

UNITED STATES DISTRICT COURT  
NORTHERN DISTRICT OF NEW YORK

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SECURITIES AND EXCHANGE COMMISSION,

*Plaintiff,*

v.

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

*Defendants.*

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**PLAINTIFF’S MEMORANDUM OF LAW IN OPPOSITION TO  
DEFENDANTS TIMOTHY MCGINN AND DAVID SMITH’S MOTION  
TO COMPEL RESPONSES TO INTERROGATORIES 1, 2 AND 3**

Seeking to compel the SEC to answer Interrogatories requesting the identity of each FINRA employee with whom the SEC has had communications, the Defendants offer only one possible grounds of relevance: that this information is needed in connection with their argument that FINRA should be deemed a “state actor.” Defendants, however, fall far short of establishing any right to discovery on its “state actor” theory. The motion to compel should be denied.

FINRA is not a state actor: it is a private, nongovernmental entity. To meet its burden of establishing that FINRA is a state actor, Defendants must present evidence that the conduct of FINRA should be attributed to the SEC because the SEC coerced FINRA into acting or because FINRA exercised powers traditionally reserved to the state. Defendants, however, do not present a shred of evidence to meet their burden, other than the undisputed fact that FINRA transmitted to the SEC documents obtained from McGinn Smith & Co., Inc. (“MS & Co.”) and certain transcripts. Defendants ignore the substantial evidence showing that the SEC did its own investigation, engage in

unfounded speculation about the reasons for certain questions asked by FINRA, and argue without basis that “FINRA was acting for the federal government.” Def. Br. at 4.

The evidence before the Court establishes beyond doubt that FINRA was not acting for the SEC. The accompanying Declaration of Michael D. Paley shows that the SEC conducted its own independent investigation and never directed FINRA’s investigation. The two Affidavits of James S. Shorris, submitted as part of FINRA’s separate motion to quash subpoenas served by Defendants (DE 192), provide further background on the FINRA investigation and provide additional evidence that FINRA did not, as defendants claim, “do [the SEC’s] bidding.” Def. Br. at 4.

In view of the complete lack of evidence of joint action offered by the Defendants, as well as the Paley Declaration and the Shorris Affidavits, which conclusively disprove Defendants’ state actor theory, no discovery should be allowed on the state actor issue.

### **ARGUMENT**

#### **DEFENDANTS ARE NOT ENTITLED TO DISCOVERY CONCERNING THE STATE ACTOR CLAIM**

Defendants’ motion to compel the SEC to identify every FINRA employee with whom the SEC communicated should be denied.<sup>1</sup> Defendants are entitled to discovery that is relevant; they are not entitled to discovery that is not relevant to any claim or defense. The only grounds for relevance of the information sought in the three interrogatories is in connection with Defendants’ new “state actor” theory. However, to justify its need for discovery Defendants must show something more than merely the

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<sup>1</sup> Defendants seek to compel responses to Interrogatories 2 and 3, which ask the SEC to identify each person at the Department of Justice and the FBI with whom it communicated, but their brief fails to explain how these Interrogatories relate to the state actor theory.

provision of documents by FINRA to the SEC. Instead of offering facts, Defendants present overblown rhetoric and hyperbole.

Defendants' burden of showing state action is as follows:

To establish a Fifth Amendment violation, a plaintiff must demonstrate "that in denying the plaintiff's constitutional rights, the defendant's conduct constituted state action." *Desiderio v. National Ass'n of Securities Dealers, Inc.*, 191 F.3d 198, 206 (2d Cir.1999), *cert. denied*, 531 U.S. 1069, 121 S.Ct. 756, 148 L.Ed.2d 659 (2001); *see also United States v. International Bd. of Teamsters*, 941 F.2d 1292, 1295 (2d Cir.1991). That is because the Fifth Amendment restricts only governmental conduct, and will constrain a private entity only insofar as its actions are found to be "fairly attributable" to the government. *See Lugar v. Edmondson Oil Co.*, 457 U.S. 922, 937, 102 S.Ct. 2744, 73 L.Ed.2d 482 (1982); *Corrigan v. Buckley*, 271 U.S. 323, 330, 46 S.Ct. 521, 70 L.Ed. 969 (1926).

Actions are "fairly attributable" to the government where "there is a sufficiently close nexus between the State and the challenged action of the regulated entity." *Jackson v. Metropolitan Edison Co.*, 419 U.S. 345, 351, 95 S.Ct. 449, 42 L.Ed.2d 477 (1974). That nexus exists either (1) where the state "has exercised coercive power [over a private decision] or has provided such significant encouragement, either overt or covert, that the choice must in law be deemed to be that of the State"; or (2) where "the private entity has exercised powers that are 'traditionally the exclusive prerogative of the State.'" *Blum v. Yaretsky*, 457 U.S. 991, 1004-05, 102 S.Ct. 2777, 73 L.Ed.2d 534 (1982) (quoting *Jackson*, 419 U.S. at 351, 95 S.Ct. 449); *see also Desiderio*, 191 F.3d at 206.

*D.L. Cromwell Investments, Inc. v. NASD Regulation, Inc.*, 279 F.3d 155, 161 (2d Cir. 2002).

*D.L. Cromwell* involved parallel investigations by the National Association of Securities Dealers (NASD), the predecessor to FINRA, and a United States Attorney's Office. Like Smith and McGinn, the subject of the NASD investigation argued for an inference of state action based on the timing of certain events in the criminal case and the NASD case. The district court rejected this as mere circumstantial inference and held that the NASD was not a state actor. 279 F.3d at 162. The Second Circuit affirmed:

Testimony in an NASD proceeding may entail exposure to criminal liability, but that in itself is not enough to establish the requisite governmental nexus. *Shvarts*,

90 F.Supp.2d at 222 (holding that “questions put to the defendants by the NASD in carrying out its own legitimate investigative purposes do not activate the privilege against self-incrimination”). *Cf. United States v. Solomon*, 509 F.2d 863, 867-71 (2d Cir.1975) (holding no violation of the Fifth Amendment where the government relied on testimony compelled in an earlier proceeding before the heavily-regulated New York Stock Exchange). To prevail, Cromwell must establish additional facts sufficient to satisfy the *Blum* test and to distinguish the present appeal from the general rule. *See Marchiano*, 134 F.Supp.2d at 95 (finding no state action in Rule 8210 demand for testimony *absent actual evidence of governmental encouragement*).

Here, the district court found “no direct evidence of such governmental involvement,” and that finding is not clearly erroneous. *D.L. Cromwell Inv., Inc. v. NASD Regulation, Inc.*, 132 F.Supp.2d 248, 252 (S.D.N.Y.2001). Cromwell invites a contrary inference from the chronology of certain events[.] . . . The district court, however, noted that these circumstantial inferences “perhaps would not be drawn so readily by those whose judgment is not tinged with self interest.” *D.L. Cromwell Inv., Inc.*, 132 F.Supp.2d at 252.

*D.L. Cromwell*, 279 F.3d at 162.

Similarly, in *United States v. Solomon*, 509 F.2d 863 (2d Cir. 1975), the New York Stock Exchange (NYSE) took testimony from a trader under threat of suspension or expulsion, and then forwarded the transcript to the SEC. 509 F.2d at 864-65. As in *D.L. Cromwell*, the Second Circuit held that there was no state action because the private actor had independent regulatory interests in making its inquiries. As is the case with FINRA, the NYSE in *Solomon* acted “in pursuance of its own interests and obligations, not as an agent of the [government].” 509 F.2d at 869.

The state actor arguments of Smith and McGinn have even less merit than those at issue in *D.L. Cromwell* and *Solomon*. The emptiness of Smith and McGinn’s argument is demonstrated by their resort to the false assertions that “the SEC made no attempt to do [an investigation],” that the SEC “relied upon FINRA to carry out its investigation,” that the SEC used FINRA “to do its bidding,” and that “the SEC did not conduct any investigation of its own.” Def. Br. at 4, 13. Such statements are belied by the evidence

of the SEC's extensive investigation shown in the papers filed on April 20, 2010, including the declarations of Israel Maya, Roseann Daniello and Lara Mehraban, and the exhibits attached to those declarations. DE 4. These lengthy and detailed declarations and the accompanying exhibits, which include numerous financial analyses done by SEC staff, plainly demonstrate that the SEC conducted an investigation of events at MS & Co. that was extensive, detailed and compelling as proof of Defendants' fraud.

Defendants assert that "[t]here is a clear pattern of coordination between the SEC and FINRA," Def. Br. at 4, but the only facts they offer in support is the transmittal of transcripts and documents to the SEC. Under the *D.L. Cromwell* and *Solomon* cases, this is plainly insufficient. Moreover, Smith and McGinn should not have been surprised that their OTR transcripts and other documents were provided to the SEC: FINRA's letter requesting the OTR disclosed that the transcripts and documents may be given to other law enforcement agencies. Specifically, Defendants were advised that "FINRA . . . routinely provides the SEC with access to its files [and] . . . FINRA may produce documents and transcripts to . . . federal and state regulatory authorities or law enforcement agencies[.]" See Letter to David Smith from FINRA Senior Examiner Steven Rowen dated January 21, 2009 (received into evidence as Exhibit 119 during the Preliminary Injunction hearing; attached hereto).

Smith and McGinn also speculate that some of the questions posed during the OTR, particularly those concerning their finances, were "out of the ordinary" and "unusual." Def. Br. at 5. This assertion is nothing but conjecture and should be disregarded. In any event, the Supplemental Shorris Affidavit, submitted as part of

FINRA's motion to quash, adequately explains FINRA's justification for such questions. DE 192-4, ¶ 5.

The Paley Declaration and the Shorris Affidavits prove that no evidence of state action exists. Michael Paley, an SEC Assistant Regional Director, stated that the FINRA and SEC declarations were conducted "independently of one another" and that the "SEC did not tell FINRA, directly or indirectly, which persons to interview, which questions to ask, which leads to pursue, or which subject areas to cover, and FINRA did not request any such direction from the SEC." Paley Decl. ¶¶ 3-4. The Shorris Supplemental Affidavit similarly states that "FINRA did not take direction from the SEC concerning FINRA's investigation of the Defendants and their Firm[.] DE 192-4.

Defendants cite to *Matter of Quattrone*, SEC Rel. No. 53547 (March 24, 2006) (Russo Decl. Exh. VV), where the Commission found that the NASD should have conducted an evidentiary hearing regarding a state actor claim. In that case, however, there was tangible evidence of joint cooperation: the SEC, NYSE and NASD sent Quattrone a letter emphasizing the "joint nature" of the investigation, stated that any settlement would have to involve both entities, and that the SEC, NASD and NYSE would all "confer to determine how to proceed if no settlement was reached." *Quattrone*, at 10. No such evidence has been presented by Smith and McGinn.

Even the *Quattrone* case, though, emphasized that "we consider the burden of demonstrating joint activities sufficient to render NASD a state actor to be high," and that "cooperation between the Commission and NASD will rarely render NASD a state actor, and the mere fact of such collaboration is generally insufficient, standing alone, to demonstrate state action." *Quattrone*, at 11.

The lack of substance of Smith and McGinn's state actor arguments is further underscored by the fact that the state actor theory was not raised until months after the conclusion of the Preliminary Injunction hearing on June 11, 2010, even though the FINRA documents were disclosed in the SEC's filings on April 20, 2010, and this fact was again referenced at the PI hearing, prior to the testimony and cross-examination of two SEC investigators Israel Maya and Roseann Daniello. Tr. at 12-14. No defendant or relief defendant, however, sought to question these SEC investigators about coordination between the SEC and FINRA. Counsel for Lynn Smith even took the deposition of SEC attorney Mehraban prior to the PI hearing, but never attempted to ask questions about coordination with FINRA. If there were the slightest merit to the state actor claim, then one of the many lawyers for the defendants and relief defendants would have sought to question these three SEC employees when they had the opportunity to do so.<sup>2</sup>

Finally, Defendants' make the farfetched assertion that the Court should "suppress the evidence the SEC obtained from FINRA," if they prove that FINRA was a state actor. Def. Br. at 14. Defendants, however, fail to cite to any state actor case in which suppression was even argued, let alone adopted as the remedy. *See D.L. Cromwell*, 279 F.3d at 155 (appellant argued that private actor should be subject to Fifth Amendment restraint). Under any circumstances, exclusion of the documents that the SEC received from FINRA – consisting mostly of MS & Co.'s own business records – would not be an available option. *United States v. Janis*, 428 U.S. 433, 447 (1976) ("In

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<sup>2</sup> Defendants claim that the SEC's relevance objection is "unclear," Def. Br. at 10, even though the SEC's grounds are set forth in the Responses and Defendants made almost no effort to learn the basis for the objection before rushing to Court with their motion to compel. The SEC's responses to Defendants' Interrogatories were e-mailed to Defendants' counsel at 5:41 p.m. on Friday, October 22, 2010. The following Monday, Defendants sent an email stating their intention to have the issue of the SEC's responses placed before the Court the next day. Counsel for the SEC then noted that the SEC had disclosed the names of more the 50 persons with whom it had communicated, but asked for an explanation for the "relevance" of a list of FINRA employees. Russo Decl. Exh. QQ.

the complex and turbulent history of the [exclusionary] rule, the Court never has applied it to exclude evidence from a civil proceeding, federal or state.”).

**CONCLUSION**

For the foregoing reasons, Defendants’ motion to compel the SEC to answer Interrogatories 1, 2 and 3 should be denied.

Dated: New York, NY  
November 29, 2010

Respectfully submitted,

**s/ David Stoelting**  
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*Of Counsel:*

Kevin McGrath  
Lara Shalov Mehraban  
Linda Arnold





January 21, 2009

Via First Class and Certified Mail (7007 1490 0002 3111 0095)

Mr. David Smith

[REDACTED] NY 12866

RE: McGinn, Smith & Co., Inc.  
Examination No.: 20080117152

Dear Mr. Smith:

In connection with the above-referenced examination, you are hereby requested under FINRA Rule 8210 to appear for an on-the-record interview ("OTR"), which has been scheduled for **February 19, 2008, at 9:30 a.m.** On that date, and at that time, please report to the 7<sup>th</sup> floor of FINRA's District Office, which is located at 581 Main Street, Suite 710, Woodbridge, NJ 07095.

You may be represented by an attorney of your choice at the OTR. You are obligated to appear on the date and at the time specified in this letter. Please contact the undersigned, or if you are represented by counsel, have your attorney contact the undersigned by February 2, 2009 to confirm that you intend to appear on the date scheduled for the OTR. If you, or your attorney will not be available to appear on the date scheduled for your OTR, or if appearing at the OTR location will be a hardship for you, please notify, or have your attorney notify, the undersigned to agree on another mutually acceptable date and time. Unless and until a postponement is agreed to, you are still obligated to appear on the date and at the time specified in this letter.

Please review the enclosed Addendum, which provides additional information regarding OTRs conducted by FINRA.

If you or your counsel have any questions, please contact the undersigned at (732) 596-2075.

Very truly yours,

A handwritten signature in black ink, appearing to read "Steven Rowen". The signature is written in a cursive style with a long horizontal line extending to the right.

Steven Rowen  
Senior Examiner

Cc: Mr. Stephen Smith, CCO  
McGinn, Smith & Co., Inc.  
Capital Center  
99 Pine St.  
Albany, NY 12207

Investor protection. Market integrity.

New Jersey District Office t 732 596 2000  
Suite 710 f 732 596 2001  
581 Main Street www.finra.org  
Woodbridge, NJ

## ADDENDUM A TO REQUEST FOR TESTIMONY

1. *Record.* Your testimony at the on-the record interview ("OTR") will be taken under oath and will be transcribed by a reporter provided by FINRA. If you desire to go off the record, please indicate or have your attorney indicate to the FINRA employee taking your testimony, who will determine whether to grant your request. The reporter will not go off the record at your, or your counsel's, direction.

2. *Counsel.* You may be represented by counsel of your choice, including counsel provided to you by a current or former employer, or by an attorney you have selected on your own. If you are not represented by counsel, please advise FINRA staff taking your testimony whenever, during your testimony, you desire to be represented by counsel. The OTR will be adjourned to afford you the opportunity to arrange to obtain legal representation.

You may be represented by counsel who also represents other persons or firms involved in this matter. You should be aware, however, that this multiple representation presents a potential conflict of interest if one client's interests are or may be adverse to another client's interests. If you are represented by counsel who also represents other persons involved in this matter, FINRA will assume that you and counsel have discussed and resolved all issues concerning possible conflicts of interest. The choice of counsel, and the responsibility for that choice, is yours.

3. *Transcript Availability.* Upon written request to FINRA, you and/or your attorney may inspect the official transcript of your OTR at FINRA's offices, or purchase a copy of the transcript from the reporting service that transcribed your interview. Please direct your request to review or purchase the transcript to the FINRA employee who has taken your testimony. FINRA staff may deny your request to obtain a copy of the transcript for good cause. (See FINRA Rule 8210(f).) FINRA staff does not release copies of exhibits to testimony but you may review these exhibits at FINRA's offices.

4. *Truthful and Accurate Testimony and Failure to Appear.* At the OTR, you are obligated to provide testimony that is truthful, accurate and complete. Should you fail to do so, you may be subject to an FINRA disciplinary action, and the imposition of disciplinary sanctions, including a bar from the securities industry, suspension, censure and/or fine. You may also be subject to prosecution for perjury for false testimony under oath.

You are obligated, under FINRA rules, to answer all questions asked by FINRA staff. Please be informed that FINRA is not a governmental agency, and thus, does not recognize the Fifth Amendment privilege against self-incrimination in any of its proceedings, including an OTR. Should you refuse to answer any questions based on an assertion of the privilege, you may be subject to a FINRA disciplinary action and the imposition of sanctions, including a bar from the securities industry, suspension, censure and/or fine.

If you fail to appear and testify at the OTR you may be subject to an FINRA disciplinary action and the imposition of sanctions, including a bar from the securities industry, suspension, censure and/or fine.

**5. Uses of Information.** FINRA's purpose in soliciting information is to gather facts to determine whether any person or firm subject to FINRA's jurisdiction has violated, is violating or is about to violate applicable securities industry rules and regulations. FINRA, as a matter of policy, conducts its investigations in a confidential and non-public manner. You should be aware, however, that, under certain circumstances, FINRA provides access to its files. For instance, FINRA is subject to oversight by the SEC and routinely provides the SEC with access to its files. In addition, pursuant to the FINRA rules, FINRA is required to produce documents and transcripts to respondents during discovery. Furthermore, FINRA may produce documents and transcripts to a litigant in response to a subpoena, to federal or state regulatory authorities or law enforcement agencies in response to a subpoena or access request or other self-regulatory organizations in response to a regulatory access request.

UNITED STATES DISTRICT COURT  
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

*Plaintiff,*

v.

10 Civ. 457  
(GLS/DRH)

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, DAVID L. SMITH,  
LYNN A. SMITH, DAVID M. WOJESKI, Trustee of  
the David L. and Lynn A. Smith Irrevocable  
Trust U/A 8/04/04, GEOFFREY R. SMITH,  
LAUREN T. SMITH, and NANCY MCGINN,

*Defendants,*

LYNN A. SMITH, and  
NANCY MCGINN,

*Relief Defendants, and*

DAVID M. WOJESKI, Trustee of the  
David L. and Lynn A. Smith Irrevocable  
Trust U/A 8/04/04,

*Intervenor.*

**DECLARATION OF MICHAEL D. PALEY**

I, Michael D. Paley, pursuant to 28 U.S.C. § 1746, declare as follows:

1. I am an Assistant Regional Director in the Division of Enforcement in the New York Regional Office of the Securities and Exchange Commission. I supervised the SEC's investigation leading to the filing of the Complaint in this action and also was the primary liaison with the Financial Industry Regulatory Authority

(“FINRA”) during the SEC’s investigation. I submit this declaration to put before the Court certain facts regarding the SEC’s investigation.

2. In December 2009, FINRA referred the McGinn, Smith & Co., Inc. (“MS & Co.”) matter to the SEC. FINRA then forwarded to the SEC documents and electronic files that had been produced to FINRA by MS & Co. Over the next several months, FINRA also provided to the SEC transcripts of on-the-record (“OTR”) interviews of David Smith, Timothy McGinn, and others.

3. The investigations of MS & Co. by FINRA and the SEC were conducted independently of one another. FINRA and the SEC did not conduct a joint investigation or inquiry, and the SEC did not direct or participate in FINRA’s investigation.

4. No SEC employees or agents attended or participated in any of the OTR interviews conducted by FINRA. The SEC also did not tell FINRA, directly or indirectly, which persons to interview, which questions to ask, which leads to pursue, or which subject areas to cover, and FINRA did not request any such direction from the SEC.

5. On January 5, 2010, the Commission, through the Division of Enforcement, issued an Order Directing Private Investigation and Designating Officers to Take Testimony (the “Formal Order”) in the *Matter of McGinn Smith & Co., Inc.*, which, among other things, ordered “that a private investigation be made to determine whether” there had been violations of the federal securities laws.

6. Pursuant to the Formal Order, the SEC conducted its own extensive investigation of MS & Co. The investigative team was comprised of at least ten SEC

employees, including attorneys, accountants and examiners. As part of this investigation, the SEC sent eleven investigative subpoenas to various banks concerning over one hundred accounts in the names of the defendants and their affiliates, and received thousands of pages in response, including account statements and account opening documents. The SEC staff also interviewed eleven investors.

7. The SEC staff spent several months analyzing the documents received pursuant to the investigative subpoenas, as well as the MS & Co. documents that FINRA provided to the SEC. For example, the SEC analyzed 35 Quicken files that were provided to FINRA by MS & Co. From these files, SEC investigative staff prepared detailed analyses of the various offerings and issuers. See Declaration of Israel Maya dated April 19, 2010 (Docket Entry 4). The SEC used the bank records it obtained through its investigative subpoenas to analyze the flow of funds between the various entities. See Declaration of Roseann Daniello dated April 19, 2010 (Docket Entry 4).

8. The SEC also spent considerable time reviewing thousands of emails produced by MS & Co. to FINRA, and relied on many of these emails to support its claims. See Declaration of Lara Shalov Mehraban dated April 19, 2010 (Docket Entry 4).

I declare under penalty of perjury that the foregoing is true and correct.

Executed on November 29, 2010  
New York, New York

  
Michael D. Paley