McGinn, Smith & Co., Inc.
99 Pine Street ~ 5th Floor
Albany, New York 12207
File # 25374
CRD # 8453
EXAM # BD2004NERO035

February 26, 2004

COMMENTS

Redacted

In addition to a review of pertinent books and records, the staff interviewed the following individuals:

David L. Smith ("Smith")	President
David P. Rees ("Rees")	Chief Financial Officer
Mark C. Casolo ("Casolo")	Senior Vice-President of Corporate Finance
Curt Maughs ("Maughs")	Information Technology Consultant

I. SUMMARY OF MAJOR FINDINGS AND DISPOSITION

The staff's examination disclosed the following violations of federal statutes and rules promulgated under the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act") and by the NASD:

- Capital Center Credit Corporation ("C4"), an entity controlled by Smith, violated **Section 15(a) of the Exchange Act**, in that the staff's review of C4's business activities disclosed that C4 is operating in the capacity of an unregistered broker-dealer. Therefore, C4 must be registered as a broker-dealer or its books and records must be encompassed in MS & Co.'s financial statements.

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- MS & Co. violated **Rule 17a-4(b)(4)** and **NASD Conduct Rule 3110** by failing to preserve for a period of three years, and/or preserve in an accessible place for two years,

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electronic communications relating to the business of the firm. Furthermore, MS & Co. also violated **NASD Conduct Rule 3010** by failing to establish, maintain, and enforce a supervisory system to ensure compliance with NASD rules and the federal securities laws relating to retention of electronic communications.

- MS & Co. violated **NASD Conduct Rule 3010(b)** by failing to establish and/or enforce adequate procedures for maintaining written complaints, arbitrations, and settlements. More specifically, the firm also failed to establish and maintain separate complaint files as specified by the Rule.

- MS & Co. violated **Rule 17a-3(a)(1)** in that the firm failed to make and keep current blotters containing an itemized daily record of all purchases and sales of securities.

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Additionally, the staff will send a violation letter to the firm addressing these issues, as well as the violations identified in the staff 's MS & Co. branch office examination (BD2003NERO142). These violations include abusive sales activities engaged in by certain registered representatives ("RRs") of the firm, including Section 5 of the Securities Act for soliciting customers and accepting their funds for an initial public offering prior to the effective registration date; selling various private placements to the firm's customers without management's knowledge or approval; and receiving undisclosed commission payments for the aggressive sales effort of a private placement of a company controlled by an officer of MS & Co.

II. BACKGROUND

MS & Co. has been registered as a broker-dealer with the Commission since October 30, 1980 and is a member of the National Association of Securities Dealers ("NASD") and the Municipal Securities Rulemaking Board ("MSRB"). MS & Co. is directly owned by Smith (50%) and Timothy M. McGinn ("McGinn"), Chairman of the Board (50%). The registrant employs 57 individuals, comprised of 52 RRs and five non-registered employees. Of the 57 employees, 37 individuals are employed at the main office in Albany, NY and 20 individuals are employed at the New York City branch office.

MS & Co. is primarily involved in underwriting or acting as a selling group participant in debt offerings, private placements, and retailing corporate equity securities over-the-counter. The firm processes approximately 737 transactions per month and maintains a total of 2,437 active accounts, comprised of 1,800 cash accounts (74%), 400 margin accounts (16%), 150 discretionary accounts (6%), and 87 investment advisory accounts (4%). The firm clears through Penson Financial Services and Bear Stearns Securities Corp. ("Bear Stearns") on a fully disclosed basis.

According to MS & Co.'s annual audited financial statements for the year ended December 31, 2002, the firm had a net income of $231,926. The following is a breakdown of the firm's primary sources of revenue:

Commissions	$4,723,430	59%
Investment Banking	2,852,148	36%

Advisory Fees	191,480	2%
Interest and Dividends	164,872	2%
Net Gain on Marketable Securities	104,153	1%
TOTAL REVENUES	$8,036,083	100%
NET INCOME	***$ 231,926***	

III. EXAMINATION PURPOSE AND SCOPE

The staff's examination of the MS & Co. main office involved a detailed review of several high yield private investment trusts offered to the firm's retail clients. In particular, the staff analyzed the firm's documentation to verify the existence of the private trusts' assets and underlying cash flows. Additional reviews were conducted to ensure that no customer funds or assets were co-mingled amongst the various private investment vehicles. The staff also interviewed key MS & Co. personnel to obtain a full understanding of the private investments' business models.

IV. RISK ASSESSMENT

The staff focused a large amount of resources examining MS & Co.'s formation and sales of private investment trusts, which are comprised of interests in security alarm monitoring contracts. For the past ten years, the private trusts have provided MS & Co.'s clients with a fixed rate of return that is securitized by the cash flows underlying the alarm monitoring contracts. In some instances, the rate of return is as high as 12%. Due to the high yields and MS & Co.'s potential conflict of interests inherent in MS & Co.'s management of the trusts it sells, the staff performed a thorough review of one trust, including a complete analysis of its cash flows, to ensure that the investment was capable of providing consistently high yields.

V. EXAMINATION FINDINGS

A. MS & Co.'s Relationship With Integrated Alarm Services Group, Inc. ("IASG")

IASG is one of the largest wholesale alarm monitoring companies in the United States. Formerly known as Integrated Alarm Services, Inc. ("IAS"), the company purchases the monitoring rights of residential and commercial accounts from independent security alarm dealers. IASG's business model relies upon the synergy between its monitoring contract acquisition, financing programs, and actual alarm monitoring services to reduce operating expenses and attract and maintain new customers. Before going public on July 24, 2003, IAS was originally owned by McGinn, Smith, and Thomas Few.[1]

Over the past 10 years, the majority of McGinn and Smith's brokerage business has focused primarily on the formation of 79 private trusts, which are comprised of purchased alarm contracts. In total, MS & Co. has securitized in excess of $400 million of monitoring contracts. The trusts typically pay MS & Co.'s clients an interest rate of 10% to 12% per year.

[1] As mentioned in an earlier section, McGinn and Smith are the owners of MS & Co.

While MS & Co. is advancing capital to the alarm dealers by purchasing the monitoring contracts, it is simultaneously structuring a note reflective of the cash flow characteristics of the underlying contracts. Subsequently, the firm sells the notes (in the form of a trust) to its customers to effectively match the cost of capital (interest paid to the trust buyer and contract purchase price) with the recurring monthly revenues ("RMR") associated with the monitoring contracts. The difference between the RMR and the cost of capital results in a gross profit to MS & Co. and their affiliates. According to Smith, the firm's profit margins from this investment vehicle range from 20% to 30% over the life of the transaction.

The trusts hold the monitoring contracts, ensuring that the debt is serviced from the monthly cash flows of the contracts. After the full maturation of the trusts, the remaining alarm monitoring contracts became the property of IAS and its affiliates. Twenty-nine of the 79 trusts formed by MS & Co. were contributed to IAS in this manner. IAS also purchased 47 trusts, which had not fully matured.[2] These assets eventually became part of IASG, providing McGinn and Smith with 43% ownership of the company prior to the company's initial public offering ("IPO").

Friedman Billing Ramsey & Company, Inc. ("FBR"), Stifel, Nicolaus & Company, Inc., and Wells Fargo Securities, LLC. led a syndicate of broker-dealers in underwriting IASG's IPO. The public offering raised over $200 million through the sale of 22 million shares of IASG at a price of $9.25 per share.[3] The staff noted that MS & Co. was not listed as a lead underwriter for the IASG public offering despite the fact that McGinn and Smith were the executive officers and part owners of the company. Smith informed the staff that due to underwriter independence rules, MS & Co. was prohibited from acting in a lead underwriter capacity.

B. Pacific Trust 02 ("Pacific Trust")

In an attempt to evaluate MS & Co.'s core business and determine the feasibility of Smith's profitability claims, the staff focused its review on Pacific Trust. According to the PPM, Pacific Trust was structured as a six year "Contract Certificate" bearing a 6% interest rate per year. The commissions paid to MS & Co. were limited to a 10% "underwriting discount." Pacific Trust was authorized to raise a maximum of $1 million with the offering commencing on July 23, 2002.[4] The PPM stated, "the offering period will end no later than six (6) months from the date of this memorandum."

While examining MS & Co.'s New York City branch office, the staff noted that only one RR at the firm sold Pacific Trust, Phillip Rabinovich ("Rabinovich"). In total, MS & Co. raised $457,000 from nine investors for Pacific Trust. Six of the nine investors invested a total of

[2] According to Smith, the remaining three trusts were not purchased due to a variety of factors including; the SAI Trust 03 shareholders refused to negotiate an early call or exchange of the notes, and; the Security Participation Trust and Pacific Trust 02 were both actively raising funds and acquiring monitoring contracts at the time of IAS's audit "cut-off" date.

[3] The majority of the offering's proceeds were used to pay down a portion of the company's debt associated with the acquisition of monitoring contracts.

[4] The offering memorandum was originally dated April 10, 2002. According to Smith it was extended to accommodate an additional investor.

$177,000 after the offering should have been closed.[5] In addition, a review of the branch's commission blotters disclosed that Rabinovich received 27% commissions from his sales of Pacific Trust, far surpassing the "10% underwriting discount" disclosed in the PPM. These conditions, combined with Smith's optimistic profitability claims, concerned the staff and warranted a review of this matter at MS & Co.'s main office.

In a conversation with the staff and a follow-up letter dated October 9, 2003, Smith attempted to explain the causes for the staff's findings. Smith explained that Pacific Trust was a deal that had problems from the very beginning. Rabinovich had introduced Smith to Fserve, Inc. ("Fserve"), a group of foreign salespeople who wanted to market MS & Co.'s trusts to Japanese investors. The group informed Smith that they could raise $20 million for alarm monitoring trusts. Fserve believed that demand for the trusts would be high because Japan's interest rates were so low (between 0% and 3%, according to Smith). Smith and Fserve decided to start their relationship with a relatively small deal, namely Pacific Trust. With respect to MS & Co.'s other trusts, Pacific Trust was assigned a comparatively low interest rate, 6%, because Smith believed that Japanese investors would be skeptical of an overly high interest rate, such as the normal 12%. Since Fserve was selling a trust with a "discounted" interest rate, it received the difference in the scheduled commission. Instead of receiving 10% as prescribed in the PPM, Fserve negotiated a 17.75% commission payout, which was not disclosed to investors.

By the end of 2002, Pacific Trust had raised $230,000 of which, Fserve had raised only $200,000 from two customers. Fserve was paid its negotiated commissions for the sales and the offering proceeds were used to purchase alarm-monitoring contracts. Then, in an apparent misunderstanding, Rabinovich began accepting new subscriptions for Pacific Trust during the summer of 2003, "thus several clients subscribed for the offering with the offering period having already expired." These new funds totaled $227,000.[6] Upon receipt of additional funds, all of MS & Co.'s administrative personnel carried out their respective duties. Thus, according to Smith's letter, "confirmations were prepared, monies accepted and deposited into the escrow account, and interest paid to the subscribers on a timely basis. However, because management was unaware of the subscriptions, neither the funds were invested nor commissions paid to McGinn Smith & Co. from the escrow account."

In an attempt to rectify the situation, MS & Co. offered each of the seven investors who had subscribed after the offering period expired the opportunity to rescind their subscriptions, "with full principal and current plus accrued interest being paid to them." In addition, MS & Co. sent an updated offering memorandum to those clients who had opted not to rescind their investments. In his letter, Smith also pledged to "immediately institute new procedures to prevent an incident such as this from happening in the future."

In his attempt to explain the situation, Smith raised the staff's suspicions by stating that commissions were not paid to MS & Co. from the escrow account. As mentioned previously, the staff noted exorbitant commissions paid to Rabinovich for his sales of Pacific Trust. In addition, Smith essentially informed the staff that Pacific Trust's investors had been paid interest without

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[5] The PPM stated that the offering period would not extend past six months, or January 23, 2003.
[6] Six new clients invested $177,000 after January 23, 2003. An existing client also invested an additional $50,000 after the offering period expired.

the trust having acquired any monitoring contracts that would have created cash flows. Despite MS & Co.'s actions to rectify the situation, the staff was concerned that Pacific Trust, and perhaps the other trusts sold by MS & Co., was a Ponzi scheme.

1. Review of Pacific Trust's Financial Statements

Since Pacific Trust is not registered with the Commission, the staff requested that MS & Co. provide documents on a voluntary basis pursuant to SEC Form 1662. The firm agreed and provided the staff with all of the documents requested. The staff conducted an exhaustive review of Pacific Trust's financials, including the Trust's balance sheet, income statement, bank statements, deposit slips, wire instructions, amortization schedule, internal accounting spreadsheets and collection reports. The staff examined all of Pacific Trust's activities from inception through September 2003.

The staff verified that all of Pacific Trust's investor funds were deposited into Pacific Trust's bank accounts and ensured that investor interest payments were drawn from the same accounts. The staff was able to trace all of Pacific Trust's monthly RMR deposits to the underlying home alarm monitoring contracts and verified that the name (or names) on the customer check matched the signature on the alarm-monitoring contract underlying the trust. The staff also verified that Pacific Trust actually purchased the portfolios of monitoring contracts and that no contracts were transferred from another source to help bolster its financial position. In addition, the staff verified that all of the deposits in Pacific Trust's accounts related to the trust's business and that no funds were transferred in from any other trust.

A review of Pacific Trust's amortization schedule disclosed that the trust is currently generating sufficient cash flows to fund the existing debt to investors through maturity.[7] The staff noted that an inherent risk in Pacific Trust's business model is the possibility of customer attrition and, thus, reduced RMR. Smith informed the staff that IASG had commissioned a study by the public accounting firm PriceWaterhouse Coopers LLC ("PWC") that determined that the average home alarm-monitoring contract has a duration of 11 years. The study also revealed that the majority of customer attrition occurs during the contract's first year. As such, Pacific Trust has an agreement with the alarm-monitoring dealer that requires a substitute for any contract, which fails to perform during the 12-month period following installation. Smith stated that this agreement with the alarm dealers helps keep attrition at a low level. Indeed, the staff observed only one of Pacific Trust's 164 customers was in default.

2. Review of Commission Payments for Selling Pacific Trust

The staff's review did not disclose any commission payments from Pacific Trust to MS & Co. or Rabinovich. Further review disclosed that Rabinovich dealt directly with MS & Co.'s FINOP, Rees, in obtaining his commission payments for his sales of Pacific Trust. Rabinovich sent Rees a copy of the commission schedule that Fserve had negotiated with Smith as justification for his commissions. The schedule provides that Fserve is due 17.75% commissions. In addition, the schedule details commission percentages for Rabinovich, which was 6% to the RR and 3.25% to

[7] Assuming that the cash flows continue during the term of the trust.

the firm. Although the schedule breaks down both commissions as separate and distinct, Rabinovich added the three together to justify a 27% commission, instead of 6%. Rees paid Rabinovich out of the firm's bank account, believing that Smith knew of the subscriptions and would transfer to MS & Co. the commissions receivable.

According to Smith, Pacific Trust did not pay the commissions because he was unaware of the new investments solicited by Rabinovich. He informed the staff that he would rectify Rabinovich's excessive commissions. Smith also stated that he would immediately purchase a portfolio of monitoring contracts to generate cash flows sufficient to pay the interest and principal due to Pacific Trust's new investors. Smith informed the staff that he would "eat" all of the losses sustained by Pacific Trust due to his firm's administrative error.
The staff's review determined that no fraudulent activity had occurred in the offering or operation of Pacific Trust and believed that no further review of MS & Co.'s trusts was warranted. **Redacted**

Since IASG is in the business of financing alarm monitoring contacts, MS & Co. was required to enter a "Non-competition agreement" with the company. Smith informed the staff that he is trying to develop a new business model, in another industry, which would substitute the steady fixed income source that his clients have come to rely upon. Therefore, the staff selected and reviewed two other investment vehicles, which were underwritten by MS & Co. after the firm exited the alarm monitoring industry. The findings are discussed below.

C. Atlantis Strategic Total Return Fund, LLC Private Placement ("ASTRF" or Fund")

A review of the firm's investment banking activity disclosed that MS & Co.'s Vice President of Finance, Casolo, was also designated as the managing member of ASTRF. Casolo informed the staff that ASTRF was created in response to the needs of his clients, most importantly, the need for a fixed income investment vehicle. Casolo informed the staff that investor funds raised through the sale of ASTRF "membership interests," are allocated amongst a combination of dividend income and long-term growth investments. Casolo hopes to provide ASTRF investors with an annual strategic total return of seven to ten percent through this investment vehicle.

The private placement strived to raise up to a maximum of $25,000,000 by issuing shares of ASTRF, packaged as units ($25,000 per unit), on a "best efforts" basis. According to the January 2003 PPM, members may not withdraw from the Fund or make a demand for paid-in-capital until the end of the second year. Moreover, withdrawal requests after the second year can only be made on a semi-annual basis or at the time of ASTRF's termination. According to the subscription agreements Casolo and MS & Co. provided to the staff, ASTRF had raised approximately $1.5 million from 36 investors as of September 2003. ASTRF claimed an

exemption from registration pursuant the Securities Act of 1933 and Rule 506 of Regulation D promulgated thereunder.[8]

The staff's analysis verified that all of the $1.5 million ASTRF investment funds were deposited into the designated ASTRF escrow account. In addition, subsequent staff reviews verified the destination of all wires/transfers executed between the ASTRF related brokerage and bank accounts.[9] The staff also traced all reported ASTRF assets to third party supporting documentation to verify their existence.

The staff's subsequent analysis and research, however, raised concerns as to Casolo's existing business relationships with CCIG.[10] Casolo's allocation of ASTRF funds disclosed possible conflicts of interest and breaches of fiduciary duty that could have a detrimental effect on ASTRF investors. These conflicts of interest and their effects are discussed below:

1. Casolo's Failure To Adequately Allocate ASTRF Investor Funds

According to the ASTRF PPM, investor monies are to be allocated amongst a limited number of assets and ASTRF should be viewed as a non-diversified investment. Despite ASTRF's concentrated investment strategy, however, the PPM also states that the Fund may only invest up to fifty percent of its committed capital in a single portfolio company.[11] A review of the ASTRF balance sheet as of September 30, 2003 revealed total assets of $1,496,377 segregated as follows: $130,290 "Cash", $150,087 "Bear Stearns Investment", and $1,216,000 "Investment."

After several revisions, Rees provided the staff with the final ASTRF schedule for the $1,216,000 "Investment" denoted on the September 30, 2003 balance sheet. The most recent revised "Investment" schedule disclosed that $1,242,000, not the originally disclosed $1,216,000 of ASTRF monies, had actually been invested in the following: $600,000 IAS one year (9%) note, $45,000 IAS two year (10%) note, $126,000 IAS five year (12%) note, $451,000 CCIG five year (12%) note, and a $20,000 Security Participation Trust ("SPT") note.[12] Therefore, the revised "Investment" allocation revealed an additional $26,000 of committed capital than previously disclosed on ASTRF's September 30, 2003 balance sheet. Based on this asset allocation, the committed capital amongst all ASTRF investments, including the Bear Stearns' investment, actually totaled $1,392,087.[13] Further staff analysis disclosed that of the $1,392,087 in ASTRF committed capital, $771,000 (55%) was concentrated in IAS investments. This allocation of committed ASTRF monies in IAS is five percent in excess of what the PPM allows

[8] ASTRF filed a Form D with the Commission on January 29, 2003.

[9] Redacted

[10] Casolo is the Chairman of CCIG. For further information pertaining to CCIG, Redacted

[11] ASTRF PPM page 17. "Concentration of Investments."

[12] Casolo informed the staff that the SPT investment was purchased by ASTRF from a client because the client needed the money for a wedding. The due date of the SPT note was November 1, 2003. Like Pacific Trust, SPT is a private trust securitized by the RMR derived from alarm monitoring contracts.

[13] This amount does not include the $130,290 ASTRF Investor monies designated as "Cash"

for committed capital and appears to be contrary to the disclosures made to ASTRF investors in the PPM.

Further analysis of ASTRF's assets disclosed that the Fund purchased both the SPT $20,000 investment and $120,000 of the IAS five year 12% note from clients of Casolo. A review of these private investments disclosed that they would be difficult to liquidate under normal circumstances because there is little or no market for them. However, it appears that ASTRF was created to provide a market for which these otherwise illiquid private investments could be bought and sold among Casolo's clients. For example, ASTRF purchased $120,000 worth of the IAS five-year note from JAT Construction ("JAT"), a retail customer of the firm. Ironically, JAT is also an ASTRF investor, which means that JAT sold a portion of the IAS five-year note to itself.

As mentioned previously, $451,000 (32%) of ASTRF's committed capital was invested in CCIG five-year (12%) notes. CCIG filed a Form D on March 24, 2003 in an effort to raise $5.5 million through the sale of five-year (12%) interest bearing notes. According to the PPM dated February 15, 2003, CCIG had attempted to raise a minimum of $500,000/maximum $5.5 million in capital.[14] According to documentation Casolo voluntarily provided to the staff, only $50,000 had been raised during the offering period, thus, the CCIG note offering never broke escrow.[15] However, Casolo subsequently filed an amended Form D on October 14, 2003, which indicated an attempt to raise a new minimum of $450,000/maximum $10 million. The amended Form D disclosed that as of October 14, 2003, $490,150 worth of the CCIG five-year notes had already been sold. Staff research disclosed that between August 28, 2003 and September 23, 2003, ASTRF purchased $451,000 worth of the CCIG five-year notes. Therefore, ASTRF investor funds were utilized by Casolo to provide CCIG's five-year note offering with 100% of the minimum capital requirement needed to break escrow.

Lastly, it should be noted that Rees had to provide the staff with several revisions of ASTRF's "Investment" schedule as of September 30, 2003. The staff found the overall maintenance of ASTRF's books and records to be lax and determined that an audit trail this deficient could compromise the adequacy in which the unregistered fund is managed.

Redacted

In addition, Casolo appears to have utilized a portion of the ASTRF's invested monies to meet the minimum escrow requirement for the CCI Group, Inc. private placement debt offering. Lastly, Casolo's position as Chairman of CCIG presents a conflict of interest as illustrated by the use of ASTRF investor monies.

2. Casolo's Breach Of Fiduciary Duty

[14] The PPM stated that the Offering would terminate on August 15, 2003.

[15] Investor Brett Vandry purchased $50,000 worth of the CCIG five-year notes on April 11, 2003.

Further review of the ASTRF PPM disclosed that ASTRF investors are subject to several fees, all of which are payable to Casolo, the managing member, and MS & Co., the management company, for services rendered. Casolo acknowledged that ASTRF investors are subject to three separate fees that are split 60/40 between Casolo and MS & Co., respectively. According to the ASTRF PPM, these fees consist of the following: a two percent gross commission fee received on the gross amount invested in the Fund, a two percent management fee payable on the first day of each quarter based on the net asset value of the Fund, and a twenty percent management interest/dividend entitlement fee on any proceeds paid out to ASTRF investors.

Based upon the fee structure, the staff asked Casolo why clients would not invest directly in the CCIG and IAS notes to avoid such fees. Casolo stated that he has developed a relationship with his clients over the years and that, "there is no difference to the clients." However, the staff's analysis disclosed that 15 of the 36 ASTRF investors (42%) had also invested directly in the CCIG five-year (12%) note or the IAS two-year (10%) note. Based upon the fees associated with ASTRF and the non-diversified nature of the Fund, the staff noted that it would have been in an ASTRF investor's best interest to have invested in these fixed income vehicles directly, rather than indirectly through ASTRF. The supposed protection against losses that investors actually realize through ASTRF's limited diversification of committed capital is not commensurate with the excessive fees imposed on the investors. The following illustrates the impact the aforementioned fees have on the overall profitability of the Fund:

> The staff conducted an analysis to calculate the annual return and fees assessed on ASTRF's original $1,216,000 "Investment" asset allocation in CCIG and IAS fixed income notes.[16] The staff utilized ASTRF's original "Investment" asset allocation as of September 30, 2003 as a model and distributed the committed capital in accordance with the previously noted Fund allocations. A projection of the ASTRF "Investment's" future cash flows through September 2004 revealed that the Fund would generate approximately $126,900. However, quarterly management fees of $2,538, coupled with management interest/dividend entitlement fees of $24,872, would result in ASTRF realizing a net profit of $99,490 (8%) over the time period.
>
> In comparison, if the same pool of ASTRF clients invested directly in CCIG and IAS fixed income notes using the same asset allocation, the realized net profit would be greater. Since client's investing directly in CCIG and IAS notes are not subject to the fees outlined in ASTRF's PPM, the total funds available for CCIG and IAS note allocation is $1,239,800.[17] The same future cash flow analysis revealed that the pool of investors would have realized a net profit of $129,560, (10.5%) approximately $30,000 (2.5%) more than those who invested indirectly through ASTRF.

[16] Staff analysis was performed prior to the receipt of the revised ASTRF "Investment" allocation as of September 30, 2003. However, the original intent of this example was to demonstrate the additional fees ASTRF investors are subject to when not investing directly. While the example was modeled after ASTRF's original September 30, 2003 balance sheet, this analysis was utilized for demonstration purposes only.

[17] Clients investing directly in CCIG and IAS notes would not be assessed the gross commission, quarterly management, and interest/dividend entitlement fees.

Furthermore, since 87 percent of ASTRF's total committed capital has been allocated between two companies in which either Casolo or MS & Co. has a vested interest, it appears that ASTRF exists to infuse additional capital into CCIG and IAS when needed. It is unknown whether current ASTRF investors who also invested directly in CCIG or IAS notes are aware of the ASTRF asset allocations. If not, this would be a material fact that was omitted from investors, which may constitute a violation of the antifraud provisions of the federal securities laws.

D. First Independent Income Notes, LLC

The review of MS & Co.'s investment banking activity also disclosed that the firm played an active role in the private placement offering of First Independent Income Notes, LLC ("FIIN"), a newly formed New York company that became established in September 2003. According to the FIIN PPM dated September 15, 2003, FIIN planned to raise up to $20,000,000 through the issuance of 5% secured senior notes due 2004, 7.5% secured senior subordinated notes due 2008, and 10.25% secured junior notes due 2008.[18] Furthermore, the PPM disclosed Smith as FIIN's executive officer and indicated that MS & Co. provided both promoter and placement agent services for the offering. FIIN claimed an exemption from registration pursuant to the Securities Act of 1933 and Rule 506 of Regulation D promulgated thereunder.

As of October 31, 2003, FIIN raised a total of $12,714,000 through the following: $7,466,000 (59%) from sixty-nine 10.25% tranche investors,[19] $4,441,000 (35%) from fifty-one 5% tranche investors, and $807,000 (6%) raised from seventeen 7.5% tranche investors. Interviews with Smith disclosed that FIIN was formed to identify and acquire various public and/or private investments. Moreover, Smith stated that the FIIN notes are secured by the investments that FIIN may acquire and that the profitability of FIIN is largely determined by the spread between the effective rate FIIN pays on acquired investments and the full rate of return received on such investments.[20] The staff's analysis disclosed that FIIN subsequently purchased four investments during October 2003:

Date(s) Purchased	Investment	Amount
October 2, 2003	Dekania CDO I, Ltd. Floating Rate Note. Matures 2034.	$2 Million
October 8, 2003	Aquatic Development Group, Inc. 12% Promissory Note. Matured November 8, 2003.	$250,000
October 14, 2003 through October 20, 2003	Maracay Homes Arizona I, LLC. ("Maracay") 14% Senior Subordinated Debenture. Matures 2010.	$5 Million

[18] Upon the maturity of the 5% secured senior notes due 2004, FIIN may continue to issue additional senior notes with a one-year maturity date up until 2007.
[19] Note that several subscribers appear to have related accounts and invest in more than one tranche.
[20] The staff verified that all incoming wires to FIIN were from subscribers and that all outgoing wires were legitimate, including legal expenses, underwriting fees, and investments.

October 20, 2003 through October 30, 2003	InCapS Funding I, Ltd. (“InCapS”) 16% Subordinated Income Note. Matures 2033.	$3 Million

The staff’s research revealed that reputable financial institutions, which included Sandler O’Neill & Partners, L.P., Friedman, Billings, Ramsey & Co. Inc., and Merrill Lynch International, underwrote the aforementioned investments purchased by FIIN. According to the FIIN PPM, FIIN investors are scheduled to receive their first quarterly interest payments commencing January 15, 2004.

E. Capital Center Credit Corporation (“C4”)

The staff’s review of FIIN wire transactions disclosed that FIIN purchased both the Maracay and InCapS investments from an entity identified as C4. According to Smith, C4 is an entity owned by himself and McGinn that is utilized as a “swamp account,” or otherwise as an unregistered proprietary account. Smith explained that C4 was created to receive customer funds, purchase investments, warehouse investments, issue short-term commercial paper, and engage in loan transactions. According to Smith, during a meeting with officials from the NASD District 11, Boston Office, several years ago, he was advised that he would either have to create a separate entity in order to provide liquidity for MS & Co. clients who invested in the firm’s private placement deals, or he would have to increase the firm’s minimum net capital requirement to $250,000. Smith chose to create a separate entity in order to continue to engage in this type of activity and circumvent the $250,000 minimum net capital requirement for the firm.[21] Subsequent examinations performed by the NASD staff failed to identify the business operations of this entity as being that of an unregistered broker-dealer.

Smith explained that it has become increasingly difficult to find viable investments for his clients. Often times, when the opportunity to purchase such an investment presents itself, the required investor capital needed to participate in a deal may be deficient. To alleviate this deficiency, C4 purchases investments and warehouses them until the pertinent investor fund has raised sufficient investor capital. Once the investor capital threshold has been raised for a fund, the fund purchases these otherwise foregone investments from C4.

Smith explained that C4 obtains its purchasing capital from a private group of investors, one of whom is Lynne Smith, Smith’s wife. In return for the borrowed capital, C4 issues the lenders short-term commercial paper for an agreed upon duration at a specified interest rate. In the case of FIIN, C4 utilized the borrowed capital to purchase and warehouse Maracay and InCapS notes, with the sole-intention of later selling these investments to FIIN.[22] Once FIIN raised sufficient investor capital, the FIIN purchased these investments directly from C4. C4 subsequently used the monies received from the sale of these investments to pay the outstanding principal and

[21] MS & Co.’s current net capital requirement is $100,000. If MS & Co. financials encompassed C4’s business activity, most notably the receipt and holding of customer securities and monies, MS & Co.’s net capital requirement would need to increase to $250,000.

[22] C4 purchased the Maracay and InCapS investments on August 18, 2003 and September 1, 2003, respectively.

interest on the issued short-term commercial paper.

As discussed previously, the staff's analysis disclosed that ASTRF also purchased assets from C4 in 2003.[23] To further illustrate C4's business function relating to this transaction, Rees informed the staff that C4 acted as an intermediary in the sale of $120,000 worth of the IAS five-year note from JAT, a retail customer account of MS & Co., to ASTRF. Documentation provided by Rees verified that JAT sold $120,000 of the IAS five-year note to C4 on April 1, 2003. A subsequent review of C4's bank statements revealed the receipt of $120,000 from ASTRF related accounts on April 2, 2003, which was subsequently wired to JAT's Bear Stearn's account for payment on April 3, 2003.[24] The investments purchased by FIIN and ASTRF from C4, were done at par, and the staff verified that the two funds, namely FIIN and ASTRF, were not charged any markups by C4 on these transactions.[25]

Based upon the staff's understanding and review of C4's business activities, it appears that C4 is operating in the capacity of an unregistered broker-dealer. The staff disclosed its findings to Smith and informed him that C4 either needs to be registered as a broker-dealer, or that the financials of C4 need to be encompassed in MS & Co.'s books and records which would effectively increase MS & Co.'s net capital requirement to $250,000. As a result of the aforementioned, MS & Co. and Smith, through C4, violated **Section 15(a) of the Exchange Act** by operating an unregistered broker-dealer.

In addition, the staff believes that the NASD erred in its advice given to the firm to create a separate entity solely to circumvent the $250,000 net capital requirement. The staff will discuss this issue with the NASD District 11 at the annual oversight meeting.

F. Mutual Fund Late Trading

Redacted Late trading refers to the practice of placing orders to buy and sell mutual fund shares after the 4 p.m. market close, but at that same day's net asset value ("NAV"), which had been set prior to the market close. Late trading capability allows certain customers to gain an unfair advantage, as they could profit from knowledge of market moving events that occur after 4 p.m., but are not yet reflected in the stale NAV. This occurs at the expense of long-term mutual fund shareholders.

The staff was asked to review the data and determine whether MS & Co. or a customer of the firm was abusing Bear Stearns' trading systems to execute late mutual fund trades and capitalize on news and price movements which occurred after the market closed. The staff reviewed 198 mutual fund transactions that were entered into Bear Stearns' systems after 4 p.m. during the

[23] FIIN purchased $5 million of Maracay and $2 million InCaps. ASTRF purchased $120,000 worth of IAS 5 year notes.
[24] JAT Bear Stearn's account **Redacted** indicates $120,000 receipt on April 3, 2003.
[25] However, the staff noted that C4 retained approximately $200,000 of accrued interest from the Maracay and InCapS positions.

period between January 1, 2001 and August 30, 2003. The staff observed that the trades were all executed on behalf of MS & Co.'s retail customers and none of the transactions appear to have been executed on behalf of the firm and/or its employees. Furthermore, the overwhelming majority of the transactions appear to be immaterial as only two were executed for amounts exceeding $30,000.[26] The staff did not observe any pattern of abusive sales activities.

G. Failure To Preserve Electronic Correspondence

The staff reviewed all e-mails sent, received, and deleted that were maintained on the registrant's e-mail server, back-up tape, and employee desktops for the time period September 2002 through December 2003 for ten employees.[27] Interviews with Maughs disclosed that the firm's e-mail server and back-up tape does not capture all e-mails and that many emails have not been preserved due to a "glitch in the system" and "bad feeds". Therefore, MS & Co. violated **Rule 17a-4(b)(4)** and **NASD Conduct Rule 3110** by failing to preserve for a period of three years, and/or preserve in an accessible place for two years, electronic communications relating to the business of the firm. Moreover, MS & Co.'s inadequate controls and procedures with regards to this matter were further exemplified by Smith's statement to the staff that Maughs failed to inform him of the situation. Therefore, MS & Co. also violated **NASD Conduct Rule 3010** by failing to establish, maintain, and enforce a supervisory system to assure compliance with NASD rules relating to retention of electronic communications.

H. Review of Complaints, Litigations, and Arbitrations

In order to determine the effectiveness of the registrant's compliance and supervisory system, the staff reviewed all complaint, arbitration, and litigation files maintained by MS & Co. for the period January 2000 through December 2003. The staff thoroughly examined the aforementioned files to identify the nature of the allegations, parties involved, settlements agreed upon, and to determine whether the files disclose a firm-wide pattern of sales practice abuses.

The staff's examination included a review of 12 files, of which five (42%) files involved arbitrations, four (33%) files involved litigations, and three (25%) files involved complaints. The nature of the allegations included misrepresentation, unsuitability, unauthorized trading, churning, and negligence. The staff's analysis disclosed that MS & Co. failed to establish complaint files for two complaints noted in the registrant's correspondence file. After reviewing the firm's incoming and outgoing correspondence file, the staff noted that two clients of MS & Co. filed complaints. However, the firm failed to establish and maintain separate complaint files for these individuals thereby violating **NASD Conduct Rule 3010(b)**. When the staff questioned Smith regarding the firm's failure to maintain separate complaint files, Smith explained that most documentation is maintained in individual customer files and not in the complaint, arbitration, litigation, or correspondence files. It should also be noted that, in 2002, MS & Co. was cited by the NASD for failing to report customer complaints in a timely manner, in violation of **NASD Conduct Rule 3070**.

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[26] Only 35 transactions exceeded $10,000, two of which involved trades of $75,000 and $79,321.

[27] The staff reviewed e-mails sent, received, and deleted by Smith, McGinn, Casolo, Teekachand Tiwari, Carlton Fletcher, Gregory Gatto, Bernardo Misseri, David Orsolino, John Thies, and Rabinovich.

I. Failure to Maintain Accurate Books and Records and a Purchase and Sales Blotter

During the course of the staff's examination of MS & Co., several requests for a listing of all private placements/deals were submitted. However, each written response provided to the staff was either inaccurate or incomplete. When this matter was brought to Smith's attention, Smith stated that MS & Co. has not had an adequate system in place for the past two years to track all underwritings and offerings. Moreover, it became evident to the staff that the registrant, in many cases, does not know the identity of the participating clients in each of the specific underwritings and offerings. Furthermore evident financial record keeping deficiencies were magnified during the staff's reviews of the ASTRF and FIIN investment documentation.

Finally, the staff requested the firm's purchase and sales blotters from August 2003 through December 2003. Smith explained that the firm does not maintain a daily purchase and sales blotter. Hence, the MS & Co. violated **Rule 17a-3(a)(1)** by failing to make and keep current blotters containing an itemized daily record of all purchases and sales of securities.

VI. NASD Oversight Comments

The NASD District 11 completed its most recent routine examination of MS & Co. on July 11, 2002. The examination uncovered violations of the NASD's books and records rules and violations of the firm's written supervisory procedures, which included the following:

- **NASD Conduct Rule 1120(a)** Continuing Education Requirements was violated in that MS & Co. failed to prevent five inactive registered persons from engaging in securities activities and receiving compensation.
- **NASD Conduct Rule 3010(b)** was violated in that the firm failed to prepare and maintain adequate written supervisory procedures pertaining to its internal controls.
- **NASD Conduct Rule 3011** was violated in that the firm failed to prepare and maintain adequate procedures as they apply to the Anti-Money Laundering Compliance Program.
- **NASD Conduct Rule 3070(c)** was violated in that the firm failed to report its quarterly customer complaint summary in a timely manner.
- **NASD Rule 6953** was violated in that the firm failed to evidence the synchronization of its business clocks.
- **MSRB Rule G-14** was violated in that the firm failed to report two of three eligible municipal customer transactions.
- **Rule 17a-3** was violated in that the firm failed to accurately compute net capital as of May 31, 2002, and failed to maintain an accurate general ledger, trial balance, and FOCUS Report.

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VII. CONCLUSION

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VIII. SUPERVISORY REVIEW AND APPROVAL

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