# UNITED STATES OF AMERICA Before the SECURITIES AND EXCHANGE COMMISSION September 16, 2008

ADMINISTRATIVE PROCEEDING File No. 3-13199

In the Matter of

CORNERSTONE CAPITAL MANAGEMENT, INC. and LAURA JEAN KENT,

Respondents.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-ANDDESIST PROCEEDINGS PURSUANT TO
SECTIONS 203(e), 203(f), AND 203(k) OF
THE INVESTMENT ADVISERS ACT OF
1940 AND SECTION 9(b) OF THE
INVESTMENT COMPANY ACT OF 1940
AND NOTICE OF HEARING

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act") and Section 9(b) of the Investment Company Act of 1940 ("Company Act") against Cornerstone Capital Management, Inc. ("Cornerstone Capital") and Laura Jean Kent ("Kent") (together, "Respondents").

II.

After an investigation, the Division of Enforcement alleges that:

### A. NATURE OF PROCEEDINGS

- 1. From 1997 to 2004, respondent Laura Kent and her investment advisory firm, respondent Cornerstone Capital, invested approximately \$15 million of client funds in five investments, each of which produced disastrous results for their clients. Four of the five investments bore the hallmarks of classic Ponzi or prime bank schemes, and the promoters of those schemes were subsequently convicted of fraud charges. Regardless of whether Respondents knew of the fraudulent nature of these investments at the outset, over time Respondents became aware of substantial evidence demonstrating that the value of the investments was severely impaired.
- 2. Despite this knowledge, Respondents have continued to issue periodic client account statements in which they list the "market price" and "total market value" of these

investments as remaining unchanged from their original cost. Respondents also have made numerous material misrepresentations and omissions about the status of the investments, including the fact that some of the promoters were convicted of fraud. Respondents knew, or were reckless or negligent in not knowing, that the values of the investments had been impaired, yet they have continued to charge a 1%-assets-under-management fee based on the initial cost of the failed investments, collecting at least \$547,035 in illegitimate fees between 2003 and 2007.

3. By failing to properly value impaired investments, and by misrepresenting and failing to disclose material facts about the investments, Respondents have violated the antifraud provisions of Sections 206(1) and 206(2) of the Advisers Act.

### B. RESPONDENTS AND OTHER RELEVANT ENTITIES

## Respondents

- 4. Cornerstone Capital is a California corporation providing investment advisory services to individual clients and three pooled investment vehicles. Cornerstone Capital registered with the Commission on July 3, 1996 and with California on July 10, 1996. Cornerstone Capital withdrew its Commission registration on July 18, 1997, and re-registered on May 31, 2006, after its purported assets under management surpassed \$25 million. Today, Cornerstone Capital claims to have nearly \$34 million in assets under management. It provides direct, personal advice to clients, who are invested in a combination of domestic and foreign stocks, bonds, and mutual funds, REITs, futures, commodities, and cash, as well as the pooled investment vehicles managed by Kent and Cornerstone Capital described below.
- 5. Kent, 59, owns and is president of Cornerstone Capital. She resides in Redwood City, California. Kent graduated from Wayne State University with a Masters in Economics and obtained an MBA from Stanford University. She holds Series 3, 7, 24, 63, and 65 securities licenses. From 1983 to 1994, she was a registered representative with the broker-dealer Kidder Peabody. Between 1994 and 1996, she was a registered representative of Cornerstone Investments, a branch of a Bay Area-based broker-dealer, Investment Architects. She founded Cornerstone Capital in 1996. In 2000, Washington state securities regulators sued Kent and Cornerstone Capital, alleging they misrepresented themselves as a Commission-registered investment adviser and defrauded clients by offering and selling fictitious securities. The state alleged that Kent offered clients investments in a fraudulent prime bank scheme. In 2004, without admitting or denying the allegations, Kent and the firm settled the Washington state proceeding, agreeing to cease and desist from violating state antifraud provisions and acting as an unregistered securities broker.

### Other Relevant Entities

6. Cornerstone Investment Circle, LLC ("CIC") is a Wyoming limited liability company formed by Kent in August 1996. Respondents use CIC as a vehicle for Cornerstone Capital clients to invest in certain alternative private investments. Since 2004, CIC has been

invested in two "programs" (as Kent calls them) described in detail below – the Precious Metals and Mining Program and the Promissory Note Program.

- 7. Cornerstone Investment Circle I & II, L.P. ("the Partnerships") are Delaware limited partnerships formed in April 2004. They began operations in July 2004 as vehicles for Cornerstone Capital clients to invest in certain alternative private investments. The Partnerships are invested in a number of programs described below, including the Costa Rican Currency Exchange Program, the Indemnity Bond Bridge Program, and the Cogeneration Project Financing Program.
- 8. Cornerstone Management Company, LLC ("Cornerstone Management") is a Delaware limited liability company controlled by Kent and is the general partner of the Partnerships. Cornerstone Management formed in July 2004 with Cornerstone Capital as the managing member.

### C. FACTS

### **Background**

- 9. In 1996, Kent formed Cornerstone Capital and registered it as an investment adviser in California. Soon afterwards, she established a limited liability company, CIC, for the purpose of investing clients in alternative private investments. Only Cornerstone Capital clients were eligible to become members of CIC. Thus, Cornerstone Capital has a direct client relationship with all investors in CIC.
- 10. The Investment Advisory Agreement between Cornerstone Capital and each client states that "[f]ees for Investment Management are computed as a percentage of assets under management at the rate of 1% annualized, subject to the minimum fee." Each Cornerstone Capital client receives a quarterly account statement that summarizes the performance of that client's portfolio for that quarter, lists the client's total assets under management, identifies the "market price" and "total market value" of each investment, and calculates a rate of return from the initial investment. In the quarterly account statements, Cornerstone Capital provides "market price" and "total market value" for all investments, regardless of whether the investment is a publicly traded stock or bond or an illiquid security, such as interests in CIC and the Partnerships.
- 11. Around June 30, 2004, Respondents reorganized CIC. Respondents formed the Partnerships and transferred to the Partnerships all investments but the Promissory Note Program and the Precious Metals and Mining Program, both of which remained as portfolio investments in CIC. Only Cornerstone Capital clients were eligible to become limited partners of the Partnerships. Thus, as with CIC members, Cornerstone Capital has a direct client relationship with all Partnership investors.

# Respondents Failed, and Continue to Fail, to Properly Value Investments That Have Been Impaired.

\$15 million in client funds into five investments, the values of which have become impaired. Respondents knew, or were reckless or negligent in not knowing, that the value of the investments had been impaired. Despite this, Respondents have continued to issue client account statements that list the market value of these investments at the original cost, and have misrepresented and omitted other material information about the status of the investments. Through this misconduct, Respondents have obtained hundreds of thousands of dollars from clients in improper fees. The five impaired investment programs are described below.

### The Costa Rican Currency Exchange Program.

- 13. In 1999, CIC, on Respondents' advice, started the Costa Rican Currency Exchange Program. The program consisted of debt and equity investments in the foreign currency exchange business of two Costa Rican brothers. Debt investors were to receive monthly interest payments, while equity investors were to have their monthly returns reinvested in the program. The investments allegedly provided working capital for the currency exchange and for other businesses of the brothers. By mid-2002, Respondents had invested nearly \$7.7 million in funds from a total of 70 clients in the program.
- 14. In July 2002, Costa Rican authorities raided the currency exchange business, seized all of its assets, and froze its bank accounts totaling \$7 million dollars (out of an estimated total of \$88 million invested by numerous investors, including CIC) while investigating the currency exchange's relationship with a Canadian drug cartel. Within six months of the raid, one of the two principals was arrested and charged by Costa Rican authorities with financial fraud. The other promoter fled. In May 2007, one promoter was found guilty of fraud, while the other promoter remains missing.
- 15. By at least December 2002, Respondents had clear indications that the value of their clients' investment in the currency exchange program was impaired. In October 2002, the currency exchange ceased operation and one month later stopped making or accruing interest payments, and has made no payments to investors since that time. The Respondents learned in December 2002 that one of the promoters had been arrested and charged with fraud and the other forced into hiding and facing a warrant for his arrest. At about the same time, Respondents learned of reports from reputable news agencies that described the currency exchange investment as a classic Ponzi scheme, including a December 13, 2002 *Wall Street Journal* article that Kent read at or near the time of publication.
- 16. Despite their knowledge of these problems, from December 2002 to the present, Respondents have continued to send their clients account statements showing the value of the currency exchange investment at its original cost plus accrued interest. For example, in four quarterly account statements to clients in 2007, Kent and Cornerstone Capital stated that the "market price" of the Costa Rican Currency Exchange Program had remained the same (and was

the same "market price" as it was in 2002). Since January 2003, Cornerstone Capital has collected at least \$345,300 in investment management fees based on this impaired investment.

The Promissory Note Program and Precious Metals and Mining Program.

- 17. Between 1997 and 1999, Cornerstone Capital clients, through CIC, invested a total of \$6.6 million in two programs referred to as the Promissory Note Program and the Precious Metals and Mining Program. Funds invested in these programs were loaned to a private company that allegedly had three separate divisions: a European bank financing group, a California-based technology group, and a group that purportedly owned mineral rights in New Mexico. The loans were evidenced by promissory notes issued by the company, which were supposedly secured by the company's technology and mineral rights, and were guaranteed by the company's promoters. Under both programs, the company was required to make monthly interest payments to Cornerstone Capital clients.
- 18. In 2000, the company defaulted on the loans and declared bankruptcy soon thereafter. In April 2001, the company's two promoters pled guilty to charges they had defrauded investors through prime bank and Ponzi schemes. On August 14, 2002, the promoters were sentenced to 18 months in federal prison for the fraud.
- 19. Respondents learned of the promoters' guilty pleas in May 2001. In early 2002, Respondents started foreclosure proceedings to secure the company's mineral rights. On February 4, 2003, Respondents filed a lawsuit against the company and the promoters alleging that the promoters defrauded Respondents in their investment dealings. Respondents obtained summary and default judgments against the promoters in October and November 2004 and foreclosed on the company's New Mexico mineral rights in September 2004. However, to date, Respondents have been unable to collect on the judgments or to develop, sell or otherwise realize any value from the foreclosed property.
- 20. In May 2002, Respondents disclosed to their clients that they had started foreclosure proceedings on the mineral rights. Respondents, however, waited until August 2004 to disclose to clients the promoters' guilty plea, when Respondents wrote to clients that the principals "entered into a plea bargain with Federal authorities regarding a suit filed by a different investor group." Additionally, Respondents did not disclose the lawsuit against the company and the promoters until February 2006, and then stated that Respondents "obtained a Summary Judgment against the two managers." Respondents have never disclosed that they alleged fraud in the legal action against the company and the promoters.
- 21. By at least February 2003, when they filed a fraud action against the company's promoters, Respondents had substantial information indicating that the value of client investments in the Promissory Note Program and the Precious Metals and Mining Program was impaired. Despite this information, Respondents have continued to value the investments in the Promissory Note Program and the Precious Metals and Mining Program at their original cost in client account statements. Since February 2003, Cornerstone Capital has collected at least \$190,095 in investment management fees based on these impaired investments.

### The Indemnity Bond Bridge Program.

- 22. In June 2004, Cornerstone Capital clients, at the direction of the Respondents, invested \$500,000 in CIC's Indemnity Bond Bridge Program. A majority of these clients invested in the program by redeeming certificates of deposit issued by a large, FDIC-insured bank. Under the program, CIC loaned money to two start-up companies through a promoter. The two start-up companies had applied for lines of credit with the promoter of the program, who in turn had purportedly secured bank loans to fund the lines of credit. The \$500,000 was to be used to purchase insurance policies from unnamed insurance companies guaranteeing that the bank loans would be repaid and allowing the banks to release funds for the lines of credit.
- 23. Unbeknownst to Cornerstone Capital clients, CIC used \$250,000 of the \$500,000 investment in an effort to obtain a \$2,500,000 line of credit for CIC's own benefit. Respondents intended to use the proceeds from the line of credit in connection with another ailing investment program. Respondents did not disclose to clients before they invested that Respondents intended to use client funds to help CIC obtain a line of credit for its own benefit.
- 24. Respondents wired the \$500,000 in client funds to a lawyer for the promoter on June 10 and 15, 2004. On or about June 30, 2004, Respondents created a disclosure document regarding the Indemnity Bond Bridge Program that materially misrepresented a key aspect of the investment. Respondents claimed that a respected 150-person California law firm served as escrow agent for the funds CIC was investing and was "authorized to release those funds upon issuance of [an] insurance binder representing the commitment of the insurance company to issue the bond." In truth, the law firm was not involved in the transaction and had no role in determining whether any insurance policy was properly issued.
- 25. Although CIC was to be repaid the full amount of client funds invested (i.e. \$500,000) plus interest by August 2004, by December 2005 it still had received no payments, and Respondents' inquiries to the promoters throughout 2004 and 2005 met with vague excuses.
- 26. In December 2005, Federal Bureau of Investigation ("FBI") agents informed Respondents that the promoters had been indicted for fraud and questioned Kent about CIC's investment in the Indemnity Bond Bridge Program. Prosecutors subsequently amended the indictment in August 2006 to name CIC as a defrauded investor. On June 22, 2007 Kent testified at the criminal trial of the promoters, who were convicted one month later. They were both sentenced to lengthy prison terms of 7 and 13 years.
- 27. To this day, Respondents have not informed clients about the information regarding the CIC investment revealed to Respondents in the FBI interview or the indictments. Instead, Respondents continually represent to clients that the investment will pay off soon.
- 28. From at least December 2005, Respondents have had substantial evidence that the value of their clients' investment in the Indemnity Bond Bridge Program is impaired. Respondents, however, continue to value the investment at its original cost (the initial investment

amount) on account statements to clients. Respondents have collected at least \$8,400 in fees on this investment since January 2006.

The Cogeneration Project Financing (Grain Mill) Program.

- 29. Between May and August 2003, Cornerstone Capital, on Respondents' advice and through CIC, provided \$235,000 in client funds to two small California energy companies for the installation and operation of a power cogeneration unit at a grain mill in Central California. The investment consisted of a promissory note to be paid back in seven years with 12% interest. Under the terms of the note, payment was to begin upon the installation and operation of the power generator.
- 30. From its inception, this program ran into delays and difficulties. After a year with no payments from the principals of the energy companies, Respondents renegotiated the contract, affording the principals more time to repay the loan. Under the terms of the new contract, the principals were to begin payment in October 2004 and continue with monthly payments through September 2011. In this contract, the promoter stated that the power generator had been installed and was fully operational. However, Respondents learned in early 2005 from a third party that the promoters' statements in the contract were false and that the generator had not been installed and was not operational. Since entering the renegotiated contract, Respondents have received just one payment for \$32,000 in early 2005.
- 31. From at least June 2005, Respondents have faced clear indications that the value of their clients' investment in this program is impaired. Despite this, until June 2007, Respondents valued the investment at its original cost in client account statements. From June 2005 to June 2007 (when Respondents reduced the value of the investment to 50% of cost), Respondents collected at least \$3,240 in fees based on this failed investment.

### D. <u>VIOLATIONS</u>

32. As a result of the conduct described above, Respondents willfully violated Sections 206(1) and 206(2) of the Advisers Act, which make it "unlawful to employ any device, scheme, or artifice to defraud any client or prospective client; and to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."

#### III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II are true and, in connection therewith, to afford Respondents an opportunity to establish any defenses to such allegations;

- B. What, if any, remedial action is appropriate in the public interest against Cornerstone Capital pursuant to Section 203(e) of the Advisers Act, including, but not limited to, civil penalties pursuant to Section 203(i) of the Advisers Act and disgorgement pursuant to Section 203(j) of the Advisers Act;
- C. What, if any, remedial action is appropriate in the public interest against Kent pursuant to Section 203(f) of the Advisers Act including, but not limited to, civil penalties pursuant to Section 203(i) of the Advisers Act and disgorgement pursuant to Section 203(j) of the Advisers Act:
- D. What, if any, remedial action is appropriate in the public interest against Kent pursuant to Section 9(b) of the Company Act; and
- E. Whether, pursuant to Section 203(k) of the Advisers Act, Respondents should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 206(1) and 206(2) of the Advisers Act.

### IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondents fail to file the directed answer, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondents personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Florence E. Harmon Acting Secretary