UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	:	
Plaintiff,	:	
v.	:	**10 Civ. 457 (GLS/DRH)**
McGINN, SMITH & CO., INC., et. al.	:	
Defendants.	:	

REPLY MEMORANDUM OF LAW IN SUPPORT OF PLAINTIFF'S APPLICATION FOR AN ORDER TO SHOW CAUSE WHY DEFENDANTS TIMOTHY M. MCGINN AND DAVID L. SMITH SHOULD NOT BE HELD IN CONTEMPT

The over-the-top rhetoric in Timothy McGinn and David Smith's opposition brief cannot hide the fact that the evidence obtained in the past few weeks demonstrates that McGinn and Smith are back in the business of peddling fraudulent notes secured by alarm contracts. This evidence shows that their new company, Security Alarm Credit LLC ("SAC"), executed loan agreements on October 12, 2010, requiring SAC to lend $425,000 to Anchor Alarm Center, Inc. ("Anchor"); that SAC has no assets to lend except the funds it raises from investors pursuant to a private placement memorandum ("PPM") containing numerous misrepresentations and omissions; and that McGinn sent an e-mail the day after the loan closed boasting that the loan will be "funding" in one week. The SAC offering, moreover, is not a one-off event: the evidence shows that McGinn and Smith plan eight such offerings over the next two years.

The potential magnitude of the harm to investors from the SAC offering is considerable, as there are already hundreds of victims of McGinn and Smith's earlier fraudulent offerings. While McGinn and Smith argue that they are merely continuing their "livelihood," Opp. Br. at 1,

the evidence shows that this "livelihood" depends on materially false disclosures to investors. McGinn and Smith should not be permitted to sell these SAC notes, or any other securities, to the public.

For the following reasons, the arguments raised in McGinn and Smith's opposition brief are without merit.

First, defendants argue that there needs to be an actual purchase and sale in order for there to be a violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Section 17(a) of the Securities Act of 1933. This, however, has never been the law. On the contrary, an actual purchase or sale is not required. Defendants also argue that there is no evidence that "an offer" of securities occurred within the meaning of Section 17(a). The evidence shows, however, that SAC closed on the Anchor loan on October 12, 2010, and that McGinn had been "pitching," *i.e.*, attempting to sell the notes, to fund that loan obligation, as evidenced by his e-mails to Anchor's president and to SAC's president, and his text messages and faxes to Paul Zindell.

Second, defendants argue that the SAC PPMs do not contain any material misrepresentations. The PPMs, however, omit material information about Anchor's finances, about the use of the loan proceeds, and about the SEC's action against McGinn and Smith. A reasonable investor in SAC notes, whose repayment depends entirely on Anchor's ability to make the loan payments, would surely want to know this information.

ARGUMENT

THE COMMISSION HAS MADE A *PRIMA FACIE* SHOWING THAT MCGINN AND SMITH ARE IN CONTEMPT OF THE PRELIMINARY INJUNCTION ORDER

McGinn and Smith argue that Section 10(b) and Rule 10b-5, and Section 17(a) cannot apply because the evidence does not show an actual purchase or sale on a SAC note.[1] Under this view, until an investor actually writes a check for a SAC note, McGinn and Smith cannot be liable under the securities laws. This highly narrow reading of Sections 10(b) and 17(a) has never been the law. Furthermore, in the context of a motion for injunctive relief to protect investors, as here, requiring a consummated transaction as a prerequisite to relief would frustrate the Court's "broad equitable powers to grant ancillary relief . . . where necessary and proper to effectuate the purposes of the securities laws." *SEC v. American Bd. of Trade, Inc.*. 830 F.2d 431, 438 (2d Cir. 1987).

As a preliminary matter, Courts draw no distinction between "in the offer or sale" language in Section 17(a) and the "in connection with the purchase or sale" language of Rule 10b-5. *See, e.g., SEC v. Tambone*, 417 F. Supp. 2d 127, 131 (D. Mass. 2006); *SEC v. Solucorp Indus*., 274 F. Supp. 2d 379, 418-19 (S.D.N.Y. 2003). *See, e.g., Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 85, 126 S. Ct. 1503, 164 L. Ed. 2d 179 (2006) (holding "it is

[1] Defendants erroneously argue that the SEC's motion for contempt must comply with Fed. R. Civil P. Rule 9(b)'s requirement that allegations of fraud must be pled with particularity. Opp. Br. at 11-13. Rule 9 deals with pleadings, however, not motions. Defendants fail to cite any case to support their claim that contempt motions must plead fraud with particularity. In any event, the SEC's moving papers more than satisfy Rule 9: the statements in the PPM that are alleged to be misrepresentations and/or material omissions are identified; those statements are attributed to McGinn and Smith; the attached PPMs are identified; and the reasons that the statements are fraudulent are discussed. The defendants therefore have ample notice of the claims upon which the contempt motion is based.

enough that the fraud alleged coincide with a securities transaction - whether by the plaintiff or by someone else") (internal quotation marks omitted); *SEC v. Rana Research, Inc*., 8 F.3d 1358, 1362 (9th Cir. 1993); *In re Ames Dept. Stores, Inc*., 991 F.2d 953, 963 (2d Cir. 1993).

Section 10(b) applies "whenever assertions are made ... in a manner reasonably calculated to influence the investing public." *SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 860-62 (2d Cir. 1968). See also SEC v. Savoy Indus., Inc., 587 F.2d 1149, 1171, 190 U.S. App. D.C. 252 (D.C. Cir. 1978)* ("In connection with" requirement is satisfied when it can reasonably be expected that a publicly disseminated document will cause reasonable investors to buy or sell securities "regardless of the motive or existence of contemporaneous transactions by or on behalf of the violator").

Defendants' argument that an actual purchase or sale must occur before Sections 10(b) and 17(a) can apply has not been adopted by any court. If that were the law, then parties could circulate any offering documents with impunity until an investor actually wrote a check. On the contrary, Courts have taken a broad approach to Section 10(b) and the Supreme Court has stated that "the statute should be construed not technically and restrictively, but flexibly to effectuate its remedial purposes." *SEC v. Zandford,* 535 U.S. 813, 819 (2002). As a result, "actual sales [are] not essential" for liability to attach under the antifraud provisions. *SEC v. Am. Commidty Exch.*, 546 F.2d 1361, 1366 (10th Cir. 1976). *See also, SEC v. Wolfson,* 539 F.3d 1249, (10th Cir. 2008) (holding that misrepresentations and omissions contained in the company's filings with the SEC satisfied the "in connection with" requirement because the documents were designed to reach investors, and were material to investors' decisions to invest). Here, the PPM is the primary document describing the SAC investment to prospective investors, and as such, is designed to

reach investors. In addition, the misrepresentations and omissions contained in the PPM are material.

The plain language of Rule 10b-5 also shows that the Court has jurisdiction to stop a fraudulent offering before it succeeds in actually defrauding investors. The rule prohibits any misstatement or omission "which operates ***or would operate*** as a fraud or deceit upon any person." Rule 10b-5, Securities Exchange Act of 1934 (emphasis added).

The evidence shows that McGinn and Smith prepared the PPM in order to induce investors to purchase SAC notes, and that the PPM contains material misrepresentations. That is all that is required to satisfy the "in connection with" and "offer or sale" requirements. The SAC offering PPM was clearly prepared, and the Anchor loan documents executed, so that the SAC notes could be sold to investors. The basic term sheet showing the terms of the SAC notes is dated August 14, 2010. Stoelting Decl. Exh. 8. On October 8, 2010, McGinn e-mailed the PPM to Zindell, referred to it as the "offering document." Zindell Decl. Exh. 1, 4. Although this PPM contains the word "draft" across a few pages, McGinn does not describe the document as a draft and there are no blank sections in the PPM.

SAC became committed to the offering on October 12, 2010, when loan documents were executed requiring SAC to loan $425,000 to Anchor. Stoelting Decl. Exhs. 12, 13, 14. SAC had no assets other than the offering proceeds, which it needed to raise in order to fulfill its obligations under the loan documents. The day after the SAC became obligated to make the $425,000 loan, Anchor's president sent an e-mail to McGinn asking "[w]hen do you think we can get some of the funding and I can started paying off some of these accounts?" Stoelting Decl. Exh. 11. McGinn responded that "[m]y guess is funding on either Monday (the 18th) or Friday (the 15th)." Stoelting Decl. Exh. 11.

On October 13, McGinn had the following e-mail exchange with SAC's president, Carolyn Gracey:

> GRACEY: Did you get my email yesterday, we need to mail back by the end of the week. thanks,
> MCGINN: Yes. Haven't looked at it yet. ***Been pitching***.
> GRACEY: how are things going? ***Is the deal sold***?
> McGINN: ***Nothing sold yet.***

Stoelting Decl. Exh. 6 (emphasis added).

In these exchanges, there is nothing tentative or ambiguous about McGinn's conduct. He is obviously selling the SAC notes as described in the PPM, and as he would be required to do under the terms of the loan agreement with Anchor. Indeed, McGinn appears confident of his ability to sell the SAC notes, given his prediction to Anchor's president that "funding" of the loan would take place on October 13 or 18.[2]

McGinn and Smith also assert that they were not under a duty to disclose "Anchor's financial data" because such information is not statutorily required under Rule 502 of Regulation D. This assertion is irrelevant -- the Commission does not currently assert that the SAC notes must be registered for failure to comply with the Rule 502(b) disclosure requirements. Instead, under Sections 10(b) and 17(a) the duty to disclose material information about Anchor arises

[2] Defendants incorrectly argue that the SEC has failed to allege any facts regarding Smith's involvement in the SAC offering aside from the "conclusory" claim that he was at one time an officer of SAC and allowed his name to be used for marketing purposes. Opp. Br. at 10-11. Defendants ignore the documented evidence provided by McGinn's own letter to Zindel that he and Smith were soliciting investors: "[a]lthough DLS [Mr. Smith] and I do not want numerous Partners, we would entertain you teaming with other(s) to make an investment." Zindell Aff., Ex. 2. In addition, McGinn advised Zindell regarding Smith role in developing the offering, stating : "he and Mr. Smith had been working on the new offering for approximately 2 ½ months." Zindell Aff. Paragraph 11. his evidence, combined with Smith's role as an officer of SAC, amply demonstrates Smith's knowing involvement in developing and marketing the PPM. Notably, neither McGinn nor Smith offer affidavits denying their involvement in drafting the PPMs, soliciting investors or knowingly or recklessly making material misrepresentations and/or omissions of material facts as alleged by the SEC.

from the actual statements made in the PPM. Under the anti-fraud provisions of the Federal securities laws, once a party chooses to speak about a certain topic it "must speak truthfully about material issues." *Caiola v. Citibank, N.S., N.Y.,* 295 F.3d 312, 331 (2d Cir. 2002).

By choosing to speak positively about the financial condition of Anchor, McGinn and Smith assumed a duty to disclose material information regarding Anchor's financial distress. Indeed, the duty to disclose is heightened because the notes are non-recourse as to SAC and repayment is entirely dependent upon Anchor's performance. The PPM describes Anchor as a successful business, having "grown revenue by 6% per year over the last three years" and having the "current capacity to grow accounts handled by 100% without further capital expenditures." Zindell Decl., Ex. 4, at 5; Stoelting Decl., Ex. 7, at 5. It also makes certain representations concerning Anchor's existing indebtedness and monthly debt payments. Zindell Decl., Ex. 4, at 4; Stoelting Decl., Ex. 7, at 4. Boilerplate risk disclosures do not suffice to warn investors of specific existing facts that call into question Anchor's ability to service the debt.

McGinn and Smith also argue that there are no material misrepresentations and omissions in the PPM. Again, however, the evidence shows three broad categories of material misrepresentations and omissions: (1) Anchor's financial condition; (2) use of proceeds; and (3) the status of the SEC action.

The PPM makes clear that the only way investor funds will be repaid is if Anchor is in a financial position to make the loan payments over the 61-month term of the notes. Any reasonable investor, therefore, would want to know the facts concerning Anchor's finances and its ability to repay the loan. The PPM, however, does not provide much detail beyond disclosing that Anchor has "grown revenue by 6% per year over the last three years." Zindell Decl. Exh. 4, at 5; Stoelting Decl. Exh. 7, at 5. The PPM fails to disclose Anchor's history of late payments

during 2009 and 2010, that the loan with Quantum Bank was restructured to allow for interest-only payments from September 2009 to May 2010, and that Anchor had a net loss during 2008 and 2009. Stoelting Decl. Exhs. 1 – 4.[3]

Defendants argue that short of an actual default they had no obligation to disclose these facts to investors. Opp. Br. at 16-17. A person who invests $50,000 in a SAC note, however, who knows that the only hope of return is if Anchor makes its loan payments, would certainly want to know of Anchor's recent and continual history of tardiness requiring the loan to be modified.

McGinn and Smith also do not dispute the promissory notes between Anchor's president and Bill Knox and the Phil Petty Irrevocable Trust. Defendants argue without support that these are "corporate obligations." However, the undisputed evidence is that Mr. Latty, Anchor's president, is the borrower under these two promissory notes (not Anchor) and that investor funds will be used to repay these sizable obligations. Even if, as Defendants argue, McGinn and Smith show that funds were subsequently provided to Anchor by Latty, the PPM still contains a glaring misrepresentation. An investor would undoubtedly want to know if over one-quarter of the loan proceeds were intended to repay a personal loan from the company's president.

The defendants also claim they made "full disclosure" by stating in the PPM that the SEC action is "without merit and [defendants] are executing a vigorous defense," Stoelting Decl. Exh. 7 at 5, and by referencing the Receiver's web site, which contains all 171 docket entries on the ECF docket. The PPM, however, fails to disclose that there is an asset freeze over defendants' assets and well as entities they controlled; and that the Court has found a substantial likelihood of

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[3] Defendants point to two unaudited financial statement and concludes that "Anchor's revenues exceed its expenses." Opp. Br. at 15. The Quantum Bank loan documents, however, show that Anchor has a net loss of $20,000 in 2009 and a net loss of $4,000 in 2008, as well as the loan modifications. Stoelting Decl. Exhs. 2, 3.

success on the merits of the SEC's allegations. A reasonable investor would want to know this information before investing in SAC notes.

Finally, in an effort to bide time to allow the defendants to continue offering securities to the public, defendants ask the Court to conduct an evidentiary hearing and, prior to such hearing, allow them time to conduct depositions of "at a minimum" six persons and entities, and "to hire an expert witness to testify as to disclosure requirements of Regulation D[.] Opp. Br. at 2-3. In this case, however, an evidentiary hearing is unnecessary. The Court need only find a single misrepresentation or omission in the PPM, and defendants have made at least seven material misrepresentations in connection with the PPM, and do not offer facts sufficient to call into question any of them, much less all of them. Further discovery will do nothing to rectify the fraudulent nature of the SAC offering.

Moreover, apart from its contempt powers, this Court has authority to stop the offering under Section 20(b) of the Securities Act of 1933 and Section 21(d) of the Securities Exchange Act of 1934, which gives the Court has "broad equitable powers to grant ancillary relief . . . where necessary and proper to effectuate the purposes of the securities laws." *SEC v. American Bd. of Trade, Inc.*, 830 F.2d 431, 438 (2nd Cir. 1987); 15 U.S.C. § 77t(b); 15 U.S.C. §78u(d)(5) ("In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.").

CONCLUSION

Plaintiff respectfully requests that the Court hold McGinn and Smith in civil contempt for their violations of the Court's Preliminary Injunction Order, enjoin the current SAC offering and enjoin McGinn and Smith from involvement in any future securities offerings without permission of the Court, freeze and return to investors any investor funds raised to date through the SAC offering and order such other relief as the Court deems appropriate.

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Respectfully submitted,

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