UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

McGINN, SMITH & CO., INC., et al.,

Defendants.

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10 Civ. 457 (GLS/DRH)

PLAINTIFF'S BRIEF IN SUPPORT OF
THE RECEIVER'S MOTION TO DISALLOW THE BROKER CLAIMS

Plaintiff Securities and Exchange Commission respectfully submits this brief in support of the motion filed by William J. Brown, as Receiver, for an Order disallowing or equitably subordinating the claims of three former McGinn, Smith & Co., Inc. ("MS & Co.") brokers, Frank H. Chiappone, William F. Lex and Philip S. Rabinovich (collectively, the "Broker Claimants").

PRELIMINARY STATEMENT

It would be unfair and inequitable for Chiappone, Lex and Rabinovich to receive any distribution. The customers – who purchased more than $75 million of the fraudulent MS & Co. notes based on the recommendations of Chiappone, Lex and Rabinovich – have suffered enormous losses and are highly unlikely to be made whole.[1] As a result, the Broker Claimants, who solicited these investments, should not be permitted to share in the Receiver's distribution. As participants in and facilitators of the

[1] In a December 30, 2015 filing, the Receiver estimated "total investor claims" to be approximately $124.1 million. Dkt. 847-2 at 5 n.1. As of September 2018, the assets of the Receivership estate totaled $15.2 million after deduction of $6.3 million distributed to investors. Dkt. 1026 at 4.

six-year fraud, the Broker Claimants do not deserve any of the funds that the Receiver has gathered for the benefit of victims. Their claims should be denied.

ARGUMENT

I. The Court Has Authority to Deny the Claims

Excluding the Broker Claimants from receiving a share of the distribution is well within this Court's power. "'In equity receiverships resulting from SEC enforcement actions, district courts have very broad powers and wide discretion to fashion remedies and determine to whom and how the Receivership Estate will be distributed.'" *SEC v. Alleca*, 12-cv-3261, 2017 WL 4174217, *4 (N.D. Ga. Sept. 21, 2017) (citations omitted). *See also* Dkt. 985 at 11-13; Dkt. 1032 at 9 (Receiver's briefs collecting cases).

II. Caselaw Supports Denial of the Claims

Insiders like the Broker Claimants are typically precluded from receiving a distribution. For example, in *SEC v. Byers*, 637 F. Supp.2d 166 (S.D.N.Y. 2009), which arose from the Wextrust Ponzi scheme, the Receiver argued that "'individuals such as Wextrust employees who actively participated in the development, implementation, and/or marketing of the fraudulent scheme' be disqualified from receiving a distribution under the Plan." *Id.* at 173. The Court agreed, finding that "[t]he Receiver's proposal to treat differently those involved in the fraudulent scheme when distributions are being made is eminently reasonable and is supported by caselaw." *Id.* at 184 (citing cases). *See also SEC v. Enterprise Trust Co.*, 08-cv-1260, 2008 WL 4534154, *4 (N.D. Ill. Oct. 7, 2008) (principals that "entered into consent decrees" were precluded from taking a share of Receiver's distribution; "Disqualifying those who took the business over the edge is the most common feature, and the least contested aspect, of distribution plans");

SEC v. Merrill Scott & Assoc., 02-cv-39, 2006 WL 3813320, *11-13 (D. Utah Dec. 26, 2006) (investor that "was more intimately involved with Merrill Scott than the vast majority of clients and his activities extended to marketing and solicitation on Merrill Scott's behalf" was precluded from receiving a distribution).

III. For Six Years, the Broker Claimants Participated in the Fraud

Chiappone, Lex and Rabinovich recommended and sold the fraudulent MS & Co. notes throughout the years of the fraud.[2] They were by far the top-selling brokers at MS & Co., and collectively sold 60% of the $126.9 million raised in the fraudulent offerings. Declaration of Kerri Palen ("Palen Decl."), Exs. 1, 2. *See also* Declaration of David Stoelting ("Stoelting Decl."), Ex. 24 (Lex, Rabinovich and Chiappone recognized as the three top-ranked MS & Co. brokers).

For their sales of the MS & Co. notes, Lex received $1.77 million in commissions, and Chiappone and Rabinovich received, respectively, $532,000 and $587,000. Palen Decl. Exs. 2 (summary), 4 (Chiappone commissions paid), 6 (Lex commissions paid), 8 (Rabinovich commissions paid). The Broker Claimants steadily sold numerous notes year after year during the fraud. Palen Decl. Exs. 3 (Chiappone summary of sales); 5 (Lex summary of sales); 7 (Rabinovich summary of sales).

The Broker Claimants knew almost nothing about the securities they recommended to their customers, did no investigation into the products, and blindly

[2] The MS & Co. offering fraud began in late 2003 with the Four Funds and continued through the Trust offerings in 2009. *SEC v. McGinn, Smith & Co., Inc.*, 95 F. Supp.3d 506, 520 (N.D.N.Y. 2015) ("McGinn and Smith violated the federal securities laws in connection with the Four Funds offerings"); *SEC v. McGinn, Smith & Co., Inc*, 10-cv-457, 2015 WL 667848, *2-4 (N.D.N.Y. Feb. 27, 2015) (facts re fraudulent offerings from 2003-2009). *See also SEC v. Smith*, 646 Fed. Appx. 42, 44 (2d Cir. 2016) (affirming disgorgement order; "the SEC alleged and proved violations from 2003 to 2009").

relied on the representations of McGinn and Smith. Stoelting Decl. Exs. 1 at 2-6 (Chiappone test.); 2 at 2 (Lex dep.); 3 at 2-4 (Rabinovich dep.).

The Broker Claimants also knew that customers would not be redeemed unless a new investment was sold – an obvious red flag indicative of a Ponzi scheme – and that investors were never told that redemptions depended on a new investment being procured. Stoelting Decl. Ex. 1 at 8-10 (Chiappone test.); 2 at 3 (Lex dep.); 3 at 6-8 (Rabinovich dep.). Lex testified that he was "very upset" when he learned that redemptions could only be paid with new investor money because "I and the investors were misled[.]" Stoelting Decl. Ex. 2 at 3. Numerous emails also show knowledge of the requirement that redeeming notes be paid with incoming investor funds. Stoelting Decl. Exs. 4, 7, 8, 13, 15, 19.

During the fraud, Lex (who sold more than $45 million of the fraudulent notes) continued promoting MS & Co. notes at the same time internal emails reveal his concern about fraud at MS & Co. Stoelting Decl. Ex. 11 (Lex: "My clients continue to ask me if they've bought into a Ponzi scheme"); 14 (Lex: my clients are "skeptical and unnerved . . . [missed redemptions] raised a credibility problem and raised doubts about the efficiency of our operations"); 16 ("Bill Lex is very concerned and upset about clients not being paid upon redemption"); 17 (Lex: "the fiduciary responsibility to the clients has been breached . . . clients have expressed concern that they were mislead about material characteristics of these investments"); 18 (Lex: solution needed for "the liquidity problem that has been created for my clients"); 20 (Lex: customers in a "cash crunch" because they "live off the income from the notes") 21 (Lex: "I am just desperate to keep some credibility with my clients so they will keep investing in McGinn, Smith & Co., Inc.

products")"); 22 (Lex: "I just got off the phone with [a customer who] is one of many people who refer to our deals as a Ponzi Scheme").

Despite these emails, Lex continued to recommend MS & Co. notes. As late as mid-July 2009, nearly six years into the fraud, Lex emailed Smith and McGinn: "WE NEED TO MAINTAIN INVESTOR CONFIDENCE IN MCGINN SMITH DEALS!!!!!!" Stoelting Decl. Ex. 23.

Rabinovich testified that he was "shell shocked" after a January 2008 meeting when Smith told a group of brokers that the Four Funds would need to be restructured. Stoelting Decl. Ex. 3 at 10. Nevertheless, Rabinovich continued to recommend MS & Co. products to his customers throughout 2008 and 2009. Rabinovich also appears to have known that his father, Stan Rabinovich, was able to redeem in full his $600,000 investment in the Firstline Trust, and that this redemption was paid with funds from other investors. Palen Decl. ¶ 13; Ex. 10.

Chiappone continued to promote MS & Co. notes although he drafted an email accusing Smith of "mismanaging the assets that my clients and I entrusted to your care." Stoelting Decl. Ex. 9. And even after Smith rejected a request for a list of investments in the Four Funds, Chiappone continued to recommend MS & Co. notes. Stoelting Decl. Ex. 6.

Chiappone, Lex and Rabinovich also did no due diligence on the Firstline offerings; as a result, they recommended and sold Firstline Trust certificates after Firstline's bankruptcy filing in January 2008. Palen Decl. Ex. 9. *See also* Stoelting Decl. Ex. 2 (Rabinovich: re Firstline, "clearly [] there wasn't enough due diligence done"); 12 (Lex: Firstline investors "are elderly, retirees or baby boomers approaching retirement").

IV. Commission Findings of the Broker Claimants' Violations

In September 2013, Chiappone, Lex, Rabinovich and others were charged in an SEC administrative proceeding with fraud and other violations of the federal securities laws. After an eighteen-day hearing, an administrative law judge (ALJ) found that Chiappone, Lex and Rabinovich, as well as the other brokers, acted at least recklessly in recommending the MS & Co. notes and, in an Initial Decision, imposed disgorgement, civil penalties, and industry bars. *Donald J. Anthony, Jr., et al*., Rel. No. 745, 2015 WL 779516 (Feb. 25, 2015) (the "Initial Decision").

Chiappone, Lex and Rabinovich appealed the Initial Decision to the Commission. The appeal was fully submitted when the Supreme Court, in an unrelated case, *Lucia v. SEC*, 138 S. Ct. 2044 (2018), held that the SEC's manner of appointing ALJs violated the appointments clause of the Constitution. As a result of *Lucia*, the Initial Decision was vacated and the Commission reassigned dozens of pending proceedings to different ALJs, including the proceeding against Chiappone, Lex and Rabinovich. *In re: Pending Admin. Proc*., Rel. No. 4993, 2018 WL 4003609 (Aug. 22, 2018).

On December 21, 2018, the Commission issued a consent Order resolving the reassigned proceeding. *Frank H. Chiappone, et al*., Rel. No. 10495, 2018 WL 6722723 (Dec. 21, 2018) (the "Commission Order"). In the Commission Order (Dkt. 1032-1), the Commission made detailed factual findings that Chiappone, Lex 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"; and ignored "the accumulation of red flags" that should have led them to "conduct[] additional inquiries regarding any MS & Co. private placement before recommending them to their

customers." 2018 WL 6722723, at *3-7 (Dkt. 1032-1 at 5-8). Chiappone, Lex and Rabinovich did not admit or deny the findings in the Commission Order.

The Order concluded that Chiappone, Lex and Rabinovich violated Section 17(a)(2) and (3) of the Securities Act of 1933; ordered them to cease and desist from committing or causing violations of these statutes, and required them to disgorge commissions received after September 2008. *Id.* at *8-9.

CONCLUSION

For the foregoing reasons, as well as for the reasons in the Receiver's briefs (Dkt. 985, 1032), the SEC respectfully requests that the Court deny the claims submitted by Chiappone, Lex and Rabinovich and preclude them from receiving any share of the Receiver's distribution.

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Respectfully submitted,

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