose to what extent it would be used.

C. **Undisclosed Misappropriation and Commingling of Client Assets**

20. Sentinel represented on its Website that "Sentinel clients receive a daily account statement (by email or fax), which shows, down to the penny, precisely what securities they own." This was on Sentinel's website as late as August 14, 2007. Sentinel did send daily account statements to its clients but they were materially false and misleading, as detailed below.

21. On August 13, 2007, Sentinel e-mailed customer account statements to its clients that were materially false and misleading. For example, the customer statements sent to clients whose assets were supposedly held in the Seg 3 account represented that the face value of the securities held in their accounts was, in the aggregate, more than \$670 million. The accounts reported no liabilities corresponding to these assets. Contrary to these representations, the Bank of New York custodial statement for the Seg 3 account on August 13 showed only approximately \$94 million of securities held on behalf of all Seg 3 clients. SEC examiners asked Sentinel's representatives about the discrepancy between the customer statements and the custodial

statement, and were informed that the customer accounts would not “tie out” because Sentinel had moved securities among the Seg accounts and its own “house” account.

22. On information and belief, for at least several months before August 13, 2007, Sentinel routinely falsely represented to its clients the amount of securities held in their accounts.

23. Before August 13, 2007, Sentinel placed at least \$460 million of clients’ securities properly belonging in segregated customer accounts in Sentinel’s “house” account. The “house” account also contained securities owned by Sentinel and, significantly, was available to be pledged as collateral. The placement of these clients’ securities in a commingled account was not disclosed to clients on the account statements. When SEC examiners asked Sentinel representatives to identify which securities in the “house” account were owned by clients or Seg accounts, Sentinel representatives responded that it could not determine who owned those securities.

D. Undisclosed Leveraging of Client Assets

24. Sentinel pledged securities belonging to clients as collateral in order to obtain a line of credit from the Bank of New York for its own benefit. The credit extended under this line of credit reached as high as \$500 million in June 2007 and is now \$321 million. The client account statements, which should have accurately reflected the portfolio holdings, the value of the portfolio and all transactions in the portfolio, did not reflect the fact that the securities had been encumbered in this manner. In other words, the clients had no way of knowing that their assets had been used by Sentinel to obtain financing for its own purposes.

25. Sentinel used client assets to obtain additional leveraged financing. A representative of Sentinel told a member of the SEC’s examination staff that since 2004 Sentinel had used \$1.5 billion in securities owned by the clients to obtain financing totaling three times

the value of those securities. Sentinel representatives told SEC examiners that the financing was used to purchase additional securities. However, the client account statements prepared and distributed by Sentinel did not reflected any of this activity.

COUNT I

Violations of Sections 206(1) and 206(2) of the Advisers Act

26. Paragraphs 1 through 25 are re-alleged and incorporated by reference herein.

27. Defendant, while acting as an investment adviser, by the use of the means and instrumentalities of interstate commerce and of the mails, directly and indirectly, has employed and is employing devices, schemes and artifices to defraud its clients and prospective clients; and has engaged and is engaging in transactions, practices and courses of business which operate as a fraud or deceit upon its clients and prospective clients.

28. By reason of the foregoing, Defendant has violated, and unless restrained and enjoined will continue to violate, Sections 206(1) and (2) of the Advisers Act [15 U.S.C. § 80b-6(1) and 80b-6(2)].

COUNT II

Violations of Section 206(4) of the Advisers Act and Rule 206(4)-2 Thereunder

29. Paragraphs 1 through 25 are realleged and incorporated by reference herein.

30. Defendant Sentinel, while acting as an investment adviser, by use of the mails or the means or instrumentalities of interstate commerce, directly or indirectly, engaged in acts, practices or courses of business which are fraudulent, deceptive or manipulative, as those terms have been defined by the SEC by rules and regulations, by taking custody of client funds or securities that were not maintained in a separate client account for each client under that client's

name; or in accounts that contain only the clients' funds and securities, under Defendant Sentinel's name as agent or trustee for the clients.

31. By reason of the foregoing, Defendant Sentinel has violated, and unless restrained and enjoined will continue to violate, Section 206(4) of the Advisers Act [15 U.S.C. §80b-6(4)] and Rules 206(4)-2 thereunder [17 C.F.R. 275.206(4)-2].

PRAYER FOR RELIEF

WHEREFORE, the SEC respectfully requests that this Court:

I.

Find that Defendant Sentinel committed the violations charged and alleged herein.

II.

Grant Orders of Preliminary and Permanent Injunction, in a form consistent with Rule 65(d) of the Federal Rules of Civil Procedure, restraining and enjoining Defendant Sentinel and its officers, agents, servants, employees, attorneys and those persons in active concert or participation with them who receive actual notice of the Orders of Preliminary and Permanent Injunction, by personal service or otherwise, and each of them, from, directly or indirectly, engaging in the acts, practices or courses of business described above, or in conduct of similar purport and object, in violation of Sections 206(1), 206(2) and 206(4) of the Advisers Act [15 U.S.C. § 80b-6(1), 80b-6(2) and 80b-6(4)] and Rule 206(4)-2 [17 C.F.R. § 275.206(4)-2] thereunder.

III.

Issue an Order requiring Defendant to disgorge all profits or ill-gotten gains that it has received as a result of the acts and courses of conduct complained of herein, with prejudgment interest.

IV.

Issue an Order directing Defendant to pay civil fines and/or penalties pursuant to Section 209(e) of the Advisers Act [15 U.S.C. § 80b-9(e)].

V.

Retain jurisdiction of this action in accordance with the principals of equity and the Federal Rules of Civil Procedure in order to implement and carry out the terms of all orders and decrees that may be entered or to entertain any suitable application or motion for additional relief within the jurisdiction of this Court.

VI.

Grant Orders for such further relief as the Court may deem appropriate.

Dated: August 20, 2007

Respectfully submitted,



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