

**STATE OF ILLINOIS  
SECRETARY OF STATE  
SECURITIES DEPARTMENT**

\_\_\_\_\_  
IN THE MATTER OF: Michael S. Rosen )  
\_\_\_\_\_)

FILE NO. 0900013

**NOTICE OF HEARING**

TO THE RESPONDENT: Michael S. Rosen  
(CRD#: 1449872)  
10 Scarsdale Farm Road  
Scarsdale, New York 10583

Michael S. Rosen  
(CRD#:1449872)  
C/o SMH Capital Inc.  
600 Travis, suite 5800  
Houston, Texas 77002-3003

You are hereby notified that pursuant to Section 11.F of the Illinois Securities Law of 1953 [815 ILCS 5] (the "Act") and 14 Ill. Adm. Code 130, Subpart K, a public hearing will be held at 69 West Washington Street, Suite 1220, Chicago, Illinois 60602, on the 27th day of May, 2009 at the hour of 10:00 a.m. or as soon as possible thereafter, before George Berbas Esq., or such other duly designated Hearing Officer of the Secretary of State.

Said hearing will be held to determine whether an Order shall be entered denying Michael S. Rosen's (the "Respondent") registration as a salesperson in the State of Illinois and/or granting such other relief as may be authorized under the Act including but not limited to the imposition of a monetary fine in the maximum amount pursuant to Section 11.E(4) of the Act, payable within ten (10) business days of the entry of the Order.

The grounds for such proposed action are as follows:

1. That on January 13, 2009, SMH Capital Inc., a registered dealer, filed a Form U-4 application for registration of the Respondent as a salesperson in the State of Illinois pursuant to Section 8 of the Act.
2. That on January 9, 2008 FINRA entered a Letter Of Acceptance, Waiver And Consent (AWC) submitted by the Respondent regarding File No. EAF0401150001 Which sanctioned the Respondent as follows:

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- a. suspension from associating in all capacities with any member firm for 20 days; and
  - b. fined \$100,000.
3. That the AWC listed the following background information:

SMH Capital Inc. (previously known as Sanders Morris Harris Inc.) and its predecessors have been members of FINRA (f/k/a National Association of Securities Dealers or NASD) since October 1987. SMH maintains its principal place of business in Houston, Texas and operates its Prime Brokerage Services Division ("the PBS Division") from New York City. SMH engages in a full-service securities business, including retail and institutional sales, investment banking services, trading, and research. SMH has approximately 425 registered employees.

The Respondent, age 44, became registered with FINRA (f/k/a National Association of Securities Dealers or NASD) in 1986. He became an associated person with SMH in July 2000. The Respondent is registered as General securities Representative (Series 7), a General Securities Principal (Series 24), Series 4 (Options Principal), a Series 55 (Equity Trader), and a Series 63. Neither SMH nor the Respondent has any relevant prior disciplinary history.

4. That the AWC found:

### OVERVIEW

- a. In July 2000, SMH expanded its business by acquiring Blackford Securities Corporation, which became SMH's PBS Division. SMH began offering a variety of services to hedge fund clients through its PBS Division. From July 2000 through at least December 2005 ("the relevant period"), however, it did not have adequate policies and procedures in place to supervise certain of the division's activities. For most of the relevant period, the firm did not have written procedures governing soft dollar payments and the supervision of SMH employees who provided services to hedge fund clients. As a result, SMH allowed improper payments of approximately \$325,000 in soft dollars to one hedge fund manager. SMH did not have adequate procedures concerning the contents of hedge fund sales materials prepared and disseminated by the firm and distributed sales literature that did not adequately disclose material investment risks to potential Investors in accordance with NASD Notice to Members 03-07. From at least January 2003 to December 2004, SMH failed to retain e-mails and instant messages sent to and received by certain employees in the PBS Division. The

Respondent, a former Blackford employee, helped operate SMH's PBS Division while simultaneously managing four hedge funds that received prime brokerage services from SMH. To address the potential conflicts that arose from his dual role, the offering documents for one share class for one fund, as well as an agreement among SMH, the Respondent, and a company that introduced investors to the hedge fund, stated that the Respondent would not share, directly or indirectly, in any commissions SMH earned from trading for the fund class. In April 2002, SMH and the Respondent modified his compensation structure so that he shared in the PBS Division's profit pool, derived in part from commissions SMH earned on the fund's trading. As a result, contrary to the above restrictions, from April 2002 to June 2004, the Respondent shared indirectly in commissions SMH earned on the fund's trading but did not amend the fund's offering document.

### FACTS

- a. SMH's Prime Brokerage Services Division
- b. In July 2000, SMH expanded its business by acquiring Blackford Securities Corporation, a firm that had been providing prime brokerage services to hedge funds. SMH's newly created PBS Division, operating out of offices on Long Island and in Manhattan, began to seek new, start-up hedge funds that could begin trading on its "prime brokerage services platform." The PBS Division offered a wide range of services to fund managers who joined its platform, including office space, telephones, internet access, computers, back office accounting, equity research, capital introduction, marketing assistance, and other forms of technical infrastructure and support. For some hedge funds, SMH dedicated certain employees to work for the fund as traders, analysts, or financial accountants.

The fund clients that utilized SMH's prime brokerage services platform directed a portion of their trading through SMH. During the relevant period, the firm collected trading commissions that ranged from approximately 1.5 to 6 cents per share, in many instances depending on the volume of trading and the level of services that the fund manager opted to receive from SMH.

Some of SMH's hedge fund clients did not join SMH's prime brokerage services platform, choosing instead to open soft dollar accounts at SMH to pay for services received from third party vendors with trading commissions. A manager would direct trades to SMH, based upon an understanding that a certain percentage of SMH's trading commissions would be credited to the fund's soft dollar account. For example, if SMH charged a particular fund 5

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cents per share for a trade, it might credit 2.5 cents per share of that commission to the fund's "soft dollar account." As the soft dollar account accumulated positive balances, the fund manager submitted or caused to be submitted to SMH invoices from third party vendors who had provided services. SMH then paid the invoices from the balances accumulated in the fund's soft dollar account.

During the relevant period, SMH's PBS Division, at one point employing approximately 15 employees, established relationships with more than 15 different hedge funds. Most operated from SMH's prime brokerage services platform, but at least seven funds used SMH to maintain soft dollar accounts. The PBS Division developed into an important part of SMH's business.

- c. SMH Improperly Allowed the Respondent to Share in Commissions Earned on Whiteford International Trading. The Respondent helped manage SMH's PBS Division after the firm acquired Blackford Securities in 2000 and, in 2002 was asked to, and did, assume management responsibilities for the division. During this period, he was also serving as a manager and investment advisor for four separate hedge funds, including an offshore fund named Whiteford International ("the WI Fund"). Consequently, the Respondent had a duty to the WI Fund to direct trades to the brokerage firm that could achieve best execution while also having a financial incentive to direct trades to SMH. In October 2001, the Respondent hired an outside firm, FG, to help find overseas investors for the WI Fund. To address this conflict, FG, the Respondent and SMH executed an agreement dated October 15, 2001, stating: "[SMH] warrants that bonuses or other cash paid to the Respondent will not be based, in whole or in part, on compensation earned by [SMH] for brokerage transactions effected for [the WI Fund]." The Respondent created a separate "B Class" of shares for the WI Fund. The "Conflicts of Interest" section of the Private Placement Memorandum (PPM) for that class stated: The Respondent is a registered representative of [SMH]. [SMH] has agreed, however, that no bonuses or other cash paid to the Respondent will be based, in whole or in part, on compensation earned by [SMH] for brokerage transactions effected for the Fund. From October 2001 to April 2002, the Respondent did not share in the WI commissions he continued to receive a salary from SMH, and his compensation was not tied directly or indirectly to the commissions from, or the level of, WI trading. By April 2002, FG had introduced many new investors into the WI Fund, and the fund had become one of the largest funds operating on the SMH platform. Even though the Respondent had been responsible for bringing this business to SMH, he was not receiving any of the benefit from the fund's trading.

In April 2002, SMH and the Respondent negotiated a new agreement that allowed the Respondent to receive bonuses from a "profit pool" derived from the overall profitability of the PBS Division. Because the profit pool included at least some money that was earned from the trading of the WI Class B shares, however, the Respondent's new compensation arrangement was contrary to the terms of the October 15, 2001 agreement and the terms of the WI Fund PPM. Nevertheless, the Respondent did not amend, and continued to disseminate, the PPM which incorrectly stated that the brokers would not share, in whole or in part, in the commissions generated through trading by the WI Fund. The Respondent continued to participate in the profit pool until June 30, 2004.

- d. The Respondent Violated NASD Rule 2110 By Altering the Brokers' Compensation So he Shared in Commissions from Hedge Fund Trading. As described above, by agreeing to alter his compensation arrangements to allow him to earn money based, in part, on trading commissions he had agreed not to receive, the Respondent engaged in activity that was not consistent with high standards of commercial honor or just and equitable principles of trade. As a result the Respondent, violated NASD Rule 2110.
5. That Section 8.E(1)(j) of the Act provides, inter alia, that the registration Of a salesperson may be denied if the Secretary of State finds that such Salesperson has been suspended by any self-regulatory organization Registered under the Federal 1934 Act or the Federal 1974 Act arising from Any fraudulent or deceptive act or a practice in violation of any rule, regulation or standard duly promulgated by the self-regulatory Organization.
6. That FINRA is a self-regulatory organization as specified in Section 8.E (1)(j) of the Act.
7. The Respondent's registration as a Salesperson in the State of Illinois is subject to denial pursuant to Section 8.E (1)(j) of the Act.

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You are further notified that you are required pursuant to Section 130.1104 of the Rules and Regulations (14 ILL. Adm. Code 130)(the "Rules"), to file an answer to the allegations outlined above within thirty (30) days of the receipt of this Notice. A failure to file an answer within the prescribed time shall be construed as an admission of the allegations contained in the Notice of Hearing.

Furthermore, you may be represented by legal counsel; may present evidence; may cross-examine witnesses and otherwise participate. A failure to so appear shall constitute default, unless any Respondent has upon due notice moved for and obtained a continuance.

A copy of the Rules, promulgated under the Act and pertaining to hearings held by the Office of the Secretary of State, Securities Department, is located at <http://www.cyberdriveillinois.com/departments/securities/lawrules.html>.

Delivery of Notice to the designated representative of any Respondent constitutes service upon such Respondent.

Dated: This 3<sup>rd</sup> day of MARCH 2009



JESSE WHITE  
Secretary of State  
State of Illinois

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