UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

CIVIL MINUTES - GENERAL

Case No.	2:15-CV-07425-RGK (PLAx)	Date	December 8, 2016
Title	***Securities and Exchange Commission v. Steve Chen***		

Present: The Honorable	R. GARY KLAUSNER, UNITED STATES DISTRICT JUDGE	
Sharon L. Williams	Not Reported	N/A
Deputy Clerk	Court Reporter / Recorder	Tape No.
Attorneys Present for Plaintiffs:	Attorneys Present for Defendants:	
Not Present	Not Present	

Proceedings: **(IN CHAMBERS)** Order Re: Plaintiff's Motion for Summary Judgment as to Liability and Injunctive Relief (DE 118)

I. INTRODUCTION

On September 28, 2015, the Securities and Exchange Commission ("SEC" or "Plaintiff") filed a Complaint against Steve Chen ("Defendant") and affiliated business entities ("Defendant Entities"). SEC alleges the following three claims: (1) Unregistered Offer and Sale of Securities in Violation of Section 5(a) and (c) of the Securities Act, 15 U.S.C. § 77e(a), (c); (2) Fraud in the Offer or Sale of Securities in Violation of Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a); and (3) Fraud in Connection with the Purchase or Sale of Securities in Violation of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5.

Presently before this Court is SEC's Motion for Summary Judgment as to Liability and Injunctive Relief Against Steve Chen ("Motion"). For the reasons below, the Court **GRANTS** the Motion.

II. FACTUAL BACKGROUND

Defendant operated and controlled Defendant Entities. Relevant to this Motion are his roles as the Incorporator, Registered Agent, Principal, President, and Chief Executive Officer of US Fine Investment Arts, Inc. ("USFIA") and President of Alliance Financial Group, Inc. ("AFG"). USFIA is the main entity in SEC's allegations.

Defendant incorporated USFIA on September 2, 2010. USFIA's business model involving various reward systems are described by witnesses and in *Bonus System*, (Del Greco Decl. Supp. Pl. SEC's Mot. Summ. J. Ex. 207 ("Ex. 207"), ECF No. 121-25,) *Compensation Plan*, (Decl. Receiver Seaman in Connection Pl's Mot. Summ. J. Ex. G ("Ex. G"), ECF No. 120-7,) and *Gem Coin Bonus System*. (Del Greco Decl. Supp. Pl. SEC's Mot. Summ. J. Ex. 219 ("Ex. 219"), ECF No. 121-27.) Although some differences exist among the descriptions, they present similar business models.

USFIA sold "membership packages" or "product package[s]." (Ex. 207, 672; Ex. G, 62; *see* Ex. 219, 683-84.) A package included at least two components: products and reward points or units. (Dep. Charlene Szu Kimura ("Kimura Dep.") 230:23-231:13, ECF No. 121-12; Decl. Coco Ke Xu Supp. Def.'s Opp'n Pl.'s Mot. Summ. J. ("Xu Decl.") ¶ 7, ECF No. 134-2; Decl. Li Cong Supp. Def.'s Opp'n Pl.'s Mot. Summ. J. ("Cong Decl.") ¶ 2, 3, ECF No. 134-4; Decl. Xin Yu Supp. Def.'s Opp'n Pl.'s Mot. Summ. J. ("Yu Decl.") ¶¶ 2, 3, ECF No. 134-5.) SEC alleges that investors who bought a package became Distributors and were granted access to a USFIA members' web portal. (Statement Uncontroverted Facts Supp. Mot. Summ. J. ("SUF") ¶ 90, 96, ECF No. 127-1.) Defendant claims that this was simply a referral program. (Xu Decl. ¶ 8.)

Products in the package included amber gemstones and jewelry. (*See* Del Greco Decl. Supp. Pl. SEC's Mot. Summ. J. Ex. 202 ("Ex. 202"), ECF No. 121-23.) USFIA claimed to own an "amber mine in the Dominican Republic, where the best of Dominican mineral ambers are discovered." (Ex. 219, 680.) Amber gemstones and jewelry in USFIA's packages came from USFIA's mine. USFIA touted its direct-to-consumer sales channel as benefiting customers. (SUF ¶ 30.) USFIA also claimed to have a monopoly over the supply of amber in the Dominican Republic. (SUF ¶ 60.) Defendant claimed to be in a position to manipulate the price of amber to increase investors' return on investments. (Kimura Dep. 231:8-13.) Amber gemstone and jewelry were displayed in USFIA's showroom with tags showing prices in the hundreds or thousands of dollars. (Dep. Chenyu Chen ("Chenyu Dep. Tr. I"), 139:17-140:7, ECF No. 121-11; Dep. George Mo ("Mo Dep. Tr. I") 160:1-5, ECF No. 121-8.) USFIA labelled one piece of amber jewelry as worth five million dollars. (Del Greco Decl. Supp. Pl. SEC's Mot. Summ. J. Ex 221 ("Ex. 221") 721, ECF No. 121-29.) According to Defendant, many investors bought USFIA's packages because of their interest in the amber gemstones and jewelry. (Cong Decl. ¶ 3; Yu Decl. ¶ 3; Xu Decl. ¶ 4.). But SEC alleges that USFIA solicited investment; amber was a gift incidental to the investment. (SUF ¶ 64.) At least some investors understood amber to be a free reward or bonus for investing in USFIA. (Mo Dep. Tr. I 94:6-24; Dep. Chenyu Chen ("Chenyu Dep. Tr. II") 35:21-36:8, 38:10-19, 41:6-9, 145:18-146:3, ECF No. 139-8; Kimura Dep. 231:8-13.) SEC also alleges that USFIA overpriced its amber gemstones and jewelry by a factor of about 20 to 1,000. (SUF ¶ 118.)

To some investors, the reward points or units entitled them to additional amber. (Xu Decl. ¶ 7.) According to other investors, the units represented investment in USFIA. (Kimura Dep. 82:16-83:7; Mo Dep. Tr. I 147:13-148:6.) Defendant personally stated that he took China Unicom public in the United States. (Kimura Dep. 80:20-82:9.) China Unicom is a Chinese telecommunications company and the world's fourth largest by subscriber base. According to USFIA material, China Unicom's subscriber base grew to several hundred million under Defendant's leadership, and its initial public offering (IPO) raised $5.7 billion dollars. (Ex. 221, 731.) Defendant also stated that USFIA was going to conduct an IPO, and that investors would receive stock in USFIA for their units when it went public. (Kimura Dep. 82:14-83:7; *see* Dep. George Mo ("Mo Dep. Tr. II") 70:2-8, ECF No. 134-9.) USFIA, however, was not registered with the SEC. (SUF ¶ 111.)

According to the documents on USFIA's Bonus System, USFIA used a multi-level marketing program comprised of Distributors to develop its marketing force. A Distributor could recruit new

investors who themselves could become Distributors, so-called downlines of the recruiting Distributor because of their relative positions in the organization chart. (*See* Ex. 207, 673; Ex. G, 63; Ex. 219, 686; Chenyu Dep. Tr. II, 73:13-15.) The recruiting process could be repeated to create generations of downlines. (*See* Ex. 207, 673; Ex. G, 63; Ex. 219, 686.) Access to USFIA's so-called Back Office web-based portal enabled Distributors to view their own account information and track their downlines. (SUF ¶ 96.)

USFIA rewarded Distributors for recruiting with various bonuses: (1) sponsor (or intermediary) bonus for selling a package to a new Distributor, (2) teamwork (or binary) bonus based on the sales of the Distributors' downlines, (3) perpetual consumption (or recurring) bonus based on the Distributors' and their downlines' repeated consumption, and (4) static bonus based on USFIA's global performance. (Ex. 207, 672-74; Ex. 219, 685-86, 689; Ex. G, 62-64.) USFIA further encouraged Distributor sales with rewards of luxury automobiles and mansions for obtaining consecutive, large teamwork bonuses. (Ex. 207, 674-75; Ex. 219, 690-91; Ex. G, 64; Mo Dep. Tr. I 149:19-150:10.) Static bonus alone, USFIA claimed, could return 1.5 times the initial investment even if the Distributor did not recruit any downlines. (Ex. 207, 673-74.) Investors understood from the marketing materials that they could earn money by recruiting additional investors. (Mo Dep. Tr. I 149:12-150:10; Chenyu Dep. Tr. II 147:4-18; Kimura Dep. 82:18-83:2.) Investors flocked to marketing meetings at USFIA office. (Mo Dep. Tr. I 30:5-12.) The Defendant Entities attracted almost two thousand Distributors throughout the world. (SUF ¶ 98.)

At some point, USFIA replaced units of USFIA with Gem Coins in the membership or product packages. Amber was still part of the package and recruitment of new investors continued. (Chenyu Dep. Tr. II 32:2-7, 71:11-15, 72:5-7, 146:25-18.) According to USFIA's Gem Coin marketing materials, Gem Coin is a digital currency supported by real gemstones and fully backed by AFG's fifty-billion-dollar assets. (Del Greco Decl. Supp. Pl. SEC's Mot. Summ. J. Ex. 222 ("Ex. 222"), 764, 766, 768, ECF 121-30; Chenyu Dep. Tr. II 95:7-10.) Investors would get an equivalent amount of Gem Coins with the purchase of gemstones from AFG. (Ex. 222, 770, 780-81.) However, at least one investor was told that investors could not purchase amber without purchasing Gem Coins (Chenyu Dep. Tr. II 32:5-7, 35:10-13.) Gem Coin marketing materials referred to Defendant as the founder and CEO of China Unicom and the CEO of AFG Inc. (Ex. 222, 779; Ex. 221, 731.) Gem Coins would become publicly available. (Ex. 221, 735, 742, 745, 747, 749.) The value of Gem Coins could only go up. (Ex. 222, 771; Ex. 221, 735; Chenyu Dep. Tr. II 94:15-25, 150:10-25.) Investors would earn lots of money.

SEC filed the Complaint after some investors complained about losing money.

III. JUDICIAL STANDARD

Under Federal Rule of Civil Procedure 56(a), a court may grant summary judgment only where "there is no genuine issue as to any material fact and . . . the movant is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(a). Upon such a showing, the court may grant summary judgment on all or part of the claim. *See id.* Facts are "material" only if dispute about them may affect the outcome of the

case under applicable substantive law. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986). A dispute about a material fact is "genuine" if the evidence is such that a reasonable jury could return a verdict for the nonmovant. *Id.*

To prevail on a summary judgment motion, the movant must show that there are no genuine issues of material fact as to matters upon which it has the burden of proof at trial. *Celotex Corp. v. Catrett*, 477 U.S. 317, 325 (1986). Such showing "must establish beyond controversy every essential element of" the movant's claim or affirmative defense. *S. Cal. Gas Co. v. City of Santa Ana*, 336 F.3d 885, 888 (9th Cir. 2003) (citation and quotation marks omitted). On issues where the movant does not have the burden of proof at trial, the movant needs to show only that there is an absence of evidence to support the nonmovant's case. *See Celotex*, 477 U.S. at 325.

To defeat a summary judgment motion, the nonmovant may not merely rely on its pleadings or on conclusory statements. *Id.* at 324. Nor may the nonmovant merely attack or discredit the movant's evidence. *See Nat'l Union Fire Ins. Co. v. Argonaut Ins. Co.*, 701 F.2d 95, 97 (9th Cir. 1983). The nonmovant must affirmatively present specific admissible evidence sufficient to create a genuine issue of material fact for trial. *Celotex*, 477 U.S. at 324.

"[I]n ruling on a motion for summary judgment, '[t]he evidence of the nonmovant is to be believed, and all justifiable inferences are to be drawn in his favor.'" *Tolan v. Cotton*, 134 S. Ct. 1861, 1863 (2014) (quoting *Anderson*, 477 U.S. at 255). The court may not determine credibility of witnesses or weigh the evidence. *Anderson*, 477 U.S. at 255. Nonmovant's "version of any disputed issue of fact . . . is presumed correct." *Eastman Kodak Co. v. Image Tech. Servs., Inc.*, 504 U.S. 451, 456 (1992). To grant summary judgment, the court should find that evidence is "so one-sided that [the movant] must prevail as a matter of law." *Anderson*, 477 U.S. at 252.

IV. EVIDENTIARY ISSUES

The crux of Defendant's argument in opposing the Motion is that Defendant sold amber, not securities. To support this argument, Defendant offers three declarations from undeposed declarants Coco Ke Xu ("Xu"), Li Cong ("Cong"), and Xin Yu ("Yu"). (Def.'s Statement Genuine Dispute Additional Undisputed Facts Opp'n Pl. SEC's Mot. Summ. J. ("SGD") ¶¶ 177, 179-187, 190, 191, 195-197, ECF No. 134-1.) The Court finds that these declarations have the potential to create a genuine issue of material fact only in a limited way.

A "declaration used to . . . oppose a motion must be made on personal knowledge [and] set out facts that would be admissible in evidence." Fed. R. Civ. P. 56(c)(4). Here, Xu's declaration is based on her personal knowledge as a customer service manager at USFIA. (Xu Decl. ¶ 3.) From her interactions, she has personal knowledge regarding the "many" customers with whom she interacted and business operations to the extent of her involvement. (Xu Decl. ¶¶ 3, 4.) However, Defendant did not lay a foundation establishing Xu's personal knowledge over every customer interaction or every aspect of the business in SEC's evidence. Characterizing Xu as a "core person in this case" "who interacted most

commonly and closely with USFIA customers" is insufficient. (Def.'s Opp'n Pl.'s Mot. Summ. J. ("Def.'s Opp'n") 3, ECF 134.) Accordingly, certain parts of her declaration are admissible only to the extent of her involvement;[1] certain parts of her declaration are conclusory, speculative, and inadmissible.[2]

The Cong and Yu declarations have similarly limited effect. Both are declarations made by USFIA customers based on their own experience. Their declarations are admissible only to the extent of their personal involvement.

Accordingly, the Motion can be granted only based on evidence not contradicted by the three declarants' statements based on their personal involvement.

To the extent the parties object to any evidence relied on by the Court in this Order, those objections are overruled.

V. DISCUSSION

A. Defendant's Scheme Involved Securities

The threshold question under SEC's three claims is whether a security is involved. *See* 15 U.S.C. § 77e(a), (c); 15 U.S.C. § 77q(a); 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. The Court finds that Defendant's scheme involved securities, whether characterized as investment contracts or pyramid scheme transactions.

The determination of whether a scheme involves a security is to be accomplished through "a thorough examination of the representations made by the defendants as the basis of the sale." *Hocking v. Dubois*, 885 F.2d 1449, 1457 (9th Cir. 1989). Such an examination should include "[p]romotional materials, merchandising approaches, oral assurances and contractual agreements." *Id.* "[I]n searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). The Court proceeds with these guidance in mind.

[1] For example, Xu's statements on "why customers made payments to USFIA, what USFIA gave customers in exchange for their payments, and the circumstances under which customers could receive payments from USFIA" are admissible only with respect to her own customer interactions. (Xu Decl. ¶ 3.)

[2] Such parts include Xu's categorical statements, *e.g.*, "[t]he company did not issue shares, dividends, ownership interests, or any similar type of thing to its employees, and certainly not to its customers;" "[b]onus points or units were only available as a reward to customers who purchased amber and/or amber jewelry from USFIA . . . [T]he bonus points or units were only redeemable for additional amber, amber jewelry products, and other USFIA-affiliated products." (Xu Decl. ¶¶ 6, 7.) Such parts also include Xu's assertion about how Chinese people generally value amber. (Xu Decl. ¶ 5.)

1. Defendant's Scheme Involved Investment Contracts

Both Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act define "security" to include an "investment contract." 15 U.S.C. §§ 77b(a)(1), 78c(a)(10). Based on the Supreme Court's definition, "an investment contract is (1) an investment of money, (2) in a common enterprise, (3) with an expectation of profits produced by the efforts of others." *Salameh v. Tarsadia Hotel*, 726 F.3d 1124, 1130 (9th Cir. 2013) (citation and quotation marks omitted); *S.E.C. v. Rubera*, 350 F.3d 1084, 1090 (9th Cir. 2003).

Here, USFIA marketing materials show packages investors could buy to become USFIA Distributors. Many investors did so; USFIA took in approximately $35.6 million from investors since mid-2011. (SUF ¶ 127.) These investments of money satisfy the first element.

For the second element, "[a] common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." *S.E.C. v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973). A common enterprise may be characterized by either vertical commonality or horizontal commonality. *S.E.C. v. R.G. Reynolds Enterprises, Inc.*, 952 F.2d 1125, 1130 (9th Cir. 1991). "Vertical commonality may be established by showing that the fortunes of the investors are linked with those of the promoters." *Id.* (citation and quotation marks omitted). Horizontal commonality exists where "[t]he participants pool their assets; they give up any claim to profits or losses attributable to their particular investments in return for a pro rata share of the profits of the enterprise; and they make their collective fortunes dependent on the success of a single common enterprise." *Hocking*, 885 F.2d at 1459.

Here, vertical commonality exists to satisfy the second element because investors' returns on all components in the package – bonuses, units or Gem Coins, and amber – are linked to USFIA's fortune. Distributors' bonuses came from USFIA's revenue. And the only source of USFIA's revenue was investments in packages. (SUF ¶¶ 127, 129.) Higher USFIA revenue would translate to higher bonuses and vice versa. This is particularly obvious for static bonus which was based on USFIA's global performance. (Ex. 207, 671, 673.) Also, since the value of the units represented USFIA's valuation, USFIA controlled Gem Coins, and USFIA had an inventory of amber, fortunes of both USFIA and investors would rise or fall together with the values of the units, Gem Coins, and amber. Thus, the fortunes of the investors were linked with those of USFIA. Defendant does not argue against the existence of vertical commonality. (*See* Def.'s Opp'n 7-8.)

Horizontal commonality also exists because the Distributors' investments – USFIA's only revenue source – were pooled to pay, for example, teamwork bonus, repeat consumption bonus, and luxury automobile and mansion awards (collectively, multi-generational bonuses); Distributors had no claims to profits or losses attributable to their particular investments; in exchange, they got sponsor and static bonuses and multi-generational bonuses "according to an exact rate" – a pro rata share – specified in the Bonus System. PRO RATA, *Black's Law Dictionary* (10th ed. 2014); *see, e.g.*, *Bonus System*, ECF No. 121-25, for the bonus rates. Finally, Distributors' collective fortunes depended on the success

of USFIA since bonuses came from USFIA's revenue. Alternatively, sponsor bonus alone can satisfy horizontal commonality. *See S.E.C. v. SG Ltd.*, 265 F.3d 42, 51 (1st Cir. 2001) (finding that referral fees paid to existing participants for inducing others to patronize the business is an alternative basis for finding horizontal commonality).

The third element is satisfied when "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *R.G. Reynolds Enterprises*, 952 F.2d at 1131. Here, Defendant as "the scheme's promoter[] controlled the methods by which the product was sold and new members were recruited." *Webster v. Omnitrition Int'l, Inc.*, 79 F.3d 776, 784 (9th Cir. 1996). Defendant's efforts in structuring the operation of USFIA and promoting its business are undeniably the ones affecting the failure or success of USFIA. Thus, investors' collective fortunes depended on the success of USFIA.

Accordingly, all three elements of investment contracts are shown. In opposition, Defendant argues that USFIA sold amber and jewelry, not securities; investors bought packages for the amber, not for the units. Taking statements from Defendant's three declarants as true, Defendant's argument is true for part of USFIA's business and customers. However, it is undisputed that at least one investor understood that he was investing in USFIA rather than buying amber. (Mo Dep. Tr. I 30:18-24, 94:6-9, ECF No. 121-8.) He signed a USFIA Membership Application which asked him to confirm his "taxpayer number" to "prevent securities fraud." (Decl. Del Greco Supp. Pl. SEC's Reply Def.'s Opp'n Summ. J. Ex. 233-C, 251, ECF No. 139-9.) It is undisputed that Defendant told an investor that, for a $10,000 investment, investors would get 100,000 shares of USFIA and "would be rewarded with amber in the value of $3,000." (Kimura Dep. 82:22-83:7.) Accordingly, investment in USFIA represented at least 70% of the value of the package. It is undisputed that Defendant asked potential investors to recruit new investors, and that the potential of making money through USFIA's Bonus System attracted investors. (*Id.* at 82:18-21, 230:14-17.) It is also undisputed that USFIA told an investor that it planned to go public, and that the value of its units would go up by 64 times. (Mo Dep. Tr. I 147:13-148:6.) Some investors put money in USFIA for the prospect of a huge return from USFIA going public. (Mo. Dep. 30:22-24, 82:1-2, 110:19-111:6, 147:13-148:6; Kimura Dep. 82:14-83:7; *see* Chenyu Dep. Tr. II 35:24-36:8, 38:10-19, 146:17-19.)

Defendant also argues that various marketing materials show USFIA sold amber. (Def.'s Opp'n 4 n.2.) But this is not inconsistent with units, Gem Coins, or recruiting bonuses being part of the package. (*See* Ex. 219, 685 (stating "When you sell packages *or* products to new distributors . . .") (emphasis added); Ex. 207, 672 (stating "When you sell a package *or* the corresponding products to a new distributor . . .") (emphasis added).)

Accordingly, Defendant's scheme involved investment contracts.

2. Defendant's Scheme Was a Pyramid Scheme

"[I]nvestments in a pyramid scheme [are] 'investment contracts' and thus securities." *Omnitrition*, 79 F.3d at 784 (citing *Glenn W. Turner Enterprises*, 474 F.2d 476). If Defendant operated a pyramid scheme, investments to join USFIA as Distributors are securities. *Id.*

Pyramid schemes "are characterized by [participants'] payment of money to the company in return for which [participants] receive (1) the right to sell a product and (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of the product to ultimate users." *Id.* at 781. "This test does not require that rewards be *completely* unrelated to product sales." *F.T.C. v. BurnLounge, Inc.*, 753 F.3d 878, 885 (9th Cir. 2014) (emphasis original). Instead, the second element is satisfied by schemes whose "focus [is] on recruitment and where rewards [are] paid in exchange for recruiting others, rather than simply selling products." *Id.*

Here, investors joined USFIA as Distributors by buying a package. Distributors' memberships entitled them to recruit and sell packages to additional investors. (Ex. 207, 672-73; Ex. G, 62-63; Ex. 219, 685-86.) Distributors had access to the USFIA Back Office web-based portal to view their account and their downline information. (SUF ¶ 96; Seaman Decl. ¶ 10, ECF No. 120.) Under the Bonus System, Distributors would receive various financial rewards for recruiting additional investors. *See supra* Part II. Although the packages included amber and some investors were ultimate users of amber, the focus of the Bonus System is clearly on recruiting new Distributors rather than simply selling amber. Indeed, "[r]ecruiting was built into the [Bonus System] in that recruiting led to eligibility for cash rewards, and more recruiting led to higher rewards." *BurnLounge*, 753 F.3d at 884. For example, teamwork bonus and perpetual consumption bonus both depend on recruiting generations of Distributors as downlines. (Ex. 207, 673-74; Ex. 219, 686-89, Ex. G, 63-64.) To remain eligible for teamwork bonus, Distributors must sell a package to a substitute Distributor when a direct downline Distributor leaves USFIA. (Ex. 207, 673; Ex. 219, 687; Ex. G, 63.) "The mere structure of the scheme suggests that [Defendant's] focus was in promoting *the program* rather than selling *the products*." *Omnitrition*, 79 F.3d at 782 (emphasis original). This focus is confirmed by how the business actually operated. For example, USFIA held daily training sessions to help Distributors recruit more investors. (Chenyu Dep. Tr. II 71:25-72:7.) In its sales pitch to sell packages, USFIA included the financial rewards from recruiting new investors as a benefit. (*Id.* at 147:5-18.) USFIA also held an award ceremony where people saw that Defendant gave car keys to top recruiters. (Mo Dep. Tr. I 149:19-150:10.) This certainly was done to spur additional recruiting activities. The promise of "big[, quick] profits" under the Bonus System enticed investors to become USFIA Distributors. (Ex. 207, 672; *see* Ex. 219, 681; Kimura Dep. 230:14-17.) The evidence shows that USFIA ran a pyramid scheme. *See BurnLounge*, 753 F.3d at 884 (finding that an illegal pyramid scheme was shown by a recruiting requirement and investors' motivation for cash bonuses).

Defendant argues that Defendant did not operate an illegal pyramid scheme because there is no evidence that USFIA required a payment to become a Distributor or that USFIA encouraged inventory loading. Defendant's first argument has no merit in light of SEC's evidence as discussed above. Illegal pyramid scheme can be found by either an entry fee or inventory loading. *Whole Living, Inc. v. Tolman*,

344 F. Supp. 2d 739, 744 (D. Utah 2004). Since evidence shows the requirement of a fee to join USFIA, a finding of inventory loading is not necessary.

Accordingly, the Court finds that Defendant's business was a pyramid scheme and involved investment contracts. Under either analysis, Defendant's business involved securities.

B. Defendant Offered and Sold Unregistered Securities

"To establish a prima facie case for violation of Section 5, the SEC must show that (1) no registration statement was in effect as to the securities; (2) the defendant directly or indirectly sold or offered to sell securities; and (3) the sale or offer was made through interstate commerce." *S.E.C. v. CMKM Diamonds, Inc.*, 729 F.3d 1248, 1255 (9th Cir. 2013). "Once the SEC introduces evidence that a defendant has violated the registration provisions, the defendant then has the burden of proof in showing entitlement to an exemption." *Id.*

Here, SEC establishes a prima facie case for Section 5 violation. USFIA was not registered with the SEC. (SUF ¶ 111.) Defendant sold or offered to sell securities. *See supra* Part V.A. People from around the country and the world invested in Defendant Entities, constituting interstate commerce. (SUF ¶ 98.) Defendant's only argument in opposition is that Defendant neither sold securities nor operated an illegal pyramid scheme. As discussed above, the Court finds Defendant's argument unpersuasive. Thus, since Defendant does not claim an entitlement to an exemption, SEC has shown no genuine issues of material facts respecting the Section 5 violation claim.

C. Defendant Committed Fraud in the Offer or Sale of Securities and in Connection with Sale of Securities

In its memorandum in support of the Motion, SEC does not contend that Defendant acted negligently and violated Sections 17(a)(2) and (a)(3) of the Securities Act. (*See* Pl. SEC's Mem. P. & A. Supp. Mot. Summ. J. 11-17, ECF No. 123.) Thus, the Court will analyze Defendant's alleged violations of Section 17(a)(1) of the Securities Act and of Rule 10b-5 under Section 10(b) of the Exchange Act.

1. Defendant's Scheme to Defraud

Section 17(a)(1) of the Securities Act makes it "unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce . . . , directly or indirectly – to employ any device, scheme, or artifice to defraud." 15 U.S.C. § 77q(a)(1). Under Section 10(b) of the Exchanges Act, Rule 10b-5(a) makes it "unlawful for any person, directly or indirectly . . . [t]o employ any device, scheme, or artifice to defraud . . . ." 17 C.F.R. § 240.10b-5(a). Under Rule 10b-5(c), it is "unlawful for any person, directly or indirectly . . . [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . . ." 17 C.F.R. § 240.10b-5(c). Both Rule 10b-5 subsections require "the use of any means or instrumentality of interstate commerce" in the unlawful action, which must be "in connection

with the purchase or sale of any security." 17 C.F.R. § 240.10b-5. Defendant violated all of these similar provisions.

As discussed above, Defendant through his involvement in USFIA, offered and sold securities, directly or indirectly. Defendant used means or instruments of communication in interstate commerce, YouTube video and USFIA web portal, for example, to reach investors worldwide. (SUF ¶¶ 2, 92, 96.) Thus, for Section 17(a)(1) and Rule 10b-5(a), SEC needs to show that Defendant employed a device, scheme, or artifice to defraud. For Rule 10b-5(c), SEC needs to show that Defendant engaged in an act, practice, or course of business which operated or would operate as a fraud or deceit upon any person.

"Pyramid schemes are . . . inherently fraudulent because they must eventually collapse." *Omnitrition*, 79 F.3d at 781. "[T]he most recent entrants [are destined] to lose their money." *Id.* at 785. As discussed above, Defendant offered to sell and sold securities in a pyramid scheme – a scheme to defraud under the Acts. Characteristic of pyramid schemes, the payment of bonuses was highly concentrated in a small percentage of USFIA Distributors. 0.6% of the Distributors received 32.3% of the bonuses. (SUF ¶ 101.) 1.9% of the Distributors received more than 52% of bonuses; the remaining 98.l% of Distributors received less than 48% of bonuses. *Id.* The vast majority of Distributors did not, and could not, get the return of their own investments since USFIA had no other income. Promised with big profits, the vast majority of Distributors were destined to lose money. USFIA's pyramid scheme is a scheme to defraud in violation of Section 17(a)(1) and Rule 10b-5(a).

"[O]peration of a pyramid scheme violates 10b–5's prohibition against engaging in an 'act, practice or course of business which operates as a fraud or deceit upon any person.' *Omnitrition*, 79 F.3d at 785 (quoting 17 C.F.R. § 240.10b-5(c)). Since Defendant operated a pyramid scheme, he violated Rule 10b-5(c).

2. Defendant's Untrue Statements

Under Section 10(b) of the Exchanges Act, Rule 10b-5(b) makes it "unlawful for any person, directly or indirectly . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5(b). This subsection also requires "the use of any means or instrumentality of interstate commerce" in the unlawful action, which must be "in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5.

As stated above, Defendant through his involvement in USFIA, offered and sold securities. Defendant used means or instruments of communication in interstate commerce to reach investors worldwide. Thus, SEC needs to show that Defendant made an untrue statement of a material fact, or omitted to state a material fact. Furthermore, SEC needs to show that the untrue statement was made "in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5.

Here, as discussed above, Defendant offered to sell and sold securities of an inherently fraudulent pyramid scheme. A promoter of such a scheme omits to state a material fact if he does not explain that the scheme is bound to collapse. *See Omnitrition*, 79 F.3d at 785. There is no evidence that Defendant warned investors that USFIA investment scheme was bound to collapse. Thus, Defendant is liable under Rule 10b-5(b).

Additionally, SEC alleges that Defendant made a number of misrepresentations. The Court finds the following statements to be misrepresentations based on undisputed evidence: (1) AFG had fifty billion dollar worth of assets. (SUF ¶ 43, Ex. 222, 764, 766, 768, ECF 121-30.) (2) Defendant took China Unicom public in the United States. (SUF ¶¶ 42, 57, 71.) (3) Defendant stated that he would take USFIA public, and that investors would receive stock in USFIA when it went public. (SUF ¶¶ 61, 74; Kimura Dep. 82:14-17.) (4) Amber gemstones and jewelry on display in USFIA showroom were tagged with prices valuing them at thousands of dollars apiece. (SUF ¶ 50.) (5) Gem Coins were back by AFG's $5 billion of gemstone assets. (SUF ¶ 94.)

These statements are false because, respectively: (1) The total value of the Defendant Entities, including AFG and other entities, is about $78 million, less than 0.2 percent of $50 billion. (SUF ¶ 108.) (2) Defendant's name did not appear on China Unicom's IPO prospectus. (SUF ¶ 110.) (3) USFIA never became a public company. (4) Amber gemstones and jewelry on display in USFIA showroom were tagged with prices much higher than their true worth. (SUF ¶¶ 50, 118.) (5) The total value of the Defendant Entities, including AFG and other entities, is about $78 million, less than 2 percent of $5 billion. (SUF ¶ 108.)

Defendant *made* these statements because he either made them personally or, given his role, had "ultimate authority over the statement[s]" in USFIA's and AFG's materials. *Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 142 (2011).

These statements are material because they are related to Defendant Entity's financial condition, *United States v. Reyes*, 660 F.3d 454, 469 (9th Cir. 2011); plans for an IPO, *see S.E.C. v. Platinum Inv. Corp.*, No. 02 CIV. 6093 (JSR), 2006 WL 2707319, at *2 (S.D.N.Y. Sept. 20, 2006); and value of personal properties, *see Herring v. State Farm Fire & Cas. Co.*, No. 4:12-CV-00509 - JEG, 2014 WL 11514686, at *5 (S.D. Iowa Mar. 31, 2014).

Defendant made these misrepresentations in connection with the sale of USFIA security. Defendant made the statements to attract more investors and succeeded in doing so. (*See, e.g.*, Kimura Dep. 230:7-12; Mo Dep. Tr. I 159:1-18.) Coincidence between scheme to defraud and sale of securities is enough to satisfy the "in connection" element of Rule 10b-5. *S.E.C. v. Zandford*, 535 U.S. 813, 822 (2002). Since USFIA's business could not continue without its only source of income from selling packages to investors, making these misrepresentations is "conduct undertaken to keep a securities fraud [pyramid] scheme alive [and] is conduct undertaken in connection with the purchase and sale of securities." *Bald Eagle Area Sch. Dist. v. Keystone Fin., Inc.*, 189 F.3d 321, 330 (3d Cir. 1999).

Defendant argues against each alleged misrepresentation, relying mostly on the contention that SEC fails to show investor reliance on the misrepresentations. This contention is factually false at least with respect to some misrepresentations. (*See, e.g.*, Kimura Dep. 230:7-17; Mo Dep. Tr. I 159:1-18.) More importantly, this contention has no support in law. "[R]eliance is not an element of a Rule 10b–5 violation by misrepresentation . . . . The SEC need not prove reliance in its action for injunctive relief on the basis of violations of section 10(b) and Rule 10b–5." *S.E.C. v. Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993); *S.E.C. v. All. Leasing Corp.*, 28 F. App'x 648, 652-53 (9th Cir. 2002) (affirming summary judgment for disgorgement and civil penalties without SEC's showing of investor reliance).

3. Defendant's Scienter

To prove its claims under Section 17(a)(1) and Rule 10b-5 under Section 10(b), SEC must show Defendant acted with scienter. *Aaron v. S.E.C.*, 446 U.S. 680, 691, 695 (1980). Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). The evidence supports a finding of scienter in two ways.

First, Defendant's operation of a pyramid scheme is sufficient to find he acted with scienter. "Misrepresentations, knowledge and intent follow from the inherently fraudulent nature of a pyramid scheme as a matter of law." *Omnitrition*, 79 F.3d at 788.

Second, Defendant's misuse of investor funds is also sufficient to find he acted with scienter. The misuse of the funds established the fraudulent nature of the scheme and the intent to defraud. *United States v. Booth*, 309 F.3d 566, 575 (9th Cir. 2002). Here, Defendant used investor money to fund a lifestyle that included multiple million-dollar mansions and luxury automobiles for him and his family. (SUF ¶¶ 136-149, 151.) Such misuse shows Defendant's intent to defraud investors for his personal gain.

Accordingly, the Court finds that Defendant committed fraud in the offer or sale of securities and in connection with sale of securities.

D. <u>Permanent Injunction Against Defendant Is Appropriate</u>

Both the Securities Act and the Exchange Act require the court to issue a permanent injunction "upon a proper showing" of "a reasonable likelihood of future violations of the securities laws." 15 U.S.C. § 77t(b); 15 U.S.C. § 78u(d); *S.E.C. v. Murphy*, 626 F.2d 633, 655 (9th Cir. 1980). This requires the court to assess the totality of the circumstances. *Murphy*, 626 F.2d at 655. Factors include: "(1) the degree of scienter involved; (2) the isolated or recurrent nature of the infraction; (3) the defendant's recognition of the wrongful nature of his conduct; (4) the likelihood, because of defendant's professional occupation, that future violations might occur; (5) and the sincerity of his assurances against future violations." *S.E.C. v. M & A W., Inc.*, 538 F.3d 1043, 1055 (9th Cir. 2008) (citation omitted).

Here, Defendant acted with a high degree of scienter; the violation took place over years and involved elaborate schemes; Defendant has shown no sign of recognition of wrongdoing and has offered no assurances against future violations. The Court finds that a reasonable likelihood of future violations exists without a permanent injunction. Thus, the Court must grant an injunction under the law.

VI. CONCLUSION

For the foregoing reasons, the Court **GRANTS** SEC's Motion for Summary Judgment as to Liability and Injunctive Relief Against Defendant Steve Chen as detailed in the accompanying Order.

IT IS SO ORDERED.

_____ : _____

Initials of Preparer _____