ADMINISTRATIVE PROCEEDING
FILE NO. 3-5492

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
POTOMAC INVESTMENT ADVISORS, LTD. WILLARD JOHN MILLER JOHN SCOTT MILLER	:
	:

INITIAL DECISION

Washington, D.C.
February 5, 1979

Max O. Regensteiner
Administrative Law Judge

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WILLARD JOHN MILLER	:	INITIAL DECISION
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APPEARANCES: Paul F. Leonard, Edward A. Kwalwasser, John R. Kiefner, Jr. and Lynda L. Cole, of the Commission's Washington Regional Office, for the Division of Enforcement.

Thomas A. Rothwell and Randy K. Dix, for respondents.

BEFORE: Max O. Regensteiner
Administrative Law Judge

In these proceedings under Section 203 of the Investment Advisers Act of 1940, the Division of Enforcement alleged that Potomac Investment Advisors, Ltd. ("Potomac"), a registered investment adviser, and Willard J. Miller ("W. Miller"), its founder and operating head, misused and converted clients' funds, in violation of antifraud provisions of the Advisers Act and the Securities Exchange Act of 1934. It also charged those respondents and John Scott Miller ("S. Miller"), W. Miller's son, with violating or aiding and abetting violations of recordkeeping provisions under the Advisers Act. Finally, it was alleged that Potomac and W. Miller had been permanently enjoined from violating those antifraud and recordkeeping provisions and S. Miller from violating the recordkeeping provisions.

Except for one aspect of the fraud charges that was added by amendment at the opening of the hearings, respondents admitted the allegations. The hearings consequently focused on that fraud allegation and on factors pertaining to the remedial action which is appropriate in the public interest. Following the hearings, the parties filed proposed findings and briefs. 1/

1/ Respondents complain that the Division, in its proposed findings and conclusions and brief, improperly sought to expand the scope of these proceedings by "offering an exhaustive recitation and analysis" of the alleged violations, when (aside from the one fraud allegation) the only issue is that of the appropriate sanctions. However, while the Division's detailed analysis of the bases for finding violations seems superfluous in view of respondents' admissions, it properly proposed findings and conclusions pertaining to those violations because such findings and conclusions are a statutory predicate to the imposition of any sanctions. Moreover, some evidence was offered bearing on the admitted violations, including parts of W. Miller's testimony presented by respondents. Such evidence "fleshed out" those violations and is significant in the resolution of the "public interest" issue.

Respondents

After a lengthy career in the banking business, including some 25 years as a trust officer, W. Miller founded Potomac in 1972. The firm commenced operations at the beginning of 1973. Throughout Potomac's existence, W. Miller has been its president and owner of about 50% of its common stock. S. Miller, who graduated from college in 1972, was the only other person active in Potomac's business. His almost exclusive function was to maintain the firm's records. Initially he held the title of secretary; later he also became vice-president. S. Miller owns less than 1% of Potomac's stock.

Violations of Antifraud Provisions

As admitted, Potomac, together with or willfully aided and abetted by W. Miller, willfully violated Sections 206(1), (2) and (4) of the Advisers Act and Rule 206(4)-2 thereunder and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The gravamen of the misconduct involves Miller's conversion of clients' funds to his own use and the use of some clients' funds for the benefit of others, all without clients' knowledge or authorization.

Potomac maintained funds of its clients in a single bank account entitled "Potomac Investment Advisors, Ltd. Special Account." A cash client ledger kept by the firm contained separate sheets for each client reflecting cash

transactions and the current balance. As of March 31, 1978, according to these records, some 90 clients had credit balances totalling $199,530. However, in the course of a compliance examination in April 1978, Commission staff examiners discovered that the balance in the Special Account was only $15,793.

The discrepancy was attributable to the fact that more than 40 accounts had debit balances totalling $183,872. Of this total, approximately $49,000 represented the debit balances of some 40 clients. In substance, Potomac had made payments for and to these clients in amounts exceeding their cash balances (including payment for Potomac's own advisory fees), using funds belonging to other clients for that purpose. The major portion of the debit total, however, reflected debit balances in accounts entitled "Wilmil & Co." and "Willard J. Miller," which W. Miller used as personal trading accounts. Miller had sustained sizeable losses in his securities transactions. In simple terms, the debit balances, totalling almost $135,000 as of March 31, 1978, represented funds converted by Miller from the Special Account so as to cover those losses.

Wilmil & Co. had been created in late 1972 as a partnership of W. and S. Miller. At the beginning of 1974, W. Miller established an account for Wilmil with Potomac and with certain broker-dealers. Initially, the account was

used to accommodate certain of Miller's friends who were not Potomac clients and wished to have securities transactions executed. The funds involved in these transactions were funnelled through the Special Account. Beginning in May 1974, however, W. Miller, with clients' funds, began to use the Wilmil account also for his personal transactions. At first those transactions were on an isolated basis, but from late 1975 on they were on a large scale. In transactions which resulted in a loss, Miller did not cover the loss. Since there were many realized losses, and, as noted below, profits were siphoned out, Wilmil's balance in the Special Account took the form of an increasingly large deficit. By March 31, 1978, the deficit had reached more than $111,000. Beginning in late 1975, in transactions where a profit was realized, W. Miller withdrew that profit by using a Miss L., S. Miller's girlfriend, as a conduit. In such transactions, when Potomac received a check for the proceeds of the sale from the executing broker, it was deposited in the Special Account. A check for the same amount was then issued to Miss L. She in turn typically issued two checks drawn on her personal account, one to Potomac in the amount of the cost of the securities and a second to W. Miller in the amount of the profit realized. In 65 transactions between December 1975 and August 1977, Miller siphoned off more than $44,000 by this method. S. Miller acted as the in-

termediary in these transactions. W. Miller acknowledged that the principal reason for using this device was to conceal the fact that the profits were going to him.

After S. Miller, approximately in September 1977, finally protested against the continued involvement of Miss L. in what he recognized to be an illegal practice, W. Miller stopped using her as a conduit. In November 1977, he opened an account in his own name. Here too, he used clients' funds. As of March 31, 1978, the account had a debit balance of $23,364, including $9,094 withdrawn by W. Miller from the account which apparently represented profits on transactions. 2/

2/ The one allegation (actually sub-allegation) which respondents did not admit was that W. Miller converted to his own use the profits siphoned out of the Wilmil account (in addition to the debit balances in that account and the W. Miller account). The Division's theory is that under the law of trusts, a trustee who misappropriates funds must not only restore those funds but must account for any profits derived from his misappropriation even if he sustained a net loss in the unauthorized transactions.

Respondents, who at the hearing had vigorously disagreed with the Division's theory, no longer dispute that the above is a correct statement of fiduciary law. They assert, however, that "in the context of the case it is an abstraction" because (a) the Division has not purported to "seek any remedy" for Potomac's clients with reference to these "alleged" profits, whose equitable distribution would in any event be purely speculative (quotations from p. 10 of respondents' brief) and (b) the record shows that Miller used some of the funds for Potomac business expenses.

Respondents' arguments do not appear to be legally sound and their second point is also factually weak. See n. 8, infra. However, the whole issue is one which, in the context of these proceedings as distinguished from an action for damages, is of little significance since the conversion of customers' funds on a large scale has been admitted.

In addition to violating the general antifraud provisions, Potomac and W. Miller failed to comply with the specific requirements of Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, applicable to an adviser having custody of clients' funds. Such funds must be deposited in one or more bank accounts, maintained in the adviser's name as agent or trustee for clients, which contain only clients' funds. Here, the Special Account was not properly denominated, and the funds of non-clients for whom the Wilmil account was used were commingled with clients' funds. Further, the quarterly clients' statements which the Rule requires were misleading in failing to disclose that clients' funds were being and had been used by W. Miller for his own purposes and in some instances for other clients' transactions and were not on hand as represented. Moreover, the annual surprise examination by an independent public accountant for the purpose of verifying clients' funds and securities, which the Rule requires, was not performed either in 1976 or 1977.

Recordkeeping Violations

Potomac, willfully aided and abetted by both Millers, willfully violated the recordkeeping provisions of Section 204 of the Advisers Act and Rule 204-2 thereunder. The firm's general ledger was not currently posted, with the result that a trial balance as of March 31, 1978 was out of balance. Order memoranda reflecting, among other

things, clients' instructions regarding securities transactions and the manner in which transactions were executed, were destroyed once a confirmation had been received from the executing broker. 3/ No record was maintained, although required, reflecting specified information concerning W. Miller's transactions on his own behalf. Moreover, certain records which the Rule requires to be maintained with respect to accounts in which Potomac had custody or possession of clients' funds or securities were not maintained. 4/

3/ Rule 204-2(e)(1) requires that records made under the Rule's provisions, such as order memoranda, be preserved for at least five years.

4/ The Division alleged two further categories of recordkeeping deficiencies. One was that Potomac did not make cash reconciliations, the other that the quarterly statements sent to clients were inaccurate. Although respondents admitted these allegations, I am unable to find that those deficiencies violated Rule 204-2. Without exploring the matter in detail, which would obviously be a needless exercise, I read the Rule's provisions pertaining to "cash reconciliations" (subparagraph (a)(4)) and "copies of all written communications" sent by the adviser (subparagraph (a)(7)) as simply requiring the preservation of the designated items to the extent and in the form in which they exist. The sending of a misleading quarterly statement violates Rule 206(4)-2, not Rule 204-2.

The Injunction

In May 1978, the Commission, on the basis of allegations substantially the same as those made by the Division herein, brought an action against respondents in the United States District Court for the Eastern District of Virginia for an injunction and other equitable relief. With respondents' consent, 5/ the Court permanently enjoined Potomac and W. Miller from violating Sections 206(1), (2) and (4) of the Advisers Act and Rule 206(4)-2 thereunder and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Potomac and both Millers from violating Section 204 of the Advisers Act and Rule 204-2 thereunder. Based on respondents' representations that they had insufficient assets to retain an independent public accountant, they were directed to make an accounting regarding clients' funds and securities which were in their custody or possession and to advise clients of the results. Pending such accounting, clients' assets were in effect frozen.

In April 1978, following the staff's discovery of the shortages, respondents had borrowed a total of more than $123,000 from four friends and relatives so as to eliminate the debit balances in the Wilmil and W. Miller accounts.

5/ Respondents neither admitted nor denied the allegations of the complaint.

As a result, respondents were in a position to make appropriate disbursement of funds and securities to clients or pursuant to clients' direction, when the Court, satisfied with the accounting, directed them to do so in June 1978. 6/ Potomac closed its doors as of the end of that month.

Public Interest

The final issue, and essentially the only contested one, concerns the remedial action that is necessary and appropriate in the public interest. The Division, stressing the seriousness of the violations and asserting that Potomac and W. Miller engaged in deceptions and misrepresentations even after the conversion of clients' funds was discovered, urges that Potomac's registration as an investment adviser be revoked and that W. Miller be "permanently" barred from association with an investment adviser. It also recommends that S. Miller be barred from such association, but subject to a right to apply after three years to become so associated in a non-supervisory position. Respondents, while not opposing the proposed revocation of Potomac's registration, urge that under all the circumstances far less stringent sanctions against the Millers would suffice.

6/ It appears that those clients who had debit balances in the Special Account had liquidated those balances by that time.

The starting point in determining appropriate sanctions is the nature of the respondents' misconduct that has been found. 7/ With respect to W. Miller, the record shows that his misconduct was not an isolated indiscretion. Rather, over an extended period he used, for his own speculative purposes, funds which clients had entrusted to him and Potomac. It was only the appearance of staff examiners which finally resulted in an end to these misappropriations. It hardly needs stating that Miller's conduct was flagrantly inconsistent with his fiduciary relationship to Potomac's clients. The fact that when he did realize profits in his transactions, he withdrew them from the Wilmil and W. J. Miller accounts, instead of using them to reduce the accounts' deficit positions, is an aggravating circumstance. 8/ Adding further to the picture of abdication by a fiduciary of a basic responsibility -- the safeguarding

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7/ The Commission has said that on the question of what action is needed to protect investors from future harm at a respondent's hands, it is pertinent to consider that the statute is drawn on the premise that past misconduct gives rise to an inference of probable future misconduct. Lamb Brothers, Inc, Securities Exchange Act Release No. 14017 (October 3, 1977), 13 SEC Docket 265, 274, n. 49. (While the statute there referred to was the Exchange Act, the concept is equally applicable under the Advisers Act.)

8/ Respondents offered evidence indicating that Miller used some of the funds so withdrawn to pay Potomac business expenses, as against using them for his purely personal benefit. That evidence is less than persuasive as to the nature of the various expenditures. In any event, however, such use of the funds could not justify the conduct in question or detract from its seriousness.

of clients' funds -- is Miller's cavalier use of some clients' funds for the benefit of others. 9/ And this does not exhaust the misconduct which has been previously catalogued.

The Division further points out, with considerable justification, that in his conduct subsequent to the discovery of the misconduct, W. Miller still failed to adhere to standards of candor and honesty which are expected from an investment adviser. For example, in a meeting with staff members shortly after such discovery, Miller answered in the affirmative the question whether he had put profits back into the Wilmil account. Miller's testimony that as he understood the question he had put the profits back, since he had restored the deficits in the Wilmil and W. J. Miller accounts, strikes me as disingenuous. Miller further

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9/ Respondents claim that this practice presented no risk to those clients who in effect acted as lenders since the deficit positions of the "borrowing" clients were essentially covered by the value of securities owned by them which were in Potomac's possession or under its control. It is not suggested that this constitutes a defense -- which of course it could not. Even as a mitigating circumstance it has little substance, because it fails to take into account fluctuations in the market value of securities and the fact that sales of securities directed by W. Miller for the purpose of covering a deficit could well have conflicted with his and Potomac's fiduciary obligations toward the client.

testified that he did not disclose to the staff members the manner in which profits were siphoned out of the Wilmil account, since he did not want to implicate Miss L., an innocent person. Such concern is strangely at odds with his use of Miss L. in his scheme over an extended period. And it is simply not correct, as respondents assert, that Potomac's records revealed the true nature of these transactions. While those records showed checks issued by Potomac to Miss L. and checks received by Potomac from her, they did not indicate her role in the scheme or disclose the payments made to Miller through her. With respect to at least some of the persons who lent him money to cover the deficits, as well as some Potomac clients who subsequent to the injunction asked Miller to act as their investment adviser and certain broker-dealer personnel with whom those persons' accounts were opened, Miller's disclosures concerning the nature of his misconduct were also less than candid. The stark and basic fact that he had misappropriated clients' funds was simply not made clear. 10/

10/ The Division would further have me find that by his conduct subsequent to the injunction, W. Miller violated the Advisers Act's registration provisions. But the order for proceedings alleged no such violation. And the Commission has held that it is not permissible to find a violation as part of the "public interest" consideration, when no such violation is alleged in the order for proceedings. International Shareholders Services Corporation, Securities Exchange Act Release No. 12389A (June 8, 1976), 9 SEC Docket 820, 825, n. 19.

Measured against the various matters and factors discussed above, the circumstances advanced by respondents as mitigating in nature carry little weight. Thus, while it is true that no client sustained a loss in his account by reason of W. Miller's conduct, the restitution that was made occurred only after Miller was caught red-handed. Unquestionably, as respondents point out, Miller and his family have already suffered greatly as a result of the matters discussed herein, and his exclusion from the investment advisory field, in which he has worked for some forty years, would tend to perpetuate his already serious economic problems. No reasonable person can be indifferent to the personal tragedy involved here. But the primary concern in this sensitive area of activity is the protection of the investing public. And consideration must also be given to the deterrent effect on others of the decision here. 11/

Respondents presented a number of former Potomac clients (some of whom had asked W. Miller to be their adviser after Potomac's demise) to testify to the competent and valuable services which Miller had provided them and to their continued confidence in him. For the most part, however, these

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11/ See Lamb Brothers, Inc., supra, n. 7; Nassar and Company, Inc., Securities Exchange Act Release No. 15347 (November 22, 1978), 16 SEC Docket 222, 228.

persons did not have a clear understanding of the nature of Miller's misconduct. By way of illustration, Mr. W., an attorney who had accounts with Potomac both personally and as trustee for two of his clients, testified that he would have no reservation about again becoming Miller's client and that he considered Miller an honorable and trustworthy individual. Respondents refer to this testimony as that of a "seasoned" attorney who fully understood the nature of Miller's misconduct. Yet, on cross-examination, Mr. W., although apprised of Miller's admissions, was unwilling to accept the fact that Miller had converted clients' funds. He did state that "perhaps" he would have to reconsider his evaluation of Miller's character if it were adjudged "in due proceeding" that Miller had engaged in such conduct. (Tr. 367).

Respondents further urge that if W. Miller is barred from obtaining employment in the investment advisory field, he will be unable to repay the persons who extended loans to him and his family to cover the deficits in the Wilmil and W. J. Miller accounts, and that it is contrary to the public interest to cause injury to those persons. Accepting the premise of the argument, 12/ it would indeed be unfortunate if the lenders were to sustain losses. But avoidance of

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12/ It should be noted that the notes given to the lenders were signed not only by W. Miller, but also by his wife and by S. Miller.

such a result cannot be achieved at the expense of exposing possible future clients, whose protection is the Commission's primary obligation under the Advisers Act, to unwarranted risk.

Under all the circumstances, it is in the public interest to revoke Potomac's registration and to bar W. Miller from being associated with an investment adviser.

In the case of S. Miller, however, a less stringent sanction than that sought by the Division is appropriate. S. Miller was not charged with participation in his father's fraudulent activities. While he has been found responsible for recordkeeping violations and has been enjoined from further such violations, the record is skimpy, because of respondents' admissions, as to the extent and seriousness of those violations. Any departure from the applicable requirements cannot be condoned. The record does indicate, however, that Potomac's records as maintained by Miller were generally accurate and current as to clients' cash and securities positions. The most serious charges against him pertain to the quarterly clients' statements which he prepared and which gave the misleading impression that the reported clients' cash position represented cash actually on hand [13/] and to the failure to have records reflecting his father's transactions. Had S. Miller disclosed

13/ Although I concluded that the misleading nature of these statements did not result in a violation of Section 204 of the Advisers Act and Rule 204-2 thereunder, it is appropriate to take this admitted conduct into account in determining the proper sanction.

the true situation to Potomac's clients, his father's fraud would undoubtedly have been nipped at the outset. On balance, taking into account the understandable (if not excusable) confidence of a relatively young son, as expressed in S. Miller's testimony, that his father would not permit clients to suffer a loss, I deem it consistent with the public interest to permit S. Miller to return to the investment advisory business under proper supervision after a 6-month exclusion.

Accordingly, IT IS ORDERED that

(1) The registration as an investment adviser of Potomac Investment Advisors, Ltd. is hereby revoked;

(2) Willard J. Miller is hereby barred from being associated with an investment adviser; and

(3) John Scott Miller is hereby barred from being associated with an investment adviser, provided that after six months from the effective date of this order he may apply to the Commission for permission to become so associated in a non-supervisory position, upon an adequate showing that he will be properly supervised. 14/

14/ All proposed findings and conclusions and contentions have been considered. They are accepted to the extent they are consistent with this decision.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice.

Pursuant to that rule, this initial decision shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 17(b) within fifteen days after service of the initial decision upon him, unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.

Max O. Regensteiner
Administrative Law Judge

Washington, D.C.
February 5, 1979