UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION

Plaintiff,

vs.

McGINN, SMITH & CO., INC.,
McGINN, SMITH ADVISORS, LLC
McGINN, SMITH CAPITAL HOLDINGS CORP.,
FIRST ADVISORY INCOME NOTES, LLC,
FIRST EXCELSIOR INCOME NOTES, LLC,
FIRST INDEPENDENT INCOME NOTES, LLC,
THIRD ALBANY INCOME NOTES, LLC,
TIMOTHY M. McGINN, AND
DAVID L. SMITH, GEOFFREY R. SMITH,
Individually and as Trustee of the David L. and
Lynn A. Smith Irrevocable Trust U/A 8/04/04,
LAUREN T. SMITH, and NANCY McGINN,

Defendants,

LYNN A. SMITH and
NANCY McGINN,

Relief Defendants. and

GEOFFREY R. SMITH, Trustee of the
David L. and Lynn A. Smith Irrevocable
Trust U/A 8/04/04,

Intervenor.

Case No. 1:10-CV-457 (GLS/CFH)

SUPPLEMENT TO THIRD MOTION OF WILLIAM J. BROWN, AS RECEIVER, FOR AN ORDER DISALLOWING CERTAIN CLAIMS <u>(BROKER CLAIMS)</u>

William J. Brown, as Receiver ("Receiver") of McGinn, Smith & Co., Inc. ("MS & Co."), respectfully submits this Supplement ("Supplement") to his Third Motion for an Order Disallowing Certain Claims (Broker Claims) (Docket No. 984) ("Motion").[1]

PRELIMINARY STATEMENT

This Supplement is filed to address recent developments relating to the Broker Claims resulting from the U.S. Supreme Court's Lucia decision[2], the resulting Offers of Settlement submitted by the former MS & Co. brokers who are the subject of the Motion, and the Securities and Exchange Commission Order Making Findings and Imposing Remedial Sanctions, etc. issued by the Commission on December 21, 2018 as a result of the brokers' Offers of Settlement, a copy of which is attached as **Exhibit A**.

On March 19, 2018, the Receiver filed the Motion for an Order disallowing or equitably subordinating the claims in this case of Frank H. Chiappone ("Chiappone"), William F. Lex ("Lex"), and Philip S. Rabinovich ("Rabinovich," and collectively with Chiappone and Lex, the "Brokers"), along with claims of a related party. The Motion was premised on factual findings made previously by the Chief Administrative Law Judge in the SEC's administrative proceeding ("Broker Proceeding") against a number of former McGinn Smith brokers including the Brokers.

In the wake of the Supreme Court's Lucia opinion, which was decided after the Chief Administrative Law Judge issued her findings and rulings against the Brokers, the Broker Proceeding was remanded for reassignment to a different administrative law judge for a new trial in accordance with the holding of Lucia.

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[1] Only one Broker, Chiappone, submitted an objection to the Motion (Docket No. 995), which was not filed timely.
[2] Lucia v. SEC, 138 S.Ct. 2044 (2018).

As part of a settlement with the Brokers and to avoid a lengthy re-trial -- the first trial lasted eighteen days -- the SEC entered on December 21, 2018 an Order Making Findings and Imposing Remedial Sanctions, which found that the Brokers violated sections 17(a)(2) and (a)(3) of the Securities Act of 1933.

Notwithstanding the reassignment of the Broker Proceeding and the Commission's December 21, 2018 Order, the relief sought by the Receiver in the Motion remains the same as explained below. The claims of the Brokers should be disallowed or equitably subordinated due to the Brokers' conduct: the Brokers (i) ignored certain "red flags" that should have prompted further inquiry, (ii) aided in the implementation of a Ponzi scheme, and (iii) failed their duty to investors (their clients) to investigate the products that they were selling. Accordingly, the Brokers should not be permitted to stand with the innocent investors who were harmed by the Brokers' conduct and share in their recovery.

BACKGROUND

On September 23, 2013, the SEC commenced the Broker Proceeding by issuing an Order Instituting Administrative and Cease-and-Desist Proceedings as to certain registered representatives who sold MS & Co. private placements in the Four Funds and the Trust Offerings. *Donald. J. Anthony, Jr., et al.*, Order Instituting Proceedings Release No. 33-9454 (Sept. 23, 2013), 107 SEC Docket 5 ("*OIP*").[3] Among those registered representatives named in the Broker Proceeding were Frank H. Chiappone, William F. Lex, and Philip S. Rabinovich. In the Broker Proceeding, the SEC alleged that the Brokers violated the securities laws by knowingly or recklessly recommending MS & Co. unregistered offerings

[3] The statement of facts at pages 2 through 11 of the Memorandum of Law in Support of Third Motion of William J. Brown, as Receiver, for an Order Disallowing Certain Claims (Broker Claims) (Docket No. 985) ("Memorandum") is incorporated as if set forth herein. Any terms not defined herein shall have the meaning given to them in the Memorandum.

to clients with no reasonable basis for the recommendation and knowing of red flags. *OIP* at 5.

On February 25, 2015, after eighteen days of hearings, the Chief Administrative Law Judge ("ALJ") entered an Initial Decision ("Initial Decision") finding that each of the Brokers willfully violated the Securities Act, the Exchange Act and Rule 10b-5 through their sales of private placements in the Four Funds and the Trust Offerings. *Donald. J. Anthony, Jr., et al.,* Initial Decision Release No. 745 (Feb. 25, 2015), 110 SEC Docket 19, modified by Order on Motions to Correct Manifest Errors of Fact in the Initial Decision, Administrative Proceedings Release No. 2528 (Apr. 9, 2015), 111 SEC Docket 5 ("*ID*"). The Brokers petitioned the SEC for review of the ALJ's Initial Decision and, on May 21, 2015, the SEC granted the Brokers' petitions. *Frank Chiappone, et al.*, Order Granting Petitions for Review and Scheduling Briefs Release No. 33-9790 (May 21, 2015), 111 SEC Docket 11. On August 15, 2017, oral argument on the Brokers' appeals was held before the SEC. *Frank Chiappone, et al.*, Order Scheduling Oral Argument Release No. 33-10382 (Jun. 30, 2017), 117 SEC Docket 1.

On March 19, 2018, before the SEC ruled on the Brokers' appeals, the Receiver filed the Motion for an Order disallowing or equitably subordinating the claims of the Brokers and a related party (collectively, the "Broker Claims"), which Broker Claims are described in greater detail on Exhibit A to the Motion. The Receiver sought to disallow or equitably subordinate the Broker Claims on the grounds that the Brokers sold private placements to unsuspecting investors in the Four Funds and the Trust Offerings while ignoring various "red flags" surrounding the offerings and the operations of MS & Co. *See*

Memorandum at 13-17. In support of the relief requested in the Motion, the Receiver relied on the ALJ's factual findings as set forth in the Initial Decision.

On June 21, 2018, after the Motion was filed, the Supreme Court of the United States handed down its decision in Lucia, holding that SEC administrative law judges were subject to the Appointments Clause of the Constitution and requiring that administrative law judges be appointed by the President, "Courts of Law," [or] "Heads of Department." *Lucia v. S.E.C.,* 138 S. Ct. at 2055. Thus, any defendant in an SEC proceeding who was tried before an administrative law judge not appointed by one of the appropriate parties was entitled to a new hearing before a properly appointed administrative law judge. *Id.*

In accordance with the holding in Lucia, on October 1, 2018, the SEC remanded the Broker Proceeding for reassignment to a new administrative law judge. *Donald. J. Anthony, Jr., et al.,* Order Release No. 6123 (Oct. 1, 2018). On December 21, 2018, as part of a settlement with the Brokers and to avoid an extensive re-trial, the SEC entered the Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Order"), attached as Exhibit A. *Frank H. Chiappone, et al.*, Order Release No. 10595 (Dec. 21, 2018).

The Order found that the Brokers violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 by "negligently failing to perform sufficient due diligence to form a reasonable basis for their recommendations of the Four Funds and Trust Offerings to their customers." Order at 5. The Order referred to several "red flags" that should have caused the Brokers to conduct additional inquires with respect to the private placements in the Four

Funds and the Trust Offerings that they sold. The Order described conflicts of interest disclosed in the private placement memoranda ("PPMs") for the Four Funds, as well as the total control held by Smith over the disposition of investor funds, without oversight or control, that should have caused the Brokers to make further, specific inquiries before recommending the Four Funds to their customers. Order at 6.

Further, the Order found that the accumulation of "red flags" since the launch of the Four Funds in 2003 should have caused the Brokers to have conducted additional inquiries with respect to any MS & Co. private placements, including the Trust Offerings. Order at 7. The Order also found that the PPMs for the Trust Offerings should have raised additional red flags that should have caused the Brokers to make further inquiries regarding the Trust Offerings, such as inconsistencies in how the Trust Offerings would make interest payments and redeem principal. *Id.*

Finally, the Order found that the Brokers failed to check publicly available information regarding the offering for Firstline Trust: Firstline Trust loaned the proceeds of investments in Firstline Trust to a company called Firstline Securities, Inc., which filed for Chapter 11 bankruptcy in the Bankruptcy Court for the District of Utah in January 2008. Order at 7. The Brokers continued to sell placements in Firstline Trust after the bankruptcy filing and remained unaware of the filing until it was disclosed to them in September, 2009. *Id.*

The Order held that, as a result of the Brokers' conduct, the Brokers violated Section 17(a)(2) and 17(a)(3) of the Securities Act of 1933. Pursuant to the Order, the Brokers are to disgorge the commissions earned on sales of private placements to the Receiver: Chiappone is ordered to disgorge $23,329, with prejudgment interest of

$3,181.49; Lex is ordered to disgorge $72,726, with prejudgment interest of $9,918.02; and Rabinovich is ordered to disgorge $53,029, with prejudgment interest of $7,231.84. Order at 9.

SUPPLEMENT

The Lucia decision created an extraordinary situation as evidenced by the fact that on December 21, 2018, the Commission approved the Broker settlement along with thirteen other decisions settling other cases requiring retrial as a result of the Lucia decision.

The findings of the Commission's Order with regard to the Broker's conduct are similar to the ones contained in the Chief Administrative Law Judge's Order -- numerous red flags and ignoring the duty to investigate. Due to the Supreme Court's Kokesh[4] decision, the penalties imposed by the Commission's Order reduced the amount of the penalties since a five-year statute of limitations now applied which resulted in a restricted amount of potential disgorgement by the Brokers. The Brokers cannot deny that the Commission's Order (Part III) contains findings by the Commission based upon a robust factual record. It is also based upon prior sworn testimony. The investor losses as a result of the Brokers' conduct remains significant.

Consistent with the entry of the Order in settlement of the SEC's claims against the Brokers, the Receiver maintains that the Broker Claims should be disallowed or equitably subordinated. By failing to investigate in the face of red flags and selling private placements in the implementation of a Ponzi scheme, the Brokers exposed numerous investors to harm. Accordingly, the Brokers should not be permitted to share in any recovery with innocent investors.

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[4] Kokesh v. SEC, 137 S. Ct. 1635 (2017).

District courts have used their discretion to exclude claimants from receiving distributions where such claimants were involved in the "development, implementation, and/or marketing" of a fraudulent Ponzi scheme. *See S.E.C. v. Byers*, 637 F.Supp.2d 166, 183 (S.D.N.Y. 2009) (approving distribution plan where employees who actively participated in a Ponzi scheme were excluded from receiving distributions). District courts have also approved distribution plans where defendants in an underlying SEC action received no recovery and non-defendant investors who received significant commissions had their claims reduced by ninety percent. *S.E.C. v. Basic Energy & Affiliated Resources, Inc.*, 273 F.2d 657, 660 (6th Cir. 2001). Courts have also approved distribution plans disallowing claims of investors who participated in a Ponzi scheme by acting recklessly when they should have realized, from the facts they knew, "that there [was] a strong probability that harm may result." *See S.E.C. v. Forte*, Civil Nos. 09-63, 09-64, 2012 WL 1719145 at *3 (E.D.Pa. May 16, 2012).

The Broker's conduct in assisting the implementation of McGinn's and Smith's Ponzi scheme is a basis for disallowance of the Broker Claims. The Brokers ignored numerous red flags that should have prompted them to conduct further inquiries and continued to sell private placements. Order at 6-7. By selling private placements in the Four Funds and the Trust Offerings to unknowing investors (all while ignoring various red flags), the Brokers helped to implement of the Ponzi scheme and caused harm to numerous investors—indeed, investor losses in the Four Funds and the Trust Offerings exceeded $87 million. *Id.* at 5. Finally, in failing to conduct any due diligence, in spite of the red flags described in the Order, the Brokers should have known the was a "strong probability" for harm to result to the investors who were relying on the Brokers' recommendations.

A district court also has "the authority to subordinate the claims of certain investors to ensure equal treatment." *S.E.C. v. Wealth Mgmt. LLC*, 628 F.3d 323, 333 (7th Cir. 2010). While equitable subordination is a concept that derives from bankruptcy case law, the district court has "the equitable power to subordinate one claim to another if it finds that the creditor's claim, while not lacking a lawful basis nonetheless results from inequitable behavior on the part of that creditor." *S.E.C. v. Am. Bd. of Trade*, 719 F.Supp. 186, 196 (S.D.N.Y. 1986) (internal quotation omitted). To equitably subordinate a claim, (1) the claimant must have engaged in some type of inequitable conduct and (2) the misconduct must have caused injury to the creditors. *S.E.C. v. Spongetech Delivery Sys., Inc.*, 98 F. Supp. 3d 530, 551 (E.D.N.Y. 2014).[5] Inequitable conduct includes "breach of fiduciary or other legally recognized duties." *Id.* at 553.

Brokers have a duty to investigate the securities that they recommend to their clients: "Brokers and salesmen are under a duty to investigate . . . . Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant." *Hanly v. S.E.C.*, 415 F.2d 589, 594-96 (2d Cir. 1969).[6]

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[5] Courts have held that negligence alone is not a sufficient basis for imposing equitable subordination. *See In re Sentinel Management Grp., Inc.*, 809 F.3d 958, 965 (7th Cir. 2016). Here, however, the SEC was required to prove *at least* negligence in order to show a violation of sections 17(a)(2) and (a)(3) of the Securities Act. *SEC v. Jankovic*, No. 15 Civ. 1248, 2017 WL 1067788, at *14 (S.D.N.Y. Mar. 21, 2017). Although the Order finds that the Brokers acted negligently in violation of the Securities Act of 1933, they also acted inequitably by failing in their duty to investors to investigate the securities recommended to their clients. *See Hanly v. S.E.C.*, 415 F.2d 589, 594-96 (2d Cir. 1969).

[6] Courts have distinguished the holding in *Hanly*, holding that a broker's duty to investigate may not be applicable in private civil actions brought for damages against brokers predicated on the broker's negligence. *See, e.g.*, *Anwar v. Fairfield Greenwich Ltd.*, No. 09-cv-118 (VM), 2015 WL 10791912 at *3 (S.D.N.Y. Aug. 13, 2015) (holding that *Hanly* was not applicable to case at hand, where damages were being sought in a civil action); *Smith v. Questar Capital Corp.*, No. 12-cv-2669 (SRN/TNL), 2013 WL 3990319 at *12 n.5 (D. Minn. Aug. 2, 2013) (holding *Hanly* inapplicable to private civil action seeking damages based on negligence of broker firm); *BNP Paribas Mortg. Corp. v. Bank of Am., N.A.,* 866 F.Supp.2d 257, 267 (S.D.N.Y. 2012) (same). In the case at bar, the Receiver is not seeking damages due to the broker's negligence in failing to fulfill their duty to investigate, but rather is seeking to equitably subordinate the Broker Claims due to the Brokers' inequitable conduct.

"When recommending specific securities, a broker . . . cannot rely solely on the materials submitted by the issuer or given to him by his employer." *S.E.C. v. Platinum Inv. Corp.*, No. 02 Civ. 6093(JSR), 2006 WL 2707319 at *3 (S.D.N.Y. Sept. 20, 2006).

If not disallowed, the Broker Claims should be equitably subordinated to the claims of innocent investors. Under securities law, the Brokers had a duty to investigate the Four Funds and the Trust Offerings that they recommended to their clients, and they could not rely solely on the information given to them by McGinn and Smith. As described in the Order, the Brokers failed this duty by ignoring numerous red flags that should have prompted them to inquire further about the private placements that they were selling. By failing their duty to investors, the Brokers acted inequitably. This inequitable conduct led to indisputable harm to innocent investors, who unknowingly invested millions of dollars in the Ponzi scheme. Thus, if not disallowed, the Broker Claims may be equitably subordinated to those claims of innocent investors.

At the very least, the Brokers should not be permitted to recover the amounts that the Order requires them to disgorge to the Receiver. The remedy of disgorgement is intended to "prevent wrongdoers from unjustly enriching themselves through violations. . . . [D]isgorgement forces a defendant to account for all profits reaped through his securities law violations . . . ." *SEC v. Cavanagh*, 445 F.3d 105, 117 (2d Cir. 2006). Thus, the Brokers should not receive any recovery on account of the Broker Claims that is funded by the amount the Brokers have been ordered to disgorge, or $169,415. Thus, if the Broker Claims are not disallowed or subordinated, the receivership funds available for recovery for purposes of calculating a distribution to the Brokers, if any, on account of the Broker Claims should be reduced by $169,415.

SUMMARY PROCEEDINGS

The Receiver has provided the Brokers listed on Exhibit A to the Motion appropriate notice and sufficient time to respond to the Motion. Accordingly, the Receiver has complied with the claim objection and notice procedures set forth in the Federal Rules of Bankruptcy Procedure ("Bankruptcy Rules") as a form of best expression of law. Bankruptcy Rule 3007 requires that a claim objection must be filed and served at least thirty days before any scheduled hearing and that the objection must be served on the claimant by first class mail. Fed. R. Bankr. P. 3007(a)(1), (2).

The Receiver requests that the Court enter an order granting the relief requested in the Motion and this Supplement without a hearing with respect to those Broker Claims for which an objection is not timely interposed. Disallowance of a claim without a hearing where there is no factual dispute is an appropriate and preferred procedure in federal receivership cases. *See S.E.C. v. Elliott*, 953 F.2d 1560, 1566 (11th Cir. 1992) (holding that summary proceedings are favored in federal receivership cases because a summary proceeding "reduces the time necessary to settle disputes, decreases litigation costs, and prevents further dissipation of receivership assets"); *United States v. Fairway Capital Corp.*, 433 F. Supp. 2d 226, 241 (D. R.I. 2006) ("Receivership courts can employ summary procedures in allowing, disallowing and subordinating claims of creditors").

CONCLUSION

The Receiver requests that the Court enter an Order substantially in the form attached to the Motion as Exhibit B disallowing, or, in the alternative, equitably subordinating the Broker Claims, together with such other and further relief as the Court deems just and proper.

Dated: January 29, 2019

PHILLIPS LYTLE LLP

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Exhibit A

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 10595 / December 21, 2018

SECURITIES EXCHANGE ACT OF 1934
Release No. 84913 / December 21, 2018

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.

ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934

I.

[illegible] instituted public administrative and cease-and-desist proceedings pursuant to Section 8A of the [illegible] H. Chiappone, Andrew G. Guzzetti, William F. Lex, Thomas E. Livingston, Brian T. Mayer, and Philip S. Rabinovich [illegible] After an initial decision had issued in this matter and an appeal by the Respondents to the Commission was pending and fully briefed, the Commission remanded the case to Chief Judge Murray for reassignment to a new Administrative Law Judge [illegible] *Lucia v. SEC*, 138 S. Ct. 2044 (2018).

II.

[illegible] has determined to accept in light of *Lucia v. SEC*. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the [illegible] Respondents and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Making Findings and Imposing

Remedial Sanctions Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of [illegible]

Respondents and the Division recognize that, according to *Lucia v. SEC*, Respondents are [illegible] Respondents knowingly and voluntarily waive any claim or entitlement to such a new hearing before another ALJ or the Commission itself. Respondents also knowingly and voluntarily waive any and all challenges to the administrative proceedings or any and all orders that were issued during or at the conclusion of those proceedings, whether before the ALJ, the Commission, or any court, based upon any alleged or actual defect in the appointment of ALJ Brenda Murray.

III.

[illegible]s, the Commission finds that:

A. RESPONDENTS

1. **Frank H. Chiappone**, 63 years old, is a resident of Clifton Park, NY. He was registered with [illegible]MS & Co. [illegible]from February 1989 to December 2009, [illegible] New York branch office.

2. **Andrew G. Guzzetti**, 71 years old, is a resident of Saratoga Springs, NY. He was registered with MS & Co. from September 2004 to December 2009, and worked from MS & [illegible]

3. **William F. Lex**, 72 years old, is a resident of Phoenixville, PA. He was registered with MS & Co. from January 1983 to December 2009, and was based in King of Prussia, Pennsylvania. In October 2010, the Financial Industry Regulatory Authority suspended Lex for failure to pay a FINRA arbitration award concerning an MS & Co. private placement customer.

4. **Thomas E. Livingston**, 60 years old, is a resident of Slingerlands, NY. He was registered with MS & Co. from October 1988 to December 2009, and became a 20% shareholder of McGinn Smith Holdi[illegible]MS Holdings[illegible]n 2004.

5. **Brian T. Mayer**, 45 years old, is a resident of Princeton, NJ. Mayer was registered with MS & Co. from July 2001 to December 2009 and McGinn Smith Advisors, LLC [illegible]MS Advisors[illegible]from February 2006 to April 2009, and worked [illegible] City branch office.

6. **Philip S. Rabinovich**, 44 years old, is a resident of Roslyn, NY. He was registered with MS & Co. from July 2001 to December 2009 and MS Advisors from August 2006 to December 2009[illegible]New York City branch office.

B. RELEVANT ENTITIES AND INDIVIDUALS

7. **MS & Co.**, a New York corporation founded in 1980 by David Smith and Timothy McGinn, had its principal place of business at 99 Pine Street, Albany, NY, and

maintained branch offices at Clifton Park, NY, New York City, and King of Prussia, PA. MS & Co. was registered with the Commission as a broker-dealer beginning in 1980 and as an investment adviser in April 2009. It was owned by Smith (50%), McGinn (50%; 30% after 2004), and Livingston (20% after 2004). From 2003 to 2009, MS & Co. had about 55 employees, including about 35 registered representatives. On December 24, 2009, MS & Co. filed a partial BD-W. On March 9, 2010, MS & Co. also withdrew its investment adviser registration. FINRA terminated MS [illegible]

8. **MS Advisors** was a New York corporation formed in 2003 with its principal place of business at 99 Pine Street, Albany, New York. MS Advisors was owned by Smith (50%), McGinn (30%) and Livingston (20%). MS Advisors was registered as an investment adviser with the Commission from January 3, 2006 to April 24, 2009, and was the investment adviser to the Four Funds (defined below) until April 2009, when it was replaced by MS & Co.

9. **MS Holdings** was owned by Smith (50%), McGinn (30%) and Livingston (20%).

10. [illegible] was a New York corporation formed in 1989 with its principal place of business at 99 Pine Street, Albany, New York. MS Capital was owned by MS Holdings (52%), McGinn (24%) and Smith (24%). MS Capital was the indenture trustee, the servicing agent and the collateral agent for the Four Funds, and the trustee for all the Trusts created between 2006 and 2009. Smith was president and McGinn was chairman of the board.

11. The **Four Funds** were New York limited liability companies, whose managing member was MS Advisors. MS & Co. served as the placement agent for the Four Funds offerings, and MS Capital acted as the Trustee. The Four Funds shared offices with MS & Co. and the other McGinn Smith entities at 99 Pine Street, Albany, NY. The Four Funds offerings are listed below, along with the contractual rate of return, the maximum amount of the offering, [illegible]

(a) First Independent Incom[illegible] million) (9/15/03);

(b) [illegible] million) (1/16/04);

(c) [illegible] million) (11/1/04); and

(d) First [illegible] million) (10/1/05).

12. The **Trust Offerings** were offerings by special purpose entities, created to invest [illegible] luxury cruises. MS & Co. acted as a placement agent and MS Capital acted as Trustee for the Trust Offerings. The Trust Offerings are listed below, along with the contractual rate of return, the maximum amount of the offering, and the date of the PPM:

(a) TDM Cable Trust 06, 7.75%/9.25% ($3,550,000) (11/13/06)

(b) TDM Verifier Trust 07, 8.25%/9% ($3,475,000) (2/23/07)

(c) Firstline Senior Trust 07, 9.25% ($1,850,000) (5/19/07)
(d) Firstline Trust 07, 11% ($1,867,000) (5/19/07)
(e) Firstline Senior Trust 07 Series B, 9.5% ($1,435,000) (10/19/07)
(f) TDM Luxury Cruise Trust 07, 10% ($3,630,000 (7/16/07)
(g) Firstline Trust 07 Series B, 11% ($2,115,000) (10/19/07)
(h) TDM Verifier Trust 08, 8.50%/10% ($3,850,000) (12/17/07)
(i) Cruise Charter Ventures Trust 08, 13% ($3,250,000) (2/14/08)
(j) Integrated Excellence Sr. Trust 08, 9% ($900,000) (5/30/08)
(k) Integrated Excellence Jr. Trust 08, 10% ($580,000) (5/30/08) (l) Fortress Trust 08, 13% ($3,060,000) (9/24/08)
(m) TDM Cable Trust 06, 10% ($1,380,000) (11/17/08)
(n) TDM Verifier Trust 09, 10% ($1,300,000) (12/15/08)
(o) TDMM Cable Jr Trust 09, 11% ($1,325,000) (1/19/09)
(p) TDMM Cable Sr. Trust 09, 9% ($1,550,000) (1/19/09)
(q) TDM Verifier Trust 07R, 9% ($2,100,000) (2/2/09)
(r) TDM Verifier Trust 08R, 9% ($2,005,000) (7/6/09)
(s) TDMM Benchmark Trust 09, 8%, 9%, 10%, 11%, 12% ($3,000,000) (8/20/09)
(t) TDM Verifier Trust 11, 9% ($1,550,000) (9/3/09)
(u) Cruise Charter Ventures, LLC, 12% ($400,000) (9/25/09)

13. [illegible] was a New York corporation formed in 2008. MS & Co. was the sales agent for the $10 million MSTF offering on April 22, 2008.

14. **Timothy M. McGinn** was the chairman, secretary and co-owner of MS & Co. From July 2003 through May 2006, McGinn served as CEO of Integrated Alarm Services Group, [illegible] McGinn from associating with any FINRA member. In February 2013, a jury in the Northern District of New York found McGinn guilty of multiple counts of mail and wire fraud, securities fraud, and filing false tax returns. In August 2013, McGinn was sentenced to 15 years in prison..

15. **David L. Smith** was the president and chief executive officer of MS & Co. and the manager of the Four Funds. Until 2007, Smith was also the chief compliance officer of MS & Co. In September 2011, FINRA permanently barred Smith from associating with any FINRA member. In February 2013, a jury in the Northern District of New York found Smith guilty of multiple counts of mail and wire fraud, securities fraud, and filing false tax returns. On August 7, 2013, Smith was sentenced to 10 years in prison.

C. THE DISTRICT COURT ACTION

16. On April 20, 2010, the Commission filed a civil action in the United States District Court for the Northern District of New York against McGinn, Smith, and numerous [illegible] them with securities fraud and other federal securities violations in connection with the actions described herein. *See SEC v. McGinn Smith & Co., Inc., et al.*, 10-CV-457 (N.D.N.Y.) (GLS- [illegible]

for a temporary restraining order and appointed a Receiver over the McGinn Smith Entities. *See id.* (Dkt. Nos. 4, 5, 96). All the McGinn Smith Entities [illegible] including MS & Co., MS Advisors, MS Capital, MS Holdings, FIIN, FEIN, FAIN and TAIN [illegible] Pursuant to a Court- [illegible] distributing collected assets to investors. *Id.* (Dkt. No. 904).

D. OVERVIEW

17. Chiappone, Lex, Mayer, and Rabinovich were among the top- selling brokers at MS & Co. Livingston sold MS & Co. private placements and was an MS & Co. principal. Guzzetti was a managing director at MS & Co. and he supervised the MS & Co. brokers. Based on the conduct described below

(a) Chiappone, Lex, Livingston, Mayer, and Rabinovich [illegible] violated Section 17(a)(2) and (3) of the Securities Act by negligently failing to perform sufficient due diligence to form a reasonable basis for their recommendations of the Four Funds and Trust Offerings to their customers.

(b) Guzzetti failed reasonably to supervise the Selling Respondents, with a view to preventing their violations, pursuant to Section 15(b)(6), incorporating by reference Section 15(b)(4)(E) of the Exchange Act.

E. THE MS & CO. OFFERINGS

18. David Smith and Timothy McGinn created and controlled the Four Funds and Trust Offerings. The offerings raised more than $125 million from more than 750 investors. Investor losses exceeded $87 million.

19. The Four Funds offerings raised at least $85 million. Smith controlled the issuers, prepared the PPMs, set the terms of the offerings, controlled the investor money, and made all the investment decisions. Pursuant to the PPMs, Four Funds investors were to receive quarterly interest payments and a return of principal upon maturity. Each offering had three tranches: the five- [illegible] 6%.

20. Although th [illegible] almost no secured assets subject to forfeiture in the event that a particular Fund failed.

21. According to the PPMs, MS & Co., as the placement agent, was to receive a commission of 2% of the offering proceeds. In addition, according to the PPMs, the brokers were [illegible]

22. As the PPMs for the offerings stated, each of the Four Funds was:

> formed to identify and acquire various public and/or private investments, which may include, without limitation, debt securities, collateralized debt obligations, bonds, equity securities, trust preferred, 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 . . . .

23. Smith invested proceeds of the Four Funds in entities that were affiliated with MS & Co., in venture capital investments, and purchased $12.8 million of pre-2003 MS & Co. offerings to pay interest or redemptions to investors. For example, Smith invested $8.8 million in alseT [illegible] a venture capital start-up company, partially-owned and controlled by Livingston and Smith. alseT [illegible] [illegible] investors.

24. In 2006, McGinn returned to MS & Co. on a full-time basis after nearly three years as CEO of IASG. McGinn created the twenty-one Trust Offerings, plus MSTF, that raised over $41 million. The Trust Offerings funded entities engaged in specific areas, such as burglar alarm service, triple play service, or luxury cruises. The PPMs for the Trust Offerings identified Livingston as the Treasurer for the Trustee, MS Holdings.

25. Smith and McGinn misused investor funds raised for the Trust Offerings. For example, they took for personal use millions of dollars in offering proceeds, used investor funds to pay earlier noteholders, and used the Trust Offering proceeds to satisfy liquidity needs for other MS & Co. entities.

1. Red Flags Surrounding the Four Funds Offerings.

26. Chiappone, Lex, Livingston, Mayer, and Rabinovich were negligent in not performing adequate due diligence in order to form a reasonable basis for their recommendations of the Four Funds to their customers. The PPMs for the Four Funds made disclosures that should have caused the Selling Respondents, as associated persons of a broker-dealer, to conduct additional inquiries.

a. The PPMs disclosed conflicts of interest between the issuers and MS & Co. Smith owned and controlled each of the issuers [illegible] which were new, single- purpose entities with no operating history [illegible] as well as the placement agent (MS & Co.) and the trustee. Smith also had total control over the disposition of investor funds, with no oversight or control. As a result, the Respondents should have made specific inquiries as to how customer money would be invested before recommending the Four Funds to their customers; and

b. The PPMs stated that the Four Funds could engage in related party [illegible] Advisor [illegible]

> offerings for which [MS & Co.] is acting as underwriter or placement Respondents should have made specific inquiries regarding the entities into which customer money would be invested before recommending the Four Funds to their customers.

27. From the commencement of the FIIN offering in September 2003 until January 2008, Smith provided the MS & Co. brokers with scant information about how he had invested the offering proceeds. Questions by the brokers were deflected with the claim that Smith had made loans to local Albany businesses with Four Funds proceeds, and those businesses desired anonymity. efusal to provide meaningful information should have prompted the Respondents to further question the propriety of the Four Funds.

2. Red Flags Surrounding the Trust Offerings.

28. On January 8, 2008, Smith and McGinn held an all-day meeting to inform MS & Co. brokers that the Four Funds were in default, that payments to investors would be curtailed, and that the offerings would be restructured.

29. After January 2008, there were thirteen offerings by MSTF and the Trusts, which raised at least $20 million. The Selling Respondents continued to sell these offerings under As a result of the accumulation of red flags since the launch of the Four Funds in September 2003, the Respondents should have conducted additional inquiries regarding any MS & Co. private placement before recommending them to their customers.

30. The Trust PPMs, like the Four Funds PPMs, raised red flags that should have caused the Respondents, as associated persons of a broker-dealer, to conduct additional inquiries prior to recommending the products to their customers. For example, the August 2009 TDMM Benchmark promised an 8 to 12% rate of return during a time when the prime rate was only 3.25%. Also, the PPM disclosed that only $1,950,000 (approximately 65%) of the total $3 million raised would actually be invested, with the remainder taken as in fees. Chiappone, Mayer, and Rabinovich, who recommended the Benchmark offering, did so without inquiring how MS & Co. intended to make 8 12% interest payments and redeem the principal upon maturity while taking over one-third of the money raised in fees.

31. Moreover, Respondents failed to check publicly-available information regarding offered the October 2007 Firstline Trust offering. In this offering, a McGinn Smith affiliate loaned the offering proceeds to Firstline Securities, Inc., a Utah corporation that sold residential alarm contracts. At the time of the offering, McGinn knew of threats by was involved in trying to resolve the disputes. After the creditors filed suit, in January 2008, Firstline filed a voluntary petition for Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the District of Utah. Lex, Chiappone, Rabinovich and Mayer sold Firstline trust certificates after the bankruptcy filing. Respondents were unaware of the bankruptcy filing until McGinn finally disclosed it to them on September 3, 2009.

F. COMMISSIONS EARNED ON MS & CO. PRIVATE PLACEMENTS

32. After [illegible] earned $23,329 in commissions on sales of MS & Co. private placements.

33. Within the statutory period for disgorgement, Lex earned $72,726 in commissions on sales of MS & Co. private placements.

34. Within the statutory period for disgorgement, Livingston earned $700 in commissions on sales of MS & Co. private placements.

35. Within the statutory period for disgorgement, Mayer earned $17,791 in commissions on sales of MS & Co. private placements.

36. Within the statutory period for disgorgement, Rabinovich earned $53,029 in commissions on sales of MS & Co. private placements.

G. GUZZETTI FAILED REASONABLY TO SUPERVISE

37. At MS & Co., Guzzetti was Head of Retail Sales, Managing Director, Private Client Group, and a Branch Manager. During this period, Guzzetti supervised MS & Co. registered representatives with regard to the Four Funds and Trust Offerings.

38. Guzzetti had direct supervisory responsibilities for the Selling Respondents. He carried out numerous managerial duties, including recruiting and hiring MS & Co. employees; assigning and reassigning customers to brokers; evaluating employee performances and awarding commissions; addressing customer grievances; answering employee questions regarding firm; and issuing instruction and guidance regarding specific financial products and transactions, administrative issues, and broader firm policy.

39. Guzzetti also sent regular e-mails summarizing MS & Co. products available for sale to customers and encouraged brokers to recommend them to customers. In a February 2006 [illegible] accounts (fear of higher i[illegible]

40. Guzzetti had a duty to investigate red flags that suggest misconduct may be occurring and to take action when made aware of suspicious conduct. Had Guzzetti responded reasonably to the red flags, he would have prevented the underlying violations committed by Chiappone, Lex, Livingston, Mayer, and Rabinovich.

H. VIOLATIONS

41. As a result of the negligent conduct described above, Chiappone, Lex, Livingston, Mayer, and Rabinovich violated Section 17(a)(2) and (3) of the Securities Act.

42. As a result of the conduct described above, Guzzetti failed reasonably to

supervise the Selling Respondents pursuant to Section 15(b)(6), incorporating by reference Section 15(b)(4)(E) of the Exchange Act, with a view to preventing their violations of Section 17(a)(2) and (3) of the Securities Act, as set forth herein.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in the Offer.

Accordingly, pursuant to Section 8A of the Securities Act and Sections 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Chiappone, Lex, Livingston, Mayer, and Rabinovich shall cease and desist from committing or causing violations of and any future violations of Section 17(a)(2) and (3) of the Securities Act;

B. Livingston shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of $85,000 in accordance with the instructions in paragraph IV(F), below. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717;

C. Guzzetti shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of $20,000 in accordance with the instructions in paragraph IV(F), below. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717;

D. Chiappone, Lex, Livingston, Mayer, and Rabinovich shall pay disgorgement and prejudgment interest as set forth in paragraphs IV(D)(1) [illegible]V(D)(5), below. Payments shall be made in accordance with the instructions in paragraph IV(F), below. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600.

1. Chiappone shall pay disgorgement of $23,329 and prejudgment interest of $3181.49 in three equal installments of $8836.83, the first of which is due within 30 days of this Order, the second of which is due within 180 days of this Order, and the third of which is due within 364 days of this Order.

2. Lex shall, within 30 days of the entry of this Order, pay disgorgement of $72,726 and prejudgment interest of $9,918.02.

3. Livingston shall, within 30 days of the entry of this Order, pay disgorgement of $700 and prejudgment interest of $95.48.

4. Mayer shall, within 30 days of the entry of this Order, pay disgorgement of $17,791 and prejudgment interest of $2426.24.

5. Rabinovich shall, within 30 days of the entry of this Order, pay disgorgement of $53,029 and prejudgment interest of $7231.84.

E. Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, a Fair Fund is created for the penalties referenced in paragraphs IV(B) and IV(C), above. Amounts

ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents each agree that in any Related Investor Action, he shall not argue that he is entitled to, nor shall he benefit by, offset or reduction of any award of [illegible] [illegible] Action grants such a Penalty Offset, Respondents each agree that he shall, within 30 days after entry of a final order granting [illegible] Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty [illegible] private damages action brought against any Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

F. Respondents shall satisfy their payment obligations set forth in paragraphs IV(B) [illegible] (D) of this Order by submitting payments to William J. Brown, the court-appointed Receiver in the District Court Action, for inclusion in the receivership estate established in that action and distribution pursuant to the court-approved Plan. Payment shall be (i) made by United States [illegible] payable [illegible] delivered or mailed to William J. Brown, Phillips Lytle LLP, Omni Plaza, 30 South Pearl Street, Albany, New York 12207; and (D) submitted under cover letter that identifies the Respondent(s) submitting the payment and the name and number of this administrative proceeding (*Frank Chiappone, et al.*, Admin. Proc. No. 3-15514) and enclosing a copy of this Order. Further, Respondents shall simultaneously transmit photocopies of evidence of payment, the cover letter sent to the Receiver, and this Order to Lara Shalov Mehraban, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, 200 Vesey Street, Suite 400, New York, NY 10281. By making the payments required under this Order, the Respondents relinquish all legal and equitable right, title, and interest in such funds and no part of the funds shall be returned to the Respondents.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondents, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
Secretary

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION

Plaintiff,

vs.

McGINN, SMITH & CO., INC.,
McGINN, SMITH ADVISORS, LLC
McGINN, SMITH CAPITAL HOLDINGS CORP.,
FIRST ADVISORY INCOME NOTES, LLC,
FIRST EXCELSIOR INCOME NOTES, LLC,
FIRST INDEPENDENT INCOME NOTES, LLC,
THIRD ALBANY INCOME NOTES, LLC,
TIMOTHY M. McGINN, AND
DAVID L. SMITH, GEOFFREY R. SMITH,
Individually and as Trustee of the David L. and
Lynn A. Smith Irrevocable Trust U/A 8/04/04,
LAUREN T. SMITH, and NANCY McGINN,

Defendants,

LYNN A. SMITH and
NANCY McGINN,

Relief Defendants. and

GEOFFREY R. SMITH, Trustee of the
David L. and Lynn A. Smith Irrevocable
Trust U/A 8/04/04,

Intervenor.

Case No. 1:10-CV-457 (GLS/CFH))

CERTIFICATE OF SERVICE

I, Karen M. Ludlow, being at all times over 18 years of age, hereby certify that on January 29, 2019, a true and correct copy of the Supplement to Third Motion of William J. Brown, as Receiver, for an Order Disallowing Certain Claims (Broker Claims) ("Motion") was caused to be served by e-mail upon all parties who receive electronic notice in this case pursuant to the Court's ECF filing system, and by First Class Mail to the parties indicated below:

- **William J. Brown** wbrown@phillipslytle.com,khatch@phillipslytle.com
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And, I hereby certify that on January 29, 2019, I mailed, via first class mail using the United States Postal Service, a copy of the Motion to the individuals listed below:

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Dated: January 29, 2019

/s/ Karen M. Ludlow
Karen M. Ludlow