UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15514

In the Matter of,

FRANK H. CHIAPPONE,
ANDREW G. GUZZETTI,
WILLIAM F. LEX,
THOMAS E. LIVINGSTON,
BRIAN T. MAYER, and
PHILIP S. RABINOVICH

JOINT BRIEF ADDRESSING CERTAIN LEGAL ISSUES IN ACCORDANCE WITH THE COMMISSION'S ORDER

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By Order dated May 21, 2015, the Commission *sua sponte* ordered six individual Respondents to submit a joint brief addressing certain legal issues and limited any individual briefs to less than that provided for in the Commission's Rules of Practice. Each Respondent objects to the Order, but nonetheless joins in this brief to the extent the legal issues are applicable to him.[1]

Each Respondent maintains that the overwhelming evidence demonstrated that he (1) did not violate any securities law, and (2) fulfilled his duties as a registered representative (or manager). These factual matters and other issues are addressed in each Respondent's Individual Brief, as limited by the Commission's *sua sponte* Order.

PRELIMINARY STATEMENT

As a matter of law, this proceeding never should have been commenced, let alone in an administrative forum. The proceeding was so fatally flawed and the hearing conducted so prejudicially that the Commission should dismiss the entire proceeding.

The discriminatory premise underlying the proceeding was that 10 out of approximately 50 registered representatives should be singled out for punishment for the fraud perpetrated by Timothy McGinn ("McGinn") and David Smith ("Smith"), even though "[t]he Division's [own] expert had no reason to believe that Respondents were aware of McGinn and Smith's fraud,"[2] and despite the fact that approximately 40 other registered representatives sold over $69 million of McGinn Smith Securities.[3] No enforcement action was taken against those

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1 There were no allegations, and thus no findings, against Respondent Guzzetti, for the Fraud Claim or the Section 5 Claim (as defined herein).

2 Decision at 4.

3 *See* Div. Ex. 591. McGinn Smith Securities refer to the 26 offerings at issue in the OIP, which includes the Four Funds and the Trust Offerings (as defined in the OIP).

registered representatives, and thus Respondents' equal protection and due process rights were violated by the commencement and prosecution of the administrative hearing.[4]

Further, the conduct of the proceeding was rife with prejudicial error and bias against Respondents. Respondents were deprived of their constitutional rights to have their case decided by a jury and presided over by an independent Article III judge of the federal judiciary. The entire proceeding violated Article II, Section 2, Clause 2 of the U.S. Constitution as the hearing officer (the "ALJ") was not appointed by the President, a court of law, or department head, and the ALJ's two-layer tenure protection was unconstitutional, which renders her decision unenforceable.[5]

Fundamental fairness required that parties be "timely" informed "of matters of fact and law asserted"[6] against them. The Order Instituting Proceedings ("OIP"), however, failed to state a claim for securities fraud under well-established federal pleading standards. Respondents were not informed when they supposedly made any material misrepresentation or omission to any investor about any McGinn Smith Security. Yet, the ALJ denied Respondents' separate motions for a more definite statement.

Having failed to inform Respondents "of matters of fact and law asserted" against them, and lacking the basic information necessary to prove any alleged violation, the Division violated SEC Rule of Practice 230(g) by improperly and prejudicially soliciting witnesses and gathering evidence to support the OIP *after* it was filed. In denying Respondents' separate motions to preclude this post-OIP fishing expedition, the ALJ thereby endorsed the Division's violation of the Rule.

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4 *Gupta v. SEC*, 796 F. Supp. 2d 503, 513-14 (S.D.N.Y. 2011).

5 *Free Enter. Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477, 487 (2010).

6 *See* 5 U.S.C. § 554(b).

The ALJ allowed the Division to present evidence about matters pre-dating by years any of the offerings at issue in the OIP. Indeed, of those 26 McGinn Smith Securities that were included in the OIP, *sixteen of them* were offered more than five years before the OIP was filed. The ALJ, however, summarily denied Respondents' separate motions that 28 U.S.C. § 2462 ("Section 2462") barred the Division's claims, all of which "first accrued" prior to September 23, 2008 – five years before the OIP was filed – thus eliminating any subject matter jurisdiction to "entertain" the proceeding.[7] Underscoring that Respondents' due process rights to a fair hearing before an independent and impartial tribunal were violated, the ALJ ruled that "when the Commission sets down a case for hearing ... the agency does not want motions...because you're second guessing their decision that ... there is a legal basis for it...."[8] In other words, instead of an independent and unbiased finder of fact, the ALJ refused to "second guess" the conclusions already reached by the Commission.

The ALJ also ignored that "[t]he fundamental requirement of due process is the opportunity to be heard 'at a meaningful time and in a meaningful manner.'"[9] Despite the stakes of this proceeding – Respondents' professional and financial livelihood – Respondents were denied meaningful time (just four months) to review the Division's gargantuan investigative record – consisting of approximately one *terabyte* (1000 gigabytes) of data and more than 100 cartons of documents. It was literally impossible for Respondents to do so prior to the hearing. Nor did Respondents have the opportunity to conduct depositions or narrow the scope of this proceeding on statute of limitations grounds as they would in federal court. This was especially prejudicial given the complexity of this case – numerous transactions spanning seven years

7 *Gabelli v. SEC*, 133 S. Ct. 1216 (2013).

8 Pre-Hearing Tr. (Jan. 21, 2014), at 30:13-21.

9 *Mathews v. Eldridge*, 424 U.S. 319, 333 (1976).

(2003-2009) – six years of which fell outside the statute of limitations – with numerous individual Respondents working in four separate locations as part of an investment banking and brokerage firm with about 50 registered representatives. While the Division had four years to prepare, Respondents had four months. Respondents were not accorded sufficient due process.

The ALJ exacerbated the deprivation of Respondents' due process rights by admitting non-party deposition testimony voluntarily given to assist the Commission in its federal court action against McGinn and Smith. Respondents provided testimony voluntarily with the explicit understanding that it was required to assist the Commission in its action against McGinn, Smith and others, and thus did not try to refresh their recollections about events from 2003, did not have MS&Co. records with which to do so, and significantly, had no reason to believe that they needed to inform the Division of each and every action *they* took to demonstrate they fulfilled their obligations as registered representatives, as they were (mis)led to believe they were not a target of any enforcement action. The Division never disclosed that Respondents were or might be a target, never provided them with SEC Form 1662, never showed them a Formal Order of Investigation, and never provided them with their deposition transcripts to review, correct, amplify or sign. Nevertheless, the ALJ denied Respondents' separate motions to exclude the non-party depositions which the Division used purportedly to impeach Respondents and on which the ALJ erroneously relied in making credibility determinations.

While this proceeding was fundamentally flawed and infected with bias and error in the process and procedure, the ALJ also committed numerous legal errors in finding Respondents violated the antifraud provisions of the federal securities laws (the "Fraud Claim") and Section 5 (the "Section 5 Claim") of the Securities Act of 1933 (the "Securities Act").

The Fraud Claim

The ALJ improperly extended the holding of *Hanly*,[10] a case with vastly different facts and circumstances, in concluding that each Respondent violated Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), and Rule 10b-5 thereunder. In so doing, the ALJ erroneously concluded that, during the period of 2003 to 2009, individual registered representatives ("RRs") had a duty to "investigate" and "verify" statements in the private place memoranda ("PPMs") and effectively replicate the due diligence conducted by the member firm's investment banking department. Notably, only conduct during the period of September 23, 2008 to 2009 should have been considered at all.

The ALJ also ignored controlling Supreme Court precedent[11] in concluding that Respondents violated Securities Act Section 17(a)(1), Exchange Act Section 10(b), and Rule 10b-5 thereunder. There was no evidence that Respondents acted with *scienter* – a state of mind embracing the intent to deceive, manipulate or defraud. Indeed, the OIP did not allege, and the Division did not contend, that Respondents had a motive to defraud their clients.

The Section 5 Claim

The ALJ also committed numerous errors in concluding that Respondents violated Securities Act Section 5. First, the ALJ considered evidence regarding the Four Funds' offerings, none of which were sold within five years of the date the OIP was filed. Second, the ALJ ignored the grossly inaccurate information on which the Division based its Section 5 claim – an admittedly inaccurate "investor database" and double hearsay that was allowed to trump the contemporaneous representations of individual investors in their purchaser questionnaires.

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10 *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969).

11 *See Aaron v. SEC*, 446 U.S. 680 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

Third, despite rejecting the Division's arguments about integration of the separate Trust Offerings, the ALJ nonetheless concluded that the Trust Offerings did not comply with Rule 502, despite the financial and non-financial disclosure in the PPMs for the Trust Offerings that was provided to all investors (not just those who may have been unaccredited).[12] Finally, the ALJ ignored that no court or the Commission has ever imposed Section 5 liability on an individual RR in circumstances such as these. Unlike here, the SEC has filed Section 5 charges, and the courts have found Section 5 violations, *only* (a) where there has been an obvious failure to comply with the registration requirement or with any claimed exemption, *and* (b) where there has been knowing or recklessly deceptive conduct.

For all of these reasons, and those set forth in their Individual Briefs, Respondents respectfully request that the Commission reverse and dismiss all charges against them.

ARGUMENT

I.

SECTION 2462 BARS THE CLAIMS ASSERTED IN THE OIP

A controlling federal statute – 28 U.S.C. § 2462 – deprived this (and any other) tribunal of subject matter jurisdiction to "entertain" all of the claims alleged in the OIP. Section 2462 provides in relevant part:

> [A] proceeding for the enforcement of any civil fine, penalty, or forfeiture ... shall not be entertained unless commenced within five years from the date when the claim first accrued.

Every claim alleged in the OIP "*first accrued*" before September 23, 2008 (i.e., more than five years prior to the date the OIP was filed). Thus, the OIP could not be "*entertained*" here.

12 Decision at 95-97.

In *Gabelli v. SEC*, the Supreme Court held that a claim "accrues" within the meaning of Section 2462 "when it comes into existence," which occurs "when the plaintiff has a complete and present cause of action." 133 S. Ct. 1216, 1220-21 (2013) (citations omitted). While a claim may accrue on more than a single occasion, the *first* accrual dictates the date from which the proceeding must be commenced. Because all claims alleged "*first accrued*" before September 23, 2008, there was no subject matter jurisdiction to "*entertain*" this case. *See Williams v. Warden*, 713 F.3d 1332, 1337-40 (11th Cir. 2013) ("the great weight of authority" holds that the statutory command – "shall not be entertained" – "is jurisdictional in nature"). In concluding otherwise, the ALJ cited two pre-*Gabelli* Commission opinions, Decision at 89, which are no longer good law following the Supreme Court's decision.

Recently, the Division's Director of Enforcement, Andrew Ceresney, acknowledged in a sworn statement the significant reasons that underscore the line in the sand drawn by Section 2462 and *Gabelli*. As stated by Ceresney, "administrative proceedings typically [but not here] result in presentation of evidence when it is relatively fresh. With the passage of time, witnesses' memories might fade and some types of evidence becomes stale." Declaration of Andrew Ceresney, dated June 24, 2015, ¶ 4 (submitted in *Hill v. SEC*, 1:15-cv-01801-LMN (N.D. Ga.)). These concerns cannot be ignored here.

It is undisputed that any claims based on the Four Funds, whether sounding in fraud or otherwise, first accrued before September 23, 2008. The Four Funds were first offered between 2003 and 2005, and no Respondent sold a Four Funds note after September 23, 2008. Div. Ex. 2. Thus, any alleged "failure to investigate," misrepresentation, or omission necessarily occurred – if at all – before September 23, 2008. Section 2462 plainly bars any claims based on the Four Funds. Further, the ALJ's hearing testimony and admitting exhibits based on conduct prior to September 23, 2008 – including evidence of McGinn and Smith's criminal acts, some of which allegedly dated back to 1999 – was highly prejudicial and contaminated the entire proceeding. No court would have admitted this irrelevant evidence.

Further, the ALJ determined that the Fraud Claim, whether based on the Four Funds *or* the Trust Offerings, accrued no later than February 1, 2008, because Respondents "had requisite scienter to violate the antifraud provisions" by that date. Decision at 115. The ALJ did not find any specific material misrepresentation or omission by any Respondent *after* February 1, 2008. As the Fraud Claim was based on Respondents' purported scienter as of February 1, 2008 – more than five years before the OIP – the entire Fraud Claim is time-barred. The Division conceded that its claims *first* accrued "from the date each Selling Respondent *first* recommended and sold one of the Four Funds notes," which was a decade ago, and demanded forfeiture of commissions from 2003. Div. Post-Hearing Br. at 37 (emphasis added). The ALJ nevertheless concluded that some (unspecified) claims survive. Decision at 89. That was error.

Moreover, insofar as any claims could be "entertained" – and they cannot – the ALJ erred in concluding that the "disgorgement" sought here – the sole compensation earned by four Respondents – was not a "forfeiture" subject to Section 2462. *SEC v. Graham*, 21 F. Supp. 3d 1300, 1310-11 (S.D. Fla. 2014) ("disgorgement ... can truly be regarded as nothing other than a forfeiture (both pecuniary and otherwise), which remedy is expressly covered by § 2462"), *appeal docketed*, No. 14-13562 (11th Cir. Aug. 8, 2014); *Coghlan v. NTSB*, 470 F.3d 1300, 1305 (11th Cir. 2006); *Johnson v. SEC*, 87 F.3d 484, 491 (D.C. Cir. 1996); *SEC v. Bartek*, 484 F. App'x 949 (5th Cir. 2014); *compare with* 15 U.S.C. § 7243 (Sarbanes-Oxley Act § 304, Forfeiture of Certain Bonuses and Profits). The ALJ recognized that "[c]ivil monetary penalties are clearly subject to the five-year statute of limitations" as are "associational bars, when, as here, the bars would be imposed punitively rather than remedially." Decision at 89. Yet, the ALJ ignored her own conclusion, as the disgorgement ordered imposed is punitive.

To avoid this result, the ALJ stated that "[d]isgorgement is an equitable remedy," Decision at 114, despite the fact that neither the Commission nor the ALJ have equitable powers, and must abide by statutes of limitations. Having chosen its own captive Article II venue, the Division could not seek *any* equitable remedies, because neither the Commission nor its ALJs have any constitutional power to grant equitable remedies and avoid statutes of limitations. *See* U.S. Const. Art. III, § 1 ("The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish"); *id.* § 2 ("The judicial Power shall extend to all Cases, in Law and Equity, arising under ... the Laws of the United States"). Simply put, the ALJ imposed the punitive remedy of forfeiture, and is not constitutionally permitted to do otherwise.[13]

But whether disgorgement, cease and desist orders, or injunctions are penalties, forfeitures, or permissible at all in an administrative proceeding does not matter here, because all claims alleged *first accrued* before September 23, 2008. Because the proceeding sought penalties for pre-September 23, 2008 conduct, the entire proceeding could *not* be "entertained," including for "non-penal" remedies for post-September 23, 2008 conduct. Section 2462 and *Gabelli*'s reasoning preclude this enforcement action, filed years after memories have faded, regardless of the labels the ALJ attached in her decision. *See United States v. Usery*, 518 U.S. 267, 284 (1996).

[13] If the Commission concludes that disgorgement here is "equitable" and not a "forfeiture" (which would be error), only clients who purchased after September 23, 2008 could arguably be considered.

II.

THE ALJ APPLIED INCORRECT LEGAL STANDARDS TO THE FRAUD CLAIM

A. Liability Under Exchange Act Section 10(b), Rule 10b-5, and Securities Act Section 17(a)(1) May Be Imposed Only for Intentional or Reckless Conduct Not Present Here

As the Supreme Court has held, the text of Section 10(b) of the Exchange Act "quite clearly evinced a congressional intent to proscribe only 'knowing or intentional misconduct.'" *Aaron v. SEC*, 446 U.S. 680, 690, 695 (1980) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201, 206 (1976)). Similar to Section 10(b), "[t]he language of § 17(a)(1) [of the Securities Act] ... plainly evinces an intent on the part of Congress to proscribe only knowing or intentional misconduct." *Id.* at 696. Accordingly, Supreme Court precedent requires proof that each Respondent acted with *scienter* – a state of mind embracing the intent to deceive, manipulate or defraud. *See id.* at 686 n.5, 697; *Hochfelder*, 425 U.S. at 193. The ALJ did not apply that standard (and the Division did not meet that burden).

The ALJ ignored that to plead (and by extension, prove) the requisite fraudulent intent, a plaintiff must either "show that defendants had both motive and opportunity to commit fraud," or adduce "facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." *Kalnit v. Eichler*, 264 F.3d 131, 138-39 (2d Cir. 2001) (internal quotations omitted). The OIP did not allege, and the Division did not contend, that any Respondent had a motive to defraud his clients. *See, e.g., In re Merrill Lynch Auction Rate Sec. Litig.*, 851 F. Supp. 2d 512, 528 (S.D.N.Y. 2012) (alleged motive "to increase or maintain profit" insufficient as such motive "could be imputed to any for-profit endeavor"). Where, as here, evidence of motive is non-existent, the Division's circumstantial evidence of recklessness "must be correspondingly greater." *Kalnit*, 264 F.3d at 142 (internal quotations omitted).

In this context, courts define "reckless" conduct as an approximation of actual intent to defraud. *See Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d Cir. 1978) (reckless conduct is "at the least, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care *to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.*") (emphasis added and internal quotations omitted); *see also Chill v. Gen. Elec. Co.*, 101 F.3d 263, 269 (2d Cir. 1996) (recklessness "must, in fact, approximate an actual intent to aid in the fraud being perpetrated") (citation omitted); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) ("[R]ecklessness should be viewed as the functional equivalent of intent....").

The Second Circuit recently reiterated that limitation in dismissing a Section 10(b) claim made against an investment advisor who "recklessly" recommended an investment in a Ponzi scheme, because there were no facts to support a finding of *scienter*. Like Respondents here, the investment advisor was not aware of any fraud at the time of the recommendation. *See South Cherry St., LLC v. Hennessee Group LLC*, 573 F.3d 98, 109 (2d Cir. 2009) (defining recklessness as "a state of mind *approximating actual intent,* and *not merely a heightened form of negligence*") (emphasis in original). Nor do grossly negligent failures of diligence approximate an actual intent to defraud. *See, e.g.*, *Gabriel Capital, L.P. v. NatWest Fin., Inc.*, 137 F. Supp. 2d 251, 263 (S.D.N.Y. 2000) ("[a]n investment advisor ... is not required to assume the role of accountant or private investigator and conduct a thorough investigation of the accuracy of the facts contained in the documents that it analyzes for the purpose of recommending an investment. The investment advisor is not the author of those documents and does not purport to certify the accuracy of those documents.").

In short, there was no evidence presented that Respondents acted intentionally or recklessly or with any motive to defraud their clients, and the ALJ's gratuitous use of the word "reckless" does not change this fact.

B. Registered Representatives Are Bound By Suitability Obligations, But Are Not Required To Replicate An Investment Banker's Due Diligence

It is well-settled that "there is no general fiduciary duty inherent in an ordinary broker/customer relationship." *Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 940-41 (2d Cir. 1998). Rather, a RR engaging in transactions in a non-discretionary account "owes duties of diligence and competence in executing the client's trade orders, and is obliged to give honest and complete information when recommending a purchase or sale." *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002).

When an investment recommendation is made by a broker-dealer (member firm) or one of its associated persons, NASD (n/k/a FINRA) rules require that it be *suitable*. Specifically, NASD Rule 2310(a), the operative rule in effect during the relevant time period, provides that "[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." NASD Rule 2310(a).

A review of applicable industry guidance confirms the long-standing distinction between customer-specific suitability determinations made by an individual broker under Rule 2310, and "due diligence investigations" performed by a broker-dealer firm. *See, e.g.*, NASD Notice to Members ("NTM") 03-07. FINRA's new guidance issued in 2011, the Division's basis for claiming a "duty to investigate" exists, is not applicable here. As one testifying expert explained: FINRA issued a "plethora" of new notices to members in 2011 "because things changed."[14]

Contrary to the ALJ's conclusion, Decision at 90, the securities industry has never imposed a generalized duty to "investigate" on individual RRs, particularly where, as here, they were not involved in the preparation of the PPMs. *See BNP Paribas Mortg. Corp. v. Bank of Am., N.A.*, 866 F. Supp. 2d 257, 268 (S.D.N.Y. 2012) (finding "no duty, under the industry notices and treatise cited ... to investigate or verify representations made in the PPM absent participation in preparation of the PPM") (citing FINRA NTM 10-22 (Apr. 2010) at 4); Charles J. Johnson & Joseph McLaughlin, *Corporate Finance and Securities Laws* 7-79 (4th ed. 2011 Supp.)).

The relevant standard of care requires RRs to have a basic understanding of the features, risks and rewards of the investments.[15] Under this standard – the only one applicable here – Respondents did all that was required of them under the law. *See also* Respondents' Individual Briefs.

C. The ALJ Erroneously Expanded *Hanly*

The ALJ rejected the established products suitability standard and, relying on *Hanly*, *Milan*, and other distinguishable cases involving boiler rooms and other egregious conduct, erroneously concluded that "it is an established principle that a registered representative has a duty to investigate the security she or he recommends to a customer to establish an adequate basis for their recommendation." Decision at 90. The ALJ expressly acknowledged numerous arguments made by some or all Respondents why *Hanly* does not apply here, most notably, that "*Hanly* and its progeny are distinguishable," *id.* at 89, only to categorically reject all

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14 Tr. 3953:20-25 (Tilken).

15 *See*, *e.g.*, Tr. 3958:19–3961:7 (Tilken).

of these arguments without meaningful analysis. Instead, the ALJ merely parroted language from *Hanly* and rigidly applied it to all Respondents. The ALJ likewise ignored the testimony about the painstaking research conducted by MS&Co.'s due diligence team on the Trust Offerings.[16]

For example, while noting that "[t]he extent of the duty of investigation depends on the facts and circumstances of each situation," the ALJ declared that attending meetings to understand each McGinn Smith Security and reviewing the PPM were insufficient because, supposedly, the "presentations [were] intended to promote sales," "[n]o one from outside MS&Co. offered any divergent or cautionary views," and Smith answered "tough questions" with "optimistic revenue projections." *Id.* The ALJ ignored evidence of the suitability analysis performed by Respondents, and the evidence that investment banking/brokerage firms routinely present private placement securities offerings in the same manner MS&Co. did.

The ALJ expanded *Hanly* to circumstances dramatically unlike the egregious conduct in the cases on which she erroneously relied as support. Under the ALJ's ruling, RRs would have to somehow engage outsiders to review their firms' offerings. If the cases indeed held as the ALJ concluded, brokers would be liable for failing to perform functions that applicable NASD and FINRA Rules clearly advised them were not their responsibility. That has never been the law, let alone industry practice, and no court has so held. Rather, *Hanly* and its progeny hold only that a broker may not blindly pass along factual representations that are obviously false, outlandish or of doubtful veracity, without some reasonable basis supporting the facts represented. *Hanly* does not hold that every stockbroker must personally investigate every

16 Tr. at 4544–4549 (Cody); 5430–5431, 5447–5448, 5568 (Chiappone).

aspect of every security recommended, and only certain circumstances – not present here – trigger the so-called "duty to investigate."

The applicable standard set forth in *Hanly* states, "[b]y his recommendation, he [registered representative] implies that *a reasonable investigation has been made* and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information." *Hanly*, 415 F.2d at 597 (emphasis added). *Hanly* requires that a reasonable investigation *has been made*; it does not require individual brokers to personally perform the due diligence process.

The ALJ ignored the stark differences between *Hanly*, *Milan*, and other distinguishable cases (where the RRs actively participated in the fraud) and the circumstances here (where Respondents did not participate and were unaware of the secret theft and diversion of funds by McGinn and Smith). In *Hanly*, the brokers made specific misrepresentations and reckless omissions that made their outlandish, highly unreasonable one-sided recommendations false and misleading. *See* 415 F.2d at 592 ("the Commission held that 'the fraud in this case consisted of the optimistic representations or the recommendations ... without disclosure of *known* or *reasonably ascertainable* adverse information which rendered [the brokers' statements] materially misleading....'") (emphasis added). The brokers falsely claimed to have purchased the stock they were recommending for their own accounts. *Id.* at 593. They said the stock would "go from 6 to 12 in two weeks," or would "double after three or four weeks." *Id.* at 593-95. But the brokers knew the company had no working capital and was operating at a loss, and failed to disclose that information to their customers. *Id.* at 594. No such facts were presented here.

Indeed, Respondents and/or their family members purchased McGinn Smith Securities, undermining any suggestion they acted with scienter or were aware of any fraud.

All of the cases imposing Section 10(b) liability against individual brokers for recommending investments to their customers involved highly unreasonable, knowing misrepresentations and omissions, or such obvious misstatements or failures to disclose that the brokers were proceeding in reckless disregard of the truth. *See SEC v. Hasho*, 784 F. Supp. 1059, 1107 (S.D.N.Y. 1992) (defendants "operated a boiler room operation" and "recommended speculative securities to mostly unsophisticated investors using high pressure and fraudulent sales pitches via long distance telephone solicitations"); *SEC v. Platinum Inv.*, 02 Civ. 0626, 2006 U.S. Dist. LEXIS 67460 (S.D.N.Y. Sept. 20, 2006) (defendant was "undoubtedly reckless" because he "failed to take even the most rudimentary steps to make sure his recommendations to his clients were responsible and reasoned," "did nothing to confirm his price or performance predictions," "did nothing to familiarize himself with private placements," and failed to read materials sent to customers); *SEC v. Milan Capital Group, Inc.*, 00 Civ. 108, 2000 U.S. Dist. LEXIS 16204, at *5-6, *13-21(S.D.N.Y. Nov. 9, 2000) (broker enabled the sale of phony IPO securities); *SEC v. Shainberg*, 316 F. App'x 1, 2 (2d Cir. 2008) (broker selling stock he *knew* was an unsound investment); *Graham v. SEC*, 222 F.3d 994, 1005-06 (D.C. Cir. 2000) (stockbroker aided a customer in executing high frequency trading scheme similar to check kiting, whose sole defense was her supervisor never questioned the trades).

SEC v. Dain Rauscher, 254 F.3d 852 (9th Cir. 2001) (cited in the Decision at 90), underscores Respondents' point that individual brokers are not required to independently investigate the securities they offer and conduct the due diligence typically performed by investment banks and others. That case involved an investment firm that underwrote municipal securities and its lead investment banker, the firm's principal, who structured the deals and prepared offering documents, *the very people who are required to conduct due diligence.* The court, citing *Hanly*, held that, as firm principal and lead underwriter, he had a duty to investigate information provided by the issuer, and failed to do so. 254 F.3d at 857-59.

Moreover, there was no allegation in the OIP or evidence presented here that any PPM included a material misrepresentation or omission (and Respondents did not assist in their preparation in any event). Nor was there evidence that any Respondent made a material misrepresentation or omission to a specific client about a specific McGinn Smith Security. The evidence established that Respondents understood the product and satisfied their suitability obligations.

At its core, this case involved a classic fraud, wherein a few individuals (*i.e.*, McGinn and Smith) went to great lengths to conceal their wrongdoing by misleading and lying to those around them, including their employees (Respondents), regulators (FINRA/NASD and the SEC), and others. It took the Division's summary witness, a certified fraud examiner, three years – with full 20/20 hindsight – to ascertain the fraud. Tr. 392:5–393:18. To punish Respondents for, in the ALJ's words, not "resolv[ing]" the supposed red flags, Decision at 91, is unfair and unwarranted under controlling law.

D. There Were No Red Flags That Altered Respondents Duties As Registered Representatives

Hanly only imposes a duty to inquire when facts are present that would cause a reasonable broker to doubt information he has been given (i.e., "red flags").[17] *Hanly*, 415 F.2d at 596. Here, there were no such facts.

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17 According to the Division's expert, a red flag is "a warning or notice of potential concerns or violations of the securities laws that require a heightened response and investigation." Div. Ex. 1 at 6.

1. The PPMs Contained Standard Disclosures

The disclosures in the PPMs for McGinn Smith Securities were customary in the industry. A comparison of the PPMs for other McGinn Smith private placements not at issue in the OIP with the PPMs for the McGinn Smith Securities (*see e.g.*, RMR Ex. 861) makes clear that the alleged "red flag" disclosures cited by the ALJ (Decision at 91-92) were typical – not red flags. *See South Cherry*, 573 F.3d at 109 (red flag must be "so obvious[ly]" indicative of fraud "that the defendant must have been aware of [the fraud]" and desirous of furthering it).

As an initial matter, that the PPMs explained risks is not indicative of fraud, but instead evidence that MS&Co. complied with its disclosure obligations so that investors could make an informed decision prior to investing. It is not a basis for finding Respondents should have conducted an "independent investigation" to "resolve" these disclosures. Decision at 91. The ALJ's suggestion that Respondents should have uncovered McGinn and Smith's well-concealed fraud, when the SEC, NASD, and others were unable to do so for years, is preposterous.

In any event, the PPMs for McGinn Smith Securities were concise (approximately 15-20 pages) and rich in lucid warnings. The PPMs for the Trust Offerings – the only relevant PPMs here, given that no Respondent sold a Four Funds note after September 23, 2008 – explained the risk factors in considerable detail. For example, the PPM for TDM Cable Trust disclosed, in part, as follows:

- "The Certificates offered hereby are suitable only for those investors whose business and investment experience makes them capable of evaluating the merits and risks of their prospective investment in the Certificates, who can afford to bear the economic risk of their investment for an indefinite period of time and have no need for liquidity in this investment." Div. Ex. 264, at 3.

- "Since there can be no assurance that the Contracts will generate sufficient income necessary to pay the Certificates, investment in the Certificates is suited for persons who have substantial income from other sources." *Id.*

- There is a potential for contract defaults in the underlying contracts in which the Trust is investing, which "would result in an interruption in available cash distributable to Certificateholders." *Id.* at 6.

- "The Trustee of the Trust Fund is McGinn, Smith Capital Holdings Corp., the sales agent for this offering is McGinn, Smith & Co. Inc., and two of the principals of TDM Cable Funding, LLC are Timothy M. McGinn and David L. Smith." *Id.*

- "The purchase of Certificates may be suitable for individuals seeking an investment intended to provide income.... Nevertheless, this investment involves a number of significant risks, including no assurance that the Certificates will be paid and illiquidity." *Id.* at 11.

The Four Funds' PPMs, insofar as they are considered at all, contained similar disclosures, including a bold-faced warning on the very first page that: "**Investing in the notes involves a high degree of risk**." Div. Ex. 5 at 1. The Four Fund PPMs also clearly explained their broad investment mandate, which was unremarkable and not a "red flag":

> We intend to use the net proceeds to acquire various public and/or private investments, which may include, without limitation, debt securities, collateralized debt obligations, bonds, equity securities, trust preferreds, collateralized stock, convertible stock, bridge loans, leases, mortgages, equipment leases, securitized cash flow instruments, and any other investments that may add value to our portfolio. . . .

Div. Ex. 5, at 15. This investment mandate was limited in only two ways: (1) "not … more than 25% of the proceeds of this offering [would be invested] in any single Investment," and (2) if any investment is "purchased from our managing member or any affiliate, we will not pay above the price paid by our managing member or such affiliate for the Investment...." *Id.* There was no evidence that MS&Co. violated the former, and no evidence that any Respondent knew or should have known MS&Co. violated the latter. It was not a red flag.

Contrary to the ALJ's finding (Decision at 91-92), disclosure of the conflicts of interest in the PPMs were not red flags. Two experts, both seasoned veterans of the securities industry, explained that conflicts of interest disclosed in a PPM do not heighten the RRs' obligations, because they were fully disclosed, and a "conflict of interest relative to issuers being affiliated with broker-dealers is almost a daily event. That is what broker-dealers do...." Tr. 3941:2-13 (Tilken). Another expert noted that affiliations between issuer and underwriter in the offer of proprietary product sales "happens all the time." Tr. 4039:21-4040:8 (Bennett). Nor was Smith's level of control over the Four Funds significant because McGinn and Smith were seasoned veterans in the capital markets, and Smith had sufficient experience and background in underwriting to launch private placements such as the Four Funds. Tr. 3921:4-17; 3927:17-25 (Tilken).

In addition, the "affiliated transactions" disclosure represents a *protective limitation* on the potential conflict of interest – *not* a cause for concern. The PPMs expressly stated that "we will not pay above the price paid by our managing member or such affiliate for the Investment." *See* Div. Ex. 5, at 15. Respondents had no reason to question the statements in the PPMs, let alone to undertake the "investigation" required by the ALJ's decision.

Moreover, investors signed subscription agreements, in which they expressly "represent[ed], and warrant[ed]," that they were aware of all of these so-called "red flags," yet chose to nonetheless invest:

- "I have received and have carefully read and understood the [PPM] given to me by the Trust Fund in connection with the offering of Certificates." Div. Ex. 264, at 23.
- "I recognize that investment in the Certificates involves substantial risk factors, including those set forth under 'Risks' in the [PPM]." *Id.*

- "I have adequate means of providing for my current needs and possible personal contingencies, and I have no need for liquidity in my investment in the Certificates." *Id.*

- "I have relied only on the foregoing information and documents in determining to make this subscription, and the decision to acquire Certificates of the Trust Fund has been made based upon my own evaluation of the merits and risks of the Trust Fund." *Id.*

The ALJ ignored these controlling contractual provisions and representations in finding some Respondents made material misrepresentations and omissions to their clients. In so doing, the ALJ accepted vague testimony from a few investors, out of hundreds, who thought McGinn Smith Securities were "safe" or who "did not study [the PPMs] in detail," in concluding that Respondents had acted with *scienter*. Decision at 20. This was plain error as a matter of law.

The Supreme Court explained:

> It will not do for a man to enter into a contract, and, when called upon to respond to its obligations, to say that he did not read it when he signed it, or did not know what it contained. If this were permitted, contracts would not be worth the paper on which they are written. But such is not the law. A contractor must stand by the words of his contract; and, if he will not read what he signs, he alone is responsible for his omission.

Upton, Assignee v. Tribilcock, 91 U.S. 45, 50 (1875) (citations omitted).

The Seventh Circuit more recently explained that "claims [of fraud] are barred by a very simple, very basic, very sensible principle of the law of fraud, both the law of securities fraud and the common law of fraud. If a *literate, competent adult* is given a document *that in readable and comprehensible prose* says X (X might be, 'this is a risky investment'), and the person who hands it to him tells him, orally, not-X ('this is a safe investment'), our literate, competent adult *cannot maintain an action for fraud against the issuer of the document*." *Carr v. CIGNA Securities, Inc.*, 95 F.3d 544, 548 (7th Cir. 1996) (emphasis added); *see also Rissman* *v. Rissman,* 213 F.3d 381, 383 (7th Cir. 2000) ("[s]ecurities law does not permit a party to a stock transaction to disavow such representations – to say, in effect, 'I lied when I told you I wasn't relying on your prior statements' and then to seek damages for their contents.").

2. *The January 2008 Meeting Was Unremarkable Given the Economic Climate At the Time*

The ALJ ignored incontrovertible evidence that the global liquidity and economic crisis adversely affected all securities – blue chip stocks, Triple A bonds, and alternative investments such as the McGinn Smith Securities – in finding that MS&Co.'s reduction of interest on just the *junior* notes of the Four Funds was a red flag that should have caused Respondents to stop offering *all* McGinn Smith Securities. *See* Decision at 115. As reported, there was a "fundamental disruption – a financial upheaval ... – that wreaked havoc ... across the country.... Businesses, large and small, have felt sting of a deep recession." [18] In the midst of this economic crisis, the January 2008 meeting could not be viewed as a red flag (nor was it).

Moreover, the impairments affecting just the *junior* notes had nothing to do with the Trust Offerings which continued to pay interest, as did the senior notes and the senior subordinated notes of the Four Funds, until the SEC commenced its action against McGinn, Smith and others in April 2010 (with the exception of one of the Firstline offerings which ceased paying interest in September 2009).

Nevertheless, according to the ALJ, on learning that the Four Funds' holdings were not diversified (in fact, each Four Fund was diversified) and that an investment by all Four Funds totaled $8 million in one investment (alseT), Respondents had "a duty to investigate ... before selling any Four Funds or Trust Offerings." Decision at 92. The PPMs of the Four

[18] National Commission on the Causes of the Financial and Economic Crisis in the United States, *Financial Crisis Inquiry Report* (2011), at xvi; *see* Tr. 5751:19-5752:8 (taking judicial notice of same); *see also* RMR Ex. 305.

Funds, however, did not state that investments within each Fund would be different from the investments in the other Funds. Further, the alseT investment was consistent with each of the Four Funds' investment mandate and concentration limitations. While the Four Funds' performance in 2008 was disappointing and a cause for concern, as was the performance of numerous debt and equity securities at this time, that did not impose a "duty to investigate" on Respondents under *Hanly* or any other applicable authority.

At a minimum, the January 2008 meeting could not and did not raise a "red flag" regarding the Trust Offerings which the Division's expert admitted "were not at all similar" to the Four Funds.[19] The investigation demanded by the ALJ would transform RRs into accountants and private investigators. Respondents had no reason to conduct such an investigation before presenting different securities (Trust Offerings) and no case authority has imposed such a duty in these circumstances.

3. Respondents Were Unaware of the Firstline Bankruptcy

The final red flag alleged by the Division was McGinn and Smith's failure to tell Respondents of the Firstline bankruptcy until September 2009. *See* Decision at 93. The Division admitted that Respondents were unaware of the Firstline bankruptcy before September 2009. *See* Div. FoF ¶ 178. Respondents did not present any McGinn Smith Securities (with a few exceptions) after learning of McGinn and Smith's failure to timely disclose the information and several left MS&Co. shortly thereafter.[20]

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[19] Div. Ex. 1 at 25.

[20] The ALJ correctly concluded that there was no "redemption policy" announced by MS&Co. in December 2006, *see* Decision at 93, and the Division has waived its right to challenge this finding by not filing a cross-petition for review.

4. *As A Matter of Law, the Alleged Red Flags Did Not Establish That Respondents Acted with Scienter*

To establish *scienter* based on red flags, there must be facts showing that (1) the defendant was actually aware of the alleged flags, *and* (2) the flags were "so obvious[ly]" indicative of fraud "that the defendant must have been aware of [the fraud]" and desirous of furthering it. *See South Cherry*, 573 F.3d at 109, 112; *Stephenson v. Citco Group Ltd.*, 700 F. Supp. 2d 599, 622-23 (S.D.N.Y. 2010); *see also MLSMK Invs. Co. v. JP Morgan Chase & Co.*, 737 F. Supp. 2d 137, 145 (S.D.N.Y. 2010) (finding allegations of *scienter* insufficient because "[w]hile it may be true that Defendants could have connected the dots to determine that Madoff was committing fraud, Plaintiff offers no facts to support the claim that they actually reached such a conclusion"); *In re J.P. Jeanneret Assocs.*, 769 F. Supp. 2d 340, 365 (S.D.N.Y. 2011) (mere "existence of 'red flags' does not satisfy the *scienter* requirement"). The ALJ ignored that there was no such showing here. *See Iowa Pub. Employees Ret. Sys. v. Deloitte & Touche LLP*, 919 F. Supp. 2d 321, 334-35 (S.D.N.Y. 2013), *aff'd*, 2014 U.S. App. LEXIS 4918, at *3-4 (2d Cir. Mar. 17, 2014).

Likewise, *disclosed* conflicts of interest, *disclosed* investments in affiliates, and *disclosed* exclusive control over an investment program - routine disclosures - are insufficient to support an inference of *scienter*. *See Stephenson v. PricewaterhouseCoopers, LLP*, 768 F. Supp. 2d 562, 574-75 (S.D.N.Y. 2011) (dismissing claim based on auditor's mere access to information by which it could have discovered warning signs and noting that "flags are not red merely because the plaintiff calls them red"); *Anwar*, 728 F. Supp. 2d at 453 (fact that "all of the Funds' assets were managed by Madoff ... with no checks and balances" was not a "flag" that supported an inference of *scienter*).

III.

RESPONDENTS DID NOT ACT NEGLIGENTLY IN VIOLATION OF SECURITIES ACT SECTION 17(A)(2) AND 17(A)(3)

The Division's claims based on Securities Act Section 17(a)(2) and (3), which present questions of fact unique to each Respondent, are addressed more fully in Respondents' Individual Briefs. Suffice it to say these claims failed because no evidence was presented of a material misstatement or omission of material fact by any Respondent to any client about any specific McGinn Smith Security after September 23, 2008 (or before then, for that matter), and, no evidence was presented showing that each Respondent's conduct "operate[d] as a fraud or deceit upon [any] purchaser." Nor did the ALJ recite evidentiary support for her naked conclusion as to each Respondent.

Moreover, as a matter of law, Section 17(a)(2) and (3) are not applicable to Respondents because, under these Sections, only the "*makers*" of statements who engage in fraudulent practices or who "obtain money or property" by means of a material misstatement or omission are covered by these provisions. *See Janus Capital Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011). Respondents did not author the PPMs, which, in any event, made no material misrepresentations or omissions, and no evidence to the contrary was otherwise adduced at the hearing. Nor did any Respondent make a material misstatement to "obtain money or property," and no evidence was presented that any Respondent had made such a misrepresentation.

IV.

RESPONDENTS DID NOT VIOLATE SECTION 5

The ALJ erred in concluding that Respondents violated Securities Act Section 5. Decision at 95-97. Relying on inaccurate information and incompetent evidence in the form of summary charts, while disregarding undisputed evidence that financial and non-financial disclosure was provided to investors, the ALJ concluded that Respondents were liable for the Section 5 Claim. Decision at 93-97. In so concluding, the ALJ imposed liability on individual brokers in a manner never before endorsed by the Commission and on conduct that preceded the OIP by far more than five years. This was plainly error.

As a threshold matter, there can be no actionable Section 5 claim regarding the Four Funds, as Respondents did not sell any Four Funds after September 23, 2008. Div. Ex. 2; *see also* 28 U.S.C. § 2462.

Moreover, insofar as the Section 5 Claim could be "entertained" at all, it was based primarily on six charts of allegedly unaccredited investors prepared by a Division paralegal, which were so fundamentally flawed, Div. Exs. 531-36, it was error to consider them. For example, a primary source of information for the charts was the McGinn Smith "investor database," Div. Ex. 591, notwithstanding testimony that the database was inaccurate. Tr. 1379:8–1380:9. And, although the Division did consider individual purchaser questionnaires – indisputably the best evidence of an investor's accredited status since it was a contemporaneous representation by that investor – the ALJ allowed the Division to disregard this information in favor of secondhand oral information provided to the Division's attorneys years later, which the ALJ referred to as "better information." Decision at 72 n.90. The Division's charts were also a moving target, with the number of allegedly unaccredited investors shrinking as Respondents' challenged the Division's evidence. For example, the Division claimed in the OIP that there were "at least 59" unaccredited investors in the fictitious MSF Conduit, then 44 in response to a motion for more definite statement, then 39 at trial.

The ALJ rejected the Division's integration theory as to the Trust Offerings (Decision at 96) – the only way in which the Division could state a Section 5 claim as "[n]one of the Trust Offerings exceeded 35 unaccredited investors" (OIP ¶ 32) – yet crafted her own theory of Section 5 liability: Respondents allegedly failed to comply with the disclosure requirements of Rule 502. Decision at 96. This point was not addressed in detail at the hearings, *as it was not an argument made by the Division*. Nevertheless, the financial and non-financial disclosure in the Trust Offerings' PPMs, *see, e.g.*, Div. Ex. 264 at 7, which were provided to accredited and unaccredited investors alike, satisfied the requirements of Rule 502. *See* 17 C.F.R. § 230.502(b)(2)(A)-(B).

The ALJ also ignored that courts and the Commission have only imposed Section 5 liability on an individual RR where (a) there was an obvious failure to comply with the registration requirement or with any claimed exemption, *and* (b) knowing or recklessly deceptive conduct by the RR. *See, e.g., SEC v. Cavanagh*, 98 Civ. 1818, 2004 U.S. Dist. LEXIS 13372, at *83 (S.D.N.Y. July 16, 2004) (defendants "merged a shell company with a small and not yet successful operating company, sold stock ... in an unregistered transaction, took control of virtually the entire market float, created a false impression of interest in the stock ... issued a false press release, and drove the stock price north of $5 in a 'pump and dump' scheme from which they ... pocketed millions of dollars."); *SEC v. Gagnon*, 10 Civ. 11891, 2012 U.S. Dist. LEXIS 38818, at *2-14, *19-27 (E.D. Mich. Mar. 22, 2012) (defendant helped orchestrate and promote a massive Ponzi scheme and made outlandish recommendations without basis, soliciting investors on his website, via email and in online chatrooms). There are no such facts in the record here.

For these reasons, Respondents did not violate Section 5.[21]

V.

RESPONDENTS WERE DEPRIVED OF THEIR EQUAL PROTECTION AND DUE PROCESS RIGHTS AND THE PROCEEDING WAS UNCONSTITUTIONAL

Although no liability should be imposed based on the evidentiary record here, the Decision should also be reversed and all charges against Respondents dismissed, because the hearing deprived Respondents of equal protection and due process rights, violated Commission rules, and violated Article II, Section 2, Clause 2 of the U.S. Constitution. Numerous examples demonstrate the unfairness and unconstitutionality of this proceeding.

The Commission's failure to bring *this* proceeding in federal court denied Respondents of their equal protection and due process rights. Despite interrelated issues between the OIP and the federal action against McGinn and Smith, the Commission prejudicially authorized this administrative proceeding rather than a federal court action. While McGinn and Smith had the ability to avail themselves of the benefits of depositions and other discovery under the Federal Rules of Civil Procedure, and the protections of the Federal Rules of Evidence, trial by jury, and an Article III judge, the Commission discriminatorily deprived Respondents of those benefits and protections. The prejudicial effect of the Commission's decision was amplified because much of the hearing was devoted to (a) McGinn and Smith, who were not parties to or present for examination, and (b) the records of MS&Co. – that Respondents did not have, but which the Division's summary witnesses spent several years analyzing. The entire basis of the Division's case was that McGinn and Smith, with the aid of inside and outside accountants, secretly stole and diverted funds, which Respondents alone supposedly should have discovered

[21] Insofar as Respondents took reasonable steps to avoid participation in any distribution violative of Section 5, see Respondents' Individual Briefs.

and thus should have stopped offering McGinn Smith Securities, even though they were suitable securities for their investors.

It is well-settled that "[t]he fundamental requirement of due process is the opportunity to be heard 'at a meaningful time and in a meaningful manner.'" *Mathews,* 424 U.S. at 333. Despite the stakes (a financial death penalty), no meaningful time (just four months) was provided to review the Division's investigative record. Due process requires the opportunity for discovery. Given its size, it was literally impossible to review the materials, which the Division only made available over a few months prior to the commencement of the hearing, and in some instances, on the eve of the hearing. The production of millions of documents that could not be reviewed is effectively producing no documents at all. *Locurto v. Giuliani*, 447 F. 3d 159 (2d Cir. 2006) (party in hearing before administrative law judges does not receive "a full and fair opportunity to litigate" where he was "denied adequate discovery" on the relevant issues); *SEC v. Collins & Aikman Corp.*, 256 F.R.D. 403, 410 (S.D.N.Y. 2009) ("While the responsive documents exist somewhere in the ten million pages produced by the SEC, the production does not respond to the straightforward request to identify documents that support the allegations in the Complaint, documents [defendant] clearly must review to prepare his defense.").

Respondents were also denied the ability to challenge the patent pleading deficiencies in the OIP, which failed even to state the Fraud Claim, as they would have had under the Federal Rules of Civil Procedure in a federal court action. And, unreliable evidence would not have been admitted in a federal court action under the Federal Rules of Evidence. Yet, here, the ALJ admitted double and triple-hearsay. *See, e.g.*, Decision at 53 (accepting testimony from Vincent O'Brien as to what his sister told him that Respondent Mayer supposedly told her at a meeting where O'Brien was not present).

Nor were Respondents ever fully or fairly informed of the claims against them, as fundamental fairness and Supreme Court precedents require. 5 U.S.C. § 554(b). The ALJ denied Respondents' separate motions for a more definite statement for the names of any investor to whom any Respondent allegedly made a material misstatement or omission, about which specific McGinn Smith Security, and when each Respondent supposedly made the material misstatement or omission. The OIP was devoid of these essential factual allegations to state a fraud claim.

Respondents' equal protection rights were further violated by the Division improperly singling them out for prosecution, even though approximately 40 other RRs sold over $69 million of McGinn Smith Securities to investors. *See* Div. Ex. 591. There was no legitimate basis to single out these Respondents when other RRs also offered McGinn Smith Securities, also did not see any red flags, also did not conduct an "investigation," and also did not "verify" statements in the PPM or statements by McGinn and Smith. *Gupta*, 796 F. Supp. 2d at 513-14.

The ALJ also ignored, and effectively sanctioned, the Division's post-OIP fishing expedition for evidence to support its claims. Many of the investor witnesses who testified admitted that they were first contacted by the Division *after* the OIP was filed. This violated Rule 230(g), and was particularly egregious considering the Commission sued McGinn, Smith, and others in federal court in April 2010 and had more than three years to speak with investors prior to filing the OIP. The ALJ nevertheless denied Respondents' separate motions to exclude the testimony of those witnesses first contacted by the Division *after* the OIP was filed.

This was not, however, the ALJ's only tainted evidentiary ruling; there were several others that were arbitrary and capricious. For example, the ALJ erroneously refused to consider or admit client affidavits stating that they did not believe a Respondent had made a material misrepresentation or omission to them and that they held Respondents in high regard. The affidavits were sworn under oath, and served the purpose of both streamlining the hearings and sparing these witnesses the considerable burden and expense of traveling from out of state to the hearing. The ALJ denied Respondents' separate motions to introduce the affidavits (or otherwise consider them), despite the fact that the clients had been served with subpoenas to appear at the hearing, but were unable to appear. The ALJ instead sustained the Division's pro forma objection to their admission, citing a desire to cross-examine the witnesses. Yet, when called upon to cross-examine those investors who did appear and testify, the Division asked few, if any, questions of those witnesses. *See, e.g.*, Tr. at 5542-43 (asking Favish if statements in his affidavit were based on his own beliefs as opposed to access to internal McGinn Smith documents). On the other hand, the ALJ allowed the Division to elicit triple-hearsay. *See* Decision at 53; *see also* Tr. at 1472 (permitting the Division to elicit testimony from an investor witness via the Division's cellphone speakerphone).

Worse, the ALJ prejudged the case as evidenced by her statement that certain proffered evidence had "nothing to do with *the violations*," Tr. 2412:5-6 (emphasis added), and that she did not want to "second guess[]" the Commission's decision to hear the case. Pre-Hearing Tr. (Jan. 21, 2015), at 30:13-21. This is a blatant violation of due process. *In re Murchison*, 349 U.S. 133, 136 (1955) ("A fair trial in a fair tribunal is a basic requirement of due process.") (internal citations and quotations omitted); *Amos Treat & Co. v. SEC*, 306 F.2d 260, 267 (D.C. Cir. 1962) ("[A]n administrative hearing ... must be attended, not only with every element of fairness but with the very appearance of complete fairness ... [to] meet the basic requirement of due process."); *Caperton v. A.T. Massey Coal Co.*, 556 U.S. 868, 883-84 (2009) (the Due Process Clause does not require "proof of actual bias," but rather whether there is a real risk of actual bias or prejudgment.); *Jaeger v. Cellco P'ship*, 2010 WL 965730, at *13 (D. Conn. Mar. 16, 2010) *aff'd*, 402 F. App'x 645 (2d Cir. 2010) ("Due process demands strict impartiality on the part of those who function in judicial or quasi-judicial capacity.").

The ALJ also erred in admitting Respondents' non-party deposition testimony voluntarily given in 2011 to assist the Commission in its federal court action against McGinn and Smith.[22] At no time did the Division disclose that Respondents were under investigation and never provided Respondents with SEC Form 1662. Nor were Respondents shown a Formal Order of Investigation that indicated that the Commission was investigating Respondents. Respondents did not try to refresh their recollections, and were not given their deposition transcripts to review, correct, amplify or sign. Despite being misled as to the Division's true intentions, the ALJ denied Respondents' separate motions to exclude their non-party deposition testimony – which she termed "investigative testimony"[23] – and instead used it as a primary basis to determine (erroneously) that Respondents were not credible because they provided additional details that they did not mention in the non-party depositions. Just as the SEC cannot use its investigatory powers to avoid application of the Federal Rules of Civil Procedure in a pending federal case,[24] it should likewise not be permitted to avoid the notice and protections typically afforded to an individual under investigation by purporting to depose him as a non-party witness pursuant to Rule 45.

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22 Respondents volunteered to assist the Division when they called. In accordance with the Division's practice, it sent a subpoena to Respondents' counsel confirming the non-party depositions. *See, e.g.*, Tr. 5850:9-18.

23 By contrast, and as further evidence of the arbitrary and capricious nature of this proceeding, Respondent Gamello's testimony was repeatedly referred to as "deposition testimony," who the ALJ found did not violate the antifraud provisions of the federal securities laws.

24 *See* Order (ECF No. 47), *SEC v. Life Partners Holdings, Inc.*, 12-cv-33 (W.D. Tex. Aug. 27, 2012).

Finally, the administrative proceeding was unconstitutional under Article II of the Constitution because (1) the ALJ's appointment violated the Appointments Clause of Article II, as she was not appointed by the President, a court of law, or a department head, *and* (2) the ALJ's two-layer tenure protection violated the Constitution's separation of powers, specifically the President's ability to exercise Executive power over his inferior officers. *See* U.S. Const. art. II § 2, cl. 2; *Freytag v. Comm'r of Internal Revenue*, 501 U.S. 868, 880 (1991); *Free Enter.*, 561 U.S. at 484, 506. As at least one district court has recently concluded, the SEC's appointment of its ALJs likely violates the Appointments Clause. *See Hill v. SEC*, No. 1:15-cv-01801-LMN, 2015 U.S. Dist. LEXIS 74822, at *51 (N.D. Ga. June 8, 2015) ("Because SEC ALJs are inferior officers, the Court finds Plaintiff has established a likelihood of success on the merits on his Appointments Clause claim.").

CONCLUSION

For these reasons, the Commission should dismiss the proceeding in its entirety.

DATED: New York, New York
July 17, 2015

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CERTIFICATE OF COMPLIANCE

This brief complies with the Commission's Extension and Word Limit Order, dated June 5, 2015. The brief contains 9,978 words, exclusive of the Table of Contents, Table of Authorities, Signature Blocks, and this Certification, as counted by Microsoft Word, the word processing system used to prepare it.

Dated: New York, New York
July 17, 2015

M. William Munno

M. William Munno

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15514

In the Matter of

DONALD J. ANTHONY, JR.,
FRANK H. CIAPPONE,
RICHARD D. FELDMANN,
WILLIAM P. GAMELLO,
ANDREW G. GUZZETTI,
WILLIAM F. LEX,
THOMAS E. LIVINGSTON,
BRIAN T. MAYER,
PHILIP S. RABINOVICH, and
RYAN C. ROGERS,

Respondents.

OPENING INDIVIDUAL BRIEF OF THOMAS LIVINGSTON

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July 20, 2015

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LIST OF ABBREVIATIONS AND TERMS

"FoF" -- Proposed Findings of Fact and Conclusions of Law of Respondent Thomas Livingston

"ID" -- Chief Judge Brenda Murray's February 25, 2015 Initial Decision

"Div. Ex. __" -- Division of Enforcement's Exhibit

"TL Ex. __" -- Thomas Livingston Exhibit

Capitalized terms, unless otherwise indicated, have the same meaning as defined in Respondent's Joint Brief.

I. SUMMARY

Throughout this case, the Division and ALJ have ignored that McGinn and Smith masterminded a sophisticated and pervasive fraud. They exploited the 20-plus year successful track record and local prominence of their firm to perpetuate their fraud. Smith and McGinn colluded with others within the firm--including its CFOs, senior accounting and legal officers--and its auditors to further their fraud, which made it virtually impossible for their crimes to be detected. Indeed, McGinn and Smith's misconduct went undetected in at least three regulatory examinations. They used "Ponzi-like" payments, false accounting entries, fraudulent tax returns, and created false documents to hide their scheme. When liquidity problems with the Four Funds arose, Smith was able to hide the true nature of the issues because the problems were completely consistent with the general economic downturn, which the Division and ALJ pretend did not exist.

The fact is that McGinn and Smith stole from their investors. Mr. Livingston is not to blame for what happened. He did not lie to anyone or commit fraud. While the ALJ included boilerplate language that Mr. Livingston made misrepresentations, none are discussed within the Initial Decision and there was no evidence of any. The ALJ's findings that Mr. Livingston failed to disclose material information to the two investor witnesses is wholly inconsistent with the evidence -- indeed, in the 119-page Decision, the ALJ completely ignored three letters that the investors received detailing the very information that the ALJ claims Mr. Livingston did not disclose. In finding Mr. Livingston negligent, the ALJ again completely ignores the uncontradicted evidence of Mr. Livingston's due diligence of the Offerings that he sold. Even putting aside that the violations cannot stand, the ALJ did not (and cannot) explain why Mr. Livingston should be permanently barred from the securities industry, while the other respondents, who were found to have violated the exact same securities laws with the exact same scienter and who received the exact same monetary penalty, were suspended for one year.

Neither the law nor facts support liability against Mr. Livingston and the charges against him should be dismissed and the punishment reversed.

II. BACKGROUND

Mr. Livingston is married with five children, ranging from 5 to 29 years old. His wife is a stay-at-home mother who cares for their 5 year old autistic son. Mr. Livingston has been in the securities industry for over 35 years, focusing almost exclusively on institutional sales and capital markets. Other than this matter, Mr. Livingston's career has been unblemished--he has never been the subject of any investigation and has no disciplinary history--both before, during, and after MS&Co. FoF 1-5.

Mr. Livingston joined MS&Co. in 1988 as an institutional salesman. He started the firm's Syndicate Department in 1995 and ran it until 2009, when he left MS&Co. Mr. Livingston's work generally focused on participation with large banks on underwriting public debt and equity offerings. While Mr. Livingston became a minority shareholder of MS&Co. in 2003, he had no role in running MS&Co. FoF 10, 16. Indeed, as the Commission stated in its civil case against McGinn and Smith, "Since [2006], [McGinn] and Smith have actively controlled virtually every aspect of the McGinn Smith Entities' operations." Sec. Am. Compl. at ¶ 38.

Importantly, no one, even the Division, claims that Mr. Livingston was knowledge of the fraud that McGinn and Smith perpetrated. *See, e.g.,* Tr. 1220, ID at 4. Mr. Livingston did not create, manage, or oversee what turned out to be fraudulent securities offerings. He had no role, much less supervisory, in the retail brokerage operations from which the investments were sold. Mr. Livingston had no participation in making the investments or otherwise handling investor proceeds, nor did he have a role in overseeing or monitoring the investment portfolio. Mr. Livingston was not involved in, nor did he have special access to, the accounting or auditing functions of the firm and had no access to its bank accounts. He did not receive the firm's financial statements except to review net capital when the firm was participating in an underwriting. Mr. Livingston did not share in the profits of the firm, but rather received a set draw that was determined by Smith based on his individual revenue generation in the syndicate department. FoF 12-17.

While at MS&Co., Mr. Livingston had a handful of retail clients. He did not act as any client's sole financial advisor nor did he manage any client's entire investment portfolio. Rather, he executed limited transactions for clients. FoF 11. Livingston did not solicit any of the sales at issue in this case. Rather, the sales came mostly from clients who had participated in the pre-2003 alarm notes, which until the fraud was revealed, had by all accounts been sound and successful investments. For instance, Daniel Ferris, who testified at the hearing, had invested in the pre-2003 alarm offerings and when those ended, he wanted to continue to invest in MS&Co. offerings. Others, like David LaFleche, knew of MS&Co.'s reputation and sought out the investment. In fact, LaFleche, who was good friends with Ferris and Mr. Livingston, knew of Ferris' investing success and wanted to invest in whatever Ferris invested in. FoF 21, 64, 65. Mr. Livingston always provided the Offering Documents to his clients and discussed the risks, which were described throughout the PPMs, with each client. FoF 69. Ultimately, Livingston sold $1,904,000 of the Four Funds offerings, not $3.5 million as the Division alleges and sold $280,000 of the Trust Offerings, not $380,000 as the Division alleges. These sales account for less than 2 percent of the $127 million in total sales by MS & Co. FoF 23-25.

Mr. Livingston currently runs the capital markets group at Halliday Financial Group. Mr. Livingston deals exclusively with underwriting SEC-registered securities in transactions primarily led by major banks, including Merrill Lynch, J.P. Morgan Chase, Wells Fargo, and Morgan Stanley. The bulk of the transactions in which Mr. Livingston is involved are fixed income securities, such as preferred stocks issued by large companies, and structured products that are FDIC insured. He is not involved in underwriting or selling unregistered securities, including private placements. He has no retail clients and has no intention of doing any retail business in the future. FoF 6-8.

Mr. Livingston is a well-respected member of the securities industry, especially within the syndication sector, and has a very strong reputation for integrity and truthfulness. He serves on the Board of Directors of the National Syndicate Association, which is the leading syndicate organization in the country. According to the co-head of capital markets for Stiffel Nicholas, who testified at the hearing, Indeed, Stiffel Nicholas does business with Halliday, a small regional firm, based solely on the reputation and character of Mr. Livingston. FoF 9. The ALJ heard testimony about Mr. Livingston's strong attitude towards compliance from Andrew Halliday, Mr. Livingston's supervisor. Tr. 5919:16 - 5921:21. As one witness put it, Mr. Livingston is a man of "impeccable" character. Tr. 5882:17 - 24.

III. ARGUMENT

The Rules of Practice provide that the Commission may "affirm, reverse, modify, set aside, or remand for further proceedings, in whole or in part, an initial decision by a hearing officer and may make any findings or conclusions that in its judgment are proper and on the basis of the record." Rule 411(a). The ALJ committed prejudicial errors during the course of the proceeding, made findings and conclusions of fact that were clearly erroneous, and reached erroneous conclusions of law.

The Decision fails to consider the appropriate relevant evidence in reaching its conclusions. Under the APA, "[a] sanction may not be imposed or rule or order issued except on consideration of the whole record or those parts thereof cited by a party and supported by and in accordance with the reliable, probative, and substantial evidence." 5 U.S.C. § 556(d). The written decision must demonstrate the fact-finder's consideration of the "whole record" and must "show the ruling on each finding, conclusion, or exception presented," including "all the material issues of fact, law, or discretion presented." *Id.* §§ 556(d), 557(c)(3)(A).

The Decision fails to comply with the APA's requirement that the agency consider "the evidence on both sides; evidence that is substantial viewed in isolation may become insubstantial when contradictory evidence is taken into account." *Landry v. FDIC*, 204 F.3d 1125, 1140 (D.C. Cir. 2000) (emphasis in original); see also *Siegel v. SEC*, 592 F.3d 147, 155 (D.C. Cir. 2010). It is reversible error for an agency to "pa[y] no heed to [respondent's] evidence." *Rockies Fund, Inc. v. SEC*, 428 F.3d 1088, 1098 (D.C. Cir. 2005). As the Commission has held, an ALJ must have "a sufficient basis on which to conclude" that the Division has proved each of its allegations. *In the Matter of Pelosi, Inv.* Advisors Act Rel. No. 3805, 2014 SEC LEXIS 1114, at *8 (Mar. 27, 2014).

Due process similarly requires the agency to base its decisions on a "full ... appreciation of all of the evidence"; the agency cannot simply "review selected parts of the record ... while ignoring other matters of record." *Cinderella Career & Finishing Sch., Inc. v. FTC*, 425 F.2d 583, 585 n.3 (D.C. Cir. 1970). Courts expect "that agencies will treat fully 'each of the pertinent factors' and issues before them"; otherwise, "the opportunities for notice and hearing in administrative proceedings would be largely illusory, with agencies free to disregard those facts or issues that prove difficult or inconvenient." *Tenneco Gas v. FERC*, 969 F.2d 1187, 1214 (D.C. Cir. 1992) (*quoting Public Serv. Comm'n for NY. v. Fed. Power Comm'n*, 511 F.2d 338, 345 (D.C. Cir. 1975)).

Here, the Decision does not consider the evidence on both sides--it perfunctorily adopts the Division's view and dismisses without even considering Mr. Livingston evidence on virtually all issues. And, while the Division's view of the evidence in isolation may appear persuasive as described in the Decision, it is insubstantial and inadequate when the complete story and all the evidence are considered. Unfortunately, that's not what occurred.

As just one example, before Mr. Livingston was able to even begin putting on evidence, it's clear that the ALJ had already made up her mind that the Four Funds' investment in alseT was improper. During one Respondent's testimony about why he thought alseT was consistent with the Four Funds' investment mandate, the ALJ abruptly interrupted and proclaimed "I don't care whether it was Pope Francis advising this Alset. I am saying the thing is these investors put money in something, and that that money was going into completely different thing." Tr. 3306:25-3307:11. This explains why the ALJ cut off testimony from Yoav Millet, a witness for Mr. Livingston, who was attempting to testify about the legitimacy of alseT, its immediate prospects for success in 2006-2007, and its negotiations with major Wall Street firms for permanent financing. Tr. 5863.

The Decision's errors, alone and in combination, violate the APA and Mr. Livingston's right to basic fairness and due process. Accordingly, for the reasons stated herein and the Joint Brief, the Commission should reverse the Decision.

A. Mr. Livingston Did Not Commit Fraud and the Evidence Does Not Support Such a Finding.

Despite the length of the ALJ's Initial Decision, the findings against Mr. Livingston are narrow. The Division presented only two investor witnesses against Mr. Livingston, Daniel Ferris and David LaFleche. The ALJ based her findings that Mr. Livingston violated Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5 on the premise that "Mr. Livingston was reckless in offering and selling securities based on material misrepresentations and omissions that he made to the witnesses who purchased private placements." ID at 104. The ALJ's conclusion is overwhelmingly contradicted by the evidence and cannot stand.

1. The ALJ Does Not Identify Any Misrepresentations Made by Mr. Livingston.

While the ALJ includes the same boiler-plate legal conclusion used for other Respondents that Mr. Livingston made "material misrepresentations," the ALJ does not identify any such alleged misrepresentations or even discuss any affirmative representations allegedly made by Mr. Livingston. *See generally* ID at 46-47, 104-05. There was no testimony about any alleged misrepresentations by either investor witness. Put simply, there are no findings in the Initial Decision or evidence introduced at the hearing to support the ALJ's finding that Mr. Livingston made "material misrepresentations." The ALJ's conclusions that Mr. Livingston made "material misrepresentations" have no support and must be reversed.

2. The ALJ's Finding that Mr. Livingston Failed to Disclosed Material Facts is Not Supported by the Evidence.

In concluding that Mr. Livingston was reckless in offering and selling securities based on material omissions to the two investor witnesses, the ALJ found that Mr. Livingston failed to disclose to Messrs. Ferris and LaFleche (1) his ownership interest in alseT and (2) Mr. Livingston's concerns about the financial trouble of the Four Funds before selling any Trust Offering. ID at 104. Both of these findings are contrary to the undisputed evidence, which the ALJ wholly ignored.

(A) Neither Ferris nor LaFleche purchased a Four Fund investment that had made a loan to alseT and, therefore, Mr. Livingston's indirect interest in alseT did not need to be disclosed.

In finding that Mr. Livingston should have disclosed his ownership interest in alseT, the ALJ completely ignored the fact that Mr. Livingston did not sell any Four Funds to Messrs. Ferris and LaFleche which, at the time of the sale, had made loans to alseT.[1]

It is undisputed that LaFleche did not purchase a Four Fund investment after December 2004. Div. Ex. 2 at 108. alseT was not even formed until 2005 and, therefore, none of the Four

[1] The ALJ does not cite to any support for her conclusion that Mr. Livingston individually had such an obligation of disclosure. Moreover, Mr. Livingston believed that, before any of the Four Funds loaned any money to alseT, David Smith had obtained a legal opinion that Mr. Livingston's involvement in alseT did not create any legal issues or disclosure requirements. FoF 86. The ALJ ignored that evidence. Further, the ALJ seems to chastise Mr. Livingston's denial that alseT was an "affiliate" of MS&Co. (ID at 42), but oddly, neither the ALJ nor the Division used the term "affiliate" as it is defined in federal securities laws. Tr. 523:5 - 524:7, Tr. 5348:2-3. alseT did not qualify as an affiliate, as defined by the '33 Act. Nevertheless, transactions with related parties were not only not prohibited by the Four Fund PPMs, but even the ALJ found that they were specifically contemplated in the PPMs. Div. Ex. 5 at 1, ID at 92.

Funds in existence as of December 2004 could have made any loans to alseT to that point. FoF 85, Div. Ex. 2 at 156. Nor was there any evidence introduced that there was any intention in December 2004 for any of Funds in which LaFleche had invested to make any loans to alseT. Therefore, there was nothing to disclose to Mr. LaFleche about alseT.

Further, Ferris only made one Four Fund investment after alseT was created.[2] In January 2006, Ferris purchased an investment in FAIN. Div. Ex. 2 at 108. The ALJ ignored the fact that as of January 2006, FAIN had not loaned any money to alseT. *Id.* at 156. There was no evidence introduced that Mr. Livingston knew or should have known that FAIN would loan money to alseT. Indeed, Mr. Livingston was not involved in the loans between the Four Funds and alseT at all. Moreover, in January 2006, Mr. Livingston believed that alseT was about to obtain permanent financing. At the time, alseT was in advanced negotiations with Merrill Lynch for permanent financing, which would have eliminated the need for any additional loans from any of the Four Funds and provided repayment of loans. FoF 94,Tr. 2282, TL Ex. 94, 98. But again, at the time that Ferris made his investment in FAIN, there were no loans to alseT by FAIN to disclose.

Accordingly, the ALJ's finding that Mr. Livingston should have disclosed the Four Fund loans to alseT to Ferris and LaFleche is based on a failure to recognize that no such investments had been made at the time those investors purchased their investments. Therefore, the ALJ's finding is wholly contrary to the evidence and was in error.

[2] The ALJ also failed to note the limited nature of Ferris' testimony. Ferris gave limited testimony and was only able to testify about the details of one investment (November 2007). Tr. 28:20-23, 34:7-15, 42:9-13. Notably, while Ferris claimed that investment was made without his authorization, that testimony was shown to be completely inaccurate. *See* FoF 83, 84. That entire subject is omitted from the Initial Decision. Ferris was unable to give any details whatsoever about any of his other investments -- indeed, his refusal to do so resulted in a heated conversation between counsel for the Division and Ferris before the hearing. Tr. at 71-73. Again, this subject was ignored in the Initial Decision. The only testimony that Ferris was able to offer about his purchase of Four Fund investments was that is was Smith, not Livingston, who described the investments to Ferris. Tr. 45-46, FoF 78. Yet again, this fact was absent from the Initial Decision.

(B) The financial troubles of the Four Funds were disclosed to Ferris and LaFleche before they made their investments in the Trust Offerings.

The core of the ALJ's fraud findings against Mr. Livingston are based upon the ALJ's erroneous conclusion that the financial troubles of the Four Funds, of which Mr. Livingston learned in December 2007, were not disclosed to Ferris or LaFleche before they made investments in the Trust Offerings in late 2008 through January 2009. ID at 104.[3] Incredibly, in reaching this conclusion the ALJ wholly ignored three letters sent to both Ferris and LaFleche during 2008, before either made a purchase of a Trust Offering in 2008, that detail the severe liquidly issues of the Four Funds. In fact, before either invested in a Trust Offering in 2008, both Ferris and LaFleche were told, initially, that their interest payments were cut by more than half, then later, that their interest payments were being suspended entirely, and finally, that the maturities on their investments were being extended from 5 years to 20 years and the interest permanently reduced. FoF 74-75, 80-82; Div. Ex. 132, 188, and 193.

As the Commission itself previously noted, a series of letters was circulated to Four Funds' investors during 2008, putting them on notice of various issues with their investments. *See, e.g., Securities Exchange Commission v. McGinn, Smith & Co., Inc., et al.*, No. 1:10-cv-00457-GLS-CFH, Plaintiff's Statement of Material Facts in Support of Motion for Summary Judgment, Dkt. No. 711, at ¶¶ 137, 140-44 (July 8, 2014). The first letter—sent within days of Mr. Livingston's memo––"was sent to Four Funds junior note holders, informing them that their interest payments would be reduced to 5% from 10.25%." *Id.* ¶ 137.[4] After setting forth an in-depth description of problems plaguing the financial markets as a result of the credit crisis, the letter states "[t]he FUNDS in which

[3] Ferris made a purchase of TDM Luxury Cruises in November 2007, before Mr. Livingston or any other Respondent learned of the Four Funds' liquidity problems. The ALJ's conclusions about what should have been disclosed to Ferris relate only to his October 2008 Trust Offering investments. ID at 104.

[4] Ferris and LaFleche were junior noteholders in each of the Four Funds in which they invested. Div. Ex. 2 at 108.

you are invested have some of those similar problems." *Id.* It goes on to outline specific issues relating to the investments, including the following:

- "The impact on the FUNDS from the aforementioned credit crisis has primarily been on liquidity and the upcoming need to sell assets in the next year to pay off maturing notes.
- "Our real concern is the present and future ability to sell our present investments at a value that is needed to meet the FUND's obligations.
- "[T]he ability to retire the entire issue at the same time as the Senior notes is most unlikely.
- [T]here is presently no market at fair prices that exist for non-public debt securities...In addition, many of the investments in these companies are dependent on new financings to have the capital to pay off their existing debt to the FUNDS. Several of our investments fall into this category."

The letter also specifically identifies alseT as a company that falls within the aforementioned category, then goes on to discuss potential issues with alseT as follows:

> Another example is a company that we have financed that is in the business of evaluating and providing capital to companies based on the worth of the company's intellectual property. A major investment bank has given the company a term sheet that will provide $750 million of financing over the next five years. However, the original structure called for a substantial portion of that capital to be provided up front and that would be used to repay our debt. The investment bank is now only willing to provide the capital on a staggered basis over the next five years, with the result that while we are confident of being repaid in full, it is not likely that we will be paid out until the fourth and fifth year of their commitment.

MS&Co. continued to provide updates on these issues to Four Funds investors as the prognosis worsened. On or about April 11, 2008, the firm sent a second letter to junior note holders in the Four Funds, including Ferris and LaFleche. App. Ex. 355 at 1. The April 2008 letter stated that, in light of the circumstances highlighted in the earlier January 2008 letter, and because two investments had eliminated their dividends or ceased distributions, the Four Funds were forced to eliminate the interest payments on Secured Junior Notes for the quarter. App. Ex. 355 at 1-2.

Finally, on or about October 13, 2008, a third letter was distributed to note holders in all tranches of the Four Funds. App. Ex. 356 at 1. The October 2008 letter stated "McGinn, Smith Advisors, LLC (MSA) has determined that as a result of losses incurred in the FUND's investments and the total illiquidity for the vast majority of the FUND's investments it is not possible to redeem the Notes on the due date of December 15, 2008 and will require a restructuring of all classes of Notes." Attached was a restructuring plan extending the maturity dates of the notes from 2008 until 2023 and reducing interest payments for all tranches. App. Ex. 356 at 8-9.

These three letters were precisely the reasons Smith provided to Mr. Livingston, both in December 2007 and after, for why the Four Funds were experiencing liquidity issues. FoF 49. Despite the Commission specifically acknowledging these letters and their forewarnings, the ALJ chose to completely ignore them in assessing Mr. Livingston's culpability. In fact, there is not a single mention of these letters in the entire Initial Decision. The ALJ does acknowledge in passing that LaFleche admitted Mr. Livingston told him his Four Fund notes were being suspended and delayed. ID at 47. But, the ALJ completely failed to acknowledge that Ferris testified that Mr. Livingston told him that his TAIN and FIIN investments were in trouble. FoF 82.[5] The overwhelming evidence is that Ferris and LaFleche were acutely aware of the significant liquidity issues and that, by the time they purchased Trust Offering on October 31, 2008, they knew that their

[5] The ALJ instead cites to testimony from Ferris about his October 2008 investments in the McGinn Smith Transactional Fund. ID at 46. However, before the Division asked Ferris about what he could recall concerning what Mr. Livingston allegedly did and did not tell him in connection with the October 2008 investments, Ferris was asked "Do you remember anything about the circumstances of those [October 2008 MSTF] investments?" Ferris said "No." Tr. at 42:9-13. Counsel for Mr. Livingston objected to further questions about the circumstances of the investments, which Ferris admittedly did not recall, but despite "having a point," the objection was overruled and the Division was allowed to ask Ferris about an investment about which he did not recall any details. *Id.* at 42:17-22. That ruling was likewise in error and the testimony about what Ferris was supposedly not told should be ignored.

Four Fund investments were in distress and that they were at risk of losing money on those investments.[6]

(C) The ALJ's Reliance on the December 2007 Memorandum is Misplaced.

In finding that Mr. Livingston acted with scienter, the ALJ places great weight on two statements in a December 2007 memorandum sent by Mr. Livingston to McGinn and Smith. ID at 104. The ALJ stated: "In the memorandum, Mr. Livingston acknowledged that funds controlled by McGinn and Smith had losses approaching $45 million dollars, and that, unbeknownst to him, the Four Funds now owned 10% of alseT and had made huge investments in companies controlled by McGinn and Smith, which Mr. Livingston described as "HUGE conflicts" and that it was 'unbelievable' such conflicts had not been disclosed. Div. Ex. 585; Tr. 5309." As shown above, Ferris and LaFleche were aware before they purchased their October 2008 Trust Offerings that their Four Fund investments were in distress. Even putting this aside, the ALJ's reliance on the December 2007 memo is misplaced and misstates the evidence surrounding it and the statements contained therein.

In December 2007, alseT was on the verge of obtaining permanent financing from Goldman Sachs, which not only would have paid off loans from the Four Funds, but more importantly, would have also provided the capital needed for alseT to progress and begin purchasing IP royalty streams. FoF 95-98. All of the effort and time that Mr. Livingston (and others) put into alseT was about to

[6] The ALJ's conclusion also assumes, without support, that there was a duty of disclosure. To demonstrate liability under Section 10(b); Rule 10b-5; or Section 17(a) based upon a failure to disclose, the SEC must show both the existence of a duty to disclose the information and the materiality of the information. *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir.); *Hoffman v. UBS-AG*, 591 F. Supp. 2d 522, 532 (S.D.N.Y. 2008); *SEC v. Pasternak*, 561 F. Supp. 2d 459, (D.N.J. 2008). "It is a well-established principle of federal securities law that silence absent a duty to disclose cannot be actionably misleading, and the mere possession of material non-public information does not create a disclosure duty." *Harborview Master Fund, L.P. v. Lightpath Techs., Inc.*, 601 F. Supp. 2d 537, 543 (S.D.N.Y. 2009); *see also Chiarella v. United States*, 445 U.S. 222, 235 (1980). "[S]ilence, [i.e., an omission] absent a duty to disclose, is not misleading under Rule 10b-5." *Wang v. Bear Stearns Companies, LLC*, 14 F. Supp. 3d 537, 543 (S.D.N.Y. 2014). Generally, a registered representative's only duty is to correct previously made affirmative statements if they later become inaccurate and to give full information regarding statements they do make if the statement would be misleading absent full disclosure. *Time Warner*, 9 F.3d at 267; *In re Marsh & Mclennan Companies, Inc. Sec. Litig.*, 501 F. Supp. 2d 452, 469 (S.D.N.Y. 2006).

be realized. Apparently seeing no more use for Mr. Livingston, others within alseT sought to push him out so that they did not have to share in alseT's success with Mr. Livingston. *Id.* McGinn and Smith, focused on getting the Four Funds repaid, sided with alseT management and asked Mr. Livingston to resign from alseT in a meeting on December 19, 2007. Mr. Livingston was furious and, in a stream of consciences, wrote the December 20, 2007 memorandum.[7] Tr. 2293.

The December 2007 memorandum is not about the Four Funds at all. The document discusses alseT, the efforts to remove Mr. Livingston, and his reasons for being so upset about what was occurring. Despite how the ALJ makes it appear, the December 2007 memo was not a manifesto by Mr. Livingston about wrongdoing he believed was occurring in the Four Funds. Mr. Livingston made clear that he did not believed that any wrongdoing was occurring at all nor did Smith reveal any to him. Tr. 5250.

Importantly, Mr. Livingston made abundantly clear that he did not understand that the Four Funds had "losses" of $45 million, but rather that $45 million of the Four Funds' investments were not performing. Tr. 2293. This is consistent with what Smith told other brokers and investors. Moreover, Mr. Livingston did not believe that Four Funds had real conflict of interest issues. Rather, this was an excuse being used by McGinn and Smith to convince Mr. Livingston to resign from alseT and he was merely pointing to instances where they had made investments in entities in which they had some ownership interest. Furthermore, in discussing the investment in Coventry, it is clear this did not relate to the Four Funds -- he mentioned "another $20 million" investment, which did not relate to the Four Funds' investment, which was significantly smaller at that time. Div. Ex. 2 at 140. Nevertheless, Mr. Livingston's point in the memorandum was that he believed investments in related parties had been fully vetted by legal counsel. He describes the alseT

[7] The memorandum was sent on December 20, 2007 and references a meeting the prior day. Div. Ex. 585. Mr. Livingston testified that the date on the memorandum (10/22/07) was from a previous document and was an error. All of the evidence indicates that the issues between Mr. Livingston and alseT management were occurring in December 2007 and not in October. *See, e.g.,* ID at 44.

investment as being "all above board" and discusses the significant sums paid by the firm to its lawyers for opinions on such issues. Div. Ex. 585 at 4.[8]

It is undisputed that Mr. Livingston did not sell a Four Fund investment after January 2007-- nearly a year before he learned of the liquidity issues. The ALJ effectively found that Mr. Livingston was reckless in selling five Trust Offerings during 2008 through January 2009 due to the problems with the Four Funds. ID at 104. But, the ALJ ignores that the Four Funds had nothing to do with the Trust Offerings. Indeed, the Division's own expert admitted that the two offerings "were not at all similar." Div. Ex. 1 at 25. Trust proceeds were used to purchase assets and revenue streams from specific purpose entities, usually related to long-term contracts for burglar alarm service, "triple play" (broadband, cable and telephone) service, or luxury cruise cabin bookings. ID at 7. The Trust Offerings were similar to the pre-Four Funds notes offered by MS&Co., for which the firm a "national reputation." ID at 3.

Moreover, unlike with the Four Funds, the shortcomings with the Trust Offerings were not the result of alleged undisclosed investments and conflicts; rather it was simply a matter of McGinn and Smith stealing funds and falsifying accounting records to cover their tracks. *See, e.g., Securities Exchange Commission v. McGinn, Smith & Co., Inc., et al.*, Memorandum-Decision and Order, No. 1:10-cv-00457-GLS-CFH, at 10-11 (Feb. 17, 2015) (hereinafter, "MDO I") at 31 (McGinn and Smith used the Trust Offerings "to structure a series of transactions that would allow various McGinn Smith Entities to siphon off millions of dollars in transaction fees and commissions…"). Nothing on the face of the Trust Offerings was improper. Instead, monies raised were actually invested in the specific streams of receivables and disclosed assets as promised,

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[8] Furthermore, as stated previously, the ALJ noted that the Four Fund PPMs disclosed potential related party transactions. ID at 92 (citing Div. Ex. 5 at 1).

including the purchase of contracts for security alarm services, broadband cable services, telephone services, and luxury cruises. *Id.* at 13-14.

Mr. Livingston was concerned to learn in December 2007 that the Four Funds had substantial non-performing assets, but it was not a surprise given the severe economic conditions facing the debt markets at the time. FoF 50. Indeed, Mr. Livingston testified: "The world was melting down. The institutional accounts that I talked to were going through virtually [sic] calamity. So this was not unique to McGinn Smith to have non-performing assets at the time." Tr. 2295:2-6. There was nothing to suggest wrongdoing by Smith. Rather, Smith appeared to have a full grasp on the situation, a plan to remediate it, and fully communicated the issues to investors. Tr. 5249-5252.

Moreover, the non-performance of the Four Funds had nothing to do with whether the Trust Offerings were sound investments. The Trust Offerings were run by McGinn and were similar to the pre-2003 offerings for which MS&Co. had a national reputation. Ultimately, those failed because McGinn and Smith stole from investors with the help of people like MS&Co.'s CFO. Mr. Livingston was not, and could not reasonably have been, aware of McGinn and Smith's crimes. ID at 71; FoF 53-55.

In sum, the ALJ's finding of scienter was unreasonable and inconsistent with a fair and balanced review of the evidence.

(D) *The ALJ Erred in Finding Scheme Liability.*

Putting aside that there were no material omissions, the ALJ's finding that Mr. Livingston's sales "constituted a necessary part of MS&Co.'s fraud and were thus part of a device, scheme, or artifice to defraud …" is not supported by the law. The ALJ did not find any conduct by Mr. Livingston beyond alleged misrepresentations and omissions. Indeed, Mr. Livingston was not involved in the creation and management of the Four Funds or Trust Offerings, nor has it been suggested that Mr. Livingston was aware of McGinn and Smith's fraudulent scheme.

Scheme liability under subsections (a) and (c) of Rule 10b-5 hinges on the performance of an inherently deceptive act that is distinct from an alleged misstatement. *SEC v. Kelly*, 817 F.Supp.2d 340, 344 (S.D.N.Y. 2011); *Cf. In the Matter of Vancock*, No. 34-61039A, 2009 WL 4026291, at *9 (S.E.C. Nov. 20, 2009). Putting aside that Mr. Livingston did not make any material misrepresentations or omissions, liability does not attach by merely repackaging fraudulent misrepresentations as a "scheme to defraud." *See SEC v. Goldstone*, 952 F.Supp.2d 1060, 1203-04 (D.N.Mex. 2013). Rather, scheme liability hinges on the performance of an inherently deceptive act that is distinct from an alleged misstatement. *SEC v. Familant*, 910 F. Supp. 2d 83, 93 (D.D.C. 2012); *WPP Lux. Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057 (9th Cir. 2011); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005); *SEC v. Goldstone*, 952 F. Supp. 2d 1060, 1234 (D.N.M. 2013); *SEC v. Kelly*, 817 F.Supp.2d 340, 344 (S.D.N.Y. 2011).

To hold a defendant accountable for an alleged "scheme," the Division must show acts by the defendant that demonstrate "illegitimate, sham, or inherently deceptive transactions where the defendant's conduct or role has the purpose and effect of creating a false appearance." *SEC v. St. Anselm Exploration Co.*, 936 F. Supp. 2d 1281, 1299 (D. Colo. 2013). "Stated differently, scheme liability exists only where there is deceptive conduct going beyond misrepresentations." *Id.* (citing *Public Pension Fund Group v. KV Pharmaceutical Co.*, 679 F.3d 972, 987 (8th Cir. 2012)). "Allegations of a scheme based on the same misstatements that would form the basis of a misrepresentation claim under Rule 10b–5(b) and nothing more are not sufficient." *Id.*

Here, the ALJ imposed scheme liability on Mr. Livingston solely based on alleged misrepresentations and omissions. ID at 104. The ALJ identified no deceptive conduct intended to defraud. Without more, this is inherently insufficient to support a finding of a violation of Section

17(a) and Rule 10b-5. While McGinn and Smith took deceptive actions with the intent of defrauding buyers, Mr. Livingston took no such actions, and the ALJ identifies none other than the bare allegation that he allegedly failed to disclose certain information. Although this might raise an inference that McGinn and Smith used registered representatives such as Mr. Livingston as innocent conduits to advance their own fraud, it raises no inference whatsoever that Mr. Livingston was engaged any such scheme. And, as discussed above, the supposed "failures to disclose" are not actionable. Thus, as a matter of law, the ALJ erred in holding that the supposed omissions were sufficient to impose scheme liability on Mr. Livingston.

B. Mr. Livingston Did Not Violate Sections 17(a)(2) or 17(a)(3).

The ALJ found that: "Mr. Livingston willfully violated Securities Act Sections 17(a)(2) and (a)(3) because, acting at least negligently, he obtained money by means of untrue material statements, i.e., his recommendation of these private placements indicated to his clients that he had some reasonable basis for believing they were good investments when he had done no investigation of their worth. By simply repeating the issuer's unchecked representations, he engaged in an act, practice, or course of business that operated as a fraud or deceit on his clients." ID at 105. This finding is not supported by the evidence or even within the Initial Decision.

First, there was absolutely no evidence that Mr. Livingston repeated anything from either the Four Fund or Trust Offering PPMs. Indeed, neither Ferris nor LaFleche testified about any affirmative representations that Mr. Livingston made to them and the ALJ does not cite any in the Initial Decision. This again is a boilerplate finding as to other Respondents, but for which the ALJ provides no support as to Mr. Livingston. Even so, Mr. Livingston cannot be liable for any alleged misstatements within the PPMs, or those which he repeated, because Mr. Livingston did not "make" the statements. *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

Second, the ALJ's finding that Mr. Livingston did not conduct any due diligence is simply wrong. Mr. Livingston did conduct due diligence of the Four Funds and the Trust Offerings which he sold. The Division's records show that as of December 31, 2003, FIIN had more than $17.68 million invested in 8 different investments. Mr. Livingston knew about all of those investments except for an alarm contract investment (SPT 01 Trust). Indeed, two of the investments (Cochise and Maracay Homes) came through introductions made by Mr. Livingston. Moreover, in reviewing the Division's 2004 balance sheet for FIIN, TAIN, and FEIN, Mr. Livingston was also personally aware of the funds' 2004 investments in, among others, Deerfield Capital, Pine Street Capital, and Raging River Apparel. Comparing the investments in which Mr. Livingston was aware to the total invested, Mr. Livingston was personally aware of at least 83% of TAIN's investments and 78% of FIIN's investments as of December 31, 2004 (TAIN and FIIN accounted for all but one of Mr. Livingston's sales to that point). Notably, 95% of Mr. Livingston's sales of the Four Funds occurred by May 2005 (all but two sales). FoF 27-29.

By the time the Four Funds were created, Mr. Livingston had worked with Smith for 15 years and had seen Smith successfully handle numerous transactions, including bank acquisitions and financing of a civic center and local hospital. FoF 19. While the ALJ mocked his testimony as not being credible, Mr. Livingston did in fact, unlike anyone else, personally observed Smith evaluating potential investment opportunities and rejecting potential investments. Mr. Livingston was the only respondent that was in the same office as Smith. Mr. Livingston saw Smith conducting due diligence on potential investments, with an experienced team, and personally observed that the due diligence was consistent with what Mr. Livingston conducted on an underwriting. Mr. Livingston frequently attended meetings with Smith and frequently spoke to him (and others) about the Four Funds investments. In fact, Mr. Livingston introduced Smith to a number of companies in which the Four Funds invested. Again, while the ALJ simply disregarded his uncontradicted testimony, because Mr. Livingston had knowledge about the companies in with the Four Funds invested, he understood the returns that the Funds could expect, and believed the interest payments to Four Fund investors were reasonable.[9] Mr. Livingston believed, based on his personal observations that Smith was making sound investment decisions consistent with the broad purpose of the Four Funds. FoF 30-33.

As for the Trust Offerings, Mr. Livingston testified about the thorough due diligence of the TDM Cable Trust 09 offering. Among other things, Mr. Livingston reviewed the assets that were being purchased, verified the assets were actually being purchased, verified that the debt service reserve fund had been funded, and talked to the servicer of the contracts. Mr. Livingston also conducted thorough due diligence on the TDM Luxury Cruise offering, including speaking to the travel agent who was booking the cruises, reviewed the company's financial statements, and confirmed the company's cash flows against what was represented in the PPM. The court-appointed receiver in the Commission's civil case identified no underlying issues with the TDM Luxury Cruise operations except that after liquidation, there was an overall loss. In looking at TDM offerings in hindsight with forensic review of its financial statements and operations, the receiver's opinion was that its underwriting was poor. The receiver admitted that there was no evidence that the brokers were aware of the poor underwriting. FoF 37-40.

The ALJ's conclusion that Mr. Livingston did no investigation is another example of the ALJ blindly accepting the Division's position without paying any heed to the actual evidence. The actual evidence does not support the ALJ's conclusion and it should be reversed.

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[9] The returns in the investments were substantiated by Pine Street Capital, a related fund to MS&Co. that was universally deemed as an enormous success, and with whose management Mr. Livingston had frequent contact. RMR 46, Tr. 5215-16.

C. The Evidence Does Not Support Upholding the ALJ's Permanent Securities Industry Bar

The ALJ's punishment of Mr. Livingston, especially imposing a permanent securities industry bar, lacks any rational basis and is an abuse of discretion.

First, for the reasons set forth at the hearing, in the Joint Brief, and in this Brief, the finding that Mr. Livingston committed fraud is not supported. There were no findings or evidence that Mr. Livingston made any material misrepresentations. As for alleged material omissions, the evidence shows that either no disclosure was needed or that the facts were known to the investors. Moreover, the evidence does not support that Mr. Livingston acted with scienter and, therefore, a permanent bar is not warranted. *Steadman v. SEC*, 603 F.2d 1126, 1141 (5th Cir. 1979) ("It would be a gross abuse of discretion to bar a [financial professional] from the industry on the basis of isolated negligent violations.").[10]

Second, even putting aside that the ALJ's finding of reckless conduct is not supported by the evidence, even if it were, the ALJ was required to, but did not, make meaningful, individualized findings to support her punishment of Respondents, especially with regard to Mr. Livingston due to the permanent bar imposed upon him. *Steadman*, 603 F.2d at 1139; *see also McCarthy v. SEC*, 406 F.3d 179, 189 (2nd Cir. 2005); *Monetta Fin. Servs, Inc. v. SEC,* 390 F.2d 952, 957 (7th Cir. 2004). The ALJ's decision to impose sanctions on the respondents merely recites the *Steadman* factors and provides vague references to the "egregious" nature of the violations. There is no meaningful consideration of each factor; rather, the ALJ makes conclusory legal declarations without discussing the unique facts of the case. ID at 112-113. Further, the ALJ discusses the *Steadman* factors as

[10] To the extent that the bar was based on Section 5 violations, there was no finding of scienter with regard to those violations nor was there any evidence that Mr. Livingston was aware or should have been aware that the offerings were not subject to an exemption from registration. Mr. Livingston reasonably relied on the representations of the issuer, the Funds' advisor (Smith), the MS&Co. compliance department, and outside counsel regarding the legality of the offering. TL Ex. 1, 2, 17, 60. Mr. Livingston was not aware that any of the offerings exceeded 35 unaccredited investors. Tr. 5237:3-21.

they relate to ***all*** of the respondents, not to each respondent individually, but then applies a different and significantly harsher punishment for Mr. Livingston. *Steadman*, 603 F.2d at 1140. In fact, she provided no reason for distinguishing Mr. Livingston at all. ID at 112-113.

Each of the selling Respondents, except Gamello, were all found to be liable for the same violations of the federal securities laws, with the same level of scienter, and each received the same monetary penalty ($130,000). ID at 93-109. Yet, Mr. Livingston was permanently barred from the securities industry, while most others were suspended for one year. *Id.* at 113. The only others permanently barred was a respondent who defaulted and Lex, who is no longer in the securities business. There is no justification given for such inequitable treatment, nor is there a rational reason to punish Mr. Livingston more than the others. *Id.* Indeed, Mr. Livingston made sales to three customers totaling $255,000 after September 23, 2008 (the relevant statute of limitations period) for which he allegedly received a total of $700 in commissions.[11] Only Feldmann (who settled) and Guzetti (an alleged supervisor) had fewer sales during the relevant time period. The ALJ further completely ignored all mitigating factors, including that Mr. Livingston has never been the subject to regulatory investigation or sanctions, is not allegedly to have engaged in any misconduct since leaving MS&Co., and he is not a threat for repeat offense because he is not a retail broker -- he deals exclusively with underwriting SEC-registered securities in transaction primarily led by the major banks, including Merrill Lynch, J.P. Morgan Chase, Wells Fargo, and Morgan Stanley. Tr. 5176:8-14. The bulk of the transactions in which Mr. Livingston is involved are fixed income securities, such as preferred stocks issued by large companies, and structured products that

[11] As set forth in his Motion to Correct the Initial Decision, with regard to the $700 payment on February 15, 2009, there is no evidence that payment related to the sale of TDMM Cable 09. In reviewing the bi-monthly schedule that Palen used for her entry for the payment on February 15, 2009, it reveals that there is no indication that payment was for a sale of TDMM Cable 09. See Liv. Ex. 126 (last page), attached hereto as Exhibit "B." Indeed, the bi-monthly schedule states the $700 was for "Net Private 70%." *Id.* The Division offered no testimony on what the Net Private 70% line item represented in the McGinn Smith bi-monthly schedules. Further, on the same schedule, there are three separate line items for TDM notes. *Id.* If the $700 related to the sale of a TDM note, it follows that the payment would have been listed under one of those three lines reserved for TDM note commissions.

are FDIC insured. He is not involved in underwriting or selling unregistered securities, including private placements. Tr. 5174:6 - 5176:7.[12]

Put simply, even if Mr. Livingston was reckless and violated the antifraud provisions (which he strongly denies), there is not a rational basis to impose "the most drastic sanction at the Commission's disposal"--a securities industry bar--against Mr. Livingston while suspending others found to have engaged in the exact same violations.[13]

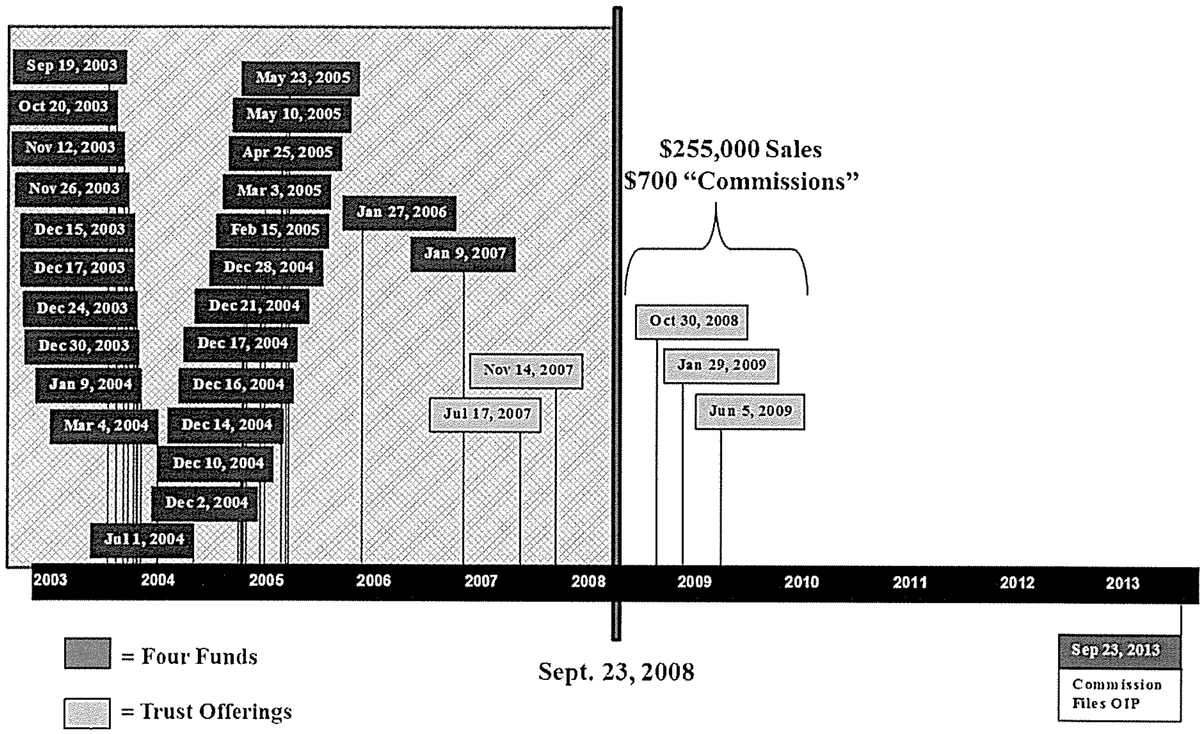
Third, in supplement to the Joint Brief, the ALJ improperly relied upon pre-September 23, 2008 conduct to impose a bar against Mr. Livingston. The ALJ wrongly found that she can rely on conduct outside of the statute of limitations in imposing a bar. ID at 2, fn 2; *In the Matter of the Application of Eric J. Brown*, SEC Release No. 3376, 2012 WL 625874 (2012); *In the Matter of Edgar B. Alacan*, SEC Release No. 8436, 2004 WL 1496843 (2004); *In the Matter of Feeley & Wilcox Asset Mgmt. Corp.*, SEC Release No. 2143, 2003 WL 22680907 (2003).

In finding Mr. Livingston violated the antifraud provisions, the ALJ relied on conduct that occurred outside the statute of limitations -- specifically, Mr. Livingston's alleged failure to disclose his interest in alseT in sales of Four Funds (all of which occurred outside the statute of limitations) and his failure to disclose his "concerns" about the Four Funds that came about in late 2007. ID at 104. Virtually all sales at issue in the case occurred outside the statute of limitations. The following timeline (using the Division's disputed list of sales and commissions) illustrates that the

[12] The ALJ also ignored several undisputed facts about Mr. Livingston, which she nevertheless highlighted to conclude that Gamello did not violate the anti-fraud provisions of the federal securities laws. ID at 101-02. Just like Gamello, except for a single sale, all of Mr. Livingston's Four Fund sales occurred shortly after the Funds began -- all FAIN sales were within first 3 months it was offered; all TAIN sales, save one, were within first 8 months of the offering; all FIIN sale were within first 6 months, and only FEIN sale was within the first 6 months. Div. Ex. 2 at 108. Moreover, just like Gamello, Mr. Livingston did not sell any Four Funds after December 2007 -- in fact, his last sale was in January 2007. *Id.* And, just like Gamello, Mr. Livingston did not sell any of the Trust Offerings after August 2009 -- his last sale was in June 2009. *Id.* It was arbitrary and capricious for the ALJ to apply one set of rules for Gamello, while ignoring the same facts as to Mr. Livingston.

[13] While no bar is appropriate, even if the Commission overrules every point of error raised by Mr. Livingston, at a minimum, he should not be treated differently than the other respondents and should only receive a year suspension.

Division's claims are based on conduct first accruing and occurring outside the statute of limitations:



While earlier events may be used to "shed light" on the character of conduct within the statute of limitations, a timely claim cannot only rely on evidence outside of the statute of limitations. *Local Lodge No. 1424 v. Nat'l Labor Relations Bd.*, 80 S.Ct.822, 826 (1960). If it is, the timely claim is not really a valid claim; it is a lawful practice cloaked in the illegality of a time-barred event. *Id.* This is a perversion of the statute of limitations and allows the Division to circumvent § 2462 to prove claims they otherwise would not be able to prove. *Id.*

Both *SEC v. Microtune* and *SEC v. Graham* considered and rejected the use of time-barred actions to prove conduct within the statute of limitations. In *Microtune*, the Court dismissed all claims reliant upon misrepresentations made in filings more than five years before the SEC complaint. *SEC v. Microtune*, 783 F.Supp.2d at 871. Specifically, the court rejected an argument that a filing within the statute of limitations was actionable for misrepresentation based on the "materially false and misleading" conduct of the defendant outside of the SOL. *Id.* at 891 n.37. The court noted this stretch of the limitations period created extensive liability beyond the limitations period, eroding the purpose of the statute of limitations. *Id.*

Graham involved a series of real estate investments that were actually unregistered securities. *SEC v. Graham*, 21 F.Supp.3d 1300, 1302 (S.D. Fl. 2014). The SEC attempted to establish violations within the statute of limitations by relying on time-barred conduct to show the actions taken during the statute of limitations were wrongful. *Id.* at 1314. For instance, the SEC claimed the prior relationship between a company run by a defendant and the violating "real estate" company was sufficient to impute time-barred violative behavior on the defendant. *Id.* The court rejected this argument stating that the evidence could not prove a violation occurred within the applicable limitations period. *Id.* The court refused to allow the SEC to create violations within the statute of limitations based upon their relationship with activities outside of limitations. *Id.*

Courts outside of the securities context have held similarly. In *US v. EME Homer City Generation L.P.*, the court determined that the new owners of a coal-fired power plant could not be held liable for their ongoing "Prevention of Significant Deterioration," ("PSD") program "violations" because the current violations were dependent on the old owners failure to obtain a PSD permit upon construction of the power plant. *EME Homer City Generation*, 823 F.Supp.2d at 285. This same rationale has been applied in the context of the statute of limitations contained in § 10(b) of the National Labor Relations Act. *Local Lodge No. 1424,* 80 S.Ct. at 822. In *Local Lodge*, the Supreme Court held an unfair union security clause claim could not be considered a violation of the National Labor Relations Act. *Id.* at 827. The Court held that the "entire foundation for the unfair labor practice charged" was the unlawful collective bargaining agreement executed outside of the statute of limitations. *Id.* The union security clause was legal on its face and relying on the time-barred agreement was an attempt to "convert what is otherwise legal into something illegal." *Id.* at 828.

Much like the new owners in *EME Homer City Generation*, Mr. Livingston's later decisions regarding the Trust Offerings cannot be considered violations without the violative conduct that occurred outside of the statute of limitations. *EME Homer City Generation*, 823 F.Supp.2d at 285. The Trust Offerings claims are wholly dependent on the untimely Four Funds violations. To allow conduct relating to the Four Funds to serve as the basis for the Trust Offerings claims would inappropriately stretch the limitations period to bring in Four Funds conduct which is time-barred by § 2462. Similar to the unfair security clause claim in *Local Lodge*, without the "red flags" and securities violations that occurred during the Four Funds time period, there is absolutely no valid claim for misrepresentation or failure to disclose by Mr. Livingston. To hold otherwise contravenes both significant case law as well as the critical public policy supported by the statute of limitations.

D. Objections to the ALJ's Factual Findings

While it is unclear to what extent the ALJ relied upon the "Factual Findings" relating to Mr. Livingston not discussed in connection with her conclusions and punishment (ID at 41-47), there are substantial errors in those findings. Most notably, Mr. Livingston objects to the following "findings":[14]

- The ALJ states that "Mr. Livingston claimed he did not know that Smith used $2 million of the FIIN offering proceeds to redeem investors in a pre-2003 alarm notes ...." ID at 43. The ALJ's statement that "Mr. Livingston claimed" to not have the knowledge is further evidence of the bias against Mr. Livingston in this proceeding -- there was never any evidence or suggestion that Mr. Livingston was aware of Smith's use of FIIN offering proceeds.

- The ALJ stated that Mr. Livingston received FOCUS reports. ID at 43. However, the ALJ omitted that Mr. Livingston only received the FOCUS reports when MS&Co. was participating in an underwriting so that Mr. Livingston could assess the firm's net capital position. Tr. 5199. Mr. Livingston did not regularly receive FOCUS reports nor did he ever receive any reports that gave him concern about the firm's financial status. Tr. 5200.

[14] It is not reasonably possible to include context to every statement that the ALJ chose to include. Mr. Livingston reserves the right to include additional information on any evidence relied upon by the Division in its Response to either the Joint or Individual Brief.

- Mr. Livingston objects to the ALJ's reliance on Division Exhibit 623. Not only is it hearsay (an objection not entertained by the ALJ during the hearing), but it's pure speculation to what "entity" or restructuring Smith was discussing. Indeed, the "entity" to which Smith appears to be referencing is a potential new entity for an IPO. The e-mail in no way indicates a financial issue with the Four Funds and any suggestion otherwise is pure speculation.

- Mr. Livingston objects to the ALJ's reliance on Division Exhibit 620 (ID at 44) because the e-mail was a privileged communication between Mr. Livingston and counsel. The ALJ incorrectly found that Mr. Livingston had waived the privilege although he had not testified about advice given from Mr. Goldstein on potential conflict of interest issues. Tr. 5327-28.

- Mr. Livingston objects to the ALJ's reliance on Division Exhibit 631. ID at 44. While the redemption issue was found to be irrelevant by the ALJ, the e-mail at issue does not indicate that Mr. Livingston was aware of a policy of having to replace customers before an investor could redeem their investment. Exhibit 631 does not involve a redemption of an investor whose note had matured. Rather, the e-mail involved a May 2007 request from an investor for an early withdrawal from his TAIN investment that was not due to mature until December 2009. Investors had no right to require repurchase of the notes before maturity. FoF 57. The Division's own expert admitted that there are no e-mails or other documents that indicate that Mr. Livingston was told investors whose notes had matured had to be replaced before they could be redeemed. FoF 56.

- Mr. Livingston objects to the ALJ's finding that Mr. Livingston "acknowledged that Rees told him [McGinn and Smith] were 'pulling money out of TDM or Verifier'." ID at 45. The ALJ omitted that Mr. Livingston made clear in his testimony that Rees told him that McGinn and Smith were legitimately making money on separate investment vehicles, like TDM and Verifier, in which Mr. Livingston did not have an interest. Mr. Livingston did not believe that McGinn and Smith were stealing investor funds, but were making money off of something that Mr. Livingston had no interest in. Tr. 2309-2311.

- The ALJ claimed that Mr. Livingston "did not mention any financial problems at MS & Co." in connection with William Carroll's purchase of TDMM Cable on June 9, 2009. ID at 46. Mr. Carroll did not testify at the hearing. And, Mr. Livingston did not testify that he "did not mention any financial problems at MS & Co." Instead, Mr. Livingston testified that he did not discuss the liquidly issues concerning the Four Funds that he noted in his December 2007 memorandum. Tr. at 5339-40. Mr. Carroll had not invested in the Four Funds and Mr. Livingston's concerns about the performance of the Four Funds in December 2007 had no relevance to Mr. Carroll's purchase in June 2009 of a trust investing in triple-play contract receivables. *Id.*

- Mr. Livingston objects to the ALJ's recitation of the testimony of Ferris and LaFleche, both because the ALJ omits any cross-examination points entirely and largely omits Mr. Livingston's testimony about his interaction with Messrs. Ferris and LaFleche. *See* FoF 61-77. In the one instance that the ALJ does note Mr.

Livingston's testimony (concerning whether one of LaFleche's purchaser questionnaires was changed), the ALJ failed to note that the change to the questionnaire was inconsistent with LaFleche's testimony because the new asset range still would have made LaFleche an unaccredited investor. FoF 77.

IV. CONCLUSION

The Commission should dismiss all charges against Livingston.

Dated: July 20, 2015

By: ______________________

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CERTIFICATE OF COMPLIANCE

I hereby certify pursuant to Rule 450(c) that this Opening Brief of Thomas Mr. Livingston is 9,819 words, exclusive of pages containing the table of contents, table of authorities, this certificate, the certificate of service, and any addendum that consists solely of copies of applicable cases, pertinent legislative provisions, or rules and exhibits, and is therefore within the word limit set by the Commission's June 5, 2015 order.

By: ______________________
Matthew G. Nielsen

CERTIFICATE OF SERVICE

I hereby certify that on the date set forth below, I filed the foregoing pleading with the Office of the Secretary of the Commission via facsimile at (703) 813-9793, and served copies on the following persons via regular mail and email, except where otherwise indicated.

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SECURITIES AND EXCHANGE COMMISSION

In the Matter of: DONALD J. ANTHONY, JR., FRANK H. CHIAPPONE, RICHARD D. FELDMAN, WILLIAM P. GAMELLO, ANDREW G. GUZZETTI, WILLIAM F. LEX, THOMAS E. LIVINGSTON, BRIAN T. MAYER, PHILIP S. RABINOVICH, and RYAN C. ROGERS, Respondents.	ADMINISTRATIVE PROCCEDING File No. 3-015514

RESPONDENT ANDREW G. GUZZETTI'S
INDIVIDUAL BRIEF IN SUPPORT OF HIS PETITION FOR REVIEW

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INTRODUCTION

Respondent Andrew G. Guzzetti, by and through his attorneys, hereby submits this Individual Brief in Support of his Petition for Review of the Administrative Law Judge's (ALJ) Decision, made final on June 17, 2015. For the reasons stated herein, the ALJ's Decision should be reversed and all charges against Mr. Guzzetti should be dismissed.

STATEMENT OF FACTS

In late 2004, Guzzetti was contacted by McGinn Smith & Co. ("MS & Co.") because the firm was interested in building its retail wealth management business. (*Tr. 4593:20-4954:18*). Specifically, the goal of MS & Co. was to transition its financial consultants from a commission, or transactional, based structure, to a fee based, or account management, approach. (*Tr. 4598:11-4599:6*). However, after joining the firm, Guzzetti, along, with Brian Mayer, spent over a year locating a clearing firm with the appropriate platform to handle the firms new fee based structure. (*Tr. 4601:4-4604:9*).

Guzzetti also spent time recruiting and training MS & Co. brokers. (*Tr. 4606:11-4607:16*). Throughout most of 2006 and 2007, a significant portion of Guzzetti's time was spent developing an innovative investment program for baby-boomers nearing retirement, including both post-retirement career and investment planning called the My Way program. (*Tr. 4607:17-4612:6*).

At no point during his time with MS & Co. was Guzzetti ever responsible for the supervision of investments in private placements, including those involved in this matter. (*Tr. 3227:7-3229:3, 4606:6-10*). Guzzetti was not involved in the creation of what the Division refers to as the Four Funds or Trusts. (*Tr. 3227:7-3229:3*). Guzzetti was not responsible for presenting these investments to the Selling Respondents and had no role in selecting the investments in any of the 25 plus offerings involved in this matter. [1] (*Tr. 4632:21-4634:12*).

As it pertains to the Four Funds and Trusts, Guzzetti's only role was to act as a conduit, passing information about the offerings from the firm's owners and supervisors David Smith and Timothy McGinn to the brokers at the firm. (*Tr. 3227:4-3229:3, 4606:6-10, 4630:16-4631:16, 4632:21-4634:12*). In addition, Guzzetti would also pass on any inquiries he received from the brokers about the Four Funds and Trusts to Smith or McGinn, depending on the investment at issue. (*Id.*) Guzzetti was not responsible for reviewing or approving customer investments or the subscription agreements in the offerings at issue. (*Tr. 3227:7-3229:3*).

Although Guzzetti became the office manager of MS & Co.'s Clifton Park, New York office in October of 2008, supervision of sales in the private placements at issue remained the responsibility of either David Smith or Timothy McGinn, depending on the offering involved. (*Tr. 3225:7-10, 3227:7-3229:3*).

At the hearing, the Division alleged that Guzzetti was aware of a number of "red flags" and failed to "put in place procedures that would have detected and prevented [] unlawful conduct" allegedly committed by the Selling Respondents. Division of Enforcement's Prehearing Memorandum ("DOE Opening Statement"), at 24.[2] However, the implementation of such procedures was well beyond the duties, responsibilities, and authority of Guzzetti while he was employed by MS & Co. Furthermore, there is no applicable securities rule or regulation requiring an individual in Guzzetti's position to implement such a procedure. (*Tr. 3223:16-3229:3*). To the

[1] Selling Respondents include Donald J. Anthony, Frank H. Chiappone, Richard D. Feldmann, William P. Gamello, William F. Lex, Thomas E. Livingston, Brian T. Mayer, Philip S. Rabinovich and Ryan C. Rogers; not Guzzetti. Division of Enforcement's Prehearing Memorandum ("DOE Opening Statement"), at 2; Division of Enforcement's Post-Hearing Brief, at 1.

[2] Pursuant to the ALJ's ruling, each party was to submit a Prehearing Brief or Memoranda as that parties opening statement in this matter.

extent that the ALJ relied on such an accusation as a basis for finding that Guzzetti was a supervisor of the transactions at issue, such reliance was made in error and the Decision should be reversed.

Prior to the institution of these proceedings, Guzzetti had no disciplinary or regulatory history and continues to maintain a stellar reputation in the securities industry. (*Tr. 4594:19-4595:2*); (*See also, Division Exhibit ("Div. Ex.") 481; Tr. 4587:3-19; Tr. 4588:18-4590:2*).

For the reasons that follow, the evidence accepted by the Court during the hearing in this matter shows that throughout his time with MS & Co. Guzzetti was not responsible for supervising sales of the private placements at issue in this matter. As a result, the Court's decision in this matter should be reversed and all charges against Guzzetti should be dismissed.

ARGUMENT

I. RESPONDENTS' JOINT BRIEF.

As addressed in the Respondents' Joint Brief, Guzzetti objects to the Commission's *sua sponte* decision requiring the Respondents to file a Joint Brief together, as well as the arbitrary limitation on the parties' Individual Briefs to less than what is provided under the Commission's Rules of Practice.

Although addressed in the Joint Brief, there are a few issues which should be discussed briefly herein as well. Guzzetti and the other Respondents were denied their Constitutional rights to have this matter heard by a jury and presided over by an independent Article III judge, as well as denied equal protection under the law and their due process rights. The Respondents were discriminated against throughout this process and were forced to present their case to an ALJ who, as will be discussed below, had decided this case before the first day of the hearing.

Furthermore, the evidence presented by the Division and relied on by the ALJ was beyond the scope of the applicable statute of limitations and this matter should not have been entertained.

Most egregiously, the ALJ applied incorrect legal standards to the Division's alleged fraud claim and inappropriately expanded the holding of *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969), and other cases cited in the Decision. Finally, the ALJ misconstrued and misunderstood a number of alleged "red flags" in formulating her decision.

For the reasons stated in the Respondent's Joint Brief, as well as those stated below, Guzzetti respectfully requests that the ALJ's Decision be reversed and the charges against him be dismissed in their entirety.

II. THE DIVISION DID NOT MAKE A REQUEST FOR EQUITABLE RELIEF AGAINST GUZZETTI AND THEREFORE, THE ALJ ERRED WHEN SHE SUSPENDED MR. GUZZETTI FROM THE INDUSTRY FOR A YEAR.

The ALJ overlooked, or ignored, the fact that the Division did not request a suspension or bar for Guzzetti in the Order Instituting Proceedings ("OIP") or its opening statement (its prehearing brief). The Division's only request for relief in the OIP and opening statement was a civil penalty and not a suspension. The Second Circuit Court of Appeals has held that "the binding effect of an opening statement within the four corners of a single trial, are . . . well established." (*United States v. McKeon,* 738 F.2d 26 (2d Cir. 1984)). As a result, the ALJ erred in suspending Guzzetti.

The ALJ failed to recognize a key distinction regarding this issue. In her decision, the ALJ confines her discussion to the Division's prehearing brief (its opening statement). However, the objection was that the Division did not seek equitable relief in either the OIP or its opening statement; i.e. a suspension of Guzzetti was never requested. As a result, it was an error for the ALJ to suspend Mr. Guzzetti. Therefore the ALJ's decision to do so should be reversed and all charges against Guzzetti should be dismissed.

III. GUZZETTI DID NOT RECEIVE A FAIR HEARING.

As is thoroughly discussed in the Respondents Joint Brief, a number of the actions of the ALJ, the Division, and the Commission have acted to deprive Respondents of their constitutional rights and the ability to have a fair trial. In addition to the reference in the Joint Brief to the ALJ's refusal to "second guess" the conclusions of the Commission in the OIP, there is additional evidence that the ALJ had accepted the Commission's version of the case prior to the start of the hearing.

On the very first day of the hearing, while discussing an Exhibit offered by the Division, the ALJ asked the Division's witness if she handled Guzzetti differently when preparing Div. Ex. 4 because Guzzetti "was a supervisor." (*Tr. 315:11-13*). Before the hearing had even begun the ALJ had already decided that Guzzetti was in fact a supervisor. As a result, the next three weeks of hearing were not about the Division meeting its burden of showing that Guzzetti was responsible for supervising the transactions at issue, but rather whether Guzzetti could convince the ALJ that her belief that Guzzetti "was a supervisor" was incorrect. This is completely inappropriate.

In addition to the Constitutional violations referenced in the Joint brief and the denial of the Respondents due process rights, the ALJ herself had already determined before the start of the hearing that Guzzetti was a supervisor. As a result, Guzzetti was denied a fair hearing and the ALJ's decision should be reversed and all charges against Guzzetti should be dismissed.

IV. THERE CAN BE NO SUPERVISORY VIOLATION IF THE SELLING RESPONDENTS DID NOT COMMIT AN UNDERLYING VIOLATION.

In the OIP the Division alleges that Guzzetti failed to adequately supervise the activities of the 9 Selling Respondents, located in multiple offices in three states. To successfully make a claim under Section 15(b)(6)(A)(i) of the Securities Exchange Act of 1934 ("Exchange Act"), incorporating by reference Section 15(b)(4)(E), the Division had the burden of "showing that under all of the circumstances, [Guzzetti] failed to exercise reasonable supervision." (*In the Matter of Arthur James Huff*, 1991 SEC LEXIS 551, 5-6, 50 S.E.C. 524, 526 (S.E.C. 1991)). Section 14(b)(4)(E) also "provides that no person shall be deemed to 'have failed to reasonably supervise any other person' if that person 'reasonably discharged the duties and obligations incumbent upon him by reason of [his firm's] procedures." (*Id.*)

Therefore, according to the language of the statutes at issue in this matter, Guzzetti cannot be found to have failed in his duty to supervise without 1) a violation by an individual subject to Guzzetti's supervision *and* 2) the firm's procedures vesting him with the duty to supervise such activity.

For the reasons described in the Respondents Joint Brief, as well as the Selling Respondents' individual briefs, the Selling Respondents did not commit any violation upon which a supervision violation against Guzzetti can be found. Furthermore, as will be discussed in more depth below, MS & Co.'s written procedures did not vest Guzzetti with the responsibility for supervising the sales at issue in this case.

Therefore, the ALJ's decision finding Guzzetti guilty of supervisory violations should be reversed and all charges against Guzzetti should be dismissed.

V. MR. GUZZETTI WAS NOT RESPONSIBLE FOR SUPERVISING THE TRANSACTIONS AT ISSUE.

A. Legal Standard.

As noted in the ALJ's decision, no person is deemed to have failed to reasonably supervise any other person if:

(i) There have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by any such person; and

(ii) Such person has reasonably discharged his duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe such procedures and system were not being complied with.

(15 U.S.C. § 78o(b)(4)(E)).

In order to prove that Guzzetti was a supervisor of the transactions at issue the Division would have needed to show that either 1) there was no system of procedures which would reasonably be expected to detect or prevent violations of the securities laws in place at MS & Co., or 2) that although there was a system, Guzzetti failed to discharge his duties and obligations pursuant to such procedures or system without a reasonable basis for believing the procedures and system were being complied with.

As will be discussed in greater depth below, the evidence admitted and testimony given at the hearing established that there was a system of procedures which were reasonably designed to detect violations of the securities laws in place at MS & Co. In addition, the evidence and testimony also establishes that Guzzetti discharged all of his duties under those procedures and had no reasonable cause to believe that the procedures were not being complied with in relation to the transactions at issue.

Simply put, the Division failed to meet its burden. The Division presented no evidence that Guzzetti was tasked with the responsibility of supervising the transactions at issue. In fact, evidence showing the exact opposite was offered and admitted into evidence in the form of the 2007 and 2008 Supervisory Compliance Manuals.

B. The ALJ Ignored The Testimony Of Multiple Witnesses Regarding The Supervisory Responsibilities Of Guzzetti.

The ALJ overlooked, discounted, or ignored the testimony of Guzzetti, Lex, Gamello, and Mayer that David L. Smith was responsible for supervising the transactions at issue. (*Tr. 1620:24-1621:4 (Lex; testified that Guzzetti was not his supervisor); Tr. 1736:24-1738:16 (Gamello;*

identified Guzzetti as one of many supervisors but that he did not know his exact role); Tr. 3247: 21-3248: 19; 3255:22-3256:12 (Mayer; identifies himself as having certain supervisory responsibilities, identifies David Smith as supervisor for the private placements at issue in this case, and states that he did not report to Guzzetti); Tr. 4629:5-11 (Guzzetti; identified Mr. Smith as supervisor of the transactions at issue); Tr. 3675:8-11 (Rodgers; testified that he reported to Brian Mayer). In fact, no witness identified Guzzetti alone as their supervisor. The testimony of the Respondents was merely that Guzzetti was *A* supervisor, not ***THE*** supervisor when it came to the offerings at issue; a rather large distinction.

Furthermore, the ALJ ignored the uncontroverted testimony of Guzzetti's expert witness Kevin Carreno. Mr. Carreno is currently a FINRA Board of Governors Member and testified that the responsibilities of Mr. Guzzetti are those belonging to a sales manager. (*Ex. AG-71, at 5; Tr. 4808:19-4809:7*). The Division did not challenge the finding of Mr. Carreno's expert report that "[a] sales manager is not a supervisory role in the ordinary use and custom of the retail brokerage industry." (*Ex. AG-71, at 5*). Mr. Carreno's report further states that a sales manager's main role and function is to "disseminate information about the markets, particular stocks that are being followed by the firm, and firm products that are available for the sales force." (*Id.*) This is exactly what Guzzetti did through his emails, which are referenced throughout the Decision.

In October of 2008, Mr. Guzzetti became the branch office manager for the Clifton Park, New York Office. (*Tr. 4626:24-4627:4*). When asked if he was approving sales in the private placements at issue after becoming the branch office manager at Clifton Park, Mr. Guzzetti testified "[n]o. Actually no one did other than David Smith." (*Tr. 4629:5-11*). Mr. Guzzetti also testified that sales of the private placements at issue in the New York office and those made by outside RRs, such as Mr. Lex, were approved by Mr. Smith as well. (*Tr. 4629:12-21*).

Mr. Guzzetti also testified that his morning emails were sent in his role as a sales manager, which was supported by the testimony of Mr. Carreno referenced above. (*Tr. 4630:16-4631:16*). Mr. Smith and others would ask Mr. Guzzetti to pass on information to the brokers, or vice versa. (*Tr. 4631:4-4631:16*). When asked about his involvement in the Four Funds, Mr. Guzzetti testified that he would attend the sales meetings introducing the Four Funds to the brokers, and if the brokers had any questions he "would relay it up to Dave Smith or ask Dave to get on one of our calls . . . because Dave ran the funds." (*Tr. 4632:21-4633:18*). His involvement was the same as to the Trusts, with the exception that questions related to the trust would be directed at Tim McGinn, as he managed the Trusts. (*Tr. 4633:11-18*).

The duties and responsibilities described above represent the limit of Mr. Guzzetti's role at the firm; that of a sales manager. This is also supported by the compliance manuals that were in place at the time of his employment. Mr. Guzzetti was never responsible for supervising the transactions at issue and the ALJ's decision should be reversed and all charges against Guzzetti should be dismissed.

C. The Supervisory Compliance Manuals Prove That Guzzetti Was Not The Supervisor For The Transactions at Issue.

The expert witness for both the Division and Guzzetti stated that the first place to start when conducting analysis of a firm supervision is the supervisory or compliance manuals. (*Tr. 1154:14-18, 1154:24-1155:4, 4832:13-20*).

Pursuant to the language of the 2007 MS & Co. Supervisory Compliance Manual ("2007 SCM") "[a]ll brokers in the NYC office [were] under Brian Mayer's direct supervision," and Brian Mayer was "under David L. Smith's supervision." (*Ex. AG-2, at 46*). At the same time, "[a]ll brokers in the Clifton Park office [were] under Carl Nicolosi's direct supervision," who was also under David L. Smith's direct supervision. (*Id.*) The 2007 SCM also states that "[a]ll Non-NYC brokers are under David L. Smith's direct supervision." (*Id.*)

In an effort to avoid the clear language of the SCM described above, the Division focused on a section of the 2007 SCM entitled "Supervision of Off-Site Personnel" which states that "Andy Guzzetti, as Managing Director – Private Client Group, is directly responsible for all outside RR's." (*Id.* at 37). However, the very same document also clearly states that "[a]ll Non-NYC brokers are under David L. Smith's direct supervision," which would include all off-site personnel, creating a rather large discrepancy which was left unaddressed by the ALJ's Decision. (*Id.* at 46).

The only specific responsibility delegated to Mr. Guzzetti in this section, that isn't directly contradicted by another portion of the SCM, was "for communications and distribution of sales material to all outside RRs." (*Id. at 37*). Although this section includes language regarding securities transactions made by outside RRs, it does not delegate that duty to Mr. Guzzetti, and establishes that he is a sales manager, not a supervisor. (*Id.*)

Furthermore, this section states that "[i]t is up to the compliance officer to ensure that these RRs are current in their out-of-state registration and that they are kept current with changes in supervisory regulations," and that "it is the responsibility of the compliance office to ensure [a] high level of professionalism." (*Id. at 37*).

In addition, throughout the 2007 SCM there is only one person referred to as a compliance officer; David L. Smith. (*Id. at 3, 4, 12, 25, 28, 30, 39, 45, 55*). If Mr. Guzzetti was responsible for all of the duties described in this section, the SCM would not use the phrase compliance officer throughout, and then mention Guzzetti by name in the final sentence. The clear language of the manual indicates that the duties not specifically enumerated for Guzzetti in this section belong to the compliance officer, David L. Smith.

The evidence establishes that Guzzetti did not become a supervisor in any capacity until October 2008. The limited "proof" of any supervisory responsibilities referenced in the ALJ's decision was prior to October 2008 and occurred more than 5 years prior to the filing of the OIP, and are therefore barred by 28 USC § 2642. (*Tr. 4626:24-4627:4*).

Neither the Division during its case in chief, nor the ALJ in her decision, made any attempt to address this rather large discrepancy in the SCM. Instead, the ALJ and the Division merely cherry picked those portions of the SCM that supported the Commission's position in the OIP.

There was no evidence submitted that Guzzetti was responsible for reviewing or supervising any of the transactions at issue and it was error for the ALJ to suspend him for a year for supervisory failures.

In addition to the failures related to the 2007 SCM cited above, the ALJ also ignored an extremely important section of both the 2007 and 2008 manuals entitled "PRIVATE PLACEMENTS/LIMITED PARTNERSHIPS." (*Ex. AG-2, at 42; Div. Ex. 329 at 44*). There can be no argument that the transactions at issue in this case would be considered a private placement and this of the manual relates directly to the transactions at issue and the supervision of same.

This section of the 2007 and 2008 SCMs described the due diligence requirements and subscription procedures when selling a private placement at MS & Co. (*Id.*) Included in this section is a discussion of the approval process for the sale of private placements. Glaringly, Guzzetti's name does not appear at all in this section which states that "[e]ach subscriber must be reviewed and accepted by a principal of the firm, with acceptance indicated by a principal signature on each Subscription Agreement." (*Id.*) As a result, there was no evidence presented at the hearings that Guzzetti had any supervisory function in relation to the offerings at issue.

The ALJ simply ignored this section of the compliance manuals, as well as the discrepancies contained throughout the SCMs regarding supervision, and found Guzzetti to be a supervisor of the Selling Respondents for the transactions at issue. This comes as no surprise. As will be discussed below, the ALJ referred to Guzzetti as a supervisor on the very first day of the hearing. (*Tr. 315:11-13*). Therefore, it appears that the ALJ only focused on those portions of the compliance manuals that fit with her prejudgment of Guzzetti, as opposed to those sections of the SCMs which directly related to the transactions at issue and makes no reference to Guzzetti at all.

D. There Is No Evidence That The Branch Office Procedure Manual Referenced In The ALJ's Decision Was Ever In Effect.

Not wanting to address the clear discrepancies in the 2007 and 2008 SCM's referenced above, or the section that clearly evidences that Guzzetti was not responsible for supervising the transactions at issue, both the Division and the ALJ's decision instead turn their focus to the MS & Co. Branch Office Procedure Manual. (*Decision at 24*). There are a number of issues with the ALJ's reliance on this document.

First, the ALJ references the document as a part of the 2008 SCM. (*Decision at 24*). However, the branch office procedure manual is undated and there was no evidence or testimony at trial that this document was a part of the 2008 SCM. Second, although accepted into evidence at the start of the hearing, this undated document was never authenticated and never identified. (*Div. Ex. 328*). The record is devoid of any evidence as to what this document was, when it was created, if it was ever used, and if it was used, when it was used. This document could have been in effect in the years before Mr. Guzzetti arrived at the firm, while he was at the firm, or in 2010 after Mr. Guzzetti left the firm. Any reliance on this document by the Division should be disregarded entirely as the Court has no information as to when it was in existence, or if it was ever in effect.

Finally, Guzzetti did not become a branch office manager until 2008, and when questioned about Div. Ex. 328, Guzzetti testified that he did not remember ever seeing this document. (*Tr. 3005:17-20*). The Division did not offer any documents or witnesses to contradict Guzzetti's testimony regarding this document or establish that such a document was ever in effect.

Considering that this document was not authenticated, there is no record of when same was in effect, and the uncontroverted testimony of Guzzetti was that he has no recollection of seeing such a document, any reliance by the ALJ on this document in finding a supervisory violation by Guzzetti was made in error. Therefore, the ALJ's decision should be reversed and all charges dismissed.

E. The Cases Cited In The ALJ's Decision Are Distinguishable From The Matter At Hand.

The cases upon which the ALJ relied to find that Guzzetti had supervisory responsibility in relation to the transactions at issue are inapposite and distinguishable from the facts of this case. In the *Matter of Gutfreund*, Respondent Fuerstein was found to have failed in his duty to supervise certain brokers at Salomon Brothers, Inc. (*In the Matter of Gutfreund, et al.*, No. 3-7930, 1992 SEC LEXIS 2939, 51 S.E.C. 93, 113 (Dec. 3, 1992)). As is the case with Guzzetti, Respondent Fuerstein did not have direct supervisory responsibility for the misconduct at issue. However, under the facts of that case, which the Division has not proven are present here, Respondent Fuerstein was found to have gained supervisory responsibility for the misconduct at issue once he became "involved in formulating management's response to the problem." (*Id., at 48-49*).

Respondent Fuerstein's involvement in formulating a response for the firm vested him with the responsibility to insure that the misconduct he was tasked with responding to was addressed and corrected. The uncontroverted evidence shows that Guzzetti was not even aware of the nefarious actions of Messrs. McGinn and Smith until after he had left MS & Co. (*Tr. 4634:20-23*).

Furthermore, there was no evidence presented that showed Guzzetti was given responsibility by the firm to look into the funds, review the investments of the Four Funds and Trusts, investigate Messrs. Smith or McGinn, nor was he ever told that the two gentlemen, who were running the firm, along with a handful of others, were participating in such a fraudulent scheme. As a result, *Gutfruend* is easily distinguished from the matter at hand.

In the Matter of Bloomfield, Respondent Gorgia failed to supervise other Respondents in the matter because he was their direct supervisor and was involved in formulating the firm's response to concerns expressed by the firm's clearing firm, Pershing. (*In the Matter of Bloomfield, et. al.*, No. 3-3871, 2011 WL 1591553 (Apr. 26, 2011), *aff'd*,2014 WL 768828 (S.E.C. Feb. 27, 2014)). Therefore, he had an affirmative obligation to follow up on those concerns, and Respondent Gorgia failed to undertake the required follow up. (*In the Matter of Bloomfield, et. al.*, 2014 WL 768828 (S.E.C. Feb. 27, 2014)). In addition, unlike the matter at hand, Mr. Gorgia was expressly given responsibility to supervise the specific misconduct at issue in the firm's Written Supervisory Procedures, whereas Guzzetti was not. (*Id.*)

In *Kolar,* Respondent Kolar was found to have violated his supervisory responsibilities because his supervisor, O'Neil, "entrusted Kolar with the specific responsibility of investigating the serious allegations that had been made against [the broker]." (*In the Matter of Kolar,* No. 3-9570, 2002 SEC LEXIS 3420, 17, 55 S.E.C. 1009, 1018 (S.E.C. June 26, 2002)). O'Neil testified that he "relied on and trusted Kolar's judgment with respect to that investigation." (*Id.*) Therefore, on appeal the Commission found that "in that instance, Kolar was specifically vested with supervisory authority." (*Id.*) At no point during the hearing in this matter did the Division present any evidence showing that Guzzetti received explicit instructions to investigate the alleged red flags identified by the Division, or the private placements at issue, as was the case in *Kolar.*

Each of these cases are inapposite to the matter at hand. Guzzetti was not given supervisory responsibility for the investments at issue. The 2007 and 2008 SCMs admitted as evidence during the hearing do not identify Guzzetti as the individual responsible for approving investments in the private placements at issue in this matter. Furthermore, the Division did not present any evidence that Guzzetti was assigned or assumed the responsibility of supervising sales of the private placements.

F. The ALJ's Decision, and the Division of Enforcement, Cite to Numerous "Facts" That Have No Relation to Supervision.

The ALJ's decision cites to a number of alleged "facts" that have no relation to whether Guzzetti had the responsibility, ability or authority to affect the conduct of the employees whose behavior is at issue. For example, the fact that Mr. Guzzetti and Mr. Mayer were involved in the process of finding a new clearing firm, is completely unrelated to the Division's supervisory allegations; as are MS & Co.'s implementation of the "Guzzetti ranking system," the fact that he recruited brokers, assigned customers to brokers, and consulted with managers regarding broker evaluations. (*Decision at 110*).

None of these acts are those of a Series 24 registered supervisor, none require registration as a supervisor, and none point to whether Guzzetti had the responsibility, ability or authority to affect the conduct of the employees whose behavior is at issue. During its recitation of proposed facts, the Division fails to mention that Guzzetti could not hire a broker without the approval of someone else at the firm. (*Tr. 4624:5-22*). More importantly, the Decision fails to mention that Mr. Guzzetti did not have the ability to fire brokers on his own, which would be the strongest evidence of an individual's ability or authority to affect the conduct of the Selling Respondents. (*Tr. 4625:2-5*).

In addition, the fact that Mr. Guzzetti "had the training and background for a supervisory position" does not mean that he was actually given the supervisory responsibilities alleged by the Division; or that he exercised such authority. Nor does his experience training financial consultants during the years prior to his joining of MS & Co., or the fact that he is working as a supervisor at another brokerage firm today. (*DOE Post-Hearing Brief, at 33*).

As such, this laundry list of facts discussed in the Decision have no bearing on whether Guzzetti supervised the transactions outlined in the OIP, during the post October 2008 time period, and discussed at the hearing in this matter.

G. There Was No Redemption Policy.

The Division premised almost its entire case against Guzzetti upon allegations that he was instrumental in enforcing MS & Co.'s redemption policy. However, as the ALJ held in her decision, there was no redemption policy at MS & Co. (*Decision at 93*). What the Division refers to as a redemption policy is actually a single email in December 2006 *(Div. Ex. 17)*, followed by a series of emails nearly a year later, sent during an extraordinary economic crisis. The Division alleges that the fraud perpetrated by Messrs. McGinn and Smith had "nearly 900 investors." *(DOE Post-Hearing Brief, at 1)*. However, Division Exhibit 17 relates to a single redemption request, made by a single client, in only one of the 20 plus investments at issue in this matter. (*See, Div. Ex. 17*). A single email is hardly evidence of a firm wide policy.

In all the millions of pages of documents exchanged between the parties in this matter there is not a piece of evidence related to the alleged redemption policy in 2003, 2004, or 2005; and only Division Exhibit 17 in all of 2006. The Division did not produce any other evidence of redemption issues in 2006, because every other redemption request in 2006 was paid in full without the requirement that a replacement be found prior to, or following, the request.

All the remaining evidence of the alleged redemption policy presented in this matter is a series of emails sent during the final few months of 2007. Not surprisingly, the issues with redemptions experienced by MS & Co. coincided with a significant economic downturn. (*Ex. AG-71 at 5*). The Division moved Division Exhibit 278, and others, in as evidence to support its argument that a redemption policy was in place.

When the Division questioned Kevin Carreno, Mr. Guzzetti's expert and a member of the FINRA Board of Governors, as to whether Division Exhibit 278 should have caused Mr. Guzzetti to question Mr. Smith regarding his request that all redemptions be replaced, he testified that "in 2007, there were a number of managers from public mutual funds to private equity fund managers that were experiencing significant liquidity problems." (*Tr. 4813:8-4814:3*). Mr. Carreno continued, "[s]o looking at [Div. Ex. 278] and the context at the time, again, I wouldn't expect Mr. Guzzetti or any supervisor to necessarily respond in the manner you suggested." (*Tr. 4813:8-4814:3*).

In addition, the possibility of the Four Funds not being able to make payments as a result of adverse market performance was disclosed to investors in the private placement memoranda (PPM) for each of the funds prior to their investment. Each PPM contains a section describing the risks factors related to that particular fund which contains the subheading "**We May Be Harmed By Adverse Economic Conditions.**" (*Div. Ex. 5, 6, 9B, and 12 at 8* (emphasis in original; section appears on page 8 of each of the Four Funds private placement memoranda)).

> A prolonged downturn in the economy could have a material adverse impact upon us, our results of operations and our ability to implement our business strategy. Similarly, adverse economic conditions or other factors might adversely affect the performance of our Investments, including the level of delinquencies, which could materially and adversely affect our results of operation, financial condition and cash flows and our ability to perform our obligations under the notes. These economic conditions could result in severe reductions in our revenues or the cash flows available to us and adversely affect our ability to make payments on the notes.

(*Div. Ex. 5, 6, 9B, 12 at 8*)

As everyone later discovered, Messrs. McGinn and Smith perpetrated an enormous fraud. However, considering the market condition at the time that Division Exhibit 278, and all but one of the emails related to the alleged redemption policy were sent to and from Mr. Guzzetti, these emails would not cause a supervisor conduct an additional inquiry. (*Tr. 4813:8-4814:3*).

As a result, all of the evidence against Guzzetti that was presented by the Division has no bearing on whether he was actually a supervisor as the ALJ found that there was no redemption policy at MS & Co.

H. Guzzetti's Morning Emails Are Not Evidence Of Supervisory Responsibilities.

The ALJ's Decision seems to place a lot of weight on the morning note emails that were sent by Guzzetti while he was employed by MS & Co. As Guzzetti testified, his morning emails were originally started so he could get information to the sales force as a whole. (*Tr. 4619:4-14*). A majority of the time, the purpose of the emails was "to motivate people to get on the phones . . . to get in front of the client." (*Tr. 4619:4-4620:6*).

Guzzetti also testified that the information in the bottom portions of the email, which contained the deal availability for products offered by the firm, came "from Patty Sicluna or, I guess, David Smith . . . or Tim McGinn." (*Tr. 4621:7-14*). If Sicluna, Smith or McGinn did not send this information to Mr. Guzzetti, it did not go in the deal availability portion of his emails as he "had no way of knowing" what was available in each offering. (*Tr. 4621:15-19*). As a perfect example of this, Guzzetti testified that there were occasions where deals that were no longer available ended up in his morning emails as a result of the fact that he was copying and pasting the previous day's emails. (*Tr. 4621:20-25*).

Guzzetti's morning note emails were not an attempt to push MS & Co. proprietary products, but rather contained quantities of investments the firm had available. (*Tr. 4622:10-23*). Furthermore, any reference the morning note emails to the amount that clients had currently invested in money markets was also not an attempt to push or solicit brokers. When asked about Division Exhibit 83, an email where Guzzetti references that clients had $24 million in money market accounts, Guzzetti testified that the purpose of that email was "to get the folks on a call to start a conversation." (*Tr. 3025:3-3026:3*). Guzzetti was telling the brokers "if you have an accredited investor in [a money market account], that does not have to keep the money liquid" the FAIN investment may appear to be an attractive choice. (*Tr. 3029:15-24*). Guzzetti was certainly not telling brokers to make unsuitable recommendations to their clients and his morning note emails certainly do not provide proof that Mr. Guzzetti was responsible for supervising the transactions at issue in this matter.

Therefore, to the extent the Decision relies on the morning note emails to find that Guzzetti was responsible for supervising the transactions at issue same should be reversed and the charges against Guzzetti should be dismissed in their entirety.

VI. THERE WAS INSUFFICIENT EVIDENCE ADMITTED DURING THE HEARING TO SUPPORT SUSPENDING GUZZETTI.

Considering the testimony of the witnesses, and the documents admitted into the record, there was insufficient evidence to suspend Guzzetti for one year. The ALJ suspended Guzzetti despite the lack of evidence of any supervisory failure by Guzzetti which occurred during the applicable time frame, i.e., after September 23, 2008. Although the Decision does reference a handful of emails that were sent by Guzzetti after September 23, 2008, each of these relate to the Division's alleged redemption policy, which the ALJ found did not exist. (*Decision at 93*).

Although the ALJ addressed numerous sales manager emails, correspondence, and events which occurred prior to September 23, 2008, there were no findings of a supervisory failure after September 23, 2008, and no basis for the suspension of Mr. Guzzetti. After September 2008 Guzzetti only supervised the activities of four of the Selling Respondents, Anthony, Feldmann, Gamello and Chiappone. The Administrative Law Judge specifically found that Gamello did not violate any rule, law or statute.

The Division's evidence established that there were no sales of the Four Funds by these brokers after the disclosures by McGinn and Smith, and limited sales of the trust offerings. The number and nature of these transactions do not support a year suspension for Guzzetti, in particular when he was not the individual supervising or approving the sales. It was an error of law to find that Guzzetti violated Exchange Act Section 15(b)(6)(A)(i), in conjunction with Section 15(b)(4)(E), by failing to supervise those individuals for these transactions.

CONCLUSION

For the reasons stated herein Andrew G. Guzzetti respectfully requests that the Decision of the ALJ be reversed and all charges against him are dismissed in their entirety.

Dated: July 17, 2015

Respectfully submitted,

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July 17, 2015

VIA FACSIMILE & UPS OVERNIGHT
FAX NO. 202-772-9324

Office of the Secretary
U.S. Securities and Exchange Commission
100 F. Street, NE
Mail Stop 1090
Washington, D.C. 20549

Re: In the Matter of Donald J. Anthony, Jr., et al
Administrative Proceeding File No. 3-15514

Dear Sir/Madam:

Enclosed for filing in the above-captioned matter, please find an original and three (3) copies of the following documents, pertaining to Respondent Frank Chiappone's Petition for Review by the Commission of the Initial Decision of Hon. Brenda Murray:

1. Respondent Chiappone's individual Brief;
2. Certificate of Service upon all parties, including the Division of Enforcement;
3. Attorney Certification of compliance with page requirements;
4. Attorney Affidavit supporting a motion for leave to adduce additional evidence;
5. Additional evidence in the form of an Affidavit by Frank Chiappone concerning certain matters relevant to Mr. Chiappone's argument that the 12-month suspension granted by Judge Murray in the Initial Decision is inappropriate;
6. Financial Disclosure Statement by Frank Chiappone, filed pursuant SEC Rules of Practice Rule 410(c) and Rule 630. Attached to the Financial Disclosure form are the required schedule containing detailed information as to Mr. Chiappone's financial accounts and tax returns.

If there are any deficiencies with respect to the above-stated enclosures, please contact me immediately at (518) 463-3990 ext. 309, and I will address any such matters immediately.

Very truly yours,

TUCZINSKI, CAVALIER & GILCHRIST, P.C.

By: ______________________
Roland M. Cavalier

RMC:mkm
Encs.
cc: David Stoelting, Esq. (via UPS overnight and email)
Richard D. Feldman (via regular mail and email)
Loren Schechter, Esq. (via regular mail and email)
Mark J. Astarita, Esq. (via regular mail and email)
Gilbert B. Abramson, Esq. (via regular mail and email)
Matthew G. Nielsen, Esq. (via regular mail and email)
M. William Munno, Esq. (via regular mail and email)

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

Administrative Proceeding File No. 3-15514

In the Matter of

DONALD J. ANTHONY, JR.,
FRANK H. CHIAPPONE,
RICHARD D. FELDMANN,
WILLIAM P. GAMELLO,
ANDREW G. GUZZETTI,
WILLIAM F. LEX,
THOMAS E. LIVINGSTON,
BRIAN T. MAYER,
PHILIP S. RABINOVICH, and
RYAN C. ROGERS,

Respondents.

RESPONDENT FRANK H. CHIAPPONE'S
INDIVIDUAL BRIEF TO THE COMMISSION

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PRELIMINARY STATEMENT

The Enforcement Division ("Division") initiated proceedings against ten registered representatives in connection with long term fraudulent conduct perpetrated by David Smith ("Smith") and Timothy McGinn ("McGinn") which, together with the market collapse of 2007-08 caused extensive investor losses. Smith and McGinn misused investors' funds to rescue failed offerings with monies from other offerings, took outrageous (sometimes undisclosed) fees, and used investor money to support lavish lifestyles. McGinn and Smith were permanently barred by FINRA and subsequently convicted on criminal charges. The lies and deceptions of McGinn and Smith continued undiscovered for more than a decade. The ALJ's ruling that the Respondent brokers violated securities laws is essentially based on her theory that they should have uncovered the fraud that McGinn and Smith had concealed so well for so long.

Chiappone's Background. Chiappone has worked in the securities industry for 34 years, holding series 7, 24, 63 & 66 licenses, is a certified retirement counselor and holds insurance licenses for life, accident and health.[1] Prior to this case, his record was spotless, having never been disciplined by the SEC, NASD or FINRA, never named in a customer lawsuit or arbitration, and never been the subject of a written complaint.[2]

Chiappone joined McGinn, Smith & Co. ("MS&Co.") in 1988, resigning in December, 2009.[3] Chiappone never sold private placements until he arrived at MS&Co.[4] He was never an owner, director or officer of MS&Co. or its affiliates,[5] including issuer companies.

Over time, MS&Co. successfully portrayed to investors, employees, and regulators that it was a substantial, successful brokerage house, with a history of private placements involving

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[1] Chiappone testimony, Transcript (hereinafter "Tr.") pp. 5399 – 5400.
[2] See, Chiappone Broker Check Report, Ex. FC-16, and Chiappone Testimony, Tr., pp. 5400 - 02.
[3] Chiappone testimony, Tr. pp. 5402 – 5403.
[4] Chiappone testimony, Tr. p.5412 – 5413.
[5] Chiappone testimony, Tr., pp. 5405 – 5412 (as to sales manager duties; pp.5411 (not a director or officer).

burglar alarm revenues. The perceived success of those offerings engendered in Chiappone a trust and confidence in McGinn and Smith, that only later was discovered to be misplaced.[6] Chiappone sold offerings referenced in the OIP because he believed that the track record of pre-OIP offerings established MS&Co's ability to locate and structure profitable deals involving recurring monthly revenues.[7] Of 64 pre-OIP offerings Chiappone sold, 61 offerings paid all interest and returned all principal to investors.[8]

Organizational Structure of MS&Co.; Due Diligence Team. MS&Co. was managed by Smith and McGinn. It employed two compliance officers, a CFO, [9] in-house counsel, outside counsel, an accounting staff, back office personnel and, most importantly, a well-qualified due diligence team. MS&Co. was not a boiler room or fly-by-night operation.

The due diligence team was assembled during the pre-2003 alarm offerings. Attorney Mary Ann Cody headed the team. She testified in detail on the due diligence team's work.[10] Several team members were recruited from the leasing division of KeyCorp., a super-regional bank. They were experienced in due diligence procedures and recurring monthly revenues, a hallmark of the Trust Offerings.[11] They visited alarm companies, reviewed operations, read alarm contracts, and phoned alarm customers to verify contract revenues.[12] Written records of diligence investigations were stored at MS&Co. headquarters.[13] In short, MS&Co. ran a first-class operation in terms of vetting prospective investment products.

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[6] Chiappone testimony, Tr. pp. 5413 – 5414).
[7] Chiappone testimony, Tr., pp.5412 – 13 as to products sold; pp. 5466 – 67 as to success of early alarm deals.
[8] Chiappone testimony, Tr. pp. 5466 – 5467 (testimony that only 3 or 4 of the 64 pre-2003 offerings did not pay investors in full).
[9] Chiappone testimony, Tr. pp. 5416 – 5417.
[10] Tr. pp. 4544 - 4549.
[11] Chiappone testimony, Tr. pp. 5419 – 5422; Cody testimony, Tr. pp. 4547 – 4548.
[12] Cody testimony, Tr. p. 4546.
[13] Cody testimony, Tr. pp. 4548.

Results of the diligence investigations were passed on to the brokers via in-person presentations by due diligence team members, who discussed the features, merits and risks of each offering,[14] including the business model, specific assets being purchased, pricing/discounts on assets purchased, risk factors, structure of the note tranches, interest rates and credit quality.[15] Brokers could and did ask questions, including Chiappone, who testified that when he asked questions he received satisfactory answers.[16]

When McGinn left MS & Co. in 2003 to form Integrated Alarm Service Group ("IASG"), some team members went with him,[17] but they returned to MS&Co. when McGinn returned in 2006.[18] That team performed due diligence on the Trust Offerings sold in late 2006 and thereafter, providing investigative services similar to that performed on the pre-2003 offerings.[19]

Chiappone's Practices; Suitability. The rules governing Chiappone's suitability obligations during times referenced in the OIP, were NYSE Rule 405 ("know your customer" rule - now known as customer-specific suitability), and NASD Rule 2310 on product suitability (now known as reasonable basis suitability).[20] Factors he considered in assessing suitability of a product for a given client included age, education, income, net worth, time horizon, risk tolerance, investment objectives, assets held outside of MS&Co., need for liquidity,[21] and risks of the proposed investment.

While nothing in his licensing exams or continuing education indicated a broker was personally responsible to perform due diligence on investment products, Chiappone understood his

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[14] Chiappone testimony, Tr. pp. 5422 – 5423; Cody testimony, Tr. pp. 4553 – 4555.
[15] Chiappone testimony, Tr. pp. 5423 – 5426; Cody testimony, Tr. pp. 4553 – 4555.
[16] Chiappone testimony, Tr. pp. 5426 – 5427; Cody testimony, Tr. pp. 4555.
[17] Cody Testimony, Tr. p. 4557.
[18] Chiappone testimony, Tr. pp. 5430 – 5431, 5447 – 5448 and 5568.
[19] Chiappone testimony, Tr. pp. 5431 – 5432.
[20] Chiappone testimony, Tr. pp. 5432 – 5433. The bifurcation of the suitability concept into "reasonable basis" and "customer-specific" appears to have been codified in FINRA Rule 2111, which was not in effect during the time period represented in the OIP.
[21] Chiappone testimony, Tr. pp. 5433 – 5435.

obligation to *understand* the features, merits and risks of each offering. But, he did not believe he needed to duplicate due diligence team's work. Respecting the division of labor within the MS&Co. structure, he reasonably relied on the work of the due diligence team to perform reasonable basis suitability. [22]

Chiappone did not offer private placements to all clients; only those for whom he deemed private placements were suitable.[23] Less than ***one in five*** (about 19%) of his customers was <u>ever</u> sold a private placement.[24] He never recommended that any customer purchase only private placements,[25] and customers generally had marketable securities in accounts with MS&Co. or other firms.[26] He <u>never</u> used discretionary authority to purchase a private placement.[27] He also sold stocks, bonds, mutual funds and insurance products to clients who purchased private placements.[28] Chiappone ensured that all of his customers were issued a PPM, and completed, signed and returned the investor questionnaire and subscription agreement, and that the information the customer provided supported his customer-specific determination.[29] Most importantly, the ALJ made no factual finding that he violated his duty to perform <u>customer-specific</u> suitability or to understand the nature of the products he recommended.

<u>**No Knowledge of Fraud.**</u> Not until after the SEC's investigation was completed, did Chiappone learn that many pre-2003 alarm offerings had been rescued with proceeds of IASG's IPO, and with new investor's money from the Four Funds offerings.[30] The record lacks any

[22] Chiappone testimony, Tr. 5435 – 5436.
[23] Chiappone testimony, Tr. 5436 – 5437 and 5453 – 5454. .
[24] Chiappone testimony, Tr. 5441 – 5443.
[25] Chiappone testimony, Tr. 5438.
[26] Mirochnik testimony, Tr. 3117.
[27] Chiappone testimony, Tr. 5454.
[28] Chiappone testimony, Tr. 5413. In a few cases, he sold only private placements to clients who owned marketable securities in accounts with other brokerage firms. See, testimony of Jerry Mirochnik, Tr., p. 3117.
[29] Chiappone testimony, Tr. 5452.
[30] Exhibit Div-002 (¶¶ 24-50, pages 8-16).

evidence that Chiappone was ever aware of any infirmity or irregularity in the finances of the pre-2003 alarm deals, until Ms. Palen testified at the hearings in this matter.[31]

Cause of Investor Losses. Unbeknownst to investors, employees, and regulators, Smith and McGinn systematically misused investor funds raised in the OIP-referenced offerings. That misapplication of investor funds was concealed by McGinn and Smith and was not reported by the company's chief financial officer, who surely knew about their actions. As admitted in a handwritten document authored by Smith, the fraudulent conduct dated back to at least late 1999 or early 2000.[32] This, coupled with the losses due to the liquidity crisis of 2007-08, was what caused investor losses. Neither Chiappone nor the other brokers were involved in the conduct that caused the losses. That is, losses were not due to false statements or omissions made in selling securities of dubious value; losses were caused by post-sale misuse of investor funds by Smith and McGinn, and to some extent to the collapse of liquidity caused by the market melt-down of 2007-08. Distilled to its essence, The ALJ ruled that Chiappone committed securities fraud because he failed to ferret out the improper, criminal acts of his superiors.

LEGAL ARGUMENT

INCORPORATION OF JOINT BRIEF ARGUMENTS.

Chiappone incorporates by reference all arguments made in the Respondents' Joint Brief, including the following:

(1) Objections to limitations on size of briefs to less than provided in SEC Rules.

(2) 28 U.S.C. §2462 bars all claims asserted in the OIP.

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[31] Testimony of Chiappone, Tr. 5466 – 5468.

[32] See the so-called "Dave Smith Confession," Exhibit Livingston-31 (Tr. 5619, mistakenly marked as Ex. Livingston-30 at Tr. 5613. A typed version is also in evidence as Ex. Livingston-32 (Tr. 5619). For testimony establishing the time frame of the undated document, see Chiappone testimony, Tr. 5613 – 5615.

(3) The ALJ ignored that, under Supreme Court precedent, Exchange Act §10(b) and Securities Act §17(a)(1) liability may be imposed only for intentional or reckless conduct, not present in this case.

(4) There is no general fiduciary duty on an individual stockbroker to a customer in a non-discretionary account.

(5) Disclosures contained in the Private Placement Memorandums (PPM's) do not constitute "red flags" – to the contrary, they comport with industry standard practice to disclose risk factors in writing.

(6) Disclosures in the PPM's are binding on investors, regardless of whether they read the PPM's, so long as the PPM's were provided to the investor.

(7) The information in the PPM's satisfy the provisions of Reg. D, Rule 502, relied on by the ALJ in imposing Securities Act §5 violations on Respondents.

(8) The ALJ erred in concluding that Respondents violated subsections 17(a)(2) & 17(a)(3) by reason of allegedly negligent conduct;

(9) The ALJ erred in concluding that Respondents violated Securities Act §5.

(10) Respondents were deprived of the equal protection and due process rights, and the proceeding was unconstitutional.

(11) The introduction of evidence of transactions (including Four Funds sales) that occurred more than five years prior to the filing of the OIP was prejudicial error, contaminating the entire proceedings.

CHIAPPONE'S INDIVIDUAL ARGUMENTS:

Point I. Industry Bar/Suspension and Cease & Desist Order Not Supported by Existing Case Law.

The ALJ ordered that Chiappone be suspended for twelve months,[33] disregarding numerous cases holding that the critical criteria in imposing a suspension, bar, or cease and desist order (injunctive relief) is whether there is a reasonable likelihood the proscribed conduct will continue.

The ALJ acknowledged that the *Steadman* factors[34] must be given consideration when considering an industry bar.[35] Nevertheless, she performed no factual analysis of *Steadman* as applied to Chiappone, premising her decision upon the ***sole factual finding*** that Chiappone currently works in the securities industry, stating: "[T]he Respondents currently work in the securities industry, so there appears to be a strong likelihood for recurrence" (Initial Decision, p.113, hereinafter"Decision"). The ALJ recites no facts supporting her conclusion that Chiappone is likely to continue to sell proprietary private placements. As precedent, The ALJ cites only an SEC release[36] in which the Commission barred an investment advisor whose conduct was considered "egregious" (market manipulation), who acted with *scienter*, engaged in repeated violations and whose assurances as to future violations were of doubtful sincerity.[37] None of those factors apply to Chiappone's actions. The ALJ cites no case holding that mere continued participation in the industry creates a likelihood of future violations. A search of cases involving suspensions/bars/injunctions turns up no case that imposes such a sanction **solely** founded on defendant's remaining employed in the securities industry. Most importantly, the ALJ ignores Chiappone's testimony that he has not sold *nor even offered* a single private placement since leaving MS&Co. in late 2009. At present, it

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[33] Decision, pp. 112-113, 117 (industry bar) & 114, 117 (cease & desist order).
[34] The *Steadman* factors are found in *Steadman v. SEC,* 603 F.2d 1126, 1140 (5th Cir. 1979).
[35] See, Decision, p. 113.
[36] Decision p.113, citing *Donald L. Koch,* Exchange Act Release #72179, 2014 SEC LEXIS 1684.
[37] *In re Donald L. Koch,* 2014 SEC LEXIS 1684 at*19-20.

has been 5½ years since he sold a private placement, strong proof that the likelihood he will again do so is nil. Also, the ALJ ignored the fact that Chiappone never sold private placements when working at other firms – only with MS&Co. – and that firm no longer exists.

A. <u>Precedent Mandates a Finding of Likelihood of Future Violations.</u>

Numerous cases hold that cease and desist orders, industry bars and suspensions are predicated upon the likelihood of future violations. See, e.g., *SEC v. Manor Nursing Centers*, 458 F2d 1082, 1101 (2d Cir. 1972) ("the critical question . . . in deciding whether to issue a permanent injunction in view of past violations is whether there is a reasonable likelihood that the wrong will be repeated"). This language in was cited approvingly in Chief Justice Burger's concurring opinion in *Aaron v. SEC,* noting that, to obtain injunctive relief, the Commission must *always* show a likelihood of future violations:

> It bears mention that this dispute [about whether *scienter* is required for certain violations], though pressed vigorously by both sides, may be much ado about nothing. *This is so because of the requirement in injunctive proceedings of a showing that "there is a reasonable likelihood that the wrong will be repeated."* (citations omitted). . . . *Because the Commission must show some likelihood of a future violation, defendants whose past actions have been in good faith are not likely to be enjoined . . . .* " *Aaron v. SEC,* 446 U.S. 680 at 703 (1980)(emphasis supplied).

The majority opinion further noted that, although scienter is not a requisite element of a violation of '33 Act §17(a)(2) & (3), that is not to say "that scienter has no bearing at all on whether a district court should enjoin a person violating or about to violate those sections:

> "In cases where the Commission is seeking to enjoin a person '*about* to engage in any acts or practices which ... *will* constitute ' a violation of those provisions, the Commission must establish a sufficient evidentiary predicate to show that such future violation may occur." (emphasis in original) (citation omitted) *Aaron,* 446 U.S. at 701.

Circuit court decisions to similar effect include *SEC v. Culpepper*, 270 F2d 241, 249 (2d Cir. 1959) ("critical question . . . in cases such as this is whether there is a reasonable expectation that the defendants will thwart the policy of the Act by engaging in activities proscribed thereby"); *SEC v. Bausch & Lomb*, 565 F2d 8, 18 (2d Circ. 1977) ("the Commission cannot obtain relief without positive proof of a reasonable likelihood that past wrong-doing will recur"). See also, *SEC v. Commonwealth Chemical Securities* wherein the Second Circuit discussed the "reasonable likelihood" test in detail, stating:

> "In some cases the collateral consequences of an injunction can be very grave . . . . The Securities Act and the Securities Exchange Act speak, after all, of enjoining 'any person [who] is engaged or about to engage in any acts or practices 'which constitute or will constitute a violation' (citation omitted). Except for the case where the SEC steps in to prevent an ongoing violation, this language seems to require a finding of 'likelihood' or 'propensity' to engage in future violations (citations omitted). As said by Professor Loss, 'the ultimate test is whether Defendant's past conduct indicates . . . that there is a reasonable likelihood of further violation in the future'. . . . *Our recent decisions have emphasized, perhaps more than older ones, the need for the SEC to go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence"* (emphasis supplied). *Commonwealth Chemical,* 574 F.2d 90, at 99-100 (2d Cir. 1978).

Other cases containing essentially identical language to that in *Commonwealth Chemical* include *SEC v. Universal Major Industries*, 446 F2d 1044, 1048 (2d Cir. 1976); *SEC v. Parklane Hosiery*, 558 F2d 1083 (2d Cir. 1977); *SEC v. Culpepper,* 270 F2d 241, 249 (2d Cir. 1959); and *SEC v. Milan Capital Group,* 2000 U.S. Dist. LEXIS 16204 (S.D.NY. 2000).

Finally, there is authority holding that a broker's conduct <u>after the initiation of proceedings</u> can be considered in reviewing sanctions imposed (*McCarthy v. SEC,* 406 F.3d 179 (2d Cir. 2005)). The *McCarthy* court stated that the purpose of sanctions is remedial, not punitive in nature, noting that the defendant had an exemplary record both before <u>and after</u> initiation of proceedings:

> "It is familiar law that the purpose of expulsion or suspension from trading is to protect investors, not to penalize brokers. In *Wright v. Securities & Exchange Commission,* we noted that the Securities Exchange Act 'authorizes an order of expulsion not as a penalty but as a means of protection investors .... The purpose of the order is remedial, not penal' (citations omitted). The Commission itself has recognized this (citation omitted). It is well-settled that such administrative proceedings are not punitive but remedial. When we suspend or bar a person, it is to

> protect the public from future harm at his or her hands. Our foremost consideration must therefore be whether McCarthy's sanction protects the trading public from further harm." . . . [F]or nine years McCarthy has proven himself to be a rule-abiding trader. Even at the time the Board summarily imposed the two-year suspension, McCarthy had been trading without incident for six years." (406 F.3d at 188-189).

For the past 5½ years, Chiappone has proven himself to be rule-abiding broker. He sold no private placements, and has migrated his practice towards investment advisory, fee-based relationships,[38] and the use of insurance company products, where the product sponsors are well-known, well-capitalized public companies.[39]

B. <u>The Steadman Factors.</u> The *Steadman* factors were laid out by the Fifth Circuit as follows:

> ". . . [A] fuller explanation of the need for these sanctions is required. At least the Commission specifically ought to consider and discuss with respect to Steadman the factors that have been deemed relevant to the issuance of an injunction: the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations." (*Steadman,* 603 F2d at 1140).

Analysis of the Steadman factors, as applied to Chiappone follows:

C. <u>Sincerity of Assurances Against Future Violations</u>. Chiappone testified that in the four plus years since he left MS&Co.[40] and affiliated with another broker, he has neither sold nor even offered a private placement to any customer.[41] No proof was introduced that contradicted his testimony. If conduct speaks louder than words, then Chiappone's conduct surely establishes that there is scant likelihood he will sell private placements in the future.

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[38] Chiappone testimony, Tr., 5612 - 5613.
[39] Tr. 5612.
[40] It was 4+ years when he testified. It is now well over 5½ years since he sold a private placement.
[41] Chiappone testimony, Tr. 5611 – 5613.

D. Lack of Scienter Affecting Suspension or Bar. Injunctive relief is more appropriate where Defendant's conduct involves a high degree of scienter (*SEC v. Posner*, 16 F3d 520, 521-522 (2d Cir. 1994); *SEC v. Milan Capital*, *supra*; and *SEC v. Drexel Burnham Lambert*, 837 F. Sup. 587, 611 (SDNY 1993)). The ALJ made no finding that Chiappone was a primary actor or even peripherally involved in the misuse of investor funds or other illicit activities. The Division's own summary witness agreed that, in a 2½ year investigation, she found no proof that Chiappone was even *aware* of the fraud committed by his superiors. The ALJ ruled that Chiappone "was at least negligent" as to violations of '33 Act §§17(a)(2) & (3),[42] never finding that he engaged in intentional wrongdoing. Hence, Chiappone's conduct does not rise to the level of scienter requisite to justify the suspension and cease and desist order imposed.

E. Egregiousness of Defendant's Actions. Chiappone can hardly be found to have acted egregiously, as the SEC essentially asserts negligence in failing to detect the illicit conduct committed by McGinn and Smith, and failure to see "red flags" which (as noted below) were not red flags at all. Bruce Becker, a Chiappone customer called to testify by the Division, who lost considerable funds, stated that he considered Chiappone to be an honest broker.[43]

F. Defendant's Recognition of Acts. While never believing that his sales of private placements were wrongful at the time sales were made, Mr. Chiappone clearly has become aware of the risks inherent in *proprietary* private placements – where the issuer and broker are commonly controlled. However, his refusal to offer *any* private placements after he left MS&Co. shows his recognition of the risks posed by proprietary product.

G. Remoteness of Violations. Another consideration in determining the appropriateness of injunctive relief is the remoteness of defendant's violations. See, *SEC v. Rind*,

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[42] Decision, p. 100.
[43] Becker testimony, Tr. 2496.

991 F.2d 1486, 1492 (9th Cir. 1993)("A court can and should consider the remoteness of the defendant's past violations in deciding whether to grant the requested equitable relief"); *Profitt v. FDIC,* 200 F3d 855,862 (D.C. Cir. 2000)(permanent bar[44] ruled punitive in nature because the injunction was "based solely on Profitt's long past conduct and made no attempt to evaluate his present fitness or competence"). In *SEC v. Jones*[45] the court made a similar finding, stating:

> "The Court also notes that several years have passed since Defendants' alleged misconduct apparently without incident. This fact further undercuts the Commission's assertion that Defendants pose a continuing risk to the public." *(SEC v. Jones,* 476 F.Supp.2d at 384).

It is now 5½ years since Chiappone sold a private placement[46], a significant time period supporting the lack of need to suspend him to protect the investing public. Any inference of future violations from past misconduct is overcome by Mr. Chiappone's having had no blemishes whatsoever on his record prior to joining MS&Co., and none since becoming employed with a new brokerage firm.

H. Burden of Proof on Likelihood of Future Violations. The burden of proof on establishing the factual foundation required for an injunction is upon the government (*SEC v. Culpepper*, 270 F2d 241, 250; *SEC v. Bausch & Lomb*, 565 F2d 8, 18 ("[T]he moving party must satisfy the court that [injunctive] relief is needed")). The Division failed to carry its' burden of proof, producing no evidence suggesting Chiappone was likely to resume selling private placements.

I. Punitive Effect of Sanctions. A 12-month suspension would likely cause irreparable harm to Mr. Chiappone, as his customers would migrate to other brokers while he was suspended, rendering the sanction punitive in nature. While generally giving deference to SEC

[44] *Profitt* involved a proceeding by the FDIC to permanently bar a bank director from the industry.
[45] 476 F.Supp.2d 375 (SDNY 2007)
[46] Palen Schedule 4c to Division Ex. 2 shows Chiappone's last sale to be dated Nov. 3, 2009. See also Tr. 5613, where Chiappone testifies that he has not sold a private placement since he disaffiliated with McGinn Smith in late 2009.

decisions regarding choice of sanctions,[47] courts have noted that the sanction chosen must be designed to protect investors, but not to punish a regulated person. *Paz Secs., Inc. vs. SEC*, 566 F.3d 1172, 1175 (D.C. Cir 2009) (Paz II); *Blinder, Robinson & Co. v. SEC,* 837 F.2d 1099, 1113 (DC Cir. 1988). See also, *SEC v.* Jones:

> "[An] injunction preventing future violations of the securities laws can be more punitive than remedial . . . . [T]he degree and extent of the consequences to the subject of the sanction must be considered as a relevant factor in determining whether the sanction is a penalty. The practical effect of such an injunction here would be to stigmatize Defendants in the investment community and significantly impair their ability to pursue a career." (*SEC v. Jones,* 476 FSupp2d at 385)(citations omitted).

J. **Limitations in Scope.** All securities referenced in the OIP were private placements, primarily fixed income notes. There was no allegation that Chiappone ever engaged in typical broker misconduct (churning, front running, penny stocks, etc.). Hence, suspension from industry participation would be completely unnecessary to protect the investing public. Should the Commission determine that some sanction is justified, it is submitted that the interests of public protection require no more than a ban on proprietary private placements.

Point II. **The Application of *Hanly* to Chiappone's Case is an Unwarranted Extension of *Hanly's* Holding.**

Legal arguments pertaining to the ALJ's application of the *Hanly* precedents are primarily detailed in Respondents' Joint Brief. This brief will supplement those arguments.

A. **Investor Losses Not Caused by Broker Misconduct:** Chiappone's conduct in recommending private placements did not ***cause*** any investor losses. Analysis of cases imposing a duty to investigate shows they all include one critical factor – the making of affirmative (materially false) statements and/or omission to state facts necessary to render other statements not

[47] *See*, e.g., *Seghers v. SEC,* 548 F.3d 129, 135 (D.C.Cir. 2008); *WHX Corp. v. SEC,* 362 F.2d 854, 859 (D.C. Cir. 2004).

misleading.[48] Each case imposing a duty to investigate cited by the ALJ involved an affirmative material representation so obviously indicative of fraud that the failure to investigate was tantamount to reckless behavior.

In *Hanley*,[49] the misrepresentations and omissions in the sales process were a direct causal factor in investors' losses, since the issuer company (Sonic) was already in financial distress and its stock seriously impaired at the time of sale. The same is true as to other cases citing *Hanly* in imposing a duty to investigate. In this matter, the issuer companies were not financially troubled *at the time securities were sold* – rather, it was the post-sale misuse of investor monies by Smith and McGinn that significantly contributed to investor losses, most prominently use of investor funds to rescue earlier failed offerings and to support their lavish lifestyles.[50] The ALJ made no finding that Chiappone misstated or omitted to state material facts on any offering. Thus, the ALJ expanded *Hanly* to impose a duty to investigate in the absence of affirmative misrepresentations or omissions. No case, rule or regulation that so holds has been found.

The ALJ instead predicated her decision on Chiappone's failure to unearth the illicit activities of his superiors, which went unnoticed by the SEC, NASD & FINRA for years. Ms. Palen, the Division's summary witness and a certified fraud examiner[51], testified that she took three years to fully understand the nature and extent of the fraud,[52] but that she found no document and

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48 See, e.g., *Abbondante v. SEC,* 209 Fed. Appx. 6 (2d Cir. 2006)(representative made affirmative representations to purchasers that their money would be invested according to a successful trading strategy involving, that [the money manager] had earned millions using this strategy, that the strategy would be profitable regardless of whether the market went up or down so long as it was volatile, that the formula would produce high returns, and investors could expect to earn approximately 6-10% on their investments per month)

49 *Hanly v. SEC,* 415 F2d 589 (2dCir. 1989).

50 That the principals of MS&Co. were involved in systemic fraud was not known to anyone until early 2010.

51 See Tr. 400-401 as to Palen's status as a certified fraud examiner.

52 Ms. Palen began working on the case in April or May of 2011 (Tr. 302). She worked on the case for three years, spending approximately half her time on the McGinn, Smith matter (Tr. 391-393).

no other evidence that any of the brokers participated in the fraudulent activity described in the OIP, nor were they even aware of the fraud until the FBI raid in April, 2010.[53]

Cases imposing a duty to investigate typically involve brokers who know that they are selling impaired securities. The fact that Chiappone bought $90,000 of MS&Co. private placements likewise sold them to his mother and other family members clearly indicates he had no misgivings about the suitability of the private placements he sold.[54]

B. **<u>ALJ Ignored Due Diligence Performed by MS&Co</u>.** *Hanly* also notes that the *degree* of independent investigation required varies in each case.[55] In this matter, Respondents were entitled to rely on the substantial investigations conducted by the MS&Co. due diligence team, as testified to by Mary Ann Cody, former MS&Co. in-house counsel. Ms. Cody's testified that the due diligence team: (i) visited alarm companies whose receivables were being purchased; (ii) read <u>each</u> alarm contracts being financed; (iii) phoned alarm customers to confirm revenue streams; and (iv) kept due diligence records in fire-proof safes (Tr. pp. 4545 – 4546). The ALJ made no finding that MS&Co. failed to perform the diligence described by Ms. Cody, she simply ignored that testimony. Mr. Chiappone testified that the due diligence team returned to MS&Co. in 2006[56] and performed due diligence on the alarm and triple play deals (Trust Offerings) sold from 2006–2009. Mr. Chiappone was entitled to rely on the work done by the due diligence team, who were trained and experienced in vetting the Trust Offerings, involving recurring monthly revenues, a business model with which they were well familiar.

C. **<u>The Application of Hanly Ignores Industry Rules and Practices</u>.** The major problem with the ALJ's application of the *Hanly* precedents is that it turns the manner in which the

[53] Tr. 393-399, 494-501.
[54] Chiappone Testimony, Tr. 5610 – 5611.
[55] *Hanly*, 415 F2d at 597.
[56] Chiappone testimony, Tr. 5430 & 5447

brokerage industry is structured on its head. Brokerage firms employ analysts to study securities and make recommendations. Registered representatives then sell what the analysts and investment committees recommend. MS&Co. private offerings were structured by investment bankers and vetted by the in-house due diligence team,[57] as required by the 2007 and 2008 Compliance Manuals introduced into evidence, which clearly stated that MS&Co. "will make a reasonable investigation" of each private placement it underwrote. [58]

Application of *Hanly* in this matter would require Respondents to disregard the work of the persons assigned to conduct due diligence on the offerings, perform the entire due diligence on their own, and make recommendations based upon their own analysis, a task for which most registered representatives utterly lack the necessary education, training, or expertise. That is not the holding of the *Hanly* precedents.

The Division's expert witness acknowledged that no Respondent in this case is a "member" within the meaning of the NASD/FINRA regulatory scheme.[59] NASD Notice to Members 03-71, issued November 2003, distinguished "due diligence" or "reasonable-basis" suitability, which it imposed exclusively on "members," (brokerage firm), from "customer-specific" suitability imposed on <u>both</u> members and "associated persons" (individual stockbrokers), stating:

> [P]erforming due diligence is crucial to a **member's** obligation to undertake the required reasonable-basis suitability analysis.... Accordingly, a **member must perform appropriate due diligence** to ensure that **it** understands the nature of the product, as well as the potential risks and rewards associated with the product. Moreover, the fact that a member intends to offer an NCI [non-conventional investment] only to institutional investors does not relieve **the member of its responsibility to conduct due diligence** and a reasonable-basis suitability analysis. (Notice 03-71, p. 767-768, emphasis added.)

[57] Testimony of Mary Ann Cody, TR. 4545 – 4552.
[58] MS & Co. 2007 Compliance Manual, Guzzetti Ex. 2, at p.42 (in evidence at Tr. 2996); MS&Co. 2008 Compliance Manual, Division exhibit DIV – 329, at page 44.
[59] Testimony of Robert Lowry, Tr. 865.

Thus, the obligation for "due diligence/reasonable-basis suitability" (determining that the product is suitable for at least some investors) is placed exclusively on the member firm; not on the individual broker.

Chiappone contends that none of industry practices, NASD/FINRA regulatory rules and pronouncements, nor case law require him to duplicate due diligence on investment products that has already been performed by the brokerage firm employing him. Hence, for the reasons described in the Joint Brief and outlined above, it is submitted that liability cannot be predicated on Chiappone's failure to duplicate the investigations conducted by the due diligence team, who had the training, background and experience necessary to perform those tasks.

Point III. **Chiappone Did Not Ignore Any "Red Flags."**

The ALJ's finding of a duty to investigate is posited upon the theory that Chiappone was reckless or negligent in failing to consider certain incidents to be "red flags" and immediately stop selling all MS&Co. private placements. The ALJ held that brokers ignored four specific "red flags" outlined below, finding that these incidents triggered a "duty to inquire" (Decision pp. 91-93). Chiappone's contests these findings, as set forth below.

A. **Restructuring of Four Funds.** The ALJ determined that, on January 8, 2008, when McGinn and Smith announced the restructuring of the Four Funds junior notes (Decision p. 92), Chiappone should have ceased selling all MS&Co. offerings. Chiappone contends that the lowering of interest payments on some of the Four Funds notes was not a red flag, given that the financial industry was suffering through one of the most severe global credit market melt-downs in history, resulting in collapse of major financial institutions. However, even if the restructuring were a red flag, it would only apply to the Four Funds junior notes (interest continued to be paid on senior and senior subordinated notes) and certainly not to the subsequent Trust Offerings because, as the Division expert witness (Mr. Lowry) admits in its expert witness report, the Four Funds and Trust offerings were entirely different types of investments. Mr. Lowry, in his report (Exhibit Div-001, p. 25) states "These offerings [the Trust Offerings] were not at all similar to the income notes [Four Funds notes] …."[60] Moreover, the Division admits as much in its proposed Findings of Fact submitted to The ALJ after the hearings, wherein it states "The Four Funds Had a Totally Different Mandate than the Pre-2003 Trust Offerings."[61]

Aside from these admissions, the following differences are readily apparent:

Four Funds:	Trust Notes (Alarm & Triple Play):
Investments Managed by Smith	Structured and managed by McGinn
Blind Pool	Investments disclosed in advance
Unlimited discretion in selecting investments	Limited to Alarm and Triple Play contracts (recurring monthly revenues)
New Concept for MS & Co	Long history of deals with alarm receivables
Included investments in equity	Invested only in debt or contract receivables

So, The ALJ's findings that brokers should have ceased selling Trust Offerings upon the restructuring of the Four Funds junior notes is simply not supported by the facts, and is even contradicted by the Division's own arguments. In any event, even if the restructuring was a red flag, Chiappone never sold a Four Funds offering after the January 8, 2008 meeting.[62]

B. Nondisclosure of Firstline Bankruptcy as Red Flag. Firstline investments were initially offered during 2007, and Firstline filed for bankruptcy in January 2008. McGinn and Smith learned of the bankruptcy shortly after it was filed, but did not disclose this to the registered representatives. To further conceal the bankruptcy, they secretly continued to make interest payments to Firstline investors using non-Firstline funds.[63] Even worse, they encouraged brokers to

[60] Lowry Report, at p. 25 of 35 (Exhibit Div-001).
[61] Division Proposed Findings of Fact, at p.32 (paragraph heading "A" to Point VIII.
[62] Proof Chiappone sold no Four Funds after January 8, 2008 is found at Div. Ex 002 [Palen Ex. 4c].
[63] Testimony of Lowry, Tr. 844; Rabinowitz, Tr. 2840; Chiappone, Tr. 2605;Cross of Bennet, Tr. 4078.

continue selling Firstline notes.[64] When they finally did disclose the bankruptcy, they failed to disclose all relevant facts (claiming interest payments were funded by an undisclosed "white knight"), and telling brokers they planned to buy the Firstline assets in a bankruptcy auction, to assist Firstline investors in recovering at least some of their investment.[65] To bolster their continuing charade, they sent emails to the brokers, updating them on progress of the Firstline "rescue plan," assuring them that they were pursuing purchase of the Firstline assets, even including drafts of purchase agreements.[66] They did not disclosed that MS&Co. did not have sufficient funds to purchase the assets. That all-important detail was not disclosed until after the brokers had already left MS&Co., in late 2009.[67]

Chiappone first learned of Firstline's bankruptcy on September 3, 2009, approximately 18 months after the bankruptcy occurred,[68] whereupon he immediately stopped selling Firstline.[69] He also decided to resign from MS&Co. and began seeking employment with another firm, departing MS&Co. in December, 2009. While FirstLine may be a red flag, the record establishes that Chiappone not only stopped selling Firstline, but only sold one other MS&Co. investment (not Firstline) after the Firstline disclosure.[70] Hence, any claimed violation of this red flag was *di minimus*. Note that, while Palen Ex. 4c to Div. Ex. 2 shows two sales, dated September 2nd and 4th 2009, the actual sales took place earlier, as Ms. Palen confirmed that the dates on this chart represent the date funds were deposited into the issuer's account; not dates of sale (Palen testimony, Tr. pp. 239-240).

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64 Chiappone Testimony, Tr. 5572 – 5573.
65 Chiappone Testimony, Tr. 5578 – 5579.
66 Chiappone Testimony, Tr. 5580 – 5584; Exhibits Div-197 & Div-199.
67 Chiappone Testimony, Tr. 5584 – 5585, Exhibit Div-200.
68 Chiappone Testimony, Tr. 5573 – 5575.
69 Chiappone Testimony, Tr. 5578.
70 Chiappone Testimony, Tr. 5588 – 5589, Decision p.15 & fn. 25, Palen Ex. 4c to Div. Ex 2.

C. **<u>Conflicts of Interest/Transactions with Affiliates</u>.** The ALJ ruled certain conflicts of interest (arising from McGinn's and Smith's dual roles as principals of the issuers and principals of the broker) and certain transactions with affiliates were both red flags (Decision, pp. 91-92). The ALJ completely ignored the fact that all conflicts and related-party transactions were fully disclosed in writing in the PPM's. Each of the Four Funds PPMs specifically stated that a fund could purchase assets from MS&Co. affiliated, but would not pay a price higher than was paid by the affiliate.[71] Conflicts were likewise disclosed in the PPM's of the Trust Offerings.[72] It was never claimed that Chiappone was involved in a conflict of interest of any sort, nor was he accused of participation in a transaction with affiliates.

In summary, there was no credible proof that Chiappone ever ignored a red flag to the detriment of any customer.

Point IV. <u>Chiappone Did Not Violate Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, or Rule 10b-5.</u>

In 1980, the U.S. Supreme Court held scienter was required for actions brought by the SEC under '33 Act §17(a)(1), '34 Act §10(b) and Rule 10b-5, also holding that scienter was not an element for claims made under '33 Act §17(a)(2) & (3), both as to private actions and Commission injunctive actions.[73] The ALJ acknowledges these scienter requirements, and further states that reckless disregard for the truth will suffice to establish scienter (Decision, p.98, citing *South Cherry*).[74] *South Cherry* sets the following standard for a finding of reckless disregard for the truth:

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[71] What was not known to Chiappone was that, in certain instances, the principals who controlled the companies actually sold assets to the Four Funds for more than the purchase price paid by the original purchaser. There was no testimony or other proof adduced that Mr. Chiappone knew about any of this misconduct.

[72] See, Division Exhibits 63, 68,69,73,264-269,376,438,462-265 & 590.

[73] *Aaron v. SEC*, 446 U.S. 680, 691, 100 S. Ct. 1945 (1980).

[74] South Cherry St.,LLC v. Hennessee Group, LLC, 573 F.3d 98,109 (2d Cir. 2009).

> "By reckless disregard for the truth, we mean "conscious recklessness—*i.e.*, a state of mind *approximating actual intent,* and *not merely a heightened form of negligence,*" (citation omitted). . . . In elaborating as to what may constitute recklessness . . . we have referred to conduct that " 'at the least ... is highly unreasonable and which represents an extreme departure from the standards of ordinary care to the extent that *the danger was either known to the defendant or so obvious that the defendant must have been aware of it,*' " (citation omitted); . . . or ignored *obvious* signs of fraud," and hence "should have known that they were misrepresenting material facts ...." (emphasis in original). *South Cherry,* 573 F3d at 109.

As detailed below, there was no proof that Chiappone's sales practices rose to this level of recklessness described in *South Cherry.*

Customer Testimony Regarding Chiappone: No one testified credibly that Mr. Chiappone ever misrepresented material facts about the Trust Offerings or omitted any material facts. Yet, the ALJ purported to find recklessness in Chiappone's transactions with three customers, two of whom testified for the Division, concluding that Chiappone "was reckless in offering and selling securities based on material misrepresentations and omissions that he made to witnesses who purchased his private placements (Decision, p. 100). The record proves otherwise.

Gary Ardizzone: The ALJ cites Ardizzone's claim that, based on conversations with Chiappone, he believed his FEIN and TAIN (Four Funds) investments were similar to the alarm deals he had previously purchased. Before reaching the merits, it must be noted that the sales of FEIN and TAIN were both made before September 23, 2008, and are beyond the period of limitations, and thus cannot form the basis for sanctions against Chiappone.[75] Moreover, Ardizzone's claim that he thought FEIN and TAIN were alarm offerings is not credible, as he was issued PPM's describing the nature of these Four Funds investments (Tr. pp.2768 & 2793), and he admitted to reading portions of the PPMs (Tr. pp. 2769 & 2793). Those PPM's clearly granted Smith an unrestricted hand in purchasing investments for the Four Funds.[76] Chiappone testified that

[75] FEIN was sold 12/15/2006, and TAIN was sold 5/23/2005. See Palen Ex. 4c to Div. Ex. 2.

[76] See Division Exhibits 5,6,9 & 12 (PPM;s for FEIN and TAIN).

he <u>did</u> specifically discuss the blind pool nature of the Four Funds with Ardizzone.[77] Most importantly, Ardizzone recanted his claim that Chiappone mislead him as to the nature of the FEIN and TAIN investments on cross-examination:

<u>Examination by Division</u>:

Q. Did you understand that TAIN – was it your belief at the time that TAIN was another alarm-type product?
A. That was my belief in any of these private placement things.

Q. Did that belief stem from anything other than your conversations with Mr. Chiappone?
A. No (Transcript 2771)

<u>Cross Examination</u>: Upon cross, he admitted (haltingly) that this was his *impression*, but that Chiappone never actually told him that. [Mr. Cavalier, referencing FEIN note]:

Q. Did Mr. Chiappone tell you that this was an alarm deal?
A. My understanding was all of these private placement things were based on the alarm business in one form or another.
Q. Well, my question to you is not what you understood. My question is, did he *tell you* that this was an alarm deal?
A. Again, my understanding from conversations with him – we had many, many conversations.
Q. Do you –
A. Whenever he had something to sell he would call and we would talk.
Q. **Do you have a specific recollection of Mr. Chiappone telling you that this was an alarm deal?**
A. **No.**
[Transcript 2796:20 – 2797:13]

There was no other testimony that Chiappone made false statements to Ardizzone, *or to any other customer!* In sum, the ALJ's finding is unsupported by credible evidence.

The ALJ also cites a sale of Fortress (Trust Offering) to Ardizzone in October of 2008, finding scienter in Chiappone's knowledge at time of sale that the Four Funds junior notes had already been restructured. However, as noted above, the Four Funds restructuring in no way constitutes as a "red flag" for the Trust Offerings, since the Division admits they were entirely separate types of investments in their expert report. This stretch to find recklessness on

[77] Chiappone testimony, Tr. 5485 – 5486.

Chiappone's part doesn't satisfy the requirements for scienter. Moreover, the ALJ ignored the fact that investor losses on both the Four Funds and Trust Offerings were not due to inherent flaws in the product *a time of sale*, but rather due to post-sale misuse of investor funds by McGinn and Smith and to global market conditions.

Bruce Becker: ALJ Murray further posits a finding of recklessness on Chiappone's sale of two Trust Offerings to Bruce Becker. Becker was a credible witness. Although called by the Division, Becker testified on cross-examination that he:

(i) declined to purchase Four Funds because he was uncomfortable with the blind pool structure of the investment, *which was explained to him by Chiappone.*[78] This casts further doubt on Ardizzone's claim that he thought the Four Funds were the same as the alarm notes.
(ii) was willing to assume moderate risk (Tr. 2913-2914);
(iii) received PPMs on all MS & Co. private placements (Tr. 2916-2918);
(iv) relied on the past successes of the pre-2003 alarm offerings in purchasing investments in 2007 and thereafter (Tr. 2920 & 2922);
(v) had adequate means to support his needs without accessing funds from the MS & Co. investments (Tr. 2925) and a net worth of $5 million in 2008-09 (Tr. 2927-2928 & 2936);[79]
(vi) understood there was liquidity risk in private placements (Tr. 2930);
(vii) understood the high interest rates in the notes indicated a higher credit risk (Tr. 2930-2931);
(viii) didn't always purchase offerings that Chiappone recommended (Tr. 2937); and
(ix) he had formerly invested in derivative securities [highly risky], but stopped due to risk (Tr. 2941-2942); and
(x) his total investment in private placements was less than 5% of his net worth (Tr. 2936).

Becker further admitted on cross-examination that he still did business with Chiappone and considered Chiappone to be an honest broker.[80] Finally, Becker (besides Ardizzone, the only witness to testify against Chiappone) actually purchased an investment from Chiappone <u>after he testified for the Division</u>![81] Yet in spite of all this testimony, The ALJ concluded that Chiappone

[78] Becker testimony, Tr. 2936:22 – 2937:21; Chiappone testimony, Tr. p. 5486.
[79] Becker's net worth at the time he sold his company was about $14 million (Tr. 2939).
[80] Becker testimony, Tr. 2496.
[81] Chiappone testimony, Tr. 5438 (Becker purchased an investment from Chiappone after he testified for the Division).

violated securities laws by selling Trust Offerings to Becker in September and December 2008 "without mentioning any misgivings about McGinn or Smith" (Decision p.100). It is submitted that there isn't even a hint of wrongdoing and no suggestion of scienter in his dealings with Becker, nor with Ardizzone.

The only other transaction cited by the ALJ is a single sale of a Trust Offering (TDMM Benchmark-10% note) to John Schneider on 11/3/2009, some two months after Chiappone first learned of the Firstline bankruptcy (Decision, p.100). The ALJ did not identify any material misstatement or omission in the sale to Schneider, Schneider did not testify, and there was no proof that Chiappone engaged in any practice or course of conduct that would operate as a fraud on Schneider.

Moreover, at the time of that sale, McGinn and Smith were still lying to the brokers, telling them MS&Co. was going to purchase the Firstline assets out of bankruptcy,[82] so Chiappone was still being misled by Smith and McGinn.

In summary, the elements of a claim under '33 Act §17(a), '34 Act §10(b) or Rule 10b-5 have not been established, even as to the subsections of §17(a) that don't require intent or recklessness as scienter. No witness testified and no other proof was introduced that Chiappone "employed any device, scheme or artifice to defraud" ('33 Act §17(a)(1)), that he "made any untrue statement of a material fact" or omitted to state facts that would violate '33 Act §17(a)(2) or '34 Act, § 10(b) and Rule 10b-5 , or engaged in a practice or course of business that would operate as a fraud or deceit ('33 Act 17(a)(3). Rather, all representations as to the private placement offerings were made by MS&Co., in writing via the PPM's. The record is bare of any statement, promise, projection or other representation as to a specific offering.

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82 Chiappone testimony, Tr. 5572-5578.

The ALJ's legal conclusions against Chiappone are not based upon affirmative untruths or intentional non-disclosures. Instead, they are based upon a perceived failure on his part to have discovered the fraud that was perpetrated by his superiors. It is submitted that this is insufficient to satisfy the clearly worded statutory text of the fraud-based provisions of the '33 Act and the '34 Exchange Act.

In conclusion, while several cases recognize that scienter may be found in recklessness (or a reckless disregard for the truth), they also acknowledge limitations on non-intentional conduct. In *South Cherry*, the Second Circuit elaborated on what constitutes recklessness in private actions: "By reckless disregard for the truth, we mean 'conscious recklessness – i.e., a **state of mind *approximating actual intent*, and *not merely a heightened form of negligence*'**" (citation omitted) (emphasis in original). *South Cherry,* 573 F3d at 109 (quoting from *Novak v. Kasaks,* 213 F3d 300, 306 (2d Cir. 2000)). In *Press Chemical,* the Second Circuit held that "[t]he scienter needed in connection with securities fraud is intent 'to deceive, manipulate, or defraud' or knowing misconduct" (citing *First Jersey Secs., Inc.*, 101 F.3d at 1467). *Press Chemical, supra,* 166 F.3d at 538.

In *Novak*, the court in noting that recklessness is harder to identify than intentional conduct, likewise put some definition as to exactly what conduct may be viewed as "reckless":

> "[W]e define reckless conduct as: at the least, conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care ... to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *Novak*, 216 F.3d at 308.

Numerous other cases contain definitions of recklessness that closely parallel that enunciated by the *Novak* court.[83] What is clear from these cases is that the conduct at issue must rise beyond simple negligence or inattention to detail. "Reckless conduct includes 'not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it'" (*SEC v. Randy,* 38 F. Supp. 2d 657, 670 (ND Ill. 1999), citing *Meadows v. SEC*, 119 F.3d 1219, 1226 (5th Cir. 1997)).

In *Merkin v. Gabriel Capital, LP,* the Southern District of New York, citing to *South Cherry,* observed that an investment advisor who recommended investments in a fund that turns out to be a Ponzi scheme will not ordinarily be held liable for securities fraud unless there exist particular facts giving rise to a strong inference that the advisor either had fraudulent intent, or acted with "conscious recklessness' as to the truth or falsity of the advisor's statements to the investor. *Merkin,* 817 F. Supp. 2d 346, 357 (S.D.N.Y. 2011). The facts in *Merkin* closely parallel those now at issue. Chiappone sold what he thought were legitimate investments, and had no information to the contrary until after he had departed from MS&CO.

While the above-cited cases involve private claims, they do provide guidance as to what conduct constitutes scienter by "recklessness" and have been cited in civil enforcement actions by the SEC. The scienter requirement has been similarly interpreted by courts in cases brought by the Division. *See, e.g., SEC v. Sayegh,* 906 F. Supp 939, 946 (S.D.N.Y. 1995) ("Scienter may be established by proving conduct that was knowing, intentional, or reckless, as opposed to merely negligent"). Something more than mere negligence, amounting to an extreme departure from the standards of ordinary care is required to establish scienter in civil proceedings brought by the

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[83] *See, e.g., Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital,* 531 F.2d 190,194 (2d Cir. 2008); *Chill v. General Elec. Co.,* 101 F.3d 263, 269 (2d Cir. 1996)(quoting *Rolf v. Blythe, Eastman Dillon & Co.,* 570 F.2d 38, 47 (2d Cir. 1978). *See also, Kalnit v. Eichler,* 264 F3d 131, 142(2d Cir. 2001).

Commission. *See, SEC v. Carriba Air, Inc.*, 681 F.2d 1318, 1324 (11th Cir. 1982), in which the panel stated:

> "Scienter may be established by a showing of knowing misconduct or *severe recklessness.* The standard in this circuit has been set forth in *SEC v. Southwest Coal and Energy Co.*, 624 F.2d 1312 (5th Cir. 1980). Proof of recklessness would require a showing that the defendant's conduct was an extreme departure of the standards of ordinary care, ... which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Carriba Air,* 681 F.2d at 1324.

In the *Southwest Coal* case cited in *Carriba Air,* above, the Fifth Circuit noted:

> "[t]he degree of recklessness in one's disregard for the truth necessary to serve as scienter is extremely high. ... Reckless conduct may be defined as a highly unreasonable omission, ***involving not merely simple, or even in excusable negligence,*** but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it. (citations omitted). An important factor in this regard is the degree of intentional wrongdoing evident in a defendant's past conduct (citation omitted). (emphasis supplied) *Southwest Coal,* 624 F.2d at 1321, fn. 17.

In so stating, the panel in *Southwest Coal* panel noted that the original formulation of this standard of recklessness was articulated in a federal district court (*Franke v. Midwestern Okla. Devel. Auth.*, 428 F. Supp. 719 (W.D. Okla. 1976)), but that it has been followed in the Third, Sixth and Seventh Circuits, as well as the Fifth and Eleventh Circuit.[84] The D.C. Circuit may require "<u>extreme</u> recklessness." *See, SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992) ("Although the [Supreme] Court has left the question open ... we have determined, along with a number of other circuits, that extreme recklessness may also satisfy this intent requirement").

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[84] Cases cited by the court in *Southwest Coal* for this standard of recklessness are: *Accord, e.g. McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979) (quoting Franke standard); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979) (same); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.) *cert. denied*, 434 U.S. 875, 98 S. Ct. 225, 54 L. Ed. 2d 155 (1977) (same). *See also, Broad v. Rockwell Int'l Corp.*, 614 F.2d 418 (5th Cir. 1980).

C. Law Applied to Facts Involving Chiappone's Activities.

Mr. Chiappone was not charged (and no evidence was adduced) with making false statements or omissions to state a material fact. He testified, as did the two witnesses who appeared on his behalf, and the two Division witnesses, that in every case, the private placements he sold were preceded by PPM's, subscription agreements and investor questionnaires. He described the procedures for sending out investor packets, and return of the executed questionnaire and subscription agreement. Chiappone testified that he disclosed the lack of liquidity risk inherent in private placements, and the PPM's contained written disclosures of myriad risk factors, as well as certain conflicts of interest.[85] No one testified credibly that Mr. Chiappone ever misrepresented the relevant facts about the Trust Offerings. All sales of Four Funds were made more than five years before the filing of the OIP.

Point VI. Sale of Unregistered Securities (Section 5 of '33 Act).

A. Chiappone Did Not Violate Section 5. The Division argued that §5 of the Securities Act was violated due to failure to qualify for the Regulation D exemption. The ALJ ruled that §5 was violated as to the Four Funds, finding that each Four Fund offering had more than 35 unaccredited investors, and the that Rule 502 information requirements were not fulfilled (Decision, 93-95). First of all, since all sales of the Four Funds investments by all Respondents occurred more than five years from the filing of the OIP, no finding of a §5 violation can be predicated on those offerings, at least as to the Division's request for civil penalties and industry bars/suspensions. Chiappone also contends that the Division's claim for disgorgement of commissions likewise fails, under the holding of *SEC v. Graham*, 21 F. Supp. 3d 1300, 1310-11 (S.D. Fla. 2014) ("disgorgement ... can truly be regarded as nothing other than a forfeiture (both

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[85] Chiappone testimony, Tr. 5701 (disclosure to clients of illiquid nature of Four Funds); Mirochnik testimony, Tr. 3117 – 3118. See also Chiappone testimony, Tr. 5659 as to risks inherent in non-marketable private placements.

pecuniary and otherwise), which remedy is expressly covered by § 2462"). The application of 28 U.S.C.A. 2462 is dealt with in detail in the Joint Brief. However, even if *Graham* is not controlling law, at best, the SEC can only obtain disgorgement, as the Division's own exhibits clearly establish that <u>all sales of the Four funds</u> were made beyond the period of limitations (Palen Exs. 4a-4s to Div. Ex.2).

As to the Trust Offerings, the Division conceded that all offerings made during the period of limitations had 35 or less unaccredited investors (Decision p.35), and the Division's own exhibits proved that all Trust Offerings were accompanied by PPM's.[86] The ALJ refused to integrate the Trust Offerings, and ruled Respondents met the five-factor Test of Rule 502(a). She found, however, that Rule 506 was not available to Respondents, on the sole grounds that Respondents did not provide financial and non-financial information to non-accredited investors per Rule 502(b)(Decision pp.96-97). In so doing, she totally ignored that fact that the PPM's contained the disclosure materials that would have satisfied Rule 502, *both as to accredited and unaccredited investors*. The Trust PPM's specifically provided that "Additional information is available upon request to the Trust" and "Only additional information provided by the Trust may be relied upon."[87] She apparently determined that Respondents should have provided information beyond that in the PPM's, which contradicts the instruction in the PPM. Since that is the sole basis for the ALJ's finding that §5 was violated as to the Trust Offerings, it cannot stand.

B. <u>Willfulness/Scienter re Section 5</u>. Should the Commission find a §5 violation occurred, the issue of scienter becomes relevant. The degree of culpability required to establish a §5 violation is not clear. Some courts, including the Southern District of New York, have determined that *scienter* is not an element of liability for §5 claims. See, *SEC v. Universal*

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86 Division Exhibits 63, 68,69,73,264-269,376,438,462-265 & 590.

87 See, e.g. Div. Ex. 14 @ p.15.

Express, Inc., 475 F. Supp. 2d. 412, 422 (S.D.N.Y. 2007); and *SEC v. Platinum Inv. Corp.*, 2006 U.S. Dist. LEXIS 67460, at [5], holding that to prove a §5 violation, the SEC must only show: (a) lack of a registration statement as to the securities sold, (b) the offer or sale of securities, and (c) use of interstate facilities, such as the phone or mails.

Decisions of appellate courts on the requirements to establish a §5 violation are less clear, particularly in the D.C. Circuit. In *Zacharias v. SEC,*[88] the SEC administrative law judge opined that §5 imposes strict liability, but also based the decision on a factual finding that respondent knew or should have known of the lack of registration. The Circuit Court then declined to pass on the issue of whether strict liability applied, affirming the SEC's finding that petitioner Zacharias knew or should have known [of the public distribution]."[89]

However, even if scienter is not strictly applicable to a determination of liability, it can and should be taken into account in determining whether the §5 violation was willful, which goes to the <u>remedy</u> that is appropriate to impose upon the broker. In *Kane v. SEC,* the Eighth Circuit held that the reasonableness of the registered representative's belief that the shares were exempt from registration was relevant to the willfulness of the violation of §5.[90]

The Eighth Circuit, in the context of a sanction imposed for violation of the §§5(a) & 5(c) has held that willfulness implies something more than mere negligence:

> "The Commission sanctioned Wasson . . . for *willfully* violating §5 of the Act and *willfully* aiding and abetting the violation of that provision. Wasson challenges the finding that he acted willfully, claiming that his behavior ... was merely negligent. . . Relying on <u>*Ernst & Ernst v. Hochfelder, supra*</u>, Wasson submits that willfulness as "a state of mind condition requires something more than negligence." . . . *We agree that the concept of willfulness implies something more than mere negligence.* (*Wasson v. SEC,* 558 F.2d 879, 887 (8th Cir. 1977)).

[88] *Zacharias v. SEC*, 569 F.3d 458 (D.C. Cir. 2009).

[89] *Zacharias,* 569 F.3d at 465-466.

[90] *Kane v. SEC,* 842 F.2d 194, 198 (8th Cir. 1988). Kane's conduct was found to be willful.

The court then noted that conduct involving disregard or reckless indifference to known facts could be regarded as "willful." In *Stead v. SEC*, the Tenth Circuit applied a test of "willfulness" that involved wrongdoing on the part of the stockbroker, finding that the SEC's determination that Stead "knew or should have known that there was no registration [was] well supported by the evidence" (*Stead,* 444 F.2d at 716). It is submitted that Chiappone's sale of Four Funds offerings (which had more than 35 unaccredited investors) is not governed by *Stead* or *Wasson.*[91] Not only did he not know that total sales of all brokers exceeded the 35 investor limit, he had no way of knowing what sales had been made by other brokers at any given point in time, as MS&Co. had four offices in three states. Chiappone testified that he lacked knowledge of how many unaccredited investors were sold by other brokers, as neither Ms. Sicluna nor anyone else ever advised him of the count.[92] While this may not avoid a violation of §5, it surely should be considered in determining what sanction, if any, is appropriate. Because it is likely that David Smith intentionally withheld information from the brokers on the number of unaccredited investors, it is respectfully requested that no suspension or monetary penalties be levied with respect to the §5 claims against Mr. Chiappone.

Point VII. <u>Scienter as Applied to Civil Penalties.</u>

The ALJ approved Tier III penalties (Decision pp 115-116). In order to impose even a Tier II penalty, 15 U.S.C. § 77h-1(g) and 15 U.S.C. § 78u-(d)3(A) require acts that "involved fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement. A Tier III penalty has the same requirements, plus substantial losses to other persons, or in the case of the '33 Act provisions, substantial gain to the offender.

---

[91] It must be noted that the broker was found to have violated '33 Act §5 in *Wasson,* as the court found he ignored an obvious need for further inquiry, and failed to disclose all relevant information to his superiors. Likewise, in the *Nees* case and the *Stead* case cited in *Wasson,* the courts found that, although willfulness implied wrongdoing, the respondent brokers had in fact knew or should have known of the lack of registration.

[92] Chiappone testimony, Tr. 5493 – 5495.

There is authority supporting scienter requirements regarding the civil penalties. In *SEC v. Kern,* the Second Circuit, in assessing Tier II and Tier III penalties under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, assumed, without deciding, that scienter is necessary to an imposition of Tier III Penalties.[93]

In assessing civil penalties, the court may take into account the fact that respondents were required to pay substantial sums in disgorgement (*SEC v. Whittemore,* 691 F. Supp.2d 198, 209 (D.D.C. 2010)). In *Whittemore,* the court imposed a $25,000 civil penalty where the maximum Tier III penalty was $ 120,000, finding it ample for the purpose of deterrence, where the defendants were all required to disgorge all of their profits on a pump and dump scheme.[94] In assessing the amount of the penalty, the court may take into account the "essential and active roles the individuals played in perpetrating the fraud ...." (*SEC v. Lybrand,* 281 F.Supp.2d 726, 732 (S.D.N.Y. 2003)). Of course, under *Gabelli,*[95] the amount of the penalties must be determined only with reference to those sales occurring after September 23, 2008. Hence, it is submitted that civil penalties are not appropriate as to Chiappone, considering that the central allegation in this case is not that Chiappone participated in or was even aware of any illicit conduct, but that he failed to ferret out the wrongful acts of others.

Point IX. <u>Chiappone Cannot be Held Responsible Acts of For Smith and McGinn</u>.

For good reason, there are limits on the scope of liability for failure to discover fraudulent conduct of others. See, *Novak v. Kasaks, supra,* 216 F.3d 300, 309; *South Cherry Street, LLC v. Hennessee Group, LLC,* 573 F.3d 98, 100 (2d Cir. 2009). By its very nature, fraud such as that perpetrated by Smith and McGinn is secretive. The suggestion that Respondents' performance of

[93] *SEC v. Kern,* 425 F.3d 143, 153 (2d Cir. 2005). The court did not decide the scienter issue, as it found defendants conduct would have met a scienter requirement.
[94] *Whittemore,* 691 F.Supp.2d at 208-209.
[95] *Gabelli v. SEC,* 133 S.Ct. 1216 (2013).

additional due diligence on a given offering would have revealed the secretive post-sale fraud ignores reality, particularly in light of regulators' failures to discover the fraud during the same time period. That their activities were concealed is established by David Smith's own admission in a handwritten letter to McGinn, written in late 1999 or early 2000:

> [I]f our trusts go into default everything else will come apart. . . . The default of the trusts will . . . *cause us to lose brokers and at least their confidence in us*, bring on crushing litigation and devastating publicity and I am convinced prosecution by regulators or worse. . . . I believe we are at risk for the raising of investment dollars that are now clearly unlikely to be repaid in full. . . . More recently, those dollars for the most part are used to fulfill investment promises to earlier investors. . . . [W]e are now in possession of indisputable empirical evidence that the new investments have no chance of being repaid in full. . . . We both know why we don't make that disclosure [disclose losses in investments] because such disclosure *would cause or salesmen to cease selling* and investors to cease buying, *thus we are misleading both our own employees and customers."* (Livingston Ex. 31[96]; Tr. pp. 5616-5618.

This is irrefutable evidence the Smith and McGinn intentionally mislead their own brokers for ten years. Yet, in spite of the fact that the SEC failed to uncover any of the material aspects of the fraud in its' 2004 examination, and NASD failed to do so in its' 2006 and 2007 examinations, The ALJ ruled that Mr. Chiappone should be severely punished for his inability to uncover a fraud committed by others and deliberately concealed by its perpetrators, for a period of over ten years.[97] The ALJ's holding that the brokers should have uncovered the fraud should be reversed.

[96] Originally mislabeled as Livingston Ex. 30).

[97] As to the SEC and NASD examinations, see Exhibits Div-370, Div-341 & Div-501.

CONCLUSION

Based on the foregoing, Respondent Chiappone respectfully requests that the Commission reverse the Decision and dismiss the proceedings., with prejudice.

Dated: July 16, 2015

Respectfully Submitted,

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CERTIFICATE OF SERVICE

I, Roland M. Cavalier, hereby certify that on this 17th day of July, 2015, I served a true and complete copy of Respondent Frank A. Chiappone's Individual Brief, together with the Affidavits of Frank Chiappone and Roland Cavalier upon the following parties in this action as follows:

Original and three (3) copies via UPS Overnight to:

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U.S. Securities and Exchange Commission
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Facsimile (202) 772-9324

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Roland M. Cavalier

Sworn to before me this
16th day of July, 2015.

Mary Kate Mulhern-Foote
Notary Public – State of New York

MARY KATE MULHERN-FOOTE
Notary Public, State of New York
No. 6150030
Qualified in Albany County
Commission Expires July 24, 2018

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING

File No. 3-15514

In the Matter of,

FRANK H. CHIAPPONE,
ANDREW G. GUZZETTI,
WILLIAM F. LEX,
THOMAS E. LIVINGSTON,
BRIAN T. MAYER, and
PHILIP S. RABINOVICH

ATTORNEY'S CERTIFICATION REGARDING PAGE REQUIREMENTS

ROLAND M. CAVALIER, states under oath that he is the attorney for Respondent Frank Chiappone in this matter and that he was the person primarily responsible for the individual Brief being submitted on behalf of Mr. Chiappone. According to the electronic word count obtained from the Microsoft word program upon which the Brief was prepared, the Brief contains less than 10,000 words, excluding cover page, table of contents and table of authorities.

Dated: July 17, 2015

TUCZINSKI, CAVALIER & GILCHRIST, P.C.

By: ______________________
ROLAND M. CAVALIER

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PHILIP S. RABINOVICH

AFFIDAVIT SUPPORTING MOTION FOR LEAVE TO ADDUCE ADDITIONAL EVIDENCE

STATE OF NEW YORK)
)SS.:
COUNTY OF ALBANY)

ROLAND M. CAVALIER, being an attorney duly licensed to practice in the State of New York, does hereby state and affirm as follows:

1. This Affidavit supports a motion made pursuant to SEC Rules of Practice, Rule 452 requesting to submit additional evidence on behalf of Respondent Frank H. Chiappone.

2. The additional evidence consists solely of an Affidavit by Respondent Frank Chiappone, which relates to Mr. Chiappone's legal argument that the 12-month suspension from practice ordered by the ALJ in the Initial Decision was inappropriate.

3. At the trial, Mr. Chiappone testified that he had not sold, nor offered, a single private placement security (the securities which are the sole subject of the above-captioned action) since he left

McGinn Smith & Company in early 2009.

4. As Mr. Chiappone states in his attached Affidavit, at this point in time, he still has not sold, nor even offered, a private placement security of any kind to any customer or potential customer. Hence, Mr. Chiappone claims that he has avoided the very type of conduct that the Division of Enforcement claims violated securities law (which Mr. Chiappone disagrees with) for a period in excess of five (5) years. Accordingly, Mr. Chiappone contends that no industry bar, nor cease and desist order is required for the protection of the investing public.

IN WITNESS WHEREOF, the undersigned has signed this Affidavit under penalties of perjury.

ROLAND M. CAVALIER

Sworn to before me this
16th day of July, 2015.

Mary Kate Mulhern-Foote
Notary Public, State of New York

MARY KATE MULHERN-FOOTE
Notary Public, State of New York
No. 6150030
Qualified in Albany County
Commission Expires July 24, 2018

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING

File No. 3-15514

In the Matter of,

FRANK H. CHIAPPONE,
ANDREW G. GUZZETTI,
WILLIAM F. LEX,
THOMAS E. LIVINGSTON,
BRIAN T. MAYER, and
PHILIP S. RABINOVICH

AFFIDAVIT SUPPORTING MOTION FOR LEAVE TO ADDUCE ADDITIONAL EVIDENCE

STATE OF NEW YORK)
)SS.:
COUNTY OF ALBANY)

FRANK H. CHIAPPONE, being duly sworn, does hereby state and affirm as follows:

1. This Affidavit supports a motion made pursuant to SEC Rules of Practice, Rule 452 requesting permission to submit additional evidence on behalf of myself as Respondent.

2. The additional evidence consists solely of an Affidavit by myself as Respondent, which relates to the legal argument that the 12-month suspension from practice ordered by the ALJ in the Initial Decision was inappropriate.

3. At the trial, I testified that I had not sold, nor offered, a single private placement security (the securities which are the sole subject of the above-captioned action) since I left McGinn Smith & Company in early 2009. Division Exhibit 2 (Palen Ex. 4c) shows that I last sold a private placement on November 3,

2009.

4. At this point in time, I <u>still</u> have not sold, nor even offered, a private placement security of any kind to any customer or potential customer. Thus, it has been five years and eight months since I last sold a private placement of any kind to any person. Hence, I claim that I have avoided the very type of conduct that the Division of Enforcement claims violated securities law (which I disagree with) for more than five and one-half years. Accordingly, I contend that no industry bar, nor cease and desist order is required for the protection of the investing public.

IN WITNESS WHEREOF, the undersigned has signed this Affidavit under penalties of perjury.

Frank H. Chiappone

FRANK H. CHIAPPONE

Sworn to before me this
17th day of July, 2015.

Notary Public, State of New York

ROLAND M. CAVALIER
Notary Public, State of New York
No. 4725079
Qualified in Albany County
Commission Expires December 31, ~~X~~ 2016

SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15514

In the Matter of	:
FRANK H. CHIAPPONE, ANDREW G. GUZZETTI, WILLIAM F. LEX, THOMAS E. LIVINGSTON, BRIAN T. MAYER, and PHILIP S. RABINOVICH,	:
Respondents.	:

RESPONDENT WILLIAM F. LEX'S INDIVIDUAL BRIEF

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PRELIMINARY STATEMENT

William (Bill) Lex is 69 years old. For over 40 years he worked in the insurance business without a claim or blemish on his record. He was trusted by everyone who knew him and with whom he did business, known by his customers as an honest man, conscientious, wanting to do what was best for his customers about whom he cared deeply. He never offered products (insurance, variable annuities, or private placements) which he would not purchase for himself and his wife, or recommend and sell to his children, his in-laws, or his dear friends. He is a man of devout faith and conscience. It was his character for honesty which enabled him to build up longstanding relationships with customers of all walks of life – everyday working people, as well as professionals, physicians, hospital executives and other professionals. By 2003, he had an active customer roll of over 2,000 people, of which 50 to 75 were purchasers of McGinn-Smith pre-AISG (2003) Alarm Notes. The rest were almost all insurance or variable annuity customers. As the ALJ found, Mr. Lex watched the performance of the Alarm Notes for several years, then bought them for himself, and after a year began offering them to customers around 1996.

Bill Lex watched the success of virtually all of the private placement products which were issued by McGinn-Smith over a period of more than 20 years. These products always paid on time and always redeemed on time. Then the Four Funds came out, and for five years, 2003 to 2007, inclusive, continued to follow that pattern of paying interest on time and redeeming on time.

McGinn-Smith was not a new broker-dealer in 2003. With at least 23 years of successful operations and with McGinn and Smith viewed important pillars of the Albany community, and having dealt with large and reputable investment banking firms, Bill Lex had great trust and respect for both these individuals and felt confident in their ability to continue to manage successful offerings.

It is in this context that the actions of Bill Lex, as well as the other Respondents, must be viewed.

Of course, we now know since the 2010 shut-down of McGinn-Smith and SEC investigation, and the McGinn and Smith criminal trial, that McGinn and Smith were engaged in various unlawful schemes to keep products afloat and to line their own pockets.

With the substantial investments of Bill Lex and his wife in the Four Funds – Bill Lex invested $400,000.00 in the first Four Funds offering – and with purchases by his children, his in-laws, and dear friends, it is impossible to comprehend how Judge Murray or this Commission could allow the label of "fraud" to be placed upon Bill Lex's shoulders. Added to these facts is the Division's own expert witness, Kerri Palen, who testified that she found no evidence that Bill Lex or the other Respondents had knowledge of McGinn and Smith's fraud or manipulations or that they benefited from McGinn and Smith's theft and manipulation of proceeds. The effect on Bill Lex's life is not softened by the ALJ's blithe use of the word "reckless," a wholly subjective term, not justified by the facts in this case.

Notwithstanding this history, the ALJ inferred in every situation that Lex's conduct was consistent with fraud, and not that Bill Lex was deceived like so many others were for so many years, and that he honestly believed in the products he sold.

ARGUMENT

William Lex, in submitting this individual brief, incorporates by reference herein the arguments made in the Joint Brief submitted contemporaneously herewith.

Respondent William F. Lex asks the Commission to reverse the Initial Decision ("I.D.") of Chief Administrative Law Judge Brenda Murray, dated February 25, 2015, as amended by the Order of April 9, 2015, and to dismiss the entire proceeding. The Judge found Mr. Lex liable under the federal securities laws in connection with the sale of certain private placements issued by McGinn Smith & Company, for which he was a registered representative and independent contractor.

Through a civil suit against McGinn Smith and a criminal suit against its principals, it was eventually learned that Timothy McGinn and David Smith were fraudulently diverting funds of McGinn Smith investors. But, as the Administrative Law Judge acknowledged: "The Division's expert had no reason to believe that Respondents [including Respondent Lex] were aware of McGinn and Smith's fraud. Tr. 1220." (I.D. at 4.) Nevertheless, the Administrative Law Judge found Mr. Lex liable under Section 5 of the 1933 Securities Act and the anti-fraud provisions of the Securities Act and the 1934 Exchange Act.

As set forth below, the Commission should reverse the decision and dismiss the proceedings because there were numerous prejudicial errors in the conduct of the proceeding, there were numerous clearly erroneous findings and conclusions of material fact, and there were numerous erroneous conclusions of law which are identified below.

I. As a matter of law, no alleged omissions or misrepresentations were material because it is undisputed that all pertinent risks of the investments were set forth in writing in the PPMs and Subscription Agreements.

A. SUMMARY OF ARGUMENT

We begin with the obvious. This is not a suitability case. It was not pleaded as such, and could not be tried as such. This case involves allegations of securities fraud and violations of §5 of the Exchange Act for sale of unregistered securities.

Judge Murray found Mr. Lex to have violated "willfully Securities Act § 17(a)(1) and Exchange Act 10(b)(5) and Rule 10(b)(5), stating that:

> "The preponderance of the evidence is that Lex was reckless in offering and selling securities based on material representations that he made to the witnesses who purchased private placements."

The fact is there were no material misrepresentations made by Mr. Lex which could result in a finding of securities fraud under any of the statutes or rules.

Judge Murray's findings against Mr. Lex are neither supported by the evidence, nor has she drawn appropriate inferences from the evidence. There were no affirmative material misrepresentations.

It appears that most, if not all, of Judge Murray's complaints about "non-investigation" relate to the Four Funds, claims clearly barred by the statute of limitations. The Judge's indiscriminate mixing of the trusts with the private placements to establish securities fraud is completely improper. As to the finding that an investigation was required because of the risks of the private placements, and her finding that the clients should have been informed of the risks of the private placements, the fact is that all of the private placements, including the trusts, provide extensive explanation of the risks inherent in the investments. As to the conflicts of interest, they were disclosed in the offering memoranda, and were neither red flags, nor did they require further explanation. As Charles Bennett, expert for William Lex, testified, the explanation in written materials that there will be conflicts of interest is not a red flag since it informs the investor in advance of actions which may be taken by the issuer. As to transactions with affiliates, these were all disclosed. These disclosures were not red flags or the cause of the losses suffered. Rather, it was the abuses of McGinn and Smith with respect to this permissible conduct which resulted in the losses.

As to the disclosures of Four Funds investments in August of 2007, all of which was before September 23, 2008, not only is this barred by the statute of limitations, and therefore irrelevant, it was also waived by the SEC in pre-trial proceedings. (See Argument below) Nevertheless, Mr. Lex explained that he was satisfied with Mr. Smith's explanation for the change in policy. This, too, was not "indicative of fraud." Here again the Judge draws an inference of wrongdoing when it is at least as plausible that Mr. Lex believed the reasons given were reasonable in light of the financial world in late 2007 and 2008.

B. <u>There Were No Material Misrepresentations or Omissions</u>

The ALJ's findings of omissions and misrepresentations by Lex are centered on his alleged failure to inform his clients that the McGinn private placements were risky, and his alleged statements that they were safe. (I.D. p. 103.) Lex denies that he characterized the investments as safe, but because the clients all received written materials that were replete with prominent warnings about the high risk of the investments, and because the investors all signed Subscription Agreements acknowledging their understanding of the high-risk nature of the investments, any alleged oral statements or omissions to the contrary are not material as a matter of law.

Under the materiality requirement for securities fraud, the allegedly false statement or omission must be one "that a reasonable investor would have considered significant in making investment decisions." <u>Ganino v. Citizens Utilities Company</u>, 228 F.3d 154, 161 (2^{nd} Cir. 2000), citing Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988). Accord, Marini v. Adamo, 2014 WL 465036 at *23 (E.D. N.Y. 2014); In re Longtop Financial Technologies Limited Securities Litigation, 939 F.Supp.2d 360, 376 (S.D.N.Y. 2013). Where all pertinent disclosures are set forth in a written PPM made available to the investor, the investor is bound with knowledge of those disclosures. Brown v. The E.F. Hutton Group, Inc., 991 F.2d 1020 (2nd Cir. 1993)(defendants allegedly orally characterized investments as "conservative" and "low risk"; affirming summary judgment for defendants because "the alleged oral statement are contradicted by the offering materials"); Mercury Air Group, Inc. v. Jet USA Airlines, Inc., 1998 WL 542291 at *7 (S.D.N.Y. 1998), aff'd, 189 F.3d 461 (2nd Cir. 1999)(dismissing securities claim because the private offering memorandum "clearly contradicts the alleged oral representations"). Therefore, as long as the investor has all pertinent truthful information in the written offering materials, any alleged oral omissions or representations to the contrary are legally insignificant and immaterial. Acme Propane, Inc. v. Tenexco, Inc., 844 F.2d 1317, 1322 (7th Cir. 1988).

"Where the facts and circumstances allegedly omitted or misrepresented have actually been disclosed in the relevant transaction document, there is no liability under the securities laws because the materiality element is absent." Taylor v. Prudential Insurance Company of America, 2003 WL 21314254 at *7 (S.D. Ind. 2003). See also, Wamser v. J.E. Liss, Inc., 838 F.Supp. 393 (E.D.Wisc. 1993.

In In the Matter of VMS Limited Partnership Securities Litigation, 1992 WL 249594 (N.D. Ill. 1992), plaintiffs alleged that the defendants violated the securities laws by orally characterizing certain investments as "secure," "conservative," and "reasonably expected to be profitable," when they were in fact highly risky. Id. at *11. In dismissing all claims, the court held that the materiality element was lacking as a matter of law because (as in this case) the alleged oral misrepresentations were contradicted by the numerous written warnings in the private placement memoranda and subscription agreements.

The PPM in VMS (as in this case) explained that "[i]nvestment in the units involves a high degree of risk" and is suitable only for persons who "could withstand a loss of their entire investment in the Units." VMS at *11. As in this case, the investors in VMS "warranted that they had reviewed the offering materials when they signed their subscription agreements." Id. at *14. The VMS court continued:

> Moreover, by signing the subscription agreement, plaintiffs expressly acknowledged that "the Units are speculative investments which involve a high degree of risk of loss by the undersigned of his entire investment." Hence, disclosures about the risky nature of the investments could hardly have been more plain.

VMS at *11. See, also, Acme Propane, Inc. v. Tenexo, Inc., 844 F.2d 1317, 1322 (7th Cir. 1988).

This principle protects against frivolous claims. See, Carr v. CIGNA Securities, Inc., 95 F.3d 544, 547 (7th Cir. 1996)(defendant allegedly told plaintiff "that the limited partnerships were safe, conservative investments"; securities fraud claim dismissed because defendant gave plaintiff "documents that disclosed the riskiness of the investment"). See also Kennedy v. Josephthal & Co., 814 F.2d 798, 805 (1st Cir. 1987

Here, this body need not try to reconstruct, as much as ten years after the fact, whether Mr. Lex orally disclosed the risks of the investments to his clients because it is undisputed that all of the pertinent risks were disclosed in writing in the PPMs and the Subscription Agreements. The investor witnesses that the Division called to testify against Mr. Lex were not deprived of this information. For example, Alice Forsyth, M.D., who testified on behalf of the Division, acknowledged that Mr. Lex always presented her with the PPMs relating to the proposed investments and gave her a full opportunity to review the written materials. (Forsyth testimony at 1514:2-10.) She testified as follows on this subject:

> Q. …Mr. Lex always provided you with whatever written material was necessary or related to the various notes; isn't that right?
>
> A. Oh, yes.
>
> Q. And gave you an opportunity to read the material?
>
> A. Oh, yes.

(Forsyth testimony at 1514:3-10.) She further testified that Mr. Lex was always available to answer any questions she might have had about the written materials. (Forsyth testimony at 1518:11-14.) Dr. Forsyth further testified that Mr. Lex always presented the McGinn Smith private placements as just one possible investment along with other alternatives, including variable annuities. (Forsyth testimony at 1495:16-1496:25.) And he left it completely up to Dr. Forsyth to decide which investments to make, if any:

> Q. [H]e left it up to you, did he not, for you to study these things and to make your own determination; isn't that right?
>
> A. Yes. We were free to choose.

(Forsyth testimony at 1497:2-6.)

The problem was not that Mr. Lex failed to provide her with all pertinent information regarding the investments, but rather that Dr. Forsyth, by her own admission, never paid attention to the information. She testified that early on she didn't review the materials because she was distracted, and later on she didn't review them because she knew her earlier McGinn Smith investments had been performing well. Her testimony was as follows:

> Q. Did he give you any written materials to review relating to the investment?

> A. Yes, he usually gave us written materials to review, and at that time--in 2003, I was still, you know…I was trying to get some other things done.
> **So I didn't pay much attention to them.** I figured that most of the things, these investments, came with papers attached, and **I didn't review them**, though.

* * *

> Q. And I assume that before you signed the subscription agreements, you at least read the language that you were signing, right?
>
> A. I **probably** did. **But mostly I didn't examine it closely** because I knew that the early McGinn investments had performed okay….
>
> **So I saw no reason to examine them closely.**

(Forsyth testimony at 1479:13-24; 1514:11-22; emphasis added.)

Similarly, Dr. Marvin Weinar, who testified on behalf of the Division, acknowledged that before he made investments Mr. Lex would meet with him, discuss the products, and give him the PPMs for him to review. (Weinar testimony at 747:15-24.) Mr. Lex explained the features of the investments, explained the three tranches, and offered only the two most secure tranches. (Weinar testimony at 758:8-759:5; 759:6-9, 19-25; 760:2-4; 762:15-763:17; 768:20-769:6.) Mr. Lex was always available and responsive to Dr. Weinar's questions. (Weinar testimony at 768:17-19; 777:17-20.)

As with Dr. Forsyth, Dr. Weinar candidly admitted that the problem was not a failure to receive the written disclosures of all of the pertinent risks, but rather his own failure to pay attention. Dr. Weinar testified that he only "skimmed [the PPM] and, sad to say, did not read it with the attention I should have." (Weinar testimony at 770:2-4.) Although he signed the Subscription Agreements and knew he was bound by what he signed, he only read the Subscription Agreements "to some extent." (Weinar testimony at 763:18-764:10.) He only "looked…over" the Subscription Agreements before signing them, even though he knew he would be bound by their terms. (Weinar testimony at 766:20-767:3.)

As set forth above, the court in Carr, supra, warned about the prospect of frivolous claims and faulty memories if investors were permitted to testify about alleged oral representations or omissions contrary to written disclosures in the offering materials. That observation is particularly apt in this case. For example, in testifying in 2014, the Division relies on Dr. Forsyth's recollection that, in December 2004, Mr. Lex allegedly told her that the risk of the TAIN investment was negligible. (Division's FOF 386.) But Dr. Forsyth candidly acknowledged that she had virtually no recollection of her discussion with Mr. Lex regarding that 2004 investment **or any of her other McGinn Smith investments.** (See Forsyth testimony at 1483:15-19, emphasis added.) As Dr. Forsyth was asked about each transaction with Mr. Lex, she made clear she had no recollection of the discussions surrounding any of them.

Mr. Stoelting asked Dr. Forsyth whether she remembered Mr. Lex making certain statements about risk in connection with her second TAIN investment and she responded that she did not remember. (Forsyth testimony at 1480:20-1481:2.)

This was also true of Dr. Forsyth's recollection with the remainder of her investments, that is, she had no specific recollection of conversations regarding any other of these sales. (Forsyth testimony at 1482:10-1487:18.

It was completely improper for Judge Murray to rely on this type of testimony, to subject Mr. Lex to substantial monetary fines, penalties and forfeitures, debarment and public obliquy and censure based on an alleged statement about "negligible risk" nearly 10 years after it was supposedly made, especially where the investor's recollection of the events from that time is admittedly hazy at best, and more precisely, non-existent. And this is not criticism of Dr.

Forsyth. This is one of the salutary rationales for holding the terms of written disclosures to be binding and conclusive, regardless of whether the investors admit that they read them, and barring investors from claiming that the broker made statements or omissions contrary to those written disclosures. Even if the witnesses are earnestly trying to recollect distant discussions to the best of their ability, it is understandable that their memories would be imperfect. It is also an important reason for respecting statute of limitations.

What investors now claim to remember as statements about the "safety" of the Four Funds in general could easily in fact have been explanations about the **relative** safety of the Senior and Senior Subordinated tranches in comparison to the Junior tranche. And it is particularly hazardous to rely on human memory of what was allegedly **not** said many years ago, as the Division does when it relies on Lex's alleged **failure** to disclose the high risks of the investments.

For the foregoing reasons, materiality is lacking as a matter of law.

C. Even if Mr. Lex had characterized the Private Placements as "safe," that is not the sort of measureable, objective assertion of fact that can form the basis of liability for alleged misrepresentations of fact.

According to Judge Murray, Lex's affirmative misrepresentation was that he told the three witnesses the private placements at issue were "safe." Lex denies he so characterized the investments (N.T. 4882:2-8), and the Commission should not base the kind of penalties imposed in this case on 7-9 year-old "statements" by witnesses who are just as likely to be testifying about their impressions or "beliefs" as opposed to actual statements. This dispute of credibility need not be resolved because, as a matter of law, the characterization of a security as "safe" is not the sort of objective, verifiable factual assertion that can give rise to an action for securities fraud.

"To be actionable [as securities fraud], a misrepresentation must be 'one of existing **fact**, and not merely an expression of opinion, expectation, or declaration of intention.'" In re Moody's Corporation Securities Litigation, 599 F.Supp.2d 493, 507 (S.D.N.Y. 2009)(emphasis added)(quoting Greenberg v. Chrust, 282 F.Supp.2d 112, 121 (S.D.N.Y. 2003); Smith v. Meyers, 130 B.R. 416, 423 (Bankr. S.D.N.Y. 1991); In re Duane Reade Inc. Securities Litigation, 2003 WL 22801416 at *4 (S.D.N.Y. 2003)). "To allege a misrepresentation or omission of material fact [under the securities laws], a plaintiff 'must point to a **factual** statement or omission--that is, one that is demonstrable as being true or false." Carlucci v. Han, 886 F.Supp.2d 497, 517 (E.D. Va. 2012)(emphasis in original)(quoting Ottmann v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 342-43 (4^{th} Cir. 2003); Longman v. Food Lion, Inc., 197 F.3d 675, 682 (4^{th} Cir. 1999)).

"Statements of 'hope, opinion, or belief about...future performance' are not actionable." In re Moody's, supra, 599 F.Supp.2d at 507 (quoting San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., 75 F.3d 801, 811 (2^{nd} Cir. 1996); Lapin v. Goldman Sachs Group, Inc., 506 F.Supp.2d 221, 239 (S.D.N.Y. 2006)). Similarly, "generalized statements of optimism that are not capable of objective verification are not actionable" under the securities laws. In re XM Satellite Radio Holdings Securities Litigation, 479 F.Supp.2d 165, 176 (D.D.C. 2007). Accord, Grossman v. Novell, Inc., 120 F.3d 1112, 1119 (10^{th} Cr. 1997); In re Harman International Industries, Inc., 2014 WL 197919 at *16 (D.D.C. 2014).

It follows that statements as to the general "riskiness" or "safety" of particular securities are too general to be actionable. Plumbers' Union Local No. 12 Pension Fund

v. Swiss Reinsurance Company, 753 F.Supp.2d 166, 182 (S.D.N.Y. 2010). "[S]tatements that the stock of defendant Monterey was a red hot stock and plaintiff could not lose on an investment in Monterey, that plaintiff would make a bundle of money on the stock of defendant Automated, and that it was impossible to lose money in an investment in Automated...are not actionable under either the federal or state securities laws." Rotstein v. Reynolds & Co., 359 F.Supp. 109, 113 (N.D. Ill. 1973). See also San Leandro, supra, 75 F.3d at 811, Dafofin Holdings S.A. v. Hotelworks.com, Inc., 2001 WL 940632 at *4 n. 6 (S.D. N.Y. 2001), Nanopierce Technologies, Inc. v. Southridge Capital Management LLC, 2003 WL 21507294 at *8 (S.D.N.Y. 2003), and In re Splash Technology Holdings Inc. Securities Litigation, 160 F.Supp.2d 1059, 1077 (N.D. Cal. 2001). Here, "safe" is a relative and subjective matter of opinion, not subject to verifiable proof as either true or false. For this reason, the allegation that an investment was characterized as "safe" cannot give rise to liability for securities fraud.

D. Even if Mr. Lex had failed to orally disclose the risks of the private placements, those omissions cannot give rise to liability because it is undisputed that those disclosures were repeatedly made in writing in the PPMs and Subscription Agreements.

According to Judge Murray, Lex "never mentioned the high risk nature of the notes...." (Division's Brief at 27.) This basis for liability fails as a matter of law because it is undisputed that all investors were repeatedly and specifically warned of the risks in the investments through the numerous disclosures in the PPMs and Subscription Agreements.

The concept of a false affirmative representation is fairly straightforward. But an **omission** is "false" only if "the omitted fact renders a public statement misleading." Carlucci v. Han, 886 F.Supp.2d 497, 517-518 (E.D. Va. 2012); Ottmann v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 343 (4^{th} Cir. 2003). Accord, Nagel v. First of Michigan Corp., 784 F.Supp. 429, 435 (W.D. Mich. 1991). The anti-fraud provisions do not require a dealer or broker "to state every fact about stock offered that a prospective purchaser might like to know or that might, if known, tend to influence his decision." Trussell v. United Underwriters, Ltd., 228 F.Supp. 757, 762 (D.Colo. 1964). "Liability may exist under Rule 10b-5 for misleading or untrue statement, but not for statements that are simply incomplete." Winer Family Trust, 503 F.3d 319, 330 (3rd Cir. 2007); In re Harman International Industries, Inc. Securities Litigation, 2014 WL 197919 at *19 (D.D.C. 2014). Accord, Brody v. Transitional Hospitals Corp., 280 F.3d 997, 1006 (9th Cir. 2002); Backman v. Polaroid Corp., 910 F.2d 10, 16 (1st Cir. 1990).

This is clear from the wording of the anti-fraud provisions themselves. The misrepresentation provision of Section 17(a) of the Securities Act makes it unlawful:

> to obtain money or property by means of any untrue statement of a material fact or any **omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.**

15 U.S.C. § 77q(a)(2)(emphasis added).

In substantively identical language, the misrepresentation provision of Rule 10b-5 makes it unlawful:

> To 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)(emphasis added).

Here, Mr. Lex was not required to orally advise his clients of the risks of the investments because those risks were thoroughly and repeatedly spelled out in writing in the PPMs and the Subscription Agreements. In connection with the purchase of the Notes in question, all of Mr.

Lex's customers signed a Subscription Agreement informing them of the detailed risks. (See Division Exhibit 5 at 36-38; and Division Exhibit 5 at 1, 9, 11-13.)

Mr. Lex's clients were already informed that there was no guarantee of liquidity, that cash flow depended in finding suitable investments, and that they could lose their entire investment. To the extent liquidity problems eventually occurred with the onset of the world-wide financial crisis, no additional oral disclosures were required to "correct" the prior written representations because the original written disclosures already fully advised the investors of that very risk, as well as all other pertinent risks.

E. <u>There Were No Red Flags That Required Investigation By Lex</u>

As part of her rationale, Judge Murray states:

> "Without resolving the red flags that he learned about on January 8, 2008, Lex recommended and sold MS&Co private placements: FAIN, TDM Cable and INEX to Forsythe, Monahan and Weinar after January 8, 2008, and he did not disclose his material information to his clients." [I.D. p. 103]

There are several problems with this conclusion, both factual and legal. Initially, we point out that on page 34 of the Initial Decision, Judge Murray found that "Lex was not invited to the meeting of registered representatives on January 8, 2008, and no one called and told him what transpired at the meeting. (N.T. 4895-97)." This was an appropriate finding in light of the fact that there was no testimony that Mr. Lex was present, and because the reduction in interest in the Four Funds notes only pertained to the junior tranche and Mr. Lex only sold senior and senior subordinated. Lex eventually heard about the interest reduction, but did not hear any of the details of Smith's presentation, not being present. On hearing of the interest reduction, Mr. Lex reasonably would have concluded that this was not evidence of "fraud" or, as Judge Murray states, "mismanagement," but actually a reasonable action for a fund manager to take (a reduction of interest in one tranche) especially in light of the serious adverse conditions in the economy at the time, to protect the more secure tranches which were going to continue to be paid regular interest. To suggest that the reduction in interest in a junior tranche only is a red flag for fraud is an unreasonable inference for the ALJ to draw.

As stated in South Cherry Street, LLC v. Hennessee Group, LLC, 573 F.3d 98 (2009) cited by Judge Murray as establishing the legal standard for reckless conduct:

> " . . . An inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent."

Here, the ALJ, without any justification, chose the inference consistent with scienter even though the innocent inference was equally, if not more, compelling and reasonable.

Finally, The Administrative Law Judge erred in finding that the January 8, 2008 notice of reduction in interest in the Four Funds' junior Notes constituted a red flag, even as to the Four Funds' junior Notes, because the possibility of such a restructuring was specifically disclosed and authorized in the Private Placement Memorandum, particularly in the event of an economic downturn. (See, e.g., Division Exhibit 5 at 13 & 14 [pages 7 & 8 of PPM].) McGinn Smith's rationale for the reduction in interest, to protect the Senior and Senior Subordinated Notes in the face of the severe, worldwide financial crisis, where Mr. Lex's clients all held Senior or Senior Subordinated Notes, did not give any indication of fraud or mismanagement, but appeared reasonable.

1. **Transactions with affiliates**

The ALJ apparently agrees with the proposition advanced by the Division that the possibility of transactions with affiliated entities is a red flag, but again, this feature of the Four Funds was fully disclosed in the PPMs. See, *e.g.*, Division Exhibit 5, PPM for FIIN at 7.

Because this feature of the investments is common and was fully disclosed in writing, it was not a red flag or cause for heightened investigation. Nevertheless, the ALJ apparently maintains that "Selling Respondents should have asked for information on all affiliated transactions and demanded to know whether the price restrictions were observed." To demand verification of whether the price restrictions on transactions with affiliates were observed, would impose an impossible burden on each of the more than 40 individual brokers, that no Rule, Notice, case or other legal authority requires. As a practical matter it would require access to, and analysis of, untold reams of banking and financial records, and would unnecessarily duplicate the work that investment bankers, accounting departments, and outside accountants are charged with performing. For purposes of efficiency, the detective work that the ALJ now imposes on individual brokers, is already allocated to those with the expertise and resources to perform it, such as investment bankers, accountants and compliance personnel inside the broker-dealer.

Kerri Palen was able to unearth such information only with training as a CPA and certified fraud examiner, subpoena power, access to 400 separate bank accounts, accountants' work papers, all of the confidential tax records and financial statements of McGinn Smith and its affiliates and principals at her disposal, three years of work, and all of the resources of the SEC behind her. (Division Exhibit 1, Palen Declaration ¶¶2, 6-9; Palen testimony at 231:17-20; 404:16-17; 509:16-25.)

While Palen conducted her investigation once, after McGinn Smith had been shut down by the SEC, under the ALJ's finding the brokers would have had to be conducting their investigation continuously throughout 2003-2009 as the Four Funds and the Trusts continued to make their investments. The law does not require brokers to duplicate the job of the broker-dealer and its team of professionals.

Before selling any private placement investment to an unaccredited client, Mr. Lex always checked first with Patricia Sicluna, the vice president of registration, to make sure that that offering had not exceeded the limit of 35 unaccredited investors. (N.T. 1618:2-17.) Patricia Sicluna kept running track of whether the number of non-accredited investors for any particular offering exceeded the limit of 35 allowed under Regulation D. For example, by e-mail dated February 21, 2006, Ms. Sicluna informed Richard Feldmann as follows: "We have room for non-accredit[ed] investors" in FAIN. (Lex Exhibit 137.) The ALJ appeared to need corroboration of Lex's testimony that he regularly called Patricia Sicluna to find out the status of unaccredited investors. The Division, which had access by subpoena during its civil case against McGinn and Smith, never presented Ms. Sicluna to contradict this testimony. The above-mentioned e-mail corroborates that she was keeping track and that she was advising brokers of the count.

2. **Confidentiality**

Lex kept up with the status of the Four Funds in regular, constant conversations and communications with Smith about their performance. (N.T. 4881:17-23.) In response to Lex's requests, Smith informed Lex what industry sectors the Four Funds were invested in, but initially explained that confidentiality agreements prevented him from disclosing the names of individual companies in which the Four Funds were invested. (N.T. 4884:21-4885:12; 4887:7-24; Lex Exhibit 25, letter dated March 22, 2006 from McGinn Smith to Mr. Lex listing the investment portfolio of FIIN, FEIN and TAIN by industry and percentage allocation.)

Smith's explanation about confidentiality agreements seemed reasonable to Lex because, based on their relationship of more than two decades at that time, Lex had every reason to trust Smith. (N.T. 4885:13-19.) As Charles Bennett explained, there is nothing suspicious or unusual about small companies requesting confidentiality for their loan or investment agreements. (Bennett testimony at 4153:11-4154:13.)

Mr. Bennett's expertise in this regard should carry significant weight because he has served as a senior capital markets executive and corporate securities lawyer with over 30 years' experience in all aspects of public, private and municipal underwritings and distributions in both governmental and private sectors. (Lex Exhibit 147, Bennett CV at 1; Bennett testimony at 4029:15-4031:8.) He was chief compliance officer and in-house counsel responsible for developing, implementing, and overseeing sales practices and compliance systems for broker-dealers and investment advisors, and he consulted with broker-dealers and investment advisors to assure compliance with applicable legal and regulatory mandates. (Lex Exhibit 147 at 1.)
Mr. Lex continued to ask Smith and McGinn Smith CFO David Rees for updates on the Four Funds' investments. (N.T. 4887:25-4889:25; Lex Exhibits 39, 40 & 78, e-mails of 8/1/07 & 8/8/07.) In response to Lex's requests, on August 9, 2007 he received written portfolio analyses of the Four Funds' investments, showing the identity of the companies, a description of the investment, the amount of principal invested, and the yields. (N.T. 4890:2-5; Lex Exhibits 63 & 125.)

After Mr. Lex received the portfolio analyses he had a follow-up discussion with McGinn Smith CFO David Rees in which Mr. Reese informed Lex and that all of the investments were performing and that there were no defaults or problems with the investments. (4890:6-16.)

By e-mail of August 15, 2007, Mr. Lex (through his assistant, Deb Adkins) wrote to David Rees as follows:

> Thank you for your listing of the assets in each of the Note Offerings. **I am confirming our recent conversations that all of the assets in the notes are performing and there are no pending or suspected defaults.** Thanks again for your help. **I would hope to be advised if any problems develop.**

(N.T. 4890:17-23; Lex Exhibit 41, emphasis added.)

There was no unusual or suspicious "secrecy" about the Four Funds investments.

3. The August 2007 Portfolio Analysis

As set forth above, in August 2007, Lex received, in response to his requests, a portfolio analysis of the Four Funds' investments, showing the identity of the companies, a description of the investments, the amount of principal invested, and the yields. (N.T. 4890:2-5; Lex Exhibit 63 & 125.) According to Judge Murray, this document was a red flag (see heading XI(C)(4) in Division's FOF page 76, stating: "The August 2007 Portfolio Analysis Received by Lex Was a Red Flag"), which required Lex to perform "due diligence on the Trust Offerings in 2008 and 2009." (Division's FOF 348.)

Judge Murray finds that the August 2007 portfolio analysis reflects overlapping investments among the Four Funds, and David Smith had initially told Lex that the Four Funds would not have overlapping investments (Division's FOF 347), and therefore a "red flag."

The first and most critical problem with this argument is that **the OIP does not characterize the August 2007 portfolio analysis as a red flag.** Indeed, the OIP does not even mention the 2007 portfolio analysis at all. In response to the concern raised in Respondents' pre-trial Motions for a More Definite Statement, the Division assured the Respondents and Judge

Murray that the recitation of red flags in the OIP was intended to be exclusive. The Division stated:

> [Respondents] complain that they are uncertain whether there are red flags other than the ones identified in the OIP. The OIP, however, should not be read to suggest that there is some category of unnamed and undisclosed red flags. **The red flags discussed in the OIP are the red flags that will be presented at trial....**

(Division's Memorandum of Law in Opposition to Motions for More Definite Statement, filed Nov. 25, 2013, at 7; emphasis added.) The August 2007 portfolio, therefore, cannot be offered as a red flag.

At trial, when the Division sought to present testimony of an alleged red flag that was not listed in the OIP, Russell Ryan, on behalf of Mr. Lex, reminded the Judge about the Division's pre-trial representation that the list of red flags in the OIP was exclusive, and the Judge properly agreed. N.T. 271:5-272:15.)

On the merits, contrary to the Division's assumption, there is no basis for concluding from the August 2007 portfolio analysis that Smith's pre-2007 statement was a "lie." It is equally plausible that the common investments reflected a change in strategy.

Lex testified that he was disappointed when he learned in August 2007 of the overlapping investments, not because Smith had "lied" to him earlier, but rather because Smith had failed to keep Lex up to date and notify Lex that his strategy had changed after Smith first indicated that he planned different investments for each of the Four Funds. (Lex testimony at 4954:6-4958:6.)

Lex did specifically inquire and follow up with Smith about the change in strategy. In response, Smith "assured [Lex] that as the manager, he was doing those assets in multiple LLCs because they were performing, and he thought if it benefits FIIN, it will benefit another one." (Lex testimony at 4958:2-6.) The explanation that the Four Funds were performing, and that Smith's strategy was working, conformed with Lex's experience in seeing his clients at that time continuing to receive all of their interest payments and redemptions on time and in full. (N.T. 4890:24-4891:13.)

Because the PPMs did not prohibit common investments among the Four Funds, and because all investors affirmed in writing that they were not relying on representations outside the PPM, any oral statement about a plan to avoid common investments was immaterial as a matter of law. Acme Propane, Inc. v. Tenexco, Inc., 844 F.2d 1317, 1322 (7th Cir. 1988); Taylor v. Prudential Insurance Company of America, 2003 WL 21314254 at *7 (S.D. Ind. 2003); Wamser v. J.E. Liss, Inc., 838 F.Supp. 393, 397 (E.D. Wisc. 1993); In the Matter of VMS Limited Parnership Securities Litigation, 1992 WL 249594 at *11 (N.D. Ill. 1992).

4. January 2008 default of the Four Funds Junior Notes

According to Judge Murray, the announcement in January 2008 of the default of the Four Funds Junior Notes should have been a red flag to the Respondents about all tranches of the Four Funds and, indeed, all McGinn Smith private placements. (I.D. p. 103.) The Division refers to a meeting on January 8, 2008 in Albany at which McGinn allegedly told the attendees that they needed to "pump out the swamp" and drive up revenues to generate fees for McGinn Smith. (Division's FOF 162.)

It is undisputed that Mr. Lex was not invited to, and did not attend, the January 8, 2008 meeting (N.T. 4895:9-15), and Judge Murray so found. (I.D. p. 34). He was not aware of the meeting, and no one told him what occurred at the meeting. (N.T. 4896:18-4897:2.)

On January 14, 2008, a draft letter intended for Junior noteholders in the Four Funds was distributed by e-mail to certain McGinn Smith brokers for their review. (Division

Exhibit 151.) The letter stated that, because of the financial crisis, McGinn Smith Advisors was taking proactive measures to protect the LLCs by reducing the interest payments to Junior noteholders only to 5%. (Division Exhibit 151.)

Mr. Lex was not listed as a recipient of the January 14, 2008 e-mail distributing the draft letter referred to above, and he did not receive the draft letter referred to above. (N.T. 4896:11-17; Division Exhibit 151.)

Although he eventually learned about the reduction in interest payments on the Junior Notes, that did not affect any of his clients precisely because he had no clients with Junior Notes. If anything, the restructuring affirmed Lex's foresight in restricting his sales to the most secure tranches, Senior and Senior Subordinated.

The Division next refers to more restructuring in April 2008. (Division's Brief at 24.) But because all of Mr. Lex's clients were in the Senior-most Notes, all of Mr. Lex's Four Funds clients continued to receive their interest payments for an additional two years, through April 2010, when the SEC shut down McGinn Smith. (N.T. 4917:23-4918:6.) In October 2008, all tranches were affected by a payment restructuring, except for interest to the Senior-most Notes. (See Division Exhibit 192.)

Mr. Lex's expert witness, Charles Bennett, explained that the restructuring of the Four Funds was not a red flag as to the Trust Offerings because the Trusts "were totally separate and segregated offerings." (N.T. 4074:6-7.) The Division's own expert acknowledged that the Trust Offerings "were not at all similar to the income notes…." (Division Exhibit 1, Lowry expert report at 25.) Indeed, the OIP itself states that the Four Funds were "far different" from the Alarm Trusts. (OIP ¶38b.)

Furthermore, as of the time Bill Lex started selling Trusts again (March 2006, see page 13 of Exhibit 4k of Division Exhibit 2), the only experience he had had with the Trusts was their exceptional performance.[1]

5. The Trust Offerings

The Division states that with the Trust Offerings, "McGinn and Smith's fraudulent uses of offering proceeds became even more flagrant," and that they engaged in "outright theft and other improper uses of offering proceeds." (Division's Brief at 24, 25.) But there is no evidence that Mr. Lex knew or should have known of the carefully concealed fraud and theft.

The Division also claims that two "red flags" are found on the face of the Trust PPMs: fees that the Division now characterizes as "exorbitant" and provision for use of Trust proceeds to redeem earlier Trust investors. (Division's Brief at 25.)

The only Trust with unusually high fees on its face was Benchmark, and the Division's own evidence reflects that **Mr. Lex never sold any Benchmark.** (See Exhibit 4k to Division Exhibit 2, summary of Lex sales.)[2] The redemption of earlier Trusts, if connected with asset acquisition, cannot be viewed as a red flag.

F. The ALJ Was Not Independent of the Prosecutorial Arm of the Commission and Lacked Independence, Violating Lex's Right to Due Process

The Administrative Law Judge demonstrated a lack of judicial independence and commingling of judicial and prosecutorial functions in her handling of Lex's Motion for

[1] Of course in hindsight, the Division says there were problems with the alarm notes that were "covered up" by the 2003 IASG public offering. But there is no evidence that Lex was aware of any of that when he was selling the post-2006 Trusts.

[2] The Division's case arises from the sale of 26 offerings. (See Division Exhibit 2, Palen Declaration¶4 and Exhibit 3 thereto.) The Division's own evidence reveals that Lex never sold any investments in three of the offerings on that list: TDM Luxury Cruise Trust, Cruise Charter Ventures Trust, and TDMM Benchmark Trust. (See Exhibit 4k to Division Exhibit 2, summary of Lex sales.)

Summary Disposition and Motion for Leave to File the Motion for Summary Disposition. For the reasons set forth in the Joint Brief, Lex was entitled to summary or partial disposition in his favor under 28 U.S.C. § 2462 because the proceeding was commenced more than five years after the claim first accrued. The Administrative Law Judge nevertheless refused to even consider the merits of Lex's Motion for Summary Disposition, reasoning that Mr. Lex's Motion differed from the obvious position of the Commission. The Judge therefore denied Lex's Motion for Leave to File Motion for Summary Disposition, and in a telephone conference on the issue the Judge explained as follows:

> My belief is that when the Commission sets a case down for hearing, and there has been no factual changes between when they made the decision to set it down and when the motion for summary disposition has been filed, that **the agency does not want motions of summary disposition granted because you're second-guessing their decision that the case needs to get set down for hearing and that there is a legal basis for it**....I work for the Federal Government. I am an Administrative Law Judge. The case is in this office. **It's been assigned to me for decision. So I have to hear it.**

(N.T. of 1/21/14 pre-hearing telephone conference at pages 30, 33-34)(emphasis added). This demonstrated that the Judge was not independent and in a position to rule on matters before her, but was bound by the Commission's prosecutorial arm, thus violating Mr. Lex's due-process right to a fair hearing before an independent tribunal.

G. The Customers Are Bound To Know of the Warnings Which They Received in the PPM and Which They Acknowledged in the Subscription Agreement. It is No Excuse That They Did Not Read Them or Pay Attention

The Administrative Law Judge erred in discounting the warnings and risks disclosed to customers in the Private Placement Memoranda on grounds that the customers allegedly "did not study them [the PPMs] in detail." (I.D. p. 91.) As a matter of law, customers are imputed with notice of disclosures they receive in writing in the PPMs, regardless of whether, or how thoroughly, they read them. Brown v. The E.F. Hutton Group, Inc., 991 F.2d 1020 (2nd Cir. 1993); Carr v. CIGNA Securities, Inc., 95 F.3d 544, 547 (7th Cir. 1996); Wamser v. J.E. Liss, Inc., 838 F.Supp. 393, 399 (E.D. Wisc. 1993).

H. The September 3, 2009 Disclosure Is Irrelevant As To Lex Because He Sold No Securities After That Date

The Administrative Law Judge's finding that the September 3, 2009 disclosure of the Firstline bankruptcy filing constituted a red flag (Initial Decision at 93) is irrelevant as to Mr. Lex, because Mr. Lex sold no securities after September 3, 2009. (See Exhibit 4k to Division Exhibit 2, Summary of Lex Sales). In fact, Lex's last sale of a McGinn Smith private placement---a Trust Offering--was July 17, 2009. (Id.) Because Mr. Lex made no sales after that date, he could not be liable for having failed to impart that information to customers in connection with sales.

I. The ALJ Erred in Connecting the Four Funds Red Flags to the Trusts

The Administrative Law Judge erred in finding that alleged red flags with respect to the Four Funds provided a basis to impose a duty on Lex to investigate the Trust Offerings, or that selling the Trusts without disclosing the Four Funds "red flags" was Securities Fraud. As the Division conceded (OIP ¶38b), the Trust Offerings were entirely different investments from the Four Funds. Unlike the Four Funds, the Trust Offerings were not blind pools. The Trust Offerings were collateralized by specific receivables, whereas the Four Funds were Notes initially dependent on unknown investments. The Trust Offerings investments were selected by Timothy McGinn, who had substantial successful experience in alarm and triple play offerings. The Trust Offerings' investments were vetted by the McGinn Smith due diligence team. All of this gave the brokers confidence in the Trusts, independent of what may have happened with the Four Funds. Furthermore, the Administrative Law Judge erred in concluding that evidence of cash flow problems in the Four Funds should have alerted brokers to problems in the alarm Notes (Trusts), or to suspect every new investment proposal affiliated with McGinn Smith. This error was particularly prejudicial because all of Mr. Lex's sales of the Four Funds were before September 23, 2008, and therefore outside the statutory (5-year) period. With no evidence of red flags pertaining to the Trust Offerings themselves that Lex sold, the Judge improperly imposed liability for sales of the Trust Offerings based on alleged red flags that: (a) pertained to entirely different investments, and (b) were outside the statutory (5-year) period. Furthermore, it was error to impose a duty to investigate the Trusts, when the purported red flags all related to the Four Funds.

J. <u>Section 5 Requires Scienter</u>

The Administrative Law Judge erred in holding that a violation of Section 5 of the Securities Act does not require scienter where Regulation D provides an exemption to the registration requirement if there are, or the issuer **"reasonably believes"** there are, no more than 35 unaccredited investors. 17 C.F.R. § 230.506. Because broker liability under this section has only been established by extension, the broker is entitled to the same standard as the issuer. The Administrative Law Judge erred in holding that Respondent Lex willfully violated Section 5 of the Securities Act where the undisputed testimony was that Mr. Lex reasonably relied on the operations manager at McGinn Smith who was charged with keeping a running total of the number of unaccredited investors for each offering, to ensure that it did not exceed the maximum number of 35, thus qualifying for the registration exemption set forth in Regulation D/SEC Rule 506.

K. It Was Reasonable For Lex to Rely on the Broker-Dealer for Product Due Diligence

To the extent that the Administrative Law Judge held that individual brokers had a duty to investigate proposed investment products, the Judge erred in finding that Mr. Lex breached that duty in this case, where the evidence established that he familiarized himself with the PPMs; reviewed them with his clients; reasonably relied on the due diligence performed by the broker-dealer that is specifically charged with the investigatory responsibility, and was particularly equipped and staffed to perform extensive due diligence; reasonably relied on the long-time, successful experience of McGinn Smith private placements; and regularly inquired of David Smith and the CFO of McGinn Smith about the status of the investments in question.

L. If Disgorgement and Penalties Are Upheld, Lex Is Entitled to Credits

The Administrative Law Judge erred in failing to credit Mr. Lex with $511,438.00 that he and his wife invested in Four Funds and Trust Offerings investments that to this day is being sequestered and exempted from any distribution by the McGinn Smith Receiver. (Lex Ex. 153 [summary of Lex family investments per Receiver's website]; Lex Ex. 55 [back-up documentation from the Receiver's web site showing the Lex family investments]; N.T. 4880.) The Administrative Law Judge erred in failing to credit Mr. Lex with $125,000 that he and his wife contributed to the Firstline rescue plan on April 12, 2010, some five months after he had terminated all association with McGinn Smith (N.T. 4919), and just days before the receivership froze all McGinn Smith assets on April 20, 2010. This was his voluntary contribution to the "rescue plan," and an attempt to save his clients from the losses in the Firstline investment.

M. The ALJ Erred In Her Cease & Desist Order Because There Was No Showing That a Future Violation Was Likely To Occur

The Administrative Law Judge erred in issuing a cease and desist order against Mr. Lex (Initial Decision at 114) because before imposing such an order, "the Commission must establish a sufficient evidentiary predicate to show that such **future** violation may occur." Aaron v. Securities and Exchange Commission, 446 U.S. 680, 701 (1980)(emphasis added), citing SEC v. Commonwealth Chemical Securities, Inc., 574 F.2d 90, 98-100 (2nd Cir. 1978). Here, there was no such evidentiary predicate because: (a) Mr. Lex had an untarnished record of 40 years in the securities industry and insurance business, with his only blemish coming as a result of a third party's secret fraudulent scheme of which he admittedly had no knowledge; and (b) it was undisputed that Mr. Lex has been out of the securities industry ever since October 2010, and he had, and has, no intention of ever returning to that industry. This is clearly penal in nature since it will likely eliminate his only way of earning a living as well – as an insurance salesman.

N. A Permanent Bar From Association With Licensed Persons Is Unnecessary Because Lex's Conduct Was At Most Negligent, and That Does Not Justify A Permanent Bar

The Administrative Law Judge erred in imposing a permanent bar on Mr. Lex's association with any broker-dealer or investment advisor (Initial Decision at 117) because such a sanction, with the attendant "loss of livelihood and the stigma attached to permanent exclusion," requires evidence "that **future** misconduct will occur." Securities and Exchange Commission v. Patel, 61 F.3d 137, 141-142 (2nd Cir. 1995)(emphasis added). There was no such evidence in this case. The Administrative Law Judge erred in imposing a permanent bar on Mr. Lex's association with any broker-dealer or investment advisor (Initial Decision at 117) because Lex was not the primary actor, but rather failed to detect a fraud perpetrated by Timothy McGinn, David Smith, who were criminally convicted. In Johnson v. Securities and Exchange Commission, 87 F.3d 484, 490 (D.C. Cir. 1996), the court reversed a **6-month** suspension where Johnson was not the primary actor in the fraud, but merely failed to detect the fraud of another broker **under her supervision**. Here, Mr. Lex was **not** responsible for supervising McGinn or Smith, yet the Judge imposed a **lifetime** suspension. This was clear error.

O. Third-Tier Penalty Was Inappropriate

The Administrative Law Judge erred in imposing a third-tier monetary penalty, the highest level, on Mr. Lex (I.D. pp. 115-116, 118) because: (1) the Judge acknowledged that only conduct occurring on or after September 23, 2008 could be considered in assessing the penalty (Initial Decision at 116); (2) the only evidence against Mr. Lex consisted of failure to conduct a sufficient investigation, as opposed to actual fraud or deceit; and (3) there is no need for deterrence because Mr. Lex has been out of the securities industry since 2010. (See I.D. p. 116, acknowledging that scienter and need for deterrence are relevant factors in assessing monetary penalty).

P. Without Red Flags Related to Trusts, It Was Inappropriate for the ALJ to Impose Disgorgement For Post-September 23, 2008 Sales

The Administrative Law Judge erred in ordering disgorgement because the only "red flags" that the Judge found related to the Four Funds, and Lex did not sell any Four Funds within the statutory period, i.e., after September 23, 2008. Lex's only sales after September 23, 2008 were of Trust Offerings. Because there were no red flags as to the Trust Offerings, Lex had no ill-gotten gains from sales after September 23, 2008 that could be subject to disgorgement. The Administrative Law Judge erred in ordering disgorgement of $169,375 (I.D. p. 117, as modified by April 9, 2015 Order on Motion to Correct Manifest Errors of Fact) because the order: (1) improperly included commissions earned on sales before September 23, 2008; and (2) constituted gross figures, from which Mr. Lex paid approximately 25% for expenses in office supplies and equipment, utilities, rent, telephones, computers, clerical help, and so on. (N.T. 4867:9-22; 4868:3-5; 4868:22-4869:4; 1583:11-14.)

Q. Lex Was Entitled To A Jury Trial And the Presumption of the Rule of Lenity In Interpretation of These Penal Securities Statutes

The case was penal and punitive in nature, in light of the claims of fraud and the requests for enhanced monetary penalties, the cease-and-desist order, and the lifetime suspension order. Accordingly, Respondent Lex was deprived of his right to:

(a) have his case decided by a jury (Article III, Sec. 2, ¶3); and

(b) before an Article III Court have the Rule of Lenity applied, requiring all statutory ambiguities to be resolved in Respondent Lex's favor.

R. **The Commission Pre-Judged The Case, Thus Depriving Lex of Due Process of Law**

Mr. Lex's due process right to a fair hearing and an impartial adjudicator was violated because the Commission prejudged the case against the brokers as evidenced by, ***inter alia,*** the following: (a) the Commission's Complaint, Motions and Briefs filed in SEC v. McGinn, Smith & Co., et al., N.D. N.Y. No. 10-CIV-457; (b) the Commission's press release issued in connection with the filing of the OIP in the instant enforcement proceeding; and (c) the Commission's Findings of Fact and Conclusions of Law filed in connection with the case against Respondent Richard D. Feldmann in the instant enforcement proceeding. The above-described documents reflect that, even before the Administrative Law Judge reached her decision in this case, the Commission had already prejudged many of the issues underlying this case in a manner adverse to the brokers, including Mr. Lex.

S. **Incorporation By Reference**

Respondent Lex incorporates by reference the claims, and assertions of error raised by the other Respondents in this case regarding the process, the findings and conclusions, the penalties, and any other issues applicable to all Respondents.

CONCLUSION

Based on the foregoing, Respondent Lex respectfully requests that the Commission reverse the Decision and dismiss the proceedings, with prejudice.

Respectfully submitted,

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DATE: July 17, 2014

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15514

In the Matter of,

FRANK H. CHIAPPONE,
ANDREW G. GUZZETTI,
WILLIAM F. LEX,
THOMAS E. LIVINGSTON,
BRIAN T. MAYER, and
PHILIP S. RABINOVICH

BRIAN T. MAYER'S INDIVIDUAL BRIEF

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Preliminary Statement

The evidence conclusively established that Mayer did *not* violate Securities Act Section 17(a), Exchange Act Section 10(b) and Rule 10b-5 thereunder (the "Fraud Claim"), or Securities Act Section 5 (the "Section 5 Claim").[1]

Mayer did not make any material misrepresentations or omissions in presenting any McGinn Smith Security to any clients and no evidence was presented to the contrary. Mayer fulfilled his obligations as a registered representative by understanding the product and performing a client suitability assessment before presenting each McGinn Smith Security to clients.

In erroneously concluding that Mayer's conduct was fraudulent or negligent, the ALJ relied on cases like *Hanly* and *Milan* (Decision at 89). *Hanly* and *Milan* involved registered representatives who actively and knowingly participated in fraud. Here, no allegation was made Mayer even knew about McGinn and Smith's secret theft and diversion of funds, and no witness testified that Mayer made a material misstatement or omission about any McGinn Smith Security, let alone within the governing five year statute of limitations of Section 2462.

The ALJ's and the Division's position that Mayer (and the other Respondents) should have "investigated" after the January 2008 meeting and not presented Trust Offerings, entirely separate investments from the Four Funds, is unsupported by the evidence. The contention is also unrealistic: Mayer, who was in the New York branch office, could not have uncovered McGinn and Smith's secret fraud in Albany, which was aided and abetted by inside and outside accountants. No case has ever imposed such a duty of investigation on a registered representative in these circumstances, let alone branded him for life as a fraudster.

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[1] Capitalized terms not otherwise defined shall have the meaning given to them in Respondents' Joint Brief.

Mayer also took reasonable steps to avoid participating in any distribution in alleged violation of Section 5 and did all that any registered representative could do to comply with the exemption. Moreover, as a matter of law (explained in the Joint Brief), Section 2462 barred any Section 5 Claim on the Four Funds, and, as conceded by the Division, none of the Trust Offerings had more than 35 unaccredited investors. *See* OIP ¶ 32.

Because he did not act fraudulently or negligently, and because he has had an unblemished record for more than five years running RMR Wealth Management ("RMR"), no penalty, suspension, disgorgement, or other relief is warranted. Nor would it be necessary to protect the public interest.

STATEMENT OF FACTS

As much of the evidence is discussed in the argument section of this brief, (and because of the reduced word limitation to which Mayer has a standing objection), an abbreviated statement of facts is presented.[2]

A. Brian Mayer

Mayer is married with two children, now ages 9 and 12. He has been in the securities industry since graduating from the University of Rhode Island in 1995, during which time no customer has ever filed a complaint against him. Mayer started his career in the securities industry with Oppenheimer & Company, and later worked as a registered representative at Mercer Partners and, from 2001 to 2009, in MS&Co.'s New York City branch office. As a registered representative, Mayer proposed diversified portfolio allocations for his clients, who were mostly accredited investors with non-discretionary accounts, a small

2 Except as otherwise noted, the statement of facts are drawn from Phil Rabinovich, Brian Mayer and Ryan Rogers' Joint Proposed Findings of Fact and Conclusions of Law, dated May 12, 2014 ("FoF"), each paragraph of which contains specific citations to the transcript (page and line) and exhibits in the record.

percentage of which included alternative investments, such as McGinn Smith Securities, which his family members also purchased. FoF ¶¶ 14-24, 424, 456, 477.

In October 2009, Mayer, together with Respondents Rabinovich and Rogers, left MS&Co. to form RMR, a SEC-registered investment advisory firm that provides financial services to high net worth individuals and small businesses. RMR has an unblemished regulatory record, does not sponsor private placements or mutual funds, and has "zero proprietary product." Tr. 4965:11-25. FoF ¶¶ 32-35, 38-39.

B. The Business of McGinn Smith

MS&Co., founded in 1980 by David Smith and Timothy McGinn, was a SEC-registered broker-dealer with its principal place of business in Albany, NY, and branch offices in New York, NY, Clifton Park, NY, and King of Prussia, PA. FoF ¶¶ 41-48.

At the time he joined MS&Co., Mayer knew of McGinn's and Smith's extensive and impressive experience as investment professionals and the extensive due diligence performed in the alarm trust business. MS&Co. had been operating for over twenty years, had a national reputation in the alarm trust business, and had done multiple offerings and municipal bond transactions. FoF ¶¶ 49, 53-55.

Mary Ann Cody, then MS&Co.'s General Counsel, detailed this due diligence process at the hearing, although it is mentioned nowhere in the Decision. Cody described how brokers at MS&Co. were informed of the due diligence at sales meetings, which was similar to how Mayer learned about the due diligence for the McGinn Smith Securities at issue in the OIP. FoF ¶¶ 59-75.

Mayer also knew of Smith's position as a managing partner of Pine Street Capital Partners ("Pine Street"), which was affiliated with MS&Co. and located at its Albany headquarters. In marketing materials, Pine Street touted its connection to MS&Co. and its access to MS&Co.'s network of relationships. Smith and the other principals at Pine Street worked together on investments made not only by Pine Street, but also the Four Funds. FEIN, TAIN, and FAIN each invested substantial amounts in Pine Street, which was a profitable investment for them. FoF ¶¶ 87-94.

C. The Offering Documents

Investors in McGinn Smith Securities purchased notes pursuant to the terms of a PPM, a Subscription Agreement, and a Purchaser Questionnaire (collectively, the "Offering Documents"). Mayer provided all of his clients and prospective clients with the Offering Documents prior to investing in McGinn Smith Securities, and no witness – whether called by Mayer or the Division – testified otherwise. Nor did any witness testify that they were directed by Mayer to complete a Purchaser Questionnaire other than truthfully and to the best of their knowledge. FoF ¶¶ 95, 99-101.

The cover page of the PPMs for the Four Funds states, in bold print, that the notes are not "**guaranteed or insured**," and that "**[i]nvesting in the notes involves a high degree of risk**." The PPMs also include, among other disclosures, (i) notices to investors, including that "[n]o person has been authorized to make any representations concerning this offering, ... other than as set forth in this memorandum, and, if made or given, these other representations or information must not be relied upon by prospective investors," (ii) risk factors, including that "the notes are suitable for purchase only by investors who are capable of bearing the economic risks of holding the notes for an indefinite period of time," and (iii) a broad investment mandate. Investors who, after receiving a PPM, decided to invest in the Four Funds, signed a Subscription Agreement in which they expressly "represent[ed], warrant[ed], and agree[d]" that, among other things, they had "carefully read the Offering Materials," and they "fully underst[ood] the Offering Materials," and they relied only on "that set forth in the Offering Materials and [their] own independent investigation" in making an investment decision. *See* Div. Ex. 5, at 1, 3, 15, 38. FoF ¶¶ 105-37.

The Offering Documents for the Trust Offerings contained similar disclosures, except that the investment mandate specified the securitized asset in which the Trust would invest – triple-play contracts, alarm contracts, or luxury cruise bookings. The PPMs also disclosed the fees and expenses associated with each Trust Offering. Investors in the Trust Offerings acknowledged in the Subscription Agreement that they "received and have carefully read and understood the [PPM]." *See* Div. Ex. 264, at 23. FoF ¶¶ 138-63.

D. Mayer Fulfilled His Duties as a Registered Representative

Mayer conducted reasonable diligence to understand the product and his customers so he could make suitability determinations or investment recommendations to a client. Mayer was not, however, required to conduct his own independent due diligence investigation. Even the Division's expert witness, a 23-year veteran of the SEC who never worked as a registered representative or for a broker-dealer, admitted that the word "investigate" is not used in the federal securities law, or any SEC or FINRA rule or regulation, regarding the duties of a registered representative before presenting a private placement security to a client for whom it would be suitable. Similarly, no FINRA rule purports to require an individual broker to review the investment banking department's due diligence files. FoF ¶¶ 164-83.

Mayer learned enough of the Four Funds' top holdings to feel comfortable that Smith would be able to achieve his mandate. FoF ¶¶ 256-62; *see also* FoF ¶¶ 242-55. Mayer did not understand the principal of the Four Funds to be in danger until April 2010 when the SEC Action commenced and the Receiver was appointed. Investors in the Four Funds received interest from 2004 until April 2010 when the Receiver was appointed, except for junior note-holders, who received interest until January 2008 (when interest was reduced to 5%) and no interest thereafter. FoF ¶¶ 265-66. Mayer did not know that McGinn and Smith secretly commingled and misused investor funds from the Trust Offerings. FoF ¶¶ 269-79.

E. There Were No Red Flags Which Should Have Caused Mayer to Conduct a Heightened Inquiry. In Any Event, His Inquiry Was Sufficient.

1. The PPMs Contained Standard Disclosures

The Division did not present any evidence that the disclosures in the PPMs for McGinn Smith Securities were other than customary in the industry. A comparison to the PPMs for other MS&Co. private placements – none of which formed the basis for the Division's fraud charges – makes clear the disclosures were standard. Mayer, other Respondents, and experts testified that the disclosures in the Four Funds' PPMs were commonplace and not a cause for concern. FoF ¶¶ 311-19.

2. Smith Never Concealed the Four Funds' Investments from Mayer

There was nothing secretive about the investments that Smith was considering and executing on behalf of the Four Funds. To the contrary, Smith looked to MS&Co. personnel to support him in making investment decisions for the Four Funds. There was no evidence that Smith concealed the Four Funds' investments from Mayer, except for some details of a few loans to local Albany-area businesses, which Smith claimed confidentiality over. Mayer knew that the Four Funds had invested in Dekania, Pali Capital (ATM deals), an Arizona real estate transaction (Maracay), CMET, Pine Street, Crystal Springs, CMS Financial, Palisades Pictures, Aquatic Development, alseT, Deerfield and GSC. Mayer received information he requested about the Four Funds and the Trust Offerings from McGinn, Smith and MS&Co.'s controller Rees. FoF ¶¶ 320-21; 325-26.

3. Mayer Was Unaware of Any Purported Redemption "Policy"

MS&Co. did not announce a "policy" in December 2006 that clients only could redeem their investment in a Four Funds note if their brokers first found a replacement investor. Mayer was never told that his client could not redeem unless a replacement investor first had been found and his clients were able to redeem their Four Funds notes and Trust Offerings certificates during 2006 and 2007. FoF ¶¶ 329-32, 336. The ALJ agreed there was no redemption policy: "[T]here is no evidence that a registered representative who did not find a new purchaser was ever unable to redeem a client." Decision at 93.

4. The January 2008 Meeting Was Unsurprising Given the Economic Downturn that Impacted the Entirety of the Global Markets

At a January 2008 meeting in Albany, McGinn and Smith informed brokers that interest would be reduced on the junior notes of the Four Funds (but not the senior notes or the senior subordinated notes). The interest reduction was unsurprising given the economic climate in 2007 and 2008, but it was unrelated to, and did not affect, the Trust Offerings. FoF ¶¶ 338-40, 344-45.

5. Mayer Was Unaware of the Firstline Bankruptcy Until After He Ceased Presenting McGinn Smith Securities to His Clients

In September 2009, McGinn, Smith and Joe Carr, General Counsel, revealed that Firstline Securities, Inc. – a residential alarm contract company that borrowed funds from the Firstline Trust offering of October 2007 – had filed for bankruptcy on January 25, 2008 in Utah. The Division admits that Mayer was unaware about the Firstline bankruptcy before September 2009. Although the Division contended that Mayer presented a Trust Offering to one customer after learning of the bankruptcy based on summary charts, that investor's dated subscription agreement makes clear that is not so. RMR Ex. 429 (dated August 28, 2009). One week later, Mayer, Rabinovich, and Rogers started RMR. FoF ¶¶ 349-50, 352, 354.

F. Mayer Made No Material Misrepresentations or Material Omissions to His Clients and Presented McGinn Smith Securities Only When Suitable

During 2003 through 2009, Mayer did not make any material misrepresentation or omission to a client about a McGinn Smith Security. Mayer had between approximately 75 to 125 accounts that were generally obtained through referrals. Mayer did *not* cold call at MS&Co. and has not done so at RMR. In presenting McGinn Smith Securities, Mayer reviewed the private placement with the client, pointed out the risks, explained that higher interest rates meant more risk, and explained that the investments were not guaranteed. Mayer's clients had non-discretionary accounts and those who invested in McGinn Smith Securities signed a subscription agreement expressly representing, among other things, that (i) they carefully reviewed the Offering Documents, (ii) in making an investment they were relying on their own evaluation of the product and the terms of the offering, (iii) no representations were made to them other than as set forth in the Offering Documents, and (iv) if such representation was made, they were not relying on it. Demonstrating his confidence in McGinn Smith Securities, Mayer presented them to his family, who purchased approximately $155,000 of the Four Funds and the Trust Offerings. FoF ¶¶ 416-20.

At the hearing, four of Mayer's clients testified in person, all of whom were accredited investors at the time they first invested in a McGinn Smith Security, and three others submitted affidavits, but the ALJ refused to admit or consider them. These investors described how Mayer provided and reviewed PPMs with them and later signed if they chose to invest. As the Division's own witness Gary von Glinow explained, prior to investing, he would "discuss[] the risks" with Mayer and tried "to come up with ways that that thing could go bad." At times, he would ask Mayer "30 or 50, 70 questions on each one of these [PPMs]," which Mayer would answer. Tr. 2818:17-22. This is mentioned nowhere in the Decision. Another investor, William

Strawbridge, who had worked with Mayer for ten years, described his interaction with Mayer as follows:

> He [Mayer] will sort of identify investment opportunities, he will bring those to me, he'll describe to me what the nature of that investment is, sort of what the business model behind it is; he'll provide me with relevant supporting information. Then I'll take that away and I will do my own independent analysis. We'll get back together, talk about it and then make a decision. And we'll do that pretty much for any type of investment we make.

Tr. 5515:12-23. Mayer's investors described him as a "forthright and effective investment professional," "the most conscientious and analytical of any of the brokers that I deal with," and an honest broker who did "a lot of good things ... for our family." RMR Ex. 606, ¶ 22; Tr. 2280:4-18. FoF ¶¶ 421-78.

Even those investors called by the Division admitted that they made their own investment decisions and decided *not* to invest in some offerings Mayer presented to them. And, although some claimed they thought their investments were "safe," they admitted that nobody told them so, they signed subscription agreements in which they acknowledged their investments involved "substantial risk," or both. Similarly, Vincent O'Brien and Thomas Alberts – both of whom had hazy recollections of investments they had made more than five years prior to the date the OIP was filed – claimed that Mayer did not tell them they could lose their investment, or the amount of certain fees charged by the Trusts, despite the fact that this information was disclosed in the Offering Materials that they attested to reading before investing. Two of the investor witnesses (Von Glinow and Alberts) were first contacted by the Division *after* the OIP was filed, and the third (O'Brien) contacted the Division because he did not get a response from the Receiver. FoF ¶¶ 451, 461, 471; *see also,* FoF ¶¶ 434-71.

G. The Division's Post-OIP Conduct And Its Effect on Mayer

Mayer learned from clients that they were first contacted by the SEC to testify against him *after* the OIP was filed on September 23, 2013. Several refused, as reflected in the Division's *Brady* disclosure. As a result of the SEC's calls, Mayer lost one 401(k) client "who had nothing to do with this case at all," but who left "because of these allegations" by the SEC. Tr. 5073:25–5074:19. Mayer also lost business from Jerry Colihan, a former client who nevertheless provided an affidavit in support of Mayer (which was not allowed into evidence or considered by the ALJ). *Id.* Mayer's clients told the SEC that they "[h]old[] Mayer in the highest regard[,] ... and never stopped trusting Mayer." RMR Ex. 873, at 2. FoF ¶¶ 692-96.

Mayer believes he should not be barred from the securities industry because (a) he did "everything that [he] possibly" could for his clients, as well as his colleagues and his employers, (b) he has been running RMR with his partners (including Rabinovich) for five years without any issues, and (c) he worked to the best of his ability. Tr. 5076:16–5077:21. This proceeding has already exacted an extraordinary toll on Mayer. He has had to sell his home, his family has been affected "beyond words," and his business reputation has been damaged such that "everyone looks at me differently now than they used to look at me." Tr. 5079:16–5080:13. FoF ¶¶ 697-98.

ARGUMENT[3]

I. Mayer Did Not Violate the Antifraud Provisions of the Federal Securities Laws

The ALJ erred in concluding that Mayer willfully violated Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5 because "Mayer was reckless in

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[3] Legal arguments common to all Respondents who petitioned for review are set forth in the Joint Brief. The brief addresses primarily the application of the governing law – as stated in the Joint Brief – to the facts specific to Mayer.

offering and selling securities" and that he "willfully violated Securities Act Sections 17(a)(2) and (a)(3) because, acting at least negligently, he obtained money by means of untrue material statements." Decision at 106. To reach this conclusion, the ALJ cherry-picked testimony and misconstrued the factual record before her, ignored significant evidence that would lead any reasonable trier of fact to conclude that Mayer did *not* violate the law, and arbitrarily and capriciously applied facts to law. Mayer was neither reckless nor negligent, and there was no evidence that he made any material misrepresentations or omissions.

A. Mayer Did Not Act With Scienter

In concluding that Mayer acted recklessly, which as a matter of law required a showing by the Division of "a state of mind approximating actual intent, and not merely a heightened form of negligence," *see South Cherry St., LLC v. Hennessee Group LLC*, 573 F.3d 98, 109 (2d Cir. 2009), the ALJ relied on two blanket assertions: (1) Mayer made "material misrepresentations and omissions ... to the witnesses who purchased private placements," and (2) Mayer "failed to investigate several red flags that were apparent to him by January 8, 2008." Decision at 106. Neither is supported by the record.

According to the ALJ, Mayer supposedly "did not mention material information to [Thomas Alberts and Vincent O'Brien] when he recommended their private placement purchases." Decision at 106. Alberts and O'Brien, both accredited investors at the time they first invested in McGinn Smith private placements, testified that they received PPMs from Mayer to review and discuss with him prior to making any investment decision. Both had hazy recollections of investments they had made more than five years prior to the date the OIP was filed, yet claimed to recall that Mayer did not tell them they could lose their investment, or the amount of certain fees charged by the Trusts.[4] Nevertheless, both admitted that they signed subscription agreements and purchaser questionnaires in which they expressly acknowledged that they had read and understood the PPMs which disclosed all of these facts, and that they relied on themselves – not Mayer – in evaluating the merits and risks of their investments. FoF ¶¶ 452-71; RMR Exs. 400, 428-29, 733. O'Brien in fact reconfirmed at the hearing that the fees in the Benchmark Trust that he was supposedly unaware of were clearly stated on the face of the Benchmark PPM, a 15-page document. Tr. 953:18–954:6; Div. Ex. 63 at 1, 8.

The ALJ ignored these witnesses' contemporaneous written attestations that they had read the PPMs, and instead credited their contrary oral testimony, years after-the-fact. This conclusion is not only belied by the documentary evidence (RMR Exs. 428-29, 733), it is contrary to law. *See* Joint Br. at 21-22. Moreover, it ignores the credible testimony of the Division's own witness – Gary Von Glinow – who testified that he would review PPMs with Mayer prior to investing to "discuss[] the risks," and that Mayer did not tell him anything that was not in the PPM. Tr. 2815:10-14, Tr. 2824:9–2825:11. We are aware of no legal authority – and the ALJ cited none – holding an individual broker liable for a supposed material omission of fact that is expressly disclosed to the investor in offering documents he is given to read and review (and which he acknowledged reading and reviewing) prior to investing. In any event, any claims by the Division arising out of Alberts' investments are plainly time-barred. *See* 28 U.S.C. § 2462.

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4 Alberts, an 84-year-old retiree, could not recall the names of several other firms where he had brokerage accounts, could not recall if he had opened an account with MS&Co., and could not recall which of his two brokers at MS&Co. (one of which was Mayer) was his broker at the time he invested in FAIN. FoF ¶¶ 463, 466, 468. Yet, the ALJ concluded that Alberts "gave credible, persuasive testimony" about what Mayer supposedly did or did not say to him a decade ago. Decision at 106.

The ALJ also erroneously concluded that Mayer was reckless in failing "to investigate several red flags that were apparent to him by January 8, 2008." Decision at 106. The ALJ identified three supposed red flags as of January 8, 2008 (which is, notably, more than five years prior to the filing of the OIP): (1) the Four Funds PPMs' disclosure of potential conflicts of interest; (2) the Four Funds PPMs' disclosure of its ability to acquire investments from affiliates; and (3) the January 2008 reduction in interest payments to junior noteholders in the Four Funds, the latter of which she claimed triggered a "duty to investigate the Four Funds' junior notes default before selling the Four Funds." Decision at 91-92.[5] As a threshold matter, it is undisputed that Mayer did not sell any Four Funds' notes – junior or otherwise – after December 2007. FoF ¶ 552. Thus, the ALJ effectively concluded that Mayer was reckless in selling the Trust Offerings based on supposed red flags relating to the Four Funds. This ignores, however, that the Four Funds had nothing to do with the Trust Offerings, which the Division's own expert witness admitted "were not at all similar" to the Four Funds. Div. Ex. 1 at 25. The Trust Offerings were managed by McGinn, not Smith, were based on cash flow from income-generating assets such as "triple play" contracts with homeowner associations that could be amortized or sold to pay the stated interest due on the trust certificates, and were unrelated to the types of investments made by the Four Funds. FoF ¶¶ 47, 273, 338.

Moreover, the disclosures in the PPMs were standard in the industry, a fact confirmed by the testimony of three of four expert witnesses, including the Division's expert witness who admitted the PPMs' discussion of potential conflicts of interest "is standard

5 The ALJ concluded that there was no "redemption policy," *see* Decision at 93, and the Division has waived its right to challenge this finding by not filing a cross-petition for review. The last red flag – the September 2009 disclosure of the Firstline bankruptcy – did not exist in January 2008. Mayer did not present any McGinn Smith Securities to his clients after he learned of the Firstline bankruptcy. FoF ¶¶ 349-54.

language." Tr. 689:21; *see also* FoF ¶¶ 311-17 & RMR Ex. 861. The ALJ ignored this evidence, too, and instead misconstrued the testimony of a fourth expert witness as having "never [been] aware of a situation where the broker-dealer was both the issuer and the placement agent in a private placement," Decision at 92, when he in fact testified that he "hadn't been involved in a situation like that," but agreed it was not unusual. Tr. 4772:11-13.

To purportedly bolster her conclusion that heightened scrutiny of the Four Funds was required based on the PPMs, the ALJ incorrectly stated that MS&Co. "was a small company creating newly formed entities." Decision at 92. As expert testimony established, and the record confirmed, "McGinn Smith was not a small company and was definitely not of recent origin. While they may have created LLCs to issue product through, which are new entities technically, they are all part of McGinn Smith, which had a long track record." Tr. 3927:3-8. Nor was the level of control that Smith exerted over the Four Funds of any great significance given McGinn and Smith's long and diverse backgrounds in capital markets, and Smith's sufficient experience and background in underwriting to launch private placements such as the Four Funds. Tellingly, none of the other 35 to 50 brokers told clients that he or she was aware of any red flags. FoF ¶¶ 318-19.

Finally, the January 2008 meeting, at which Mayer learned that interest would be reduced on the junior notes of the Four Funds (but not the senior or senior subordinated notes), was unsurprising given the global economic recession. At the meeting, Smith went over specific investments, identified where there was stress on the portfolio, and stated his belief that the stress was a temporary, not permanent, issue. McGinn talked about undertaking additional revenue initiatives to shore up some of the problems in the Four Funds. Mayer did not regard the news as a red flag because (a) numerous, similar investments were suffering impairments, and (b) other investments could not refinance because of the credit crisis. Mayer informed his clients who purchased junior notes about the reduction of interest, and Smith sent letters to investors explaining the situation. Mayer believed Smith's plan to amortize the junior notes could succeed because he had "seen other trusts amortized down to zero," and because he "believed strongly that at some point in the future the markets would rebound." Tr. 5032:12–5034:12; FoF ¶¶ 338-40, 344-45.

In sum, no reasonable and unbiased trier of fact could consider the evidence presented at the hearing and conclude that Mayer acted with scienter. Mayer presented McGinn Smith Securities to his clients when suitable. That Mayer, along with the SEC, the NASD, and countless others, did not uncover the secret theft and diversion of funds by his superiors does not make him liable for fraud.

B. Mayer Acted Prudently and Fulfilled His Duties as a Registered Representative

Equally unsupported is the ALJ's conclusion that Mayer "violated Securities Act Sections 17(a)(2) and (a)(3) because, acting at least negligently, he obtained money by means of untrue material statements." Decision at 106. According to the ALJ, Mayer's "recommendation of these private placements indicated to his clients that he had some reasonable basis for believing they were good investments when he had done no investigation of their worth," and "[b]y simply repeating the issuer's unchecked representations, he engaged in an act, practice, or course of business that operated as a fraud or deceit on his clients." *Id.* Aside from repeating statutory language, the ALJ failed to identify any "untrue material statements" Mayer made to any investor about any McGinn Smith Security, or any representations Mayer made to any investor about any McGinn Smith Security that supposedly did not have a reasonable basis. The overwhelming evidence established that Mayer acted prudently and fulfilled his duties as a registered representative.

The ALJ's naked assertion that Mayer's "credibility is highly suspect because Mayer gave very different testimony on the same subject at different times," Decision at 105, ignored the evidentiary record. Any objective reading of Mayer's testimony demonstrates that he testified truthfully and to the best of his then-recollection, whether during his non-party deposition or at trial. Mayer's testimony, together with that of his investors and the contemporaneous documents, made clear that Mayer discharged his duties as required.

The ALJ's reliance on Mayer's 2011 non-party deposition testimony from the SEC's separate action against McGinn and Smith in federal court (the "SEC Action") to purportedly undermine his credibility should be disregarded as fundamentally flawed. At the time Mayer testified as a non-party deponent, he had not refreshed his recollection or understood that he was a target of the SEC's investigation. The SEC in fact (mis)led him to believe he was assisting in the SEC Action, which is contrary to its stated mission to act "honestly, forthrightly, and impartially in every aspect of [its] work." SEC Enforcement Manual (June 4, 2015), § 1.4.1. Indeed, Smith sat across from Mayer as he provided what the ALJ has now termed "investigative" testimony.[6] The SEC never provided Mayer with Form 1662, or showed him a Formal Order of Investigation. Nor did the SEC ever send him a copy of his non-party deposition transcript to review, correct, clarify or sign. Had Mayer known his actions (or supposed inactions) were in question, he would have refreshed his recollection and provided

6 Decision at 48. Ironically, the ALJ referred to Respondent Gamello's non-party deposition testimony as "deposition testimony," and noted that he "takes issue with the Division's use of his deposition testimony, where he testified without any records and in the belief he was called to assist the Commission's case against McGinn and Smith." *Id.* at 20 n.31. Mayer likewise objected and filed a motion to that effect.

additional – not *different* – information at his non-party deposition to demonstrate he fulfilled his obligations as a registered representative. The hearing was effectively Mayer's first opportunity to tell his side of the story in response to the Division's charges against him, and he should not be penalized for expanding upon the answers given during his non-party deposition. FoF ¶¶ 527, 531-32.

Nor was Mayer's non-party deposition testimony inconsistent with his trial testimony. For example, the ALJ asserted that Mayer testified during his non-party deposition that he "didn't have specific investments" as to the Four Funds, but testified at the hearings that he knew a number of the investments made by the Four Funds. Decision at 105. The ALJ's cherry-picked quotation from Mayer's deposition is highly misleading. The answer given during Mayer's non-party deposition was in response to a question about what he knew FIIN was "*going to* invest in" at the time Gary Von Glinow invested in FIIN (October 2003). Tr. 3290:10-11; Tr. 3357:24–3358:18; Div. Ex. 2, Ex. 4o. At that time, FIIN was a blind pool with no investments, something the ALJ later acknowledged in finding Gamello "credible" when he gave similar testimony as to his knowledge of the Four Funds' investments shortly after they were offered. Decision at 101.

At the hearing, and after Mayer learned that the Division was challenging his knowledge and understanding of the Four Funds' portfolios, he provided details as to his knowledge of investments the Four Funds had made during the broader time period of 2003 to 2007. Tr. 3278:8–3283:24. His testimony included details as to what he knew regarding specific investments, when he learned them, who he learned them from, and what he saw to verify them. These details were provided in response to the following question posed by the Division: "[f]or any of the Four Funds between 2003 and 2007, did you have an understanding of some of the investments that were made by those LLCs?" Tr. 3278:3-6. The ALJ, however, interrupted Mayer mid-answer, and inexplicably said, "I think maybe she is talking about did you see a balance sheet or an income statement or a statement of assets that had these things listed? I mean, this is talk about deals, and I guess that's what investment people and broker dealers do all the time." Tr. 3283:25–3284:7. That was *not* the question, and for the ALJ to now discredit Mayer's testimony, further establishes the infirmity of the Decision.

The other supposed inconsistency was with respect to Mayer's knowledge of an investment in alseT. Decision at 105. Mayer testified at both his non-party deposition *and* the hearing that he knew of the alseT investment, but did not know all of the details of the investment. Tr. 3462:2-3 ("I knew about Alset. I did not know the structure of the investment.") (quoting non-party deposition testimony); Tr. 3305:3-4 ("I recall knowing that some of the McGinn Smith funds invested in Alset.") (hearing testimony). This testimony is not inconsistent.

The ALJ blindly accepted the Division's arguments and ignored Mayer's testimony. For example, the Division repeatedly inferred that any investment in alseT was improper because it was a venture capital investment despite the fact that the Four Funds' PPMs did *not* preclude such an investment. After Mayer explained why he thought an investment in alseT *was* consistent with the Four Funds' investment mandate and that alseT had attracted financing interest from Deutsche Bank, Tr. 3306:17-23, the ALJ interrupted with the following outburst: "I don't care whether it was Pope Francis that was advising this Alset. I am saying the thing is these investors put their money in something, and that that money was going into a completely different thing." Tr. 3306:25–3307:11. Shockingly, the ALJ's comments – evidencing extreme bias, prejudgment and a misapprehension of the testimony – came before Mayer's own counsel had elicited any testimony from him.

The overwhelming evidence established that Mayer understood and fulfilled his duties as a registered representative. Before presenting any private placements (including McGinn Smith Securities), Mayer had a practice of first understanding the offering, deciding if he liked the product and, if so, presenting it to clients for whom the investment would be suitable, generally in face-to-face meetings. As Mayer explained, he understood "the mechanics of the product ... the structure of the product, the risk/reward of the product," but he also went further and tried "to poke holes how the investment is not going to work." Tr. 5006:10–5007:19. Division witness Gary Von Glinow confirmed Mayer's testimony, stating that in discussing prospective investments with Mayer, he tried "to come up with ways that that thing could go bad." Tr. 2824:9–2825:11. Tr. 2818:17-22. As a result of Mayer's independent inquiry and analysis, there were "numerous transactions over the years that were offered at McGinn Smith" that Mayer did *not* present to his clients. Tr. 5022:10-18. When he did present suitable investment opportunities to clients, Mayer had a process of (a) analyzing "the client's goals and objectives," (b) "doing our research" to "come up with an asset allocation strategy," (c) going back to the client about the proposed allocation strategy, (d) implementing the strategy, and (e) monitoring the assets and managers. Tr. 5023:3–5025:2; FoF ¶¶ 235-37.

Before the Four Funds launched in October 2003, Mayer had numerous conversations with Smith about what the Four Funds would invest in, including transactions not otherwise available to retail investors, such as trust preferreds. Mayer also spoke with Smith about the debt coverage, and saw that the Four Funds' investments were targeted to yield more than 12%. FoF ¶¶ 240-41. Despite the ALJ's sweeping conclusion that "[n]owhere in the record is there any evidence that Mayer challenged or verified Smith's major assumption that ... Smith was able to achieve a 12% return on investments," Decision at 105, the evidence was replete with examples of how Mayer verified this information. FoF ¶¶ 242-44.

First, the evidence showed that Mayer independently analyzed whether the Four Funds' interest rates were achievable before offering the notes to investors and independently researched the types of investments going into the Four Funds. Tr. 3335:14-23. In so doing, Mayer saw that some investments were targeted to yield *more* than 12%, notably Deerfield, Dekania and InCaps, which were underwritten by Deutsche Bank, Merrill Lynch, and Sandler O'Neill, among others. Mayer in fact gave detailed testimony as to how the Four Funds' interest rates were achievable given these returns. Tr. 3332:20–3335:4; RMR Exs. 502A, 513D, Lex Ex. 141.[7] Mayer, however, did not think of his inquiry and analysis as an "investigation" or "due diligence," which are terms he uses to describe what investment bankers or compliance personnel do. Tr. 3342:13-25; FoF ¶¶ 240-42.

Second, Mayer reviewed the Pine Street presentation, which stated that FIIN was in fact generating a weighted average annual return of 17.6%, far more than the 12% needed to achieve the Four Funds' interest rates. RMR Ex. 46. The presentation also disclosed specifics about more than $10 million of investments by FIIN. RMR Ex. 46.

Finally, Mayer's independent analysis of these investments, including the interest rates and debt coverage, are reflected in his contemporaneous notes that he took at sales meetings when investments were presented. RMR Ex. 280. As a result of his analysis, Mayer viewed the interest rates on McGinn Smith Securities as reasonable given the risk/reward in comparison to

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[7] In fact, the SEC's post-examination letter to MS&Co. in February 2004 noted that "reputable financial institutions, which included Sandler O'Neill & Partners, L.P., Friedman, Billings, Ramsey & Co. Inc., and Merrill Lynch International, underwrote ... investments purchased by FIIN." Livingston Ex. 103, at 12.

similar investments. Mayer also reasonably believed that MS&Co. had conducted reasonable due diligence on its private placements. FoF ¶¶ 246-49.

Mayer explained that investments for the Four Funds came from different sources, and, although Smith made the ultimate decision, various people conducted due diligence on potential investments and gave feedback to Smith. Mayer was aware of due diligence performed by MS&Co.'s investment banking department regarding the Four Funds, including review of (a) alarm contracts, (b) transactions offered by Wall Street firms, and (c) deal flow from firms Smith had prior relationships with, including Pine Street and Gersten Savage, which dealt with many smaller investments. Mayer learned about specific investments that were considered by the Four Funds from Smith and reputable investment bankers, including Deutsche Bank, Goldman Sachs, UBS, and Morgan Stanley. Mayer also attended due diligence meetings with CMET, Palisades, Pine Street and CMS, all Four Funds' investments. As a result of his inquiries, Mayer knew that the Four Funds had invested in, for example, Pine Street, Deerfield, and GSC Capital, as had Mayer's clients. Mayer saw prices paid for the investments and evidence that the investments had been made. Mayer also knew the Four Funds invested in alarm contracts, but there was no evidence that he was aware these contracts were purchased from the Pre-2003 Trust Offerings. FoF ¶¶ 245-51. In a particularly poignant passage of Mayer's testimony – mentioned nowhere in the Decision – he described in detail what he did and who he spoke with to understand the products her offered to his clients. Tr. 4998:4—5002:17.

Further, Mayer, together with Respondents Rabinovich and Rogers, worked as a team, frequently discussing with each other the details of the various investment opportunities presented by MS&Co. prior to offering them to their clients. As further evidence of Mayer's *independent* analysis of these various investment opportunities, he often reached different conclusions about an investment. For example, Mayer, after conducting his own independent inquiry, decided not to offer the TDM Luxury Cruise Trust Offering to his clients; Rabinovich, after conducting his own independent inquiry, decided not to offer MSTF to his clients. Respondent Gamello – who the ALJ deemed "credible" (Decision at 101) – confirmed that "the RMR guys ... are different personalities.... They are very thorough." Tr. 5945:7-11; Decision at 20 n.33; FoF ¶¶ 283-85.

Ignoring this evidence, the ALJ declared that "[t]here is no evidence in the record that Mayer did any serious, objective analysis or review of the private placements, which would provide a basis for recommending them to investors." Decision at 105. No unbiased fact finder could make such a declaration given the evidence adduced at the hearing, and the ALJ cited nothing to support these baseless assertions.

In one particularly convoluted portion of the Decision, the ALJ recited a handful of out-of-context statements regarding whether Mayer had seen balance sheets or income statements for the Four Funds, seemingly to make Mayer seem incredible. Decision at 105. Mayer, however, succinctly and logically explained how he requested, received, and reviewed cash flow information on the Four Funds, which showed sufficient money coming in to satisfy debt coverage. Mayer explained that seeing cash flow information was more important than seeing a balance sheet, because the balance sheet does not show "if a security is paying or not" and "just tells you ... whether they are holding at par, greater than par or less than par." Tr. 4981:17–4982:16; RMR Ex. 229. Mayer explained that an income statement is also not relevant because it does not show yield. Mayer further testified that the "only value that matters is [the] initial purchase price and sales price" of the investment. Tr. 5117:11–5118:7. By way of example, Mayer noted that Pine Street's portfolio had a loss in the first year, yet ultimately returned 160% to investors. FoF ¶¶ 256-62. That the ALJ chastised Mayer for this testimony only shows her misapprehension of the mechanics of the Four Funds – not that Mayer failed to fulfill his duties as a registered representative.

Mayer also understood the Trust Offerings, as these types of deals had been offered by MS&Co. for decades. Upon joining MS&Co. in 2001, Mayer went to Albany for product training in MS&Co.'s alarm contract business in which the Pre-2003 Trust Offerings invested. MS&Co. provided Mayer with written materials describing a "step by step overview" of the alarm contract business. Tr. 4971:21–4972:15. Although MS&Co. did not originate new alarm trusts between 2003 and 2006, the Trust Offerings commenced in 2006 upon the return of McGinn, and were similar to the Pre-2003 Trust Offerings. Mayer noted that a team of individuals, including McGinn, Matthew Rogers, and others, presented the Trust Offerings to MS&Co.'s brokers. During these presentations, Mayer saw the cash flow numbers presented and achieved on the Trust Offerings. In presenting the Trust Offerings to his clients, Mayer's general practice was to explain the history of MS&Co.'s alarm contract financing and how the trust amortization process worked. Mayer also explained to his clients MS&Co.'s various roles in the transaction. FoF ¶¶ 269-79.

Notably, the ALJ's legal conclusions contain no discussion of Mayer's analysis and understanding of the Trust Offerings. Decision at 105-06. At most, the ALJ mentions the Trusts in passing when she inexplicably concluded that Mayer engaged in securities fraud when he did not orally convey certain information to investors that was provided to them in writing, a concept that is non-existent in the relevant caselaw. The ALJ's omission is a significant one, because all of the alleged conduct relating to the Four Funds took place far more than five years prior to the date the OIP was filed, and cannot be considered as a basis to impose penalties on Mayer.

The ALJ also ignored several undisputed facts about Mayer, which she nevertheless highlighted to conclude that Gamello did *not* violate the antifraud provisions of the federal securities laws. For example, in clearing Gamello of all charges, the ALJ found significant the following facts: (1) twelve of Gamello's twenty-two FAIN sales occurred within three and a half months of the offering, at a time when it was a blind pool with no investments, (2) Gamello did not sell any of the Four Funds after December 2007, and (3) Gamello did not sell any of the Trust Offerings after August 2009. Decision at 101-02. The same was true about Mayer: (1) both of Mayer's FIIN sales, two of his three FEIN sales, and all nine of Mayer's TAIN sales (excluding TAIN rollovers) were made *within the first month of the offering*, (2) Mayer did not sell any of the Four Funds after January 2008 (a single senior TAIN was rolled over in August 2008), and (3) Mayer did not sell any of the Trust Offerings after early September 2009, when he learned of the Firstline bankruptcy. Div. Ex. 2, at Ex. 4o; FoF ¶¶ 352, 553. To conclude that these facts are relevant to Gamello, but not Mayer, is plainly arbitrary and capricious. Notably, the Division did not petition for review of the ALJ's decision as to Gamello, and the Commission declined to review it on its own initiative.

In short, the overwhelming documentary and testimonial evidence demonstrated that Mayer did not violate Securities Act Section 17(a)(2) or (3), and that he acted prudently and fulfilled his duties as a registered representative.

II. Mayer Did Not Violate Securities Act Section 5

In imposing Section 5 liability on Mayer, the ALJ ignored two critical points. First, as a matter of law, there can be no actionable Section 5 claim regarding the Four Funds, as Mayer did not sell any Four Funds after January 2008 (there was an August 2008 rollover, noted above), and any such claim is time-barred. FoF ¶ 553; *see also* 28 U.S.C. § 2462. Second, despite acknowledging that Rules 506 and 508 allow for a defense based on Mayer's reasonable belief, the ALJ sweepingly declared that Mayer "d[id] not explain how [his] supposed lack of knowledge of the number of unaccredited investors could be considered a 'reasonable' belief that there were fewer than thirty-five unaccredited investors." Decision at 95. This statement ignores the overwhelming evidence to the contrary.

Under Rule 506, offerings of unregistered securities may be made to an unlimited number of "accredited investors," provided ... the issuer *reasonably believes* there are no more than, 35 additional unaccredited investors. 17 C.F.R. § 230.506(b)(2)(i) (emphasis added). Rule 508 further provides that "[a] failure to comply with a term, condition or requirement of [Rule 506] will not result in the loss of the exemption ... if the person relying on the exemption shows: ... (3) A good faith and *reasonable* attempt was made to comply with all applicable terms, conditions and requirements of [Rule 506]." *Id.* § 230.508(a)(3) (emphasis added). The record was replete with examples of Mayer's reasonable belief that both the Four Funds and the Trust Offerings were exempt from registration.

Mayer presented McGinn Smith Securities to primarily accredited investors and did not engage in general solicitations or "cold calls." He did so after qualifying his clients in advance to be sure that they were an accredited investor (or had the financial knowledge to invest) and that the investment product was suitable for their particular investment objectives. He provided his clients with PPMs that he reviewed with them before they made any decision to invest in McGinn Smith Securities. Mayer understood that, under Regulation D, there could be up to 35 unaccredited investors and was never told that more than 35 unaccredited investors had invested in any McGinn Smith private placement. Mayer had no authority to accept subscriptions for McGinn Smith Securities, which were sent to Albany and processed by Sicluna, and had no reason to know the number of unaccredited investors in any given private placement. Collectively, Mayer presented the Four Funds to two allegedly unaccredited investors, and the Trust Offerings to four allegedly unaccredited investors. There was evidence, however, that some of these investors were in fact accredited. Only two invested after September 23, 2008. FoF ¶¶ 648-66.

Further, Mayer followed McGinn Smith's procedures when presenting private placements to his customers. Mayer also knew that the SEC, the NASD, and MS&Co.'s outside compliance consultant, conducted examinations of MS&Co. during 2004 to 2007, and that none raised any issues regarding the number of unaccredited investors in McGinn Smith Securities. The SEC specifically examined for Section 5 violations regarding FIIN, but found none. The NASD specifically examined Form D filings for TAIN and FAIN, but did not find that more than 35 unaccredited investors had been accepted in any offering. FoF ¶¶ 616-22.

Thus, the ALJ's conclusion that Mayer failed to explain how he held a "reasonable" belief that the offerings complied with Rule 506 is belied by the record. There was simply no legal or factual basis to impose Section 5 liability on Mayer.

III. In Imposing Sanctions, the ALJ Did Not Objectively Consider The *Steadman* Factors And Ignored That The Vast Majority of Alleged Misconduct Occurred Prior to September 23, 2008

The ALJ expressly acknowledged that "[i]ndustry bars are considered penalties under Section 2462," and that "[t]o determine whether a sanction is in the public interest, the Commission considers the *Steadman* factors," Decision at 112-13, yet failed to objectively apply either principle of law to the facts of this case. When appropriately considered, it is apparent that Mayer should not be subject to the sanctions ordered by the ALJ.

Notwithstanding the ALJ's baseless assertion that "multiple recurrent violations ... occurred on or after September 23, 2008," Decision at 112, the evidence proved otherwise. Mayer did not sell any of the Four Funds after January 2008. FoF ¶ 553. Mayer also did not sell six of the Trust Offerings after September 23, 2008, and did not sell four of the Trust Offerings *ever*. FoF ¶ 556. Thus, by the ALJ's own reasoning, as mandated by the Supreme Court's decision in *Gabelli*, not a single scrap of evidence or line of testimony relating to the Four Funds or these ten Trust Offerings can be considered in imposing penalties upon Mayer.

Moreover, the Division identified 23 investors of Mayer who purchased a McGinn Smith Security. 20 of them (87%) first purchased a McGinn Smith Security prior to September 23, 2008, and 15 of them engaged *exclusively* in transactions prior to September 23, 2008, including Division witness Alberts, who invested more than six years prior to the date the OIP was filed. FoF ¶ 548. Of those investors who did engage in transactions after September 23, 2008, this included Mayer's own witness William Strawbridge and Gregg Chaplin, an investor identified in the Division's *Brady* disclosure, both of whom also provided affidavits in support of Mayer. Div. Ex. 2, at Ex. 4q; RMR Ex. 873; RMR Motion to Admit Prior Sworn Statements, dated Jan. 15, 2014, at 2-3. Of the dollar amount invested by clients of Mayer after September 23, 2008, more than 80% came from these and other non-testifying investors, and cannot possibly have been considered as part of the alleged "multiple recurrent violations ... [that supposedly] occurred on or after September 23, 2008." Decision at 112. Indeed, Strawbridge described Mayer as a "forthright and effective investment professional," RMR Ex. 606, ¶ 17, and "the most conscientious and analytical of any of the brokers that I deal with." Tr. 5527:20–5528:7. Chaplin told the Division that he did not think Mayer "intentionally misled him." RMR Ex. 873.

Turning then to the *Steadman* factors, as applied to the limited evidence of conduct that occurred *after* September 23, 2008, the ALJ's cursory analysis was utterly deficient. As noted in *Steadman*, "when the Commission chooses to order the most drastic remedies at its disposal, it has a greater burden to show with particularity the facts and policies that support those sanctions and why less severe action would not serve to protect investors." *Steadman v. SEC*, 603 F.2d 1126, 1137 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981); *see also Paz Sec. v. SEC*, 494 F.3d 1059, 1065 (D.C. Cir. 2007) ("The Commission must be particularly careful to address mitigating factors before it affirms an order expelling a member from the NASD or barring an individual from associating with an NASD member firm – the securities industry equivalent of capital punishment."). Here, the ALJ merely "reference[d] the[] [*Steadman*] factors," but the Decision "does not reflect that the [ALJ] meaningfully considered these factors when [she] imposed sanctions." *Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952, 957 (7th Cir. 2004).

The ALJ's imposition of a one-year suspension – a financial death knell for all practical purposes – a cease-and-desist order, disgorgement, a third-tier penalty, and an unstated amount of interest totaling in excess of $160,000, was unjustified and unnecessary to protect the public interest. Decision at 116-18; Order Correcting Decision at 4. The evidence demonstrated that Mayer did not act with scienter and his conduct was not egregious, which is highly relevant to the question of what, if any, remedial action should be taken in the public interest, or whether penalties should apply at all. *See In re Steadman Sec. Corp.*, 1977 SEC LEXIS 1388, 30, 46 S.E.C. 896, 909 (June 29, 1977) ("[I]ntent is ... highly germane to determining the quantum of the remedial action, if any, that due regard for the public interest requires us to take"); *Steadman*, 603 F.2d at 1140-41 ("respondent's state of mind is highly relevant in determining the remedy to impose.").

Mayer fulfilled his duties as a registered representative. Significantly, Mayer believed in the investments as his family purchased them, undermining any suggestion he acted with scienter. RMR Ex. 804. The five clients who testified or submitted affidavits in support of Mayer showed that Mayer worked with them to further their interests, and dealt with them fairly, honestly, and in good faith. They stood by him even after learning of McGinn and Smith's secret theft and diversion of funds. Indeed, many remain clients. FoF ¶¶ 433, 694-96. Even Division witness Gary Von Glinow described Mayer as an honest broker who did "a lot of good things ... for our family." Tr. 2280:4-18. None of this is mentioned in the ALJ's purported *Steadman* analysis.

Mayer has also acted in his clients' best interests since leaving MS&Co. in 2009. Among other things, Mayer has continued to monitor his clients' investments in the Four Funds and the Trust Offerings. Upon learning of the SEC Action, Mayer informed his clients, followed the Receiver's website, and helped his clients pursue actions against NFS, which valued McGinn Smith Securities at par (or par less amortization). Since April 2010, McGinn Smith Securities have generated cash flows to support the Receiver's operations, and Mayer, along with Rabinovich, helped the Receiver collect assets for the estate by liquidating two Four Funds' investments (Deerfield Capital and CMET) and by identifying a market for a third (InCaps). He "offered [his] assistance to the receiver from day one," and helped liquidate these securities "at the best possible price to maximize the value" to investors. Tr. 5078:3–5079:15. Mayer also provided non-party deposition testimony in the SEC Action, and cooperated with the Assistant U.S. Attorney in its criminal action against McGinn and Smith, provided testimony as requested, and was listed as a government trial witness. FoF ¶¶ 527, 536, 538-44. These facts, too, are nowhere to be found in the ALJ's *Steadman* discussion.

Seemingly, the sole justification for the suspension of Mayer was the ALJ's perfunctory conclusion that Mayer "currently work[s] in the securities industry, so there appears to be a strong likelihood for recurrence." Decision at 113. The ALJ, however, did not consider that for more than five years, Mayer has provided financial services to clients through RMR, a SEC-registered investment advisory firm, without any client or regulatory complaint. RMR has "zero proprietary product" and does not sponsor private placements or mutual funds. FoF ¶¶ 33-35. There simply is no basis to believe that Mayer is a threat to the investing public. *See, e.g., SEC v. Bausch & Lomb*, 565 F.2d 8, 18 (2d Cir. 1977) (requiring "positive proof of a reasonable likelihood that past wrongdoing will recur"); *see also Monetta*, 390 F.3d at 958 (remanding to reconsider appropriate sanctions where respondent's different client-base made "the possibility of a future violation remote"). The Division's delay in bringing this case – more than three years after commencing its federal action against McGinn and Smith and significantly longer since the alleged violations occurred – also undermines any concern for the recurrence of future violations. *Monetta*, 390 F.3d at 357 ("the allocations took place a decade ago ... suggesting that the likelihood of a future violation is slight") (citing *Johnson v. SEC*, 87 F.3d 484, 490 n.9 (D.C. Cir. 1996)).

Moreover, the ALJ's claw back of *all* commissions earned after February 1, 2008, including commissions earned from clients who testified or submitted affidavits on his behalf and were identified in the Division's *Brady* disclosure, none of whom believed they were misled (and were not misled), has no basis in fact or in law. It is particularly unjustified because the evidence demonstrated that Mayer did not act fraudulently or even negligently.

In sum, to punish Mayer for his failure to uncover the fraud of McGinn and Smith, or as the ALJ put it, to "resolve" the so-called red flags, Decision at 108, ignores that their fraud went undiscovered for years by the SEC, the NASD, and countless others. Indeed, it took the SEC's seasoned staff accountant three years, devoting "a little less than half" of her time, to piece together her declaration that was a centerpiece of the Division's case. Tr. 392:5–393:18. This is not, as the ALJ claimed, "blam[ing]" others, Decision at 113, but rather, proof positive that Mayer did not bury his head in the sand and blindly recommend securities to his clients. To the contrary, Mayer performed product and customer suitability analyses before presenting investments to his accredited investor clients, only a fraction of which included McGinn Smith Securities. FoF ¶¶ 235-37, 650-51. To require Mayer, a relatively young man with a family to support (FoF ¶ 15), to pay a substantial penalty, disgorgement, and interest, and at the same time, effectively end his career in the securities industry, is not remedial, but punitive. It is unwarranted based on the evidence presented. Given Mayer's unblemished, 20-year record in the securities industry,[8] and investors affirming or testifying to his honesty, no sanctions should be imposed.

[8] The ALJ's statement that "Mayer settled a customer complaint with FINRA for $20,000" (Decision at 48, n.3) is false. Mayer was *not* personally accused of any wrongdoing in the complaint referenced in his Broker Check Report, and Mayer made *no* settlement contribution. FoF ¶ 17; *see also* Division's FoF ¶ 522 ("Mayer did not individually contribute to this settlement.").

Conclusion

The Commission should dismiss all charges against Mayer.

DATED: New York, New York
July 17, 2015

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CERTIFICATE OF COMPLIANCE

This brief complies with the Commission's Extension and Word Limit Order, dated June 5, 2015. The brief contains 9,831 words, exclusive of the Table of Contents, Table of Authorities, Signature Block, and this Certification, as counted by Microsoft Word, the word processing system used to prepare it.

Dated: New York, New York
July 17, 2015

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SK 27029 0001 6711030

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15514

In the Matter of,

FRANK H. CHIAPPONE,
ANDREW G. GUZZETTI,
WILLIAM F. LEX,
THOMAS E. LIVINGSTON,
BRIAN T. MAYER, and
PHILIP S. RABINOVICH

PHILIP S. RABINOVICH'S INDIVIDUAL BRIEF

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Preliminary Statement

The evidence conclusively established that Rabinovich did *not* violate Securities Act Section 17(a), Exchange Act Section 10(b) and Rule 10b-5 thereunder (the "Fraud Claim"), or Securities Act Section 5 (the "Section 5 Claim").[1]

Rabinovich did not make any material misrepresentations or omissions in presenting any McGinn Smith Security to any clients and no evidence was presented to the contrary. Rabinovich fulfilled his obligations as a registered representative by understanding the product and performing a client suitability assessment before presenting each McGinn Smith Security to clients. He continued to research and monitor his clients' investments, went beyond what was required of a registered representative, and went to extraordinary lengths to help his clients after leaving MS&Co. in October 2009.

The evidence irrefutably demonstrated that there were no "red flags" that should have caused Rabinovich to conduct a heightened inquiry. The PPMs of the Four Funds – the first of which was issued in September 2003 – contained industry standard provisions. The January 8, 2008 meeting at which it was announced that the interest rate on just the *junior* notes of the Four Funds was being reduced was unremarkable given the global liquidity and economic crisis. The ALJ's and the Division's position that Rabinovich should have "investigated" after the January 2008 meeting and "resolved" the so-called red flags is unsupported by the evidence. The contention is also unrealistic: Rabinovich, who was in the New York branch office, could not have uncovered McGinn and Smith's secret fraud in Albany. No case has ever imposed such a duty of investigation on a registered representative in these circumstances. In any event, neither the PPMs nor the January 2008 meeting were red flags that should have caused

1 Capitalized terms not otherwise defined shall have the meaning given to them in Respondents' Joint Brief.

Rabinovich to "investigate" or cease offering the separate and unrelated Trust Offerings, which had nothing to do with the Four Funds, and Rabinovich did not offer the Four Funds after January 2008.

In erroneously concluding that Rabinovich's conduct was fraudulent or negligent, the ALJ relied on "boiler room" cases like *Hanly* and *Milan* (Decision at 89). *Hanly* and *Milan* involved registered representatives who actively and knowingly participated in fraud. Here, no allegation was made that Rabinovich knew about McGinn and Smith's secret theft and diversion of funds, and no witness testified that Rabinovich made a material misstatement or omission about any McGinn Smith Security, let alone within the governing five-year statute of limitations.

Rabinovich also took reasonable steps to avoid participating in any distribution in alleged violation of Securities Act Section 5. He presented McGinn Smith Securities to his accredited investor clients, and those few who were not accredited either had been accredited or had the requisite knowledge and experience in financial and business matters to evaluate the merits and risks of the investment. Rabinovich followed MS&Co.'s written procedures for offering private placements; had his clients complete subscription agreements and questionnaires to confirm their accredited status or knowledge and experience; spoke with and was informed by McGinn Smith's legal, compliance and investment banking departments that the securities were exempt from registration; and knew outside counsel had advised MS&Co. that the offerings were exempt from registration. Rabinovich did all that any registered representative could do to comply with the exemption. Moreover, as a matter of law (explained in the Joint Brief), Section 2462 barred any Section 5 Claim on the Four Funds, and, as conceded by the Division, none of the Trust Offerings had more than 35 unaccredited investors. *See* OIP ¶ 32.

Because he did not act fraudulently or negligently, and because he has had an unblemished record for more than five years running RMR Wealth Management ("RMR"), no penalty, suspension, disgorgement, or other relief is warranted. Nor would it be necessary to protect the public interest.

STATEMENT OF FACTS

As much of the evidence is discussed in the argument section of this brief (and because of the reduced word limitation to which Rabinovich has a standing objection), an abbreviated statement of facts is presented.[2]

A. Philip Rabinovich

Rabinovich is married with three children, now ages 3 to 12. He has been in the securities industry since graduating Tufts University in 1996, during which time no customer has ever filed a complaint against him. Rabinovich worked in investment banking at Merrill Lynch and Bear Stearns before joining Mercer Partners as a registered representative in 1999. From 2001 to 2009, Rabinovich worked as a registered representative in MS&Co.'s New York City branch office. At MS&Co., Rabinovich proposed diversified portfolio allocations for his clients, who were mostly accredited investors with non-discretionary accounts, less than 20% of which included alternative investments, such as McGinn Smith Securities, which his family members also purchased. Rabinovich was never instructed to offer McGinn Smith Securities to clients. FoF ¶¶ 1-13, 377, 364, 366, 367, 385.

In October 2009, Rabinovich, together with Respondents Mayer and Rogers, left MS&Co. to form RMR, a SEC-registered investment advisory firm that provides a variety of

[2] Except as otherwise noted, the statement of facts are drawn from Phil Rabinovich, Brian Mayer and Ryan Rogers' Joint Proposed Findings of Fact and Conclusions of Law, dated May 12, 2014 ("FoF"), each paragraph of which contains specific citations to the transcript (page and line) and exhibits in the record.

financial services to high net worth individuals and small businesses. RMR has an unblemished regulatory record, does not sponsor private placements or mutual funds, and has "zero proprietary product." Tr. 4965:11-25. Rabinovich is a registered investment advisor representative with RMR. FoF ¶¶ 32-37.

B. The Business of McGinn Smith

MS&Co., founded in 1980 by David Smith and Timothy McGinn, was a SEC-registered broker dealer with its principal place of business in Albany, NY, and branch offices in New York, NY, Clifton Park, NY, and King of Prussia, PA. FoF ¶¶ 41-48.

At the time he joined MS&Co., Rabinovich knew of McGinn's and Smith's extensive and impressive experience as investment professionals and the extensive due diligence performed in the alarm trust business. MS&Co. had been operating for over twenty years, had a national reputation in the alarm trust business, and had done multiple offerings and municipal bond transactions. FoF ¶¶ 49-52. Mary Ann Cody, then MS&Co.'s General Counsel, detailed this due diligence process at the hearing, although it is mentioned nowhere in the Decision. Cody described how brokers at MS&Co. were informed of the due diligence performed at sales meetings, which was similar to how Rabinovich learned about the due diligence for the McGinn Smith Securities at issue in the OIP. FoF ¶¶ 59-75.

Rabinovich also knew of Smith's position as a managing partner of Pine Street Capital Partners ("Pine Street"), which was affiliated with MS&Co. and located at its Albany headquarters. Pine Street was formed around the same time as the Four Funds and, similar to the Four Funds, investors purchased interests pursuant to the terms of a PPM and a subscription agreement. In marketing materials, Pine Street touted its connection to MS&Co. and its access to MS&Co.'s network of relationships. Smith and the other principals at Pine Street worked together on investments made not only by Pine Street, but also the Four Funds. FEIN, TAIN, and FAIN each invested substantial amounts in Pine Street, which was a profitable investment for them. FoF ¶¶ 87-94. Pine Street was not the subject of the OIP's allegations.

C. The Offering Documents

Investors in McGinn Smith Securities purchased notes pursuant to the terms of a PPM, a Subscription Agreement, and a Purchaser Questionnaire (collectively, the "Offering Documents"). Rabinovich provided all of his clients and prospective clients with the Offering Documents prior to investing in McGinn Smith Securities. No witness – whether called by Rabinovich or the Division – testified otherwise. Nor did any witness testify that they were directed by Rabinovich to complete a Purchaser Questionnaire other than truthfully and to the best of their knowledge. FoF ¶¶ 95-98.

The cover page of the PPMs for the Four Funds stated, in bold print, that the notes are not "**guaranteed or insured**," and that **"[i]nvesting in the notes involves a high degree of risk**." The PPMs clearly disclosed that (i) "[n]o person has been authorized to make any representations concerning this offering, ... other than as set forth in this memorandum, and, if made or given, these other representations or information must not be relied upon by prospective investors," (ii) "the notes are suitable for purchase only by investors who are capable of bearing the economic risks of holding the notes for an indefinite period of time," and (iii) the Four Funds' broad investment mandate. Investors who, after receiving a PPM, decided to invest in the Four Funds, signed a Subscription Agreement in which they expressly "represent[ed], warrant[ed], and agree[d]" that, among other things, they had "carefully read the Offering Materials," and they "fully underst[ood] the Offering Materials," and they relied only on "that set forth in the Offering Materials and [their] own independent investigation" in making an investment decision. *See* Div. Ex. 5, at 1, 3, 15, 38. FoF ¶¶ 105-37.

The Offering Documents for the Trust Offerings contained similar disclosures, except that the investment mandate specified the securitized asset in which the Trust would invest – triple-play contracts, alarm contracts, or luxury cruise bookings. The PPMs also disclosed the fees and expenses associated with each Trust Offering. Investors in the Trust Offerings acknowledged in the Subscription Agreement that they "received and have carefully read and understood the [PPM]." *See* Div. Ex. 264, at 23. FoF ¶¶ 138-63.

D. Rabinovich Fulfilled His Duties as a Registered Representative

Rabinovich conducted reasonable diligence to understand the product and his customers so he could make suitability determinations or investment recommendations to a client. Rabinovich was not, however, required to conduct his own independent due diligence investigation. Even the Division's expert witness, a 23-year veteran of the SEC who never worked as a registered representative or for a broker-dealer, admitted that the word "investigate" is *not* used in the federal securities law, or any SEC or FINRA rule or regulation regarding the duties of a registered representative before presenting a private placement security to a client. Similarly, no FINRA rule purports to require an individual broker to review the investment banking department's due diligence files. FoF ¶¶ 164-83.

After analyzing the product and assessing customer suitability, Rabinovich called or met the client, again explained the investment, reviewed the PPM with the client, and asked the client to read the PPM and raise any questions or concerns. Rabinovich followed up, and again reviewed the risks and the investment. If the client decided to proceed, Rabinovich sent the subscription documents, which the client would complete and send to MS&Co. employee, Patty Sicluna, in Albany. Rabinovich also followed the procedures detailed in the MS&Co. compliance manual for offering private placements. FoF ¶¶ 193-94.

E. There Were No Red Flags Which Should Have Caused Rabinovich to Conduct a Heightened Inquiry. In Any Event, His Inquiry Was Sufficient.

1. The PPMs Contained Standard Disclosures

No evidence was presented that the disclosures in the PPMs for McGinn Smith Securities were other than ordinary and customary in the industry. A comparison to the PPMs with other MS&Co. private placements – none of which formed the basis for the Division's fraud charges – makes clear that the disclosures were standard. Rabinovich, other Respondents, and experts testified that the disclosures in the Four Funds' PPMs were commonplace and not a cause for concern. FoF ¶¶ 311-19.

2. Smith Never Concealed the Four Funds' Investments from Rabinovich

There was nothing secretive about the investments that Smith was considering and executing on behalf of the Four Funds. To the contrary, Smith looked to MS&Co. personnel to support him in making investment decisions for the Four Funds. There was no evidence that Smith concealed the Four Funds' investments from Rabinovich, except for some details of a few loans to local Albany-area businesses, which Smith claimed confidentiality over. Smith discussed with Rabinovich the "types of investments he was making, both specific investments and specific sectors" (Tr. 1937:11-17), and Rabinovich knew the major investments made by the Four Funds, including alseT, Coventry, trust preferred CDOs (Dekania and InCaps), the ATM deals (Cherokee and Cochise), Pine Street, Deerfield, GSC, CMET, Palisades Pictures, Exchange Boulevard, alarm contracts, Vidsoft, Vigilant and Maracay Homes. From time to time, Rabinovich received schedules of investments and financial information for each of the Four Funds. FoF ¶¶ 320-28.

3. Rabinovich Was Unaware of Any Purported Redemption "Policy"

MS&Co. did not announce a "policy" in December 2006 that clients only could redeem their investment in a Four Funds note if their brokers first found a replacement investor. Rabinovich was never told that his client could not redeem unless a replacement investor first had been found. Rabinovich's clients redeemed their Four Funds notes and Trust Offerings certificates during 2006 and 2007, and timely received interest payments from 2003 through 2007. Nowhere in the Division's nearly 400 exhibits is any email or document establishing that Rabinovich knew about or was told about a redemption policy. Prior to the maturity date of a private placement, MS&Co. asked investors if they wanted to redeem or "roll" the investment. When a client elected to redeem, the broker had the right of first refusal to see if one of his clients was interested in the private placement security. If not, it went into MS&Co.'s inventory for other brokers to present to their clients. During 2003 through 2009, MS&Co. tried to make a secondary market – match a buyer and a seller to trade a security – which was not a red flag, but rather an accommodation, as the PPMs stated the private placement investments were illiquid. FoF ¶¶ 329-35. The ALJ agreed: "[T]here is no evidence that a registered representative who did not find a new purchaser was ever unable to redeem a client. It was reasonable for the registered representatives to accept [MS&Co. 's] efforts to create a secondary market for illiquid securities." Decision at 93.

4. The January 2008 Meeting Was Unsurprising Given the Economic Downturn that Impacted the Entirety of the Global Markets

At a January 2008 meeting in Albany, McGinn and Smith informed brokers that interest would be reduced on the junior notes of the Four Funds (but not the senior notes or the senior subordinated notes). The interest reduction was unsurprising given the global economic recession, but it was unrelated to, and did not affect, the Trust Offerings. After the meeting, Rabinovich explained the impairments to his clients, and that MS&Co. would be attempting to work through the adverse market and economic environment. Rabinovich viewed MS&Co. 's 15-year restructuring plan as conservative, and believed it was achievable. FoF ¶¶ 338-43; Div. Exs. 132, 195; RMR Ex. 855.

5. Rabinovich Was Unaware of the Firstline Bankruptcy Until After He Ceased Presenting McGinn Smith Securities to His Clients

In September 2009, McGinn, Smith and Joe Carr, General Counsel, revealed that Firstline Securities, Inc. – a residential alarm contract company that borrowed funds from the Firstline Trust offering of October 2007 – had filed for bankruptcy on January 25, 2008 in Utah. The Division admits that Rabinovich was unaware about the Firstline bankruptcy before September 2009. Rabinovich was shocked by not receiving disclosure earlier, and he immediately informed his Firstline investors. Although the Division contends that Rabinovich presented Trust Offerings to two customers after learning of the bankruptcy based on summary charts, Rabinovich explained that he presented, and his clients subscribed to, those investments in August 2009 before he learned of the bankruptcy. One week later, Rabinovich, Mayer and Rogers started RMR. FoF ¶¶ 349-51, 354.

F. Rabinovich Made No Material Misrepresentations or Material Omissions to His Clients and Presented McGinn Smith Securities Only When Suitable

During 2003 through 2009, Rabinovich did not make any material misrepresentations or omissions to any client about a McGinn Smith Security.

Five of Rabinovich's clients testified in person, all of whom were accredited investors at the time they invested in McGinn Smith Securities. Nine other investors who were subpoenaed, but unable to travel to the hearing, submitted affidavits, but the ALJ refused to admit or consider them. Of those who did testify, three were called by Rabinovich (Rowe, Favish, and Kogan); two by the Division (Patel and Chapman). They described how Rabinovich provided them with PPMs that they reviewed with him and later signed if they chose to invest. As one investor explained, "Phil always provided thoughtful analysis," and "he was providing a valuable resource to me." Tr. 4375:21–4377:2. Another testified that Rabinovich presented investment opportunities that were within his comfort zone and consistent with his tolerance for risk. Rabinovich's investors described him as "a man of honesty and high integrity," and "thorough and honest and straightforward in his dealings with me." RMR Ex. 625, ¶ 12. Three of the testifying investors have remained as Rabinovich's client at RMR. FoF ¶¶ 371-415.

The two investors called by the Division admitted that they made their own investment decisions and did *not* invest in some of the investments that Rabinovich presented to them. And, although they claimed that they thought their investments were "safe," they admitted that nobody told them so, and they signed subscription agreements in which they acknowledged their investments involved "substantial risk." Chapman, who the Division only contacted *after* the OIP was filed, made one investment in a McGinn Smith Security, and did so in March 2005. Patel agreed to testify for the Division "if you can help me to get my money back." Tr. 198:11–199:2; FoF ¶¶ 398-415.

G. The Division's Post-OIP Conduct And Its Effect on Rabinovich

The evidence established that the Division tried to find support for the allegations in the OIP *after* it was filed. Rabinovich learned from clients that the Division first contacted them *after* the OIP was filed. As a result of the Division's calls, Rabinovich lost several clients, and another withdrew a portion of his account. Nevertheless, as the *Brady* disclosures revealed, Rabinovich's clients told the Division that Rabinovich is "honest," "ok," "got hurt a lot," "read her the 'element of risk' for every deal," was "[h]onest as the day is long," and "did nothing wrong." FoF ¶¶ 685-89; RMR Ex. 873.

Rabinovich explained in his testimony that he believes he "deserve[s] to continue to work, to continue to provide for my family and try to overcome the damage that ... McGinn Smith has done to me.... I just want the opportunity to continue to do what I love to do and I know that I can do to the best of my ability for my clients that depend on me and for my family that depends on me." Tr. 4489:2–4490:18. Rabinovich described the effect this proceeding has had on him and his family as "tremendously painful," causing "the loss of clients," and an "enormous hit to my reputation." *Id.* FoF ¶¶ 690-91.

ARGUMENT[3]

I. Rabinovich Did Not Violate the Antifraud Provisions of the Federal Securities Laws

The ALJ erred in concluding that "Rabinovich willfully violated Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5 because he was reckless in offering and selling securities," and that he "violated Securities Act Sections 17(a)(2) and (a)(3) because, acting at least negligently, he obtained money by means of untrue material statements." Decision at 108. To reach this conclusion, the ALJ cherry-picked testimony and misconstrued the factual record before her, ignored significant evidence that would lead any reasonable trier of fact to conclude that Rabinovich did *not* violate the law, and arbitrarily and capriciously applied facts to law. Rabinovich was neither reckless nor negligent, and there was no evidence that he made any material misrepresentations or omissions. The Commission should reverse.

A. Rabinovich Did Not Act With Scienter

In concluding that Rabinovich acted recklessly, which as a matter of law required a showing by the Division of "a state of mind approximating actual intent, and not merely a heightened form of negligence," *see South Cherry St., LLC v. Hennessee Group LLC*, 573 F.3d

[3] Legal arguments, common to all Respondents who petitioned for review, are set forth in the Joint Brief. This brief addresses primarily the application of the governing law – as stated in the Joint Brief – to the facts specific to Rabinovich.

98, 109 (2d Cir. 2009), the ALJ cited just three "facts": (1) Rabinovich "falsely represented to Chapman that FEIN was a low risk investment," (2) "he did not make Patel aware of material facts surrounding the Trust Offerings," and (3) "he failed to investigate several red flags that were apparent to him by January 8, 2008." Decision at 108. None is supported by the record.

Patricia Chapman, a former systems engineer and an accredited investor with a net worth greater than $1,000,000 when she invested in McGinn Smith private placements, was first contacted by the Division to be a witness only a few months before the hearings began. As relevant here, Chapman made a single investment in FEIN some eight years prior to the filing of the OIP. As was his practice, Rabinovich provided Chapman with PPMs to review and discuss with him prior to making any investment decision. Chapman testified that she made her own investment decisions, as shown by her decision *not* to invest in TAIN after receiving the offering documents from Rabinovich in November 2004. Further, the uncontroverted documentary evidence established that by signing her FEIN subscription agreement, Chapman expressly acknowledged that she read and understood the FEIN PPM, the front cover of which stated in bold print, "**[i]nvesting in the notes involves a high degree of risk**," Div. Ex. 6 at 1, and that she relied on herself – not Rabinovich – in evaluating the merits and risks of her investment in FEIN. FoF ¶¶ 409-15; RMR Ex. 820. The ALJ ignored these contemporaneous written attestations, and instead credited Chapman's oral testimony, some eight years after-the-fact, that she supposedly understood FEIN to be a "safe bond" based on her conversations with Rabinovich. Tr. 2184:7–2185:8. This conclusion is not only belied by the documentary evidence (RMR Ex. 820), it is contrary to law. *See* Joint Br. at 21-22. In any event, any claims by the Division arising out of Chapman's single 2005 investment are plainly time-barred. *See* 28 U.S.C. § 2462.

Ketan Patel, an accredited investor with medical degrees from India and the United States and an annual income between $200,000 to $300,000, agreed to testify for the Division "if you can help me to get my money back." Tr. 198:25–199:1. Similar to Chapman, Patel received PPMs from Rabinovich to review before deciding whether to invest, and made his own investment decisions. As relevant here, Patel made three investments in the Trust Offerings, the largest of which ($25,000) preceded the OIP by more than five years. Although Patel claimed that he *thought* his investments were "safe," he admitted that nobody *told* him they were safe. Tr. 157:6-9. Nevertheless, Patel expressly acknowledged in his subscription agreements that he relied on himself in evaluating the merits and risks of his investments in the Trusts. Most significantly, however, the "material facts surrounding the Trust Offerings" that the ALJ concluded Rabinovich "did not make Patel aware of" (i.e., substantial risk factors, fees and expenses), Decision at 108, were fully disclosed in the PPMs that Patel attested to reading and understanding at the time he invested. FoF ¶¶ 398-408; RMR Exs. 707, 710, 711. We are aware of no legal authority – and the ALJ cited none – holding an individual broker liable for a supposed material omission of fact that is expressly disclosed to the investor in offering documents he is given to read and review (and which he acknowledged reading and reviewing) prior to investing.

The ALJ also erroneously concluded that Rabinovich was reckless in failing "to investigate several red flags that were apparent to him by January 8, 2008." Decision at 108. The ALJ identified three supposed red flags as of January 8, 2008 (which is, notably, more than five years prior to the filing of the OIP): (1) the Four Funds PPMs' disclosure of potential conflicts of interest; (2) the Four Funds PPMs' disclosure of its ability to acquire investments from affiliates; and (3) the January 2008 reduction in interest payments to junior noteholders in the Four Funds, the latter of which she claimed triggered a "duty to investigate the Four Funds' junior notes default before selling the Four Funds." Decision at 91-92.[4] As a threshold matter, it is undisputed that Rabinovich did not sell any Four Funds' notes – junior or otherwise – after December 2007. FoF ¶ 552. Thus, the ALJ effectively concluded that Rabinovich was reckless in selling the Trust Offerings based on supposed red flags relating to the Four Funds. This ignores, however, that the Four Funds had nothing to do with the Trust Offerings, which the Division's own expert witness admitted "were not at all similar" to the Four Funds. Div. Ex. 1 at 25. The Trust Offerings were managed by McGinn, not Smith, were based on cash flow from income-generating assets such as "triple play" contracts with homeowner associations that could be amortized or sold to pay the stated interest due on the trust certificates, and were unrelated to the types of investments made by the Four Funds. FoF ¶¶ 47, 273, 338.

Moreover, the disclosures in the PPMs were standard in the industry, a fact confirmed by the testimony of three of four expert witnesses, including the Division's expert witness who admitted the PPMs' discussion of potential conflicts of interest "is standard language." Tr. 689:21; *see also* FoF ¶¶ 311-17 & RMR Ex. 861. The ALJ ignored this evidence, too, and instead misconstrued the testimony of a fourth expert witness as having "never [been] aware of a situation where the broker-dealer was both the issuer and the placement agent in a private placement," Decision at 92, when he in fact testified that he "hadn't been involved in a situation like that," but agreed it was not unusual. Tr. 4772:11-13.

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4 The ALJ concluded that there was no "redemption policy" announced by MS&Co. in December 2006, *see* Decision at 93, and the Division has waived its right to challenge this finding by not filing a cross-petition for review. The last alleged red flag –the September 2009 disclosure of the Firstline bankruptcy – did not yet exist in January 2008. Further, the evidence established that Rabinovich did not present any McGinn Smith Securities to his clients after he learned of the Firstline bankruptcy. FoF ¶¶ 349-54.

To purportedly bolster her conclusion that heightened scrutiny of the Four Funds was required based on the PPMs, the ALJ incorrectly stated that MS&Co. "was a small company creating newly formed entities." Decision at 92. As expert testimony established, and the record confirmed, "McGinn Smith was not a small company and was definitely not of recent origin. While they may have created LLCs to issue product through, which are new entities technically, they are all part of McGinn Smith, which had a long track record." Tr. 3927:3-8. Nor was the level of control that Smith exerted over the Four Funds of any great significance given McGinn and Smith's long and diverse backgrounds in capital markets, and Smith's sufficient experience and background in underwriting to launch private placements such as the Four Funds. It is telling that none of the other 35 to 50 brokers of MS&Co. who presented McGinn Smith Securities to clients told them that he or she was aware of any red flags. FoF ¶¶ 318-19.

Finally, the January 2008 meeting, at which Rabinovich learned that interest would be reduced on the junior notes of the Four Funds (but not the senior or senior subordinated notes), was unsurprising given the global economic recession. At the meeting, Smith went over specific investments, identified where there was stress on the portfolio, and stated his belief that the stress was a temporary, not permanent, issue. McGinn talked about undertaking additional revenue initiatives to shore up some of the problems in the Four Funds. Rabinovich was unhappy and disappointed about the news conveyed at the meeting, but not shocked given what was going on in the credit and equity markets. After the meeting, Rabinovich explained the impairments to his clients, and that MS&Co. would be attempting to work through the adverse market and economic environment. FoF ¶¶ 338-43.

In sum, no reasonable and unbiased trier of fact could consider the evidence presented at the hearings and conclude that Rabinovich acted with scienter, particularly where, as here, Rabinovich and his family invested, and lost, significant sums in McGinn Smith Securities – far more than Rabinovich earned selling them. Not surprisingly, the ALJ cited only a single case to supposedly support her conclusion. Decision at 108 (citing *SEC v. Milan Capital Group, Inc.*, 00 Civ. 108, 2000 U.S. Dist. LEXIS 16204 (S.D.N.Y. Nov. 9, 2000)). *Milan*, however, is easily distinguishable, as in that case, the defendant-broker enabled the sale of phony IPO securities that were obviously a sham. *Milan* at *5-6, *13-21. Here, Rabinovich presented legitimate private placements to his accredited investor clients when suitable, which securities suffered losses in a difficult market. Rabinovich in fact had less of a financial incentive to present McGinn Smith Securities than equities as commissions on equity trades were higher than private placements. Indeed, private placements comprised less than 20% of his client's assets. FoF ¶ 384. That Rabinovich, along with the SEC, the NASD, and countless others, did not uncover the secret theft and diversion of funds by his superiors does not make him liable for fraud.

B. Rabinovich Acted Prudently and Fulfilled His Duties as a Registered Representative

Equally unsupported is the ALJ's conclusion that Rabinovich "violated Securities Act Sections 17(a)(2) and (a)(3) because, acting at least negligently, he obtained money by means of untrue material statements: his representations that he had some reasonable basis for recommending the securities and the omissions that he was simply repeating the issuer's representations," which the ALJ concluded "operated as a fraud or deceit on his clients." Decision at 108. Aside from repeating statutory language, the ALJ failed to identify any "untrue material statements" Rabinovich made to any investor about any McGinn Smith Security, or any representations Rabinovich made to any investor about any McGinn Smith Security that supposedly did not have a reasonable basis. The overwhelming evidence established that Rabinovich acted prudently and fulfilled his duties as a registered representative.

The ALJ's naked assertion that Rabinovich's "testimony was often inconsistent or contradicted by other evidence," Decision at 106, ignored the evidentiary record. While stating that "[i]t is impossible to know how much Rabinovich knew about" the Four Funds before the January 2008 meeting, the ALJ ignored Rabinovich's testimony, contemporaneous documents, and her own recital (*id.* at 106-07) which made clear that Rabinovich discharged his duties as required.

For example, Rabinovich did not present FIIN until some three years after it was offered and he saw some of the investments by FIIN, an undisputed fact acknowledged by the ALJ. Decision at 107. Rabinovich knew that FIIN was generating a weighted average annual return of 17.6% and knew specifics about more than $10 million of investments by FIIN, facts that were expressly noted in a Pine Street presentation that Rabinovich reviewed. RMR Ex. 46; Tr. 4436:10–4437:4. Unexplained by the ALJ is how having awareness of FIIN's investments prior to presenting it to clients in 2006 supports the assertion that "Rabinovich did not conduct a sufficient investigation into the Four Funds and Trust Offerings" to recommend them to clients, or that "Rabinovich dismissed a number of [unidentified] red flags." Decision at 107. It does not.

Moreover, the ALJ's reliance on Rabinovich's 2011 non-party deposition testimony from the SEC's separate action against McGinn and Smith in federal court (the "<u>SEC Action</u>") to purportedly undermine his credibility should be disregarded as fundamentally flawed. At the time Rabinovich testified as a non-party deponent, he had not refreshed his recollection or understood that he was a target of the SEC's investigation. The SEC in fact (mis)led him to believe he was assisting in the SEC Action, which is contrary to its stated mission to act "honestly, forthrightly, and impartially in every aspect of [its] work." SEC Enforcement Manual (June 4, 2015), § 1.4.1. The SEC never provided Rabinovich with Form 1662, or showed him a Formal Order of Investigation. Nor did the SEC ever send him a copy of his non-party deposition transcript to review, correct, clarify or sign, which the ALJ has now termed "investigative" testimony.[5] Rabinovich did not learn that the SEC was considering charges against him until some 17 months after his non-party deposition. Had Rabinovich known his actions (or supposed inactions) were in question, he would have refreshed his recollection and provided *additional* – not *different* – information at his non-party deposition to demonstrate he fulfilled his obligations as a registered representative. The hearing was effectively Rabinovich's first opportunity to tell his side of the story in response to the Division's charges against him, and he should not be penalized for expanding upon the answers given during his non-party deposition. FoF ¶¶ 527-30, 535, 537.

Nor was Rabinovich's non-party deposition testimony inconsistent with his trial testimony. In fact, Rabinovich's non-party deposition testimony only further demonstrates the steps he took to understand the products he offered to his clients, notwithstanding the Division's selective and misleading use of it at the hearing that was endorsed by the ALJ. For example, the Division purported to impeach Rabinovich's trial testimony that he knew of the due diligence performed on the Four Funds' investments by reputable Wall Street institutions, cherry-picking a statement from his non-party deposition that "Mr. Smith did the due diligence." Tr. 1967:15-18.

5 Decision at 56. Ironically, the ALJ referred to Respondent Gamello's non-party deposition testimony as "deposition testimony," and noted that he "takes issue with the Division's use of his deposition testimony, where he testified without any records and in the belief he was called to assist the Commission's case against McGinn and Smith." *Id.* at 20 n.31. Rabinovich likewise objected and filed a motion to that effect.

After Rabinovich noted the Division was mischaracterizing his testimony and even informed the ALJ that his answer was clarified "if you keep reading down [in the deposition transcript]," Tr. 1969:6-8, the ALJ denied Rabinovich the opportunity to clarify, stating "we can't go through the whole transcript." Tr. 1971:20-21. Later in the proceedings, Rabinovich's counsel did clarify the record with the following additional testimony from Rabinovich's non-party deposition: "I am referring to the offering within the [Four Funds] notes. So if you are talking about publicly traded companies or transactions that are underwritten by investment banks [as many investments of the Four Funds were], I think there is a level of due diligence and product and industry scrutiny that is assumed at that level." Tr. 2173:7-12.

In any event, the overwhelming evidence established that Rabinovich understood and fulfilled his duties as a registered representative. Rabinovich understood the product before presenting it to his clients. He analyzed the investment by (a) attending management's presentation of the investment, (b) reviewing the PPM, (c) asking follow-up questions of management, (d) discussing the investment opportunity with his colleagues, and (e) making a suitability determination regarding specific clients. Rabinovich also did independent research and spoke with others at MS&Co. Rabinovich determined client suitability by having detailed discussions with clients about their financial picture, investment objectives, risk tolerance, and overall goals, after which Rabinovich prepared plans for clients regarding asset allocation, plans he continues to prepare to this day. FoF ¶¶ 188-94.

Rabinovich knew about the due diligence performed and product and industry scrutiny by investment banks on large portions of the investments made by the Four Funds, including Deutsche Bank, Credit Suisse, Stifel Nicolaus, Merrill Lynch, Sandler O'Neill, and Citibank as did the SEC. *See* Livingston Ex. 103, at 12 (SEC's post-examination letter to

MS&Co. in February 2004 noting that "reputable financial institutions, which included Sandler O'Neill & Partners, L.P., Friedman, Billings, Ramsey & Co. Inc., and Merrill Lynch International, underwrote ... investments purchased by FIIN"). Rabinovich also informed himself about the due diligence performed by MS&Co.'s investment banking department through discussions with McGinn, Smith, Matthew Rogers, the Pine Street bankers and others, as well as through management's presentations of the investments. For example, when FIIN was first presented to brokers, they were told the details of the types of investments that would be made and the debt coverage for the senior, senior subordinated and junior note tranches. The debt coverage ratios for the senior and senior subordinated notes were in fact "substantially greater" than the Pre-2003 Trust Offerings. FoF ¶¶ 195-96.

Further, Rabinovich, together with Respondents Mayer and Rogers, worked as a team, frequently discussing with each other the details of the various investment opportunities presented by MS&Co. prior to offering them to their clients. As further evidence of Rabinovich's *independent* analysis of these various investment opportunities, the team often reached different conclusions. For example, Rabinovich, after conducting his own independent inquiry, decided not to offer MSTF to his clients; Mayer, after conducting his own independent inquiry, decided not to offer the TDM Luxury Cruise Trust Offering to his clients. Respondent Gamello – who the ALJ deemed "credible" (Decision at 101) – confirmed that "the RMR guys ... are different personalities.... They are very thorough." Tr. 5945:7-11; Decision at 20 n.33; FoF ¶¶ 283-85.

While Smith was the ultimate decision-maker for investments made by the Four Funds, Rabinovich knew that Smith had a "large infrastructure around him that assisted him in the investment selection process." Tr. 1925:16-22. Among others, Tim Welles and Mike Lasch of Pine Street, and Scott Weisman, head of MS&Co.'s investment banking, assisted Smith in the investment selection process. Rabinovich was aware of internal oversight (legal, compliance, accounting), outside counsel (Gersten Savage), outside accountants (Piaker Lyons) and regulatory oversight of Smith in managing the Four Funds. FoF ¶¶ 197-200.

At the hearing, Rabinovich testified at length about his knowledge of the due diligence performed on many of the Four Funds' investments. For example, Rabinovich worked closely with Weisman, who worked in the New York City branch office and conducted due diligence on Vigilant and Vidsoft, two Four Funds investments. Rabinovich learned of the due diligence performed on Dekania and CMET, also Four Funds investments, through his review of offering materials and his attendance at due diligence meetings. Rabinovich reviewed presentations and offering documents for Maracay Homes, GSC and Deerfield. The Four Funds invested in all of them. Rabinovich learned of the Four Funds' investment in 74 State Street through Welles, who was involved in due diligence on the investment, and Rabinovich met with management of State Street Hospitality, which owned 74 State Street. Rabinovich knew alseT was an intellectual property, royalty business in which the Four Funds had invested, and that Deutsche Bank and Goldman Sachs, among others, were interested in financing alseT. FoF ¶¶ 201-11; *see also*, FoF ¶¶ 46, 195-200.

Ignoring the uncontradicted evidence, the ALJ declared "there is no persuasive evidence that before January 8, 2008, Rabinovich requested balance sheets or factual information about the Four Funds or Trust Offerings.... [He] did not conduct a sufficient investigation, dismissed a number of red flags ... and parroted Smith's optimistic statements about the Four Funds to his customers as fact." Decision at 107. No unbiased fact finder could make such a declaration given the evidence adduced at the hearing, and the ALJ cited nothing to support these baseless assertions. For example, no witness testified that Rabinovich "parroted Smith's optimistic statements about the Four Funds." Rabinovich also asked for and received balance sheets for the Four Funds between 2003 and 2007, which showed the Four Funds' assets. Rabinovich noted that the balance sheets held the investments at cost, and thus did not reflect the current value of the investments. Rabinovich also checked with Smith regarding the performance of the Four Funds and reviewed his clients' account statements to confirm that they had received interest on their investments. And, investors in the Four Funds did receive interest from 2004 until April 2010 when the Receiver was appointed, except for junior note-holders, who received interest until January 2008 (when interest was reduced to 5%) and no interest thereafter. Rabinovich had no complaints from clients about their investment in the Four Funds during 2004 through 2007, and he had no reason to be concerned about the performance of the Four Funds until January 2008. FoF ¶¶ 216-20.

Particularly egregious was the ALJ's reference to Rabinovich's October 20, 2008 letter to Stan Rowe, noting his view that a "fifteen-year amortization [of Four Funds notes] was too conservative," Decision at 58, meaning that the economic recession may resolve itself in fewer than 15 years. The ALJ failed to mention that the letter was sent to Rowe, who is Rabinovich's current client at RMR, testified on behalf of Rabinovich at the hearings, and referred to him as "thorough and honest and straightforward in his dealings with me." Tr. 4377:3-15; FoF ¶¶ 371-80. More fundamentally, however, the ALJ failed to explain how Rabinovich's October 2008 letter concerns any purchase by any client of TAIN or FAIN, as it is uncontroverted that Rabinovich did not offer any Four Funds notes after December 2007. FoF ¶ 552.

Rabinovich also performed his duties to understand the Trust Offerings. Similar to the Four Funds, he did so by attending management presentations and reviewing the PPMs, and his contemporaneous notes (as well as his testimony) reflected his analysis and understanding of those investments. RMR Exs. 863-70. In addition, the PPMs for the Trust Offerings fully disclosed the underlying investments and the due diligence conducted on those investments. Based on management's presentations, the PPMs, and his understanding of the investments, Rabinovich viewed the Trust Offerings favorably. For example, Rabinovich believed the Benchmark investment, with its five-tier amortization structure, was very achievable given the distressed purchase price for the asset and "terminal value of eight times [EBITDA]." Tr. 4471:9–4472:5. As part of his due diligence, Rabinovich calculated the return needed to pay interest and principal before offering Benchmark to clients. Rabinovich explained that once the senior Benchmark notes were amortized, the asset should, under normal market conditions, potentially sell for 2½ times the price the Trust paid for it. Benchmark investors received their principal and interest payments until April 2010 when the Receiver was appointed. FoF ¶¶ 227-34.

In one of the most glaring examples of the arbitrary and capricious nature of the Decision, the ALJ ignored Rabinovich's testimony about Benchmark, yet noted the following about Gamello in concluding he did *not* violate the antifraud provisions of the federal securities laws: "[I]t was not unreasonable for Gamello to have accepted McGinn's assertions that the contracts underlying Benchmark were bought at a low price, and that, if the economy improved, the contracts could likely be sold for much higher multiples and the offering could earn the projected returns." Decision at 102. The ALJ also ignored that Rabinovich, like Gamello, did not offer the Four Funds after December 2007, FoF ¶ 552, and did not offer the Trusts after he learned of the Firstline bankruptcy in September 2009, FoF ¶ 349-54, two facts that the ALJ cited as support for her conclusion that Gamello did not violate the law. Decision at 102.

Notably, the Division did not petition for review of the ALJ's decision as to Gamello, and the Commission declined to review it on its own initiative.[6]

In short, the overwhelming documentary and testimonial evidence demonstrated that Rabinovich did not violate Securities Act Section 17(a)(2) or (3), and that he acted prudently and fulfilled his duties as a registered representative.

II. Rabinovich Did Not Violate Securities Act Section 5

In imposing Section 5 liability on Rabinovich, the ALJ ignored two critical points. First, as a matter of law, there can be no actionable Section 5 claim regarding the Four Funds, as Rabinovich did not sell any Four Funds after December 2007, and any such claim is time-barred. FoF ¶ 552; *see also* 28 U.S.C. § 2462. Second, despite paying lip service to Rules 506 and 508, which allow for a defense based on Rabinovich's reasonable belief, the ALJ sweepingly declared that Rabinovich "d[id] not explain how [his] supposed lack of knowledge of the number of unaccredited investors could be considered a 'reasonable' belief that there were fewer than thirty-five unaccredited investors." Decision at 95. This statement ignores the overwhelming evidence to the contrary.

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[6] Equally arbitrary and capricious was the ALJ's recitation of the testimony of Stephen Fowler, a client of Respondent Rogers (which calls into question whether the ALJ watched the video deposition or read the transcript at all). Decision at 67. Nowhere in her "findings of fact" does the ALJ mention the following: (1) Fowler has a net worth of \$20 to \$25 million; (2) Fowler earned approximately \$1.5 million on a \$50,000 investment in other private placements recommended by Rogers; (3) Fowler described his risk tolerance as "high," Fowler Dep. Tr. 10:2-7; (4) Fowler received PPMs from Rogers prior to investing and would "typically" discuss the risks and other terms with Rogers, *id.* 40:4-9, 42:4-6; (5) Fowler did not view the Four Funds' restructuring in 2008 as "any cause for alarm about the other investments" (i.e., the Trust Offerings), *id.* 17:18—18:5; (6) Fowler invested in MSTF following an in-person meeting with McGinn and Rogers because he "had cash looking for a high return," "had a high tolerance for risk," and "the investment [made] a very handsome return ... in the first year," *id.* 15:23—16:8; and (7) Fowler remained a client of Rogers at RMR at the time of the hearing. FoF ¶¶ 494-503.

Under Rule 506, offerings of unregistered securities may be made to an unlimited number of "accredited investors," provided ... the issuer *reasonably believes* there are no more than, 35 additional unaccredited investors. 17 C.F.R. § 230.506(b)(2)(i) (emphasis added). Rule 508 further provides that "[a] failure to comply with a term, condition or requirement of [Rule 506] will not result in the loss of the exemption ... if the person relying on the exemption shows: ... (3) A good faith and *reasonable* attempt was made to comply with all applicable terms, conditions and requirements of [Rule 506]." *Id.* § 230.508(a)(3) (emphasis added). The record was replete with examples of Rabinovich's reasonable belief that both the Four Funds and the Trust Offerings were exempt from registration.

Rabinovich presented McGinn Smith Securities to primarily accredited investors and did not engage in general solicitations or "cold calls." He did so after qualifying his clients in advance to be sure that they were an accredited investor or that the investment product was suitable for their particular investment objectives. He provided his clients with PPMs that he reviewed with them before they made any decision to invest in McGinn Smith Securities. Rabinovich understood that, under Regulation D, there could be up to 35 unaccredited investors in any McGinn Smith private placement, but was never told that more than 35 unaccredited investors had invested in any McGinn Smith private placement. Rabinovich nevertheless had no authority to accept subscriptions for McGinn Smith Securities, which were sent to Albany and processed by Sicluna, and thus no reason to know the number of unaccredited investors in any given private placement. Collectively, Rabinovich presented the Four Funds to five allegedly unaccredited investors, and the Trust Offerings in the fictitious conduits to just one allegedly unaccredited investor, and there was evidence that some of these investors were in fact accredited, only one of which invested after September 23, 2008. FoF ¶¶ 623-47.

Further, Rabinovich followed MS&Co.'s procedures when presenting private placements to his customers. Rabinovich also knew that the SEC, the NASD, and MS&Co.'s outside compliance consultant, conducted examinations of MS&Co. during 2004 to 2007, and that none raised any issues regarding the number of unaccredited investors in McGinn Smith Securities. The SEC specifically examined for Section 5 violations regarding FIIN, but found none. The NASD specifically examined Form D filings for TAIN and FAIN, but did not find that more than 35 unaccredited investors had been accepted in any offering. FoF ¶¶ 616-22.

Thus, the ALJ's conclusion that Rabinovich failed to explain how he held a "reasonable" belief that the offerings complied with Rule 506 is belied by the record. There was simply no legal or factual basis to impose Section 5 liability on Rabinovich.

III. In Imposing Sanctions, the ALJ Did Not Objectively Consider The *Steadman* Factors And Ignored That The Vast Majority of Alleged Misconduct Occurred Prior to September 23, 2008

The ALJ expressly acknowledged that "[i]ndustry bars are considered penalties under Section 2462," and that "[t]o determine whether a sanction is in the public interest, the Commission considers the *Steadman* factors," Decision at 112-13, yet failed to objectively apply either principle of law to the facts of this case. When appropriately considered, it is apparent that Rabinovich should not be subject to the sanctions ordered by the ALJ.

Notwithstanding the ALJ's baseless assertion that "multiple recurrent violations ... occurred on or after September 23, 2008," Decision at 112, the evidence proved otherwise. Rabinovich he did not sell any of the Four Funds after December 2007. FoF ¶ 552. Rabinovich also did not sell seven of the Trust Offerings after September 23, 2008, and did not sell three of the Trust Offerings *ever*. FoF ¶ 556. Thus, by the ALJ's own reasoning, as mandated by the Supreme Court's decision in *Gabelli*, not a single scrap of evidence or line of testimony relating to the Four Funds or these ten Trust Offerings can be considered in imposing penalties upon Rabinovich.

Moreover, the Division identified 47 investors of Rabinovich who purchased a McGinn Smith Security. 43 of them (91%) first purchased a McGinn Smith Security prior to September 23, 2008, and 26 of them engaged *exclusively* in transactions prior to September 23, 2008, including Division witness Chapman, who invested more than eight years prior to the date the OIP was filed. FoF ¶ 547. Of those investors who did engage in transactions after September 23, 2008, this included Rabinovich, his father (Stan Rabinovich), his father-in-law (Jeffrey Kaplan), Rabinovich's own witness Stan Rowe, two investors identified in the Division's Brady disclosure (Amar and Ramesh Bhandari), and four investors who provided affidavits in support of Rabinovich (Dov Junik, Claude Penchina, Stan Rowe, and Amar Bhandari). Div. Ex. 2, at Ex. 4q; RMR Ex. 873; RMR Motion to Admit Prior Sworn Statements, dated Jan. 15, 2014, at 2-3. Collectively, these investors comprised approximately 69% of the dollar amount invested by clients of Rabinovich after September 23, 2008, and cannot possibly have been considered as part of the alleged "multiple recurrent violations ... [that supposedly] occurred on or after September 23, 2008." Decision at 112. By contrast, the sole witness called by the Division who invested after September 23, 2008 (Ketan Patel), was responsible for 1% of the post-September 23, 2008 dollar amount invested. *Id.* There was no testimony offered or received by the remaining 30%.

Turning then to the *Steadman* factors, as applied to the limited evidence of conduct that occurred *after* September 23, 2008, the ALJ's cursory analysis was utterly deficient. As noted in *Steadman*, "when the Commission chooses to order the most drastic remedies at its disposal, it has a greater burden to show with particularity the facts and policies that support those sanctions and why less severe action would not serve to protect investors." *Steadman v. SEC*, 603 F.2d 1126, 1137 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981); *see also Paz Sec. v. SEC*, 494 F.3d 1059, 1065 (D.C. Cir. 2007) ("The Commission must be particularly careful to address mitigating factors before it affirms an order expelling a member from the NASD or barring an individual from associating with an NASD member firm – the securities industry equivalent of capital punishment."). Here, the ALJ merely "reference[d] the[] [*Steadman*] factors," but the Decision "does not reflect that the [ALJ] meaningfully considered these factors when [she] imposed sanctions." *Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952, 957 (7th Cir. 2004).

The ALJ's imposition of a one-year suspension – a financial death knell for all practical purposes – a cease-and-desist order, disgorgement, a third-tier penalty, and an unstated amount of interest totaling in excess of $250,000, was unjustified and unnecessary to protect the public interest. Decision at 116-18; Order Correcting Decision at 4. The evidence demonstrated that Rabinovich did not act with scienter and his conduct was not egregious, which is highly relevant to the question of what, if any, remedial action should be taken in the public interest, or whether penalties should apply at all. *See In re Steadman Sec. Corp.*, 1977 SEC LEXIS 1388, 30, 46 S.E.C. 896, 909 (June 29, 1977) ("[I]ntent is ... highly germane to determining the quantum of the remedial action, if any, that due regard for the public interest requires us to take"); *Steadman*, 603 F.2d at 1140-41 ("respondent's state of mind is highly relevant in determining the remedy to impose.").

Rabinovich fulfilled his duties as a registered representative. Significantly, Rabinovich believed in the investments as his family *and Rabinovich himself* purchased them, undermining any suggestion he acted with scienter. RMR Ex. 803. The fifteen clients who testified or submitted affidavits in support of Rabinovich showed that Rabinovich worked with them to further their interests, and dealt with them fairly, honestly, and in good faith. They stood by him even after learning of McGinn and Smith's secret theft and diversion of funds. Indeed, many remain clients. FoF ¶¶ 380, 388, 397, 688-89. None of this is mentioned in the ALJ's purported *Steadman* analysis.

Rabinovich has also acted in his clients' best interests since leaving MS&Co. in 2009. Among other things, Rabinovich has continued to monitor his clients' investments in the Four Funds and the Trust Offerings. Upon learning of the SEC Action, Rabinovich informed his clients, followed the Receiver's website, and helped his clients file claims and write to elected officials for legislation that would allow SIPC benefits. Since April 2010, McGinn Smith Securities have generated cash flows to support the Receiver's operations, and Rabinovich, along with Mayer, helped the Receiver collect assets for the estate by liquidating two Four Funds' investments (Deerfield Capital and CMET) and by identifying a market for a third (InCaps). He "offered [his] assistance to the receiver from day one," and helped liquidate these securities "at the best possible price to maximize the value" to investors. Tr. 5078:3–5079:15. Rabinovich also provided non-party deposition testimony in the SEC Action, and testified on behalf of the U.S. at trial in its criminal action against McGinn and Smith. FoF ¶¶ 527, 535, 538-44. These facts, too, are nowhere to be found in the ALJ's discussion of appropriate sanctions.

Seemingly, the sole justification for the suspension of Rabinovich was the ALJ's perfunctory conclusion that Rabinovich "currently work[s] in the securities industry, so there appears to be a strong likelihood for recurrence." Decision at 113. The ALJ, however, did not consider that for more than five years, Rabinovich has provided financial services to clients through RMR, a SEC-registered investment advisory firm, without any client or regulatory complaint. RMR has "zero proprietary product" and does not sponsor private placements or mutual funds. FoF ¶¶ 33-35. There simply is no basis to believe that Rabinovich is a threat to the investing public. *See, e.g., SEC v. Bausch & Lomb*, 565 F.2d 8, 18 (2d Cir. 1977) (requiring "positive proof of a reasonable likelihood that past wrongdoing will recur"); *see also Monetta*, 390 F.3d at 958 (remanding to reconsider appropriate sanctions where respondent's different client-base made "the possibility of a future violation remote"). The Division's delay in bringing this case – more than three years after commencing its federal action against McGinn and Smith and significantly longer since the alleged violations occurred – also undermines its feigned concern for the recurrence of future violations. *Monetta*, 390 F.3d at 357 ("the allocations took place a decade ago ... suggesting that the likelihood of a future violation is slight") (citing *Johnson v. SEC*, 87 F.3d 484, 490 n.9 (D.C. Cir. 1996)).

Moreover, the ALJ's claw back of *all* commissions earned after February 1, 2008, including commissions earned from clients who testified or submitted affidavits on his behalf and were identified in the Division's *Brady* disclosure, none of whom believed they were misled (and were not misled), has no basis in fact or in law. It is particularly unjustified because the evidence demonstrated that Rabinovich did not act fraudulently or even negligently.

In sum, to punish Rabinovich for his failure to uncover the fraud of McGinn and Smith, or as the ALJ put it, to "resolve" the so-called red flags, Decision at 108, ignores that their fraud went undiscovered for years by the SEC, the NASD, and countless others. Indeed, it took the SEC's seasoned staff accountant "a little less than half" of her time over the course of three years to piece together her declaration that was a centerpiece of the Division's case. Tr. 392:5-393:18. This is not, as the ALJ claimed, "blam[ing]" others, Decision at 113, but rather, proof positive that Rabinovich did not bury his head in the sand and blindly recommend securities to his clients. To the contrary, Rabinovich performed product and customer suitability analyses before presenting investments to his accredited investor clients, only a fraction of which included McGinn Smith Securities. FoF ¶¶ 13, 191-93, 625-26. To require Rabinovich, a relatively young man with a family to support (FoF ¶ 2), to pay a substantial penalty, disgorgement, and interest, and at the same time, effectively end his career in the securities industry, is not remedial, but punitive. It is unwarranted based on the evidence presented. Given Rabinovich's unblemished, 20-year record in the securities industry, and investors affirming or testifying to his honesty, no sanctions should be imposed.

Conclusion

The Commission should dismiss all charges against Rabinovich.

DATED: New York, New York
July 17, 2015

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CERTIFICATE OF COMPLIANCE

This brief complies with the Commission's Extension and Word Limit Order, dated June 5, 2015. The brief contains 9,633 words, exclusive of the Table of Contents, Table of Authorities, Signature Block, and this Certification, as counted by Microsoft Word, the word processing system used to prepare it.

Dated: New York, New York
July 17, 2015

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