

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

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SECURITIES AND EXCHANGE COMMISSION

Plaintiff,

vs.

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

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

Defendants,

LYNN A. SMITH and
NANCY McGINN,

Relief Defendants. and

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

Intervenor.
-----X

**NOTICE OF THIRD MOTION OF WILLIAM J. BROWN, AS RECEIVER,
FOR AN ORDER DISALLOWING CERTAIN CLAIMS
(BROKER CLAIMS)**

PLEASE TAKE NOTICE that upon the Motion of William J. Brown, as Receiver, for an Order disallowing certain claims of former McGinn Smith & Co., Inc. brokers and related parties (“Motion”), Phillips Lytle LLP will move before the Hon. Christian F. Hummel, United States Magistrate Judge, United States District Court for the Northern District of New York, James T. Foley - U.S. Courthouse, 445 Broadway, Albany,

New York 12207-2924, on April 19, 2018 at 9:30 a.m., seeking an Order to be entered approving the Motion.

PLEASE TAKE FURTHER NOTICE that objections, if any, to the relief requested in the Motion must be made in writing, and should be filed and served upon the undersigned at the address listed below in accordance with the Federal Rules of Civil Procedure and the Local Rules for the United States District Court for the Northern District of New York.

PLEASE TAKE FURTHER NOTICE that if no responses are timely filed and served with respect to the Motion or any claim listed in Exhibits A through C to the Motion, the Court may enter an Order granting the Motion and disallowing any claim without further notice or opportunity to be heard offered to any party.

Dated: March 19, 2018

PHILLIPS LYTTLE LLP

By /s/ Catherine N. Eisenhut
William J. Brown (Bar Roll #601330)
Catherine N. Eisenhut (Bar Roll #520849)
Attorneys for Receiver
Omni Plaza
30 South Pearl Street
Albany, New York 12207
Telephone No. (518) 472-1224

and

One Canalside
125 Main Street
Buffalo, New York 14203
Telephone No.: (716) 847-8400

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

Defendants,

LYNN A. SMITH and
NANCY MCGINN,

Relief Defendants. and

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

Intervenor.
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**THIRD MOTION OF WILLIAM J. BROWN, AS RECEIVER,
FOR AN ORDER DISALLOWING CERTAIN CLAIMS
(BROKER CLAIMS)**

William J. Brown, as Receiver (“Receiver”), by his counsel, Phillips Lytle LLP,
moves (the “Motion”) for an order disallowing or equitably subordinating certain Broker
Claims (as defined in the accompanying Declaration), and respectfully represents as follows:

The Receiver files the Motion to request entry of an Order disallowing or, in the alternative, equitably subordinating the Broker Claims listed on Exhibit A to this Motion based on the accompanying Memorandum of Law and Declaration of William J. Brown, as Receiver (“Declaration”), each dated March 19, 2018.

RELIEF REQUESTED

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

Dated: March 19, 2018

PHILLIPS LYTTLE LLP

By /s/ Catherine N. Eisenhut
William J. Brown (Bar Roll #601330)
Catherine N. Eisenhut (Bar Roll #520849)
Attorneys for Receiver
Omni Plaza
30 South Pearl Street
Albany, New York 12207
Telephone No. (518) 472-1224

and

One Canalside
125 Main Street
Buffalo, New York 14203
Telephone No.: (716) 847-8400

Doc #01-3106321.2

Exhibit A

EXHIBIT A**Broker Claims**

Investor Name	Claim Number	Description of Investment	Amount of Claim
Chiappone, Frank	4451D	TAIN Secured Junior Notes Due 12/15/2009	\$ 50,000.00
Chiappone, Frank H.	Paper claim - duplicative of Claim #4451D	Third Albany Income Notes	\$ 50,000.00
Lex, Kathleen	5547D	FAIN Secured Senior Subordinated Notes	\$100,000.00
Lex, Kathleen	Paper claim - duplicative of Claim #5547D	FAIN Secured Senior Subordinated Notes	\$100,000.00
Lex, Kathleen	5549D	TAIN Secured Senior Notes	\$ 9,093.29
Lex, Kathleen	Paper claim - duplicative of Claim #5549D	TAIN Secured Senior Notes	\$ 9,093.29
Lex, Kathleen	5550D	TAIN Secured Senior Notes	\$ 4,546.64
Lex, Kathleen	Paper claim - duplicative of Claim #5550D	TAIN Secured Senior Notes	\$ 4,546.64
Lex, Kathleen	5551D	TAIN Secured Senior Notes	\$113,666.07
Lex, Kathleen	Paper claim - duplicative of Claim #5551D	TAIN Secured Senior Notes	\$113,666.07
Lex, Kimellen & William	5552D	FIIN Secured Senior Notes	\$ 22,733.21
Lex, William 401K	5563D	Firstline Trust 07 9.25% Senior Contract Certificates Due 09/01/10	\$ 55,302.25
Lex, William F. 401K	Paper claim - duplicative of Claim #5563D	Firstline Trust 07 9.25% Senior Contract Certificates Due 09/01/10	\$ 55,302.25
Lex, William 401K	5564D	TDM Verifier Trust 07R Contract Certificates	\$ 10,000.00

Lex, William F. 401K	Paper claim - duplicative of Claim #5564D	TDM Verifier Trust 07R Contract Certificates	\$ 10,000.00
Lex, William 401K	5565D	TDM Verifier Trust 07R Contract Certificates	\$ 10,000.00
Lex, William F. 401K	Paper claim - duplicative of Claim #5565D	TDM Verifier Trust 07R Contract Certificates	\$ 10,000.00
Lex, William 401K	5566D	TDM Verifier Trust 09 10% Contract Certificates Due 12/31/11	\$ 4,511.88
Lex, William F. 401K	Paper claim - duplicative of Claim #5566D	TDM Verifier Trust 09 10% Contract Certificates Due 12/31/11	\$ 4,511.88
Lex, William F. & Kathleen C.	5553D (paper claim)	McGinn, Smith Firstline Funding, LLC	\$125,000.00
Lex, William F. & Kathleen C.	5554D	FIIN Secured Senior Notes	\$ 9,093.29
Lex, Kathleen C.	Paper claim - duplicative of Claim #5554D	FIIN Secured Senior Notes	\$ 9,093.29
Lex, William F. & Kathleen C.	5555D	FIIN Secured Senior Notes	\$150,039.22
Lex, Kathleen C.	Paper claim - duplicative of Claim #5555D	FIIN Secured Senior Notes	\$150,039.22
Rabinovich, Philip	6124D	TDM Verifier Trust 11 Contract Certificates 9%	\$ 23,849.63
Rabinovich, Philip	Paper claim - duplicative of Claim #6124D	TDM Verifier Trust 11	\$ 25,000.00

Doc #01-3106369.1

Exhibit B

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

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SECURITIES AND EXCHANGE COMMISSION

Plaintiff,

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Case No. 1:10-CV-457
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McGINN, SMITH & CO., INC.,
McGINN, SMITH ADVISORS, LLC
McGINN, SMITH CAPITAL HOLDINGS CORP.,
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FIRST EXCELSIOR INCOME NOTES, LLC,
FIRST INDEPENDENT INCOME NOTES, LLC,
THIRD ALBANY INCOME NOTES, LLC,
TIMOTHY M. McGINN, AND
DAVID L. SMITH, GEOFFREY R. SMITH,
Individually and as Trustee of the David L. and
Lynn A. Smith Irrevocable Trust U/A 8/04/04,
LAUREN T. SMITH, and NANCY McGINN,

Defendants,

LYNN A. SMITH and
NANCY McGINN,

Relief Defendants. and

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

Intervenor.
-----X

**ORDER APPROVING THIRD MOTION OF WILLIAM J. BROWN, AS
RECEIVER, FOR AN ORDER DISALLOWING CERTAIN CLAIMS
(BROKER CLAIMS)**

Upon the Third Motion of William J. Brown, as Receiver, for an Order
Disallowing Certain Claims (Broker Claims); and notice of the Motion having been given to
the Securities and Exchange Commission, each Broker listed on Exhibit A to the Motion,
Kathleen Lex, and Kimellen Lex, by first class mail, and all parties who have filed a Notice
of Appearance in this action by ECF, and all creditors of the McGinn, Smith entities and

other parties in interest via the Receiver's website, which notice is deemed good and sufficient notice; and the Court having deemed that sufficient cause exists; it is therefore

ORDERED, that the Motion is approved, and it is further

ORDERED, that each of the Broker Claims listed on Exhibit A to the Motion is disallowed; and the rights of the Receiver to object on any other basis to the claims of all investors or claimants is expressly preserved.

Dated: April ____, 2018

HON. CHRISTIAN F. HUMMEL

Doc #01-3106322.3

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

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SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

vs.

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

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

Defendants,

LYNN A. SMITH and
NANCY McGINN,

Relief Defendants,

- and -

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

Intervenor.

-----X
**DECLARATION OF WILLIAM J. BROWN, AS RECEIVER, IN SUPPORT OF
THIRD MOTION FOR AN ORDER DISALLOWING CERTAIN CLAIMS
(BROKER CLAIMS)**

William J. Brown, as Receiver, declares, under the penalty of perjury, pursuant to 28
U.S.C. § 1746, as follows:

1. I am the Receiver of McGinn, Smith & Co. Inc., et al. (“MS & Co.”) appointed by the Court in this action pursuant to the Preliminary Injunction Order dated July 26, 2010 (Docket No. 96).

2. I make this Declaration in support of the Receiver’s Motion (“Motion”) for an Order disallowing or equitably subordinating the claims of certain Brokers (as defined below).

3. Attached as Exhibit A to this Declaration is the Order Instituting Administrative and Cease-and-Desist Proceedings (“OIP”) issued by the Securities and Exchange Commission (“SEC”) as to certain registered representatives who sold MS & Co. private placements. *Donald. J. Anthony, Jr., et al.*, Order Instituting Proceedings Release No. 33-9454 (Sept. 23, 2013), 107 SEC Docket 5.

4. Attached as Exhibit B to this Declaration is the Chief Administrative Law Judge’s Initial Decision with respect to the OIP. *Donald. J. Anthony, Jr., et al.*, Initial Decision Release No. 745 (Feb. 25, 2015), 110 SEC Docket 19, *modified by* Order on Motions to Correct Manifest Errors of Fact in the Initial Decision, Administrative Proceedings Release No. 2528 (Apr. 9, 2015), 11 SEC Docket 5

PROCEDURAL BACKGROUND

5. MS & Co. was a broker-dealer registered with the Securities and Exchange Commission (“SEC”) with its headquarters in Albany, New York from 1981 to 2009. From 2003 through 2010, the broker-dealer was owned by David L. Smith (“Smith”), Timothy M. McGinn (“McGinn”), and Thomas E. Livingston.

6. On April 20, 2010, the Securities and Exchange Commission (“SEC”) filed a Complaint initiating the above-captioned action (Docket No. 1). Also, on April 20,

2010, this Court granted a Temporary Restraining Order (Docket No. 5), which, among other things, froze certain assets of the above-captioned Defendants and Relief Defendants, and appointed the Receiver as temporary receiver with respect to numerous entities controlled or owned by Defendants Timothy M. McGinn and David L. Smith including those listed on Exhibit A to the Preliminary Injunction Order entered in this action (Docket No. 96) (collectively, the “MS Entities”). At the time of the Receiver’s appointment, total bank account balances (not including some remote business operations whose bank accounts were not immediately visible to the Receiver’s staff) were \$485,491.63. (Docket No. 49 at 6).

7. On July 26, 2010, following a hearing, the Court entered an order granting the SEC’s Motion for a Preliminary Injunction and appointing the Receiver as receiver, pending a final disposition of the action (“Preliminary Injunction Order”) (Docket No. 96).

8. On August 3, 2010, the SEC filed an Amended Complaint (Docket No. 100). On June 8, 2011, the SEC filed a Second Amended Complaint (the “Complaint”) (Docket No. 334). On February 17, 2015, the Court issued its Memorandum-Decision and Order (Docket No. 807) (“MDO”) granting the SEC’s motion for summary judgment. The Court entered judgments in favor of the SEC in 2016 (Docket Nos. 835, 836, 837).

BROKER PROCEEDINGS

9. On September 23, 2013, the SEC issued the OIP as to certain registered representatives who sold MS & Co. private placements in the Four Funds and the Trust Offerings. *Donald J. Anthony, Jr., et al.*, Order Instituting Proceedings Release No. 33-9454 (Sept. 23, 2013), 107 SEC Docket 5. Among those registered representatives named in

the OIP were Frank H. Chiappone (“Chiappone”), William F. Lex (“Lex”), and Philip S. Rabinovich (“Rabinovich” and collectively with Chiappone and Lex, the “Brokers”). The SEC alleged that the Brokers violated the securities laws by knowingly or recklessly recommending MS & Co. unregistered offerings to clients with no reasonable basis for the recommendation and knowing of red flags, and misrepresenting and omitting material information. OIP at 5. The SEC did not allege that the Brokers had actual knowledge of the fraud.

10. On February 25, 2015, the ALJ entered the Initial Decision finding that each of the Brokers willfully violated the Securities Act, the Exchange Act and Rule 10b-5 through their sales of private placements in the Four Funds and the Trust Offerings. *Donald J. Anthony, Jr., et al.*, Initial Decision Release No. 745 (Feb. 25, 2015), 110 SEC Docket 19, *modified by* Order on Motions to Correct Manifest Errors of Fact in the Initial Decision, Administrative Proceedings Release No. 2528 (Apr. 9, 2015), 11 SEC Docket 5. The Brokers petitioned the SEC for review of the ALJ’s Initial Decision and, on May 21, 2015, the SEC granted the Brokers’ petitions. *Frank Chiappone, et al.*, Order Granting Petitions for Review and Scheduling Briefs Release No. 33-9790 (May 21, 2015), 111 SEC Docket 11. On August 15, 2017, oral argument on the Brokers’ appeals was held before the SEC. *Frank Chiappone, et al.*, Order Scheduling Oral Argument Release No. 33-10382 (Jun. 30, 2017), 117 SEC Docket 1. The SEC has not yet ruled on the Broker’s appeals.

CLAIMS OBJECTION MOTIONS

11. On September 21, 2017, in my capacity as Receiver, I filed a Motion (Docket No. 937) (“First Claims Motion”) to seek disallowance of certain filed paper claims that were duplicative of the corresponding claims granted by the Receiver. On November 9,

2017, I filed a Statement (Docket No. 957) in furtherance of the First Claims Motion, adjourning the First Claims Motion with respect to those duplicative investor paper claims filed by investors whose Receiver-granted claims have been disputed by the Receiver. On December 28, 2017, the Court entered an Order granting the First Claims Motion and disallowing the duplicative paper claims other than with respect to those filed by investors with disputed claims (Docket No. 966).

12. On February 15, 2018, in my capacity as Receiver, I filed a Motion (Docket No. 974) (“Second Claims Motion”) to seek disallowance of certain filed paper claims for which there is no basis for payment in the books and records of MS & Co. The return date of the Second Claims Motion is April 19, 2018.

BROKER CLAIMS

13. Each of the Brokers and, in the case of Lex, his wife-transferee, hold disputed claims against certain of the MS Entities and, as required by the Court-approved claims procedures, have filed duplicative paper claims on account of their investments as required by the Court-approved claims procedure, as well as paper claims for amounts in excess of their disputed claims or for investments for which there is no record in the books and records of MS & Co. (collectively, the “Broker Claims”). The Broker Claims are listed in detail on Exhibit A to the Motion. Altogether, there are fourteen Broker Claims (exclusive of the duplicate paper claims).

14. Among the Broker Claims listed on Exhibit A are certain claims belonging to Kathleen C. Lex, who, upon information and belief, is the wife of Lex. Ms. Lex holds four claims, three on account of investments made in TAIN and one on account of an investment in FAIN. Copies of the original investment registers for the FAIN Secured

Senior Subordinated Notes and the TAIN Secured Senior Notes, which were excel spreadsheets maintained internally at MS & Co. to track investments, are attached to this Declaration as Exhibit C (the "Investment Registers"). The Investment Registers have been redacted to protect certain personal information, as well as to remove certain extraneous information.

15. The Investment Registers show that in 2006 and 2007, Lex and Ms. Lex jointly made three investments in TAIN and one investment in FAIN. Those investments were subsequently transferred on or after April 23, 2009, for the TAIN investments, and September 10, 2009, for the FAIN investment. Three investments for TAIN and one investment for FAIN, each in the same amount as the joint investments, were transferred into Ms. Lex's name on or after April 23, 2009, for the TAIN investments, or September 10, 2009, for the FAIN investment. The investments transferred to Ms. Lex's name were the same investments originally made jointly by Ms. Lex and Lex.

NOTICE

16. In connection with service of the Motion and all accompanying papers, including this Declaration, I will cause to be mailed to each of the Brokers listed on Exhibit A to the Motion, including Kathleen Lex and Kimellen Lex, a copy of the Motion and related pleadings.

Dated: March 19, 2018

/s/ William J. Brown
William J. Brown

Exhibit A

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9454 / September 23, 2013

SECURITIES EXCHANGE ACT OF 1934
Release No. 70473 / September 23, 2013

INVESTMENT ADVISERS ACT OF 1940
Release No. 3674 / September 23, 2013

INVESTMENT COMPANY ACT OF 1940
Release No. 30694 / September 23, 2013

ADMINISTRATIVE PROCEEDING
File No. 3-15514

In the Matter of

**DONALD J. ANTHONY, JR.,
FRANK H. CHIAPPONE,
RICHARD D. FELDMANN,
WILLIAM P. GAMELLO,
ANDREW G. GUZZETTI,
WILLIAM F. LEX,
THOMAS E. LIVINGSTON,
BRIAN T. MAYER,
PHILIP S. RABINOVICH, and
RYAN C. ROGERS,**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS PURSUANT
TO SECTION 8A OF THE SECURITIES
ACT OF 1933, SECTIONS 15(b) AND
21C OF THE SECURITIES
EXCHANGE ACT OF 1934, SECTION
203(f) OF THE INVESTMENT
ADVISERS ACT OF 1940, AND
SECTION 9(b) OF THE INVESTMENT
COMPANY ACT OF 1940 AND
NOTICE OF HEARING**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”), Sections 15(b) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”), Section 203(f) of the Investment Advisers Act of 1940 (“Advisers Act”), and Section 9(b) of the Investment Company Act of 1940 (“Company Act”) against Donald J. Anthony, Jr.,

Frank H. Chiappone, Richard D. Feldmann, William P. Gamello, Andrew G. Guzzetti, William F. Lex, Thomas E. Livingston, Brian T. Mayer, Philip S. Rabinovich and Ryan C. Rogers (“Respondents”).

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. **Donald J. Anthony, Jr.**, 60 years old, is a resident of Loudonville, NY. He was registered with McGinn, Smith & Co., Inc. (“MS & Co.”) from November 1997 to December 2009, and McGinn, Smith Advisors, LLC (“MS Advisors”) from February 2006 to December 2009.
2. **Frank H. Chiappone**, 57 years old, is a resident of Clifton Park, NY. He was registered with MS & Co. from February 1989 to December 2009.
3. **Richard D. Feldmann**, 74 years old, is a resident of Delmar, NY. He was registered with MS & Co. from July 1987 to December 2009.
4. **William P. Gamello**, 49 years old, is a resident of Rexford, NY. He was registered with MS & Co. from April 2005 to December 2009.
5. **Andrew G. Guzzetti**, 66 years old, is a resident of Saratoga Springs, NY. He was registered with MS & Co. from September 2004 to December 2009.
6. **William F. Lex**, 67 years old, is a resident of Phoenixville, PA. He was registered with MS & Co. from January 1983 to December 2009.
7. **Thomas E. Livingston**, 55 years old, is a resident of Slingerlands, NY. He was registered with MS & Co. from October 1988 to December 2009, and became a 20% shareholder of MS Holdings in 2004.
8. **Brian T. Mayer**, 40 years old, is a resident of Princeton, NJ. Mayer was registered with MS & Co. from July 2001 to December 2009, and MS Advisors from February 2006 to April 2009.
9. **Philip S. Rabinovich**, 39 years old, is a resident of Roslyn, NY. He was registered with MS & Co. from July 2001 to December 2009, and with MS Advisors from August 2006 to December 2009.
10. **Ryan C. Rogers**, 40 years old, is a resident of East Northport, NY. He was registered with MS & Co. from July 2001 to December 2009, and with MS Advisors from February 2006 to April 2009.

B. RELEVANT ENTITIES¹ AND INDIVIDUALS

11. **MS & Co.**, a New York corporation founded in 1980 by David Smith and Timothy McGinn, had its principal place of business at 99 Pine Street, Albany, NY, and maintained branch offices at Clifton Park, NY, New York, NY, and King of Prussia, PA. MS & Co. was registered with the Commission as a broker-dealer beginning in 1980 and as an investment adviser in April 2009. It was owned by Smith (50%), McGinn (50%; 30% after 2004), and Thomas Livingston (20% after 2004). From 2003 to 2009, MS & Co. had about 55 employees, including about 35 registered representatives. On December 24, 2009, MS & Co. filed a partial BD-W. On March 9, 2010, MS & Co. also withdrew its investment adviser registration. FINRA terminated MS & Co.'s FINRA membership on August 4, 2010.

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

13. **McGinn, Smith Holdings, LLC (“MS Holdings”)** was owned by Smith (50%), McGinn (30%) and Livingston (20%).

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

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

¹ On April 20, 2010, the United States District Court for the Northern District of New York granted the SEC's motion for a temporary restraining order and appointed a Receiver over numerous entities controlled or owned by Timothy McGinn and David Smith. *See SEC v. McGinn Smith & Co., Inc., et al.*, 10-CV-457 (N.D.N.Y.) (GLS/CFH) (Dkt. Nos. 4, 5, 96). All the McGinn Smith entities—including MS & Co., MS Advisors, MS Capital, MS Holdings, FIIN, FEIN, FAIN and TAIN—remain under the Receiver's control.

- (a) First Independent Income Notes, LLC (“FIIN”), 5%/7.5%/10.25% (\$20 million) (9/15/03);
- (b) First Excelsior Income Notes LLC (“FEIN”), 5%/7.5%/10.25% (\$20 million) (1/16/04);
- (c) Third Albany Income Notes, LLC (“TAIN”), 5.75%/7.75%/10.25% (\$30 million) (11/1/04); and
- (d) First Advisory Income Notes, LLC (“FAIN”), 6%/7.75%/10.25% (\$20 million) (10/1/05).

16. The **Trust Offerings** were offerings by special purpose entities, purportedly to invest in contracts for burglar alarm service, “triple play” (broadband, cable and telephone) service or luxury cruises. MS & Co. acted as a placement agent and MS Capital acted as Trustee for the Trust Offerings. The Trust Offerings are listed below, along with the promised rate of return, the maximum amount of the offering, and the date of the PPM:

- (a) TDM Cable Trust 06, 7.75%/9.25% (\$3,550,000) (11/13/06)
- (b) TDM Verifier Trust 07, 8.25%/9% (\$3,475,000) (2/23/07)
- (c) Firstline Senior Trust 07, 9.25% (\$1,850,000) (5/19/07)
- (d) Firstline Trust 07, 11% (\$1,867,000) (5/19/07)
- (e) Firstline Senior Trust 07 Series B, 9.5% (\$1,435,000) (10/19/07)
- (f) TDM Luxury Cruise Trust 07, 10% (\$3,630,000) (7/16/07)
- (g) Firstline Trust 07 Series B, 11% (\$2,115,000) (10/19/07)
- (h) TDM Verifier Trust 08, 8.50%/10% (\$3,850,000) (12/17/07)
- (i) Cruise Charter Ventures Trust 08, 13% (\$3,250,000) (2/14/08)
- (j) Integrated Excellence Sr. Trust 08, 9% (\$900,000) (5/30/08)
- (k) Integrated Excellence Jr. Trust 08, 10% (\$580,000) (5/30/08)
- (l) Fortress Trust 08, 13% (\$3,060,000) (9/24/08)
- (m) TDM Cable Trust 06, 10% (\$1,380,000) (11/17/08)
- (n) TDM Verifier Trust 09, 10% (\$1,300,000) (12/15/08)
- (o) TDMM Cable Jr Trust 09, 11% (\$1,325,000) (1/19/09)
- (p) TDMM Cable Sr. Trust 09, 9% (\$1,550,000) (1/19/09)
- (q) TDM Verifier Trust 07R, 9% (\$2,100,000) (2/2/09)
- (r) TDM Verifier Trust 08R, 9% (\$2,005,000) (7/6/09)
- (s) TDMM Benchmark Trust 09, 8%, 9%, 10%, 11%, 12% (\$3,000,000) (8/20/09)
- (t) TDM Verifier Trust 11, 9% (\$1,550,000) (9/3/09)
- (u) Cruise Charter Ventures, LLC, 12% (\$400,000) (9/25/09)

17. **McGinn Smith Transaction Funding (“MSTF”)** was a New York corporation formed in 2008. Like the Four Funds and Trust offerings, the \$10 million MSTF offering on April 22, 2008 was underwritten by MS & Co.

18. **Timothy M. McGinn**, 64 years old, was the chairman, secretary and co-owner of MS & Co. From July 2003 through May 2006, McGinn served as CEO of Integrated Alarm Services Group, Inc. (“IASG”), which went public in July 2003. In September 2011, FINRA permanently barred McGinn from associating with any FINRA member. On February 6, 2013, following a four-week trial, a jury in the Northern District of New York found McGinn guilty of multiple counts of mail and wire fraud, securities fraud, and filing false tax returns. *United States v. Timothy M. McGinn & David L. Smith*,

12-CR-28 (DNH) (N.D.N.Y.). On August 7, 2013, McGinn was sentenced to 15 years in prison and ordered to pay restitution of \$5,992,800.

19. **David L. Smith**, 67 years old, was the president and chief executive officer of MS & Co. and the manager of the Four Funds. Until 2007, Smith was also the chief compliance officer of MS & Co. In September 2011, FINRA permanently barred Smith from associating with any FINRA member. On February 6, 2013, following a four-week trial, a jury in the Northern District of New York found Smith guilty of multiple counts of mail and wire fraud, securities fraud, and filing false tax returns. *United States v. Timothy M. McGinn & David L. Smith*, 12-CR-28 (DNH) (N.D.N.Y.). On August 7, 2013, Smith was sentenced to 10 years in prison and ordered to pay restitution of \$5,989,736.

C. OVERVIEW

20. Respondents Anthony, Chiappone, Feldmann, Gamello, Lex, Livingston, Mayer, Rabinovich and Rogers were among the top-selling brokers at MS & Co. They sold millions of dollars of MS & Co. private placements in spite of numerous red flags, including a policy—which was clearly inconsistent with the terms of the offerings—that required them to “replace” customers seeking to redeem notes with new customers before the redemption would be honored. Guzzetti, a supervisor at MS & Co., failed to take any action despite knowledge of red flags. Based on their conduct, Respondents committed the following violations:

- a) Anthony, Chiappone, Feldmann, Gamello, Lex, Livingston, Mayer, Rabinovich and Rogers willfully violated Sections 5(a) and (c) of the Securities Act by offering and selling notes for which no registration statements were in effect;
- b) Anthony, Chiappone, Feldmann, Gamello, Lex, Livingston, Mayer, Rabinovich and Rogers willfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, by knowingly or recklessly, or negligently, failing to perform reasonable due diligence to form a reasonable basis for their recommendations to customers, and made misrepresentations and omissions in recommending the Four Funds and Trust Offerings; and
- c) Guzzetti failed reasonably to supervise the other Respondents, pursuant to Section 15(b)(6), incorporating by reference Section 15(b)(4)(E) of the Exchange Act.

D. THE MS & CO. OFFERINGS

21. David Smith and Timothy McGinn created and controlled the Four Funds and Trust Offerings. The offerings raised more than \$125 million from more than 750 investors. Investor losses exceed \$80 million.

22. The Four Funds offerings—FIIN (Sept. 2003), FEIN (Jan. 2004), TAIN (Nov. 2004) and FAIN (Oct. 2005)—raised at least \$85 million. Smith controlled the

issuers, prepared the private placement memoranda (“PPMs”), set the terms of the offerings, controlled the investor money, and made all the investment decisions. Four Funds investors were promised quarterly interest payments and a return of principal upon maturity. Each offering had three tranches: the five-year “secured junior” notes paid 10.25%; the three or five year “secured senior subordinated” paid 7.5% or 7.75%; and the one-year “secured senior” notes paid 5%, 5.75% or 6%.

23. Although the Four Funds PPMs labeled each tranche as “secured,” there were no secured assets subject to forfeiture in the event that a particular Fund failed.

24. According to the PPMs, MS & Co., as the placement agent, was to receive a commission of 2% of the offering proceeds. In addition, according to the PPMs, the brokers were entitled to (and did receive) “incentive commissions . . . [paid] to our managing member’s salesmen at the rate of 2% of the aggregate principal amount of the notes per year over the term of the notes.”

25. Smith had no experience in making investment decisions and managing investments for entities like the Four Funds, and Smith had broad flexibility in making investment decisions. As the PPMs for the offerings stated, each of the Four Funds was:

formed to identify and acquire various public and/or private investments, which may include, without limitation, debt securities, collateralized debt obligations, bonds, equity securities, trust preferred, collateralized stock, convertible stock, bridge loans, leases, mortgages, equipment leases, securitized cash flow instruments, and any other investments that may add value to our portfolio

26. The PPMs stated that the notes would be offered only to accredited investors, as defined in Rule 501(a) of Regulation D. To this end, the PPMs required that each investor “represent in writing that it qualifies as an ‘accredited investor’ . . . and must demonstrate the basis for such qualification.” The subscription agreements similarly reiterated that the notes were offered to accredited investors only.

27. Despite these representations, each of the Four Funds offerings had more than 35 unaccredited investors. The Respondents sold the Four Funds to unaccredited investors.

28. In September 2003, just weeks after the launch of the FIIN offering, Smith began diverting millions of dollars to pay investors in pre-2003 MS & Co. offerings.²

² From 1990 through early 2003, Smith and McGinn orchestrated, through MS & Co. and related entities, dozens of note offerings secured by residential alarm contracts.

Overall, Smith used at least \$12.8 million of the Four Funds offering proceeds to pay investors in pre-2003 MS & Co. offerings.

29. Smith invested a majority of the Four Funds' proceeds in entities that were affiliated with MS & Co., even though the PPM did not disclose this, and in risky and highly speculative venture capital investments. For example, Smith invested \$8.8 million in alseT Management, a start-up partially-owned and controlled by Livingston and Smith himself, which never earned any revenue. The Four Funds' investments did not generate sufficient returns required to meet the issuers' obligations to investors.

30. In 2006, McGinn returned to MS & Co. on a full-time basis after nearly three years as CEO of IASG. McGinn created the twenty-one Trust Offerings, plus MSTF, that raised over \$41 million. The Trust Offerings ostensibly were created to fund entities engaged in specific areas, such as burglar alarm service, triple play service, or luxury cruises. These entities, however, were not funded directly by the issuer; instead, in most cases, the offering proceeds were first transferred to various conduit entities, primarily McGinn Smith Funding LLC (the "MSF Conduit") or TDM Cable Funding LLC (the "TDM Conduit").

31. The proceeds of the Trust Offerings were commingled and then used as needed by MS & Co., including infusing cash into the faltering Four Funds. The conduits and their corresponding Trust Offerings are listed below:

TDM Conduit

- TDM Cable Trust 06, 7.75%/9.25% (11/13/2006)
- TDM Verifier Trust 07, 8.25%/9.00% (2/23/2007)
- TDM Luxury Cruise, 10% (7/16/2007)
- TDM Cable Trust 06, 10% (11/17/2008)
- TDMM Cable Senior Trust 09, 9% (1/19/2009)
- TDMM Cable Jr. Trust 09, 11% (1/19/2009)
- TDM Verifier Trust 07R, 9% (2/2/2009)
- TDM Verifier Trust 08R (7/6/2009)

MSF Conduit

- Firstline Senior Trust 07, 9.25%/11% (5/19/2007)
- Firstline Trust 07 Series B, 9.5%/11% (10/19/2007)
- TDM Verifier Trust 08, 8.5%/10% (12/17/2007)
- TDM Verifier Trust 09, 10% (12/15/2008)

32. The Trust PPMs stated that they would "generally be offered only to accredited investors," but also provided for 35 or fewer unaccredited investors, supposedly under Rule 506. None of the Trust Offerings exceeded 35 unaccredited investors. When integrated according to their Conduit entity, however, Rule 506's limitation on unaccredited investors was breached: at least 69 investors in the Trusts tied to the TDM Conduit were unaccredited, and at least 59 investors in the Trusts linked to the MSF Conduit were unaccredited.

33. The Trust Offerings continued the egregious misuse of investor funds. Smith and McGinn, for example, took for personal use millions of dollars in offering proceeds from the TDM Cable 06, TDMM Cable, Integrated Excellence, MSTF and Fortress offerings, used investor funds to pay earlier noteholders, and used the Trust Offering proceeds to satisfy liquidity needs for other MS & Co. entities.

E. THE RESPONDENTS' ILLEGAL CONDUCT

34. The Respondents, as associated persons of a broker-dealer, had an obligation to conduct a reasonable investigation of the issuers in order to form a reasonable basis for any recommendation to customers regarding the MS & Co. offerings. By making a recommendation, the Respondents implicitly represented to their customers that they had an adequate basis for the recommendation. A broker has a duty to investigate the truth of the representations he makes to customers, because, by virtue of his title, customers are entitled to presume that the representations made were the result of reasonable investigation.

35. The Respondents blindly relied upon Smith and McGinn, even in the face of red flags. The Respondents, as licensed securities professionals, knew or should have known that securities issued by smaller companies of recent origin require more thorough investigation. They should not simply parrot the marketing information furnished by Smith and McGinn, particularly in the face of red flags. In addition, where Respondents lacked essential information about an issuer or its securities when making a recommendation, they failed to disclose this fact as well as the risks that arose from their lack of information.

36. The Respondents' due diligence, which at best consisted of reading the PPMs, was wholly inadequate, despite their knowledge that the issuers were completely controlled by Smith and McGinn. There were numerous red flags, moreover, that should have alerted the Respondents to the need for a thorough investigation. Instead, the Respondents blindly sold whatever private placement Smith and McGinn told them to sell.

37. The Respondents also made material misrepresentations and omissions when recommending the Four Funds and Trust Offerings to their customers.

The Respondents Knew of Red Flags Surrounding the Four Funds Offerings.

38. Anthony, Chiappone, Feldmann, Gamello, Lex, Livingston, Mayer, Rabinovich and Rogers performed inadequate due diligence prior to recommending the Four Funds to their customers. The PPMs for the Four Funds, which they read or were reckless in not reading, made disclosures that should have caused the Respondents, as associated persons of a broker-dealer, to conduct a searching inquiry prior to recommending the products to their customers. This heightened duty arose from the following factors:

- a. The PPMs made clear that Smith owned and controlled each of the issuers—which were new, single-purpose entities with no operating history—as well as the placement agent (MS & Co.) and the trustee. Smith also had

total control over the disposition of investor funds, with absolutely no oversight or control. As a result, the Respondents should have made specific inquiries as to how customer money would be invested before recommending the Four Funds to their customers.

- b. The Respondents knew or should have known that Smith had never before managed offerings of the size and scope of the Four Funds. The debt offerings that MS & Co. had done before 2003 were small-scale note offerings tied to the income streams from home alarm contracts, far different from the broad and non-specific investment mandate of Four Funds offerings.³ Given Smith's lack of experience in this area, and the Respondents' knowledge of this lack of experience, they should have made specific inquiries as to how Smith planned to invest the offering proceeds. This is particularly true given fact that the issuers' ability to make the relatively high interest payments, and to return the investors' principal, depended on the nature of the investments;
- c. The PPMs stated that the Four Funds could acquire investments "from our managing member [MS Advisors] or any affiliate," could "purchase securities from issuers in offerings for which [MS & Co.] is acting as underwriter or placement agent," and that "[a]ffiliates of the placement agent may purchase a portion of the notes offered hereby." As a result, the Respondents should have inquired whether Smith—who controlled without oversight the issuers, the placement agent and the disposition of investor funds—did engage in any transactions with affiliates. If they had, they would have discovered that nearly half of the offering proceeds had been invested in affiliates; and
- d. Despite the complete prohibition on sales to unaccredited investors in the Four Funds PPMs, the Respondents knew that sales were being made to unaccredited investors. The Respondents, therefore, knew that the PPMs' prohibition on sales to unaccredited investors was disregarded, which should have caused them to make inquiries.

³ The Respondents, when recommending the Four Funds and Trust Offerings, held out the pre-2003 alarm note offerings as indicative of Smith and McGinn's integrity and skill. These earlier offerings, however, were also mismanaged. In a handwritten letter from Smith to McGinn in 2000, Smith characterized the pre-2003 offerings as a "Ponzi Scheme" because the offering proceeds "for the most part are used to fulfill the investment promise to earlier investors . . . the new investments have no chance of being repaid in full." These offerings were eventually paid off not from the income stream generated by the investments, but rather through the IASG IPO in July 2003, as well as over \$12 million from the Four Funds offerings.

39. These factors should have prompted the Respondents to conduct a searching inquiry into the offerings. Instead, they essentially turned a blind eye and sold the Four Funds offerings with no specific knowledge of how investor funds were being used.

Smith's Refusal to Disclose to the Brokers How He Had Invested Four Funds Offering Proceeds Was a Red Flag.

40. From the commencement of the FIIN offering in September 2003 until January 2008, Smith provided his brokers with no specific information about how he had invested the offering proceeds. Any questions by the brokers were deflected with the claim that Smith had made loans to local Albany businesses with Four Funds proceeds, and those businesses desired anonymity. Indeed, Smith steadfastly refused to give the brokers any meaningful information about how he had invested the Four Funds offering proceeds. This refusal should have prompted the brokers to further question the propriety of the Four Funds.

41. The information blackout that Smith imposed was contrary to the PPMs, which stated that an "annual statement of the operations consisting of a balance sheet and income statement" would be provided to investors upon request. These reports, however, were never made available and it appears that no brokers requested this information before January 2008, when Smith disclosed that the Four Funds would be restructured.

42. MS & Co.'s compliance manual, moreover, stated that "it will make a reasonable investigation . . . [and] Paperwork recording the due diligence will be kept in the legal files." The Respondents also never asked to see the due diligence files, notwithstanding the red flags regarding the Four Funds.

The Respondents Continued to Recommend MS & Co. Offerings Despite Knowledge of the Redemption Policy – Another Major Red Flag.

43. By 2006, the Funds began having significant difficulty in meeting the redemption requests. Smith therefore instituted a policy that required brokers to "replace" customers seeking to redeem Four Funds notes, including maturing notes, with new customers (the "Redemption Policy"). The PPMs, however, did not state that a customer's right to redemption depended on finding a "replacement."

44. The Redemption Policy was another red flag that put the Respondents on notice that the Four Funds were being handled much differently from what the PPMs provided. None of the Respondents, however, undertook any investigation of the offerings; they also failed to disclose this material information to their customers; and they continued to recommend MS & Co. private placements to their customers for several more years.

45. The Respondents learned of the policy at different times beginning in late 2006. They were shocked by the policy and knew that it was contrary to the PPMs. The Respondents, however, did not disclose the Redemption Policy to customers, even those who sought to reinvest, or "roll over," Four Funds notes at maturity. Collectively, the Respondents raised millions of dollars in MS & Co. private placements after learning of the

policy. They stood to profit if a customer elected to roll over, and would receive their annual commission for the life of the note. The Respondents sought redemptions for current customers even knowing that the redemption would be paid not with investment returns, as the PPMs represented, but rather with new investor funds.

The Respondents Continued to Sell the Trust Offerings Despite Learning in January 2008 that the Four Funds Had Been Mismanaged.

46. On January 8, 2008, Smith and McGinn held an all-day meeting to inform the brokers, including the Respondents, that the Four Funds were in default, that payments to investors would be curtailed, and that the offerings would be restructured. Smith revealed that the Four Funds investment portfolios consisted of loans to small, local businesses, some of which had already filed for bankruptcy; risky venture capital investments; investments with sub-prime exposure; and other nonperforming investments. By contrast, the Four Funds each had made only one investment in a publicly-traded security: Exchange Boulevard.com, a risky venture capital company that was quoted on OTC Link, formerly known as the Pink Sheets.

47. None of the Respondents, despite the alarming disclosures in this meeting, requested any kind of probing investigation into what happened to the Four Funds or the ongoing Trust Offerings. After the January 2008 meeting, there were thirteen offerings by MSTF and the Trusts, which raised at least \$20 million. As a result of the accumulation of red flags since the launch of the Four Funds in September 2003, the Respondents should have conducted a searching inquiry regarding any MS & Co. private placement. Instead, they recommended the Trust Offerings to their customers based on insufficient due diligence.

48. During the three years of the Trust and MSTF Offerings, investor funds were being used in ways contrary to the uses described in the PPMs; for example, Smith and McGinn took at least \$4 million in offering proceeds for themselves and another MS & Co. officer. Offering proceeds also were used to pay investors in earlier offerings and MS & Co.'s payroll.

49. In the Trust Offerings, the amount actually invested pursuant to a particular PPM was far less than that PPM disclosed.

50. The Trust PPMs, moreover, like the Four Funds PPMs, raised red flags that should have been readily apparent to the brokers. For example, the August 2009 TDMM Benchmark Trust 09 ("Benchmark") PPM should have raised a red flag. Benchmark promised a high rate of return, which ranged from 8% to 12%, during a time when the prime rate was only 3.25%. The Respondents should have been skeptical of Benchmark's ability to meet the promised interest payments especially when considering that the PPM disclosed that only \$1,950,000 (approximately 65%) of the total \$3 million raised would actually be invested, with the remainder siphoned off in fees. The Respondents who recommended the Benchmark offering did so despite the exorbitant fees, and without questioning how MS & Co. planned to make 8 – 12% interest payments and redeem the principal upon maturity while taking over one-third of the money raised in fees.

51. The second Firstline Trust offering of October 19, 2007 raised \$3.2 million from investors (an earlier Firstline offering in May 2007 had raised \$3.7 million). In this offering, a McGinn Smith affiliate loaned the offering proceeds to Firstline Securities, Inc., a Utah corporation that sold residential alarm contracts. At the time of the October 2007 offering, McGinn had been informed of the threat of crippling litigation by one of Firstline's creditors, and McGinn was personally involved in trying to resolve the dispute. Litigation resulted and, on January 25, 2008, Firstline filed a voluntary petition for Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the District of Utah. If the Respondents had conducted due diligence in response to red flags, they would have discovered the legal issues, which should have caused them to stop selling the Firstline offering. Instead, they were unaware of the bankruptcy filing until McGinn finally disclosed it in September 2009. Lex, Feldmann, Chiappone, Rabinovich and Mayer sold Firstline trust certificates after the bankruptcy filing.

F. SALES AND COMMISSIONS

52. **Anthony** sold approximately \$2.2 million of the Four Funds, and approximately \$630,000 of the Trust Offerings. He earned approximately \$104,000 in commissions.

53. **Chiappone** sold approximately \$12 million of the Four Funds offerings and approximately \$3.4 million of the Trust Offerings. He earned approximately \$513,000 in commissions.

54. **Feldmann** sold approximately \$5.4 million of the Four Funds offerings and approximately \$595,000 of the Trust Offerings. Feldmann earned approximately \$299,000 in commissions.

55. **Gamello** sold approximately \$1.3 million of the Four Funds offerings and approximately \$1.6 million of the Trusts. He earned approximately \$74,500 in commissions.

56. **Lex** sold approximately \$38.5 million of the Four Funds offerings and approximately \$6.6 million of the Trust Offerings. He earned approximately \$1,523,000 in commissions.

57. **Livingston** sold approximately \$3.5 million of the Four Funds offerings and approximately \$380,000 of the Trust Offerings. His total commissions were approximately \$143,000.

58. **Mayer** sold approximately \$1.7 million of the Four Funds offerings and approximately \$1.9 million of the Trust Offerings. He earned approximately \$81,000 in commissions, plus an additional 2% of the gross commissions generated by the New York City office.

59. **Rabinovich** sold approximately \$20.3 million of the Four Funds offerings and approximately \$6.8 of the Trust Offerings. He earned approximately \$578,000 in commissions.

60. **Rogers** sold approximately \$2 million of the Four Funds and approximately \$5.2 million of the Trust Offerings. He earned approximately \$240,000 in commissions.

G. GUZZETTI FAILED REASONABLY TO SUPERVISE

61. Guzzetti was the managing director of the MS & Co. Private Client Group from 2004 until late 2009. During this period, Guzzetti supervised MS & Co. registered representatives with regard to the Four Funds and Trust Offerings.

62. Guzzetti, who also earned about \$6,000 in commissions, had direct supervisory responsibilities of the Respondents. He carried out numerous managerial duties, including recruiting and hiring MS & Co. employees; assigning and reassigning customers to brokers; evaluating employee performances and awarding commissions; addressing customer grievances; answering employee questions regarding the firm; and issuing instruction and guidance regarding specific financial products and transactions, administrative issues, and broader firm policy.

63. Guzzetti also sent regular e-mails summarizing MS & Co. products available for sale to customers. In a February 2006 email, for example, Guzzetti stated that “there are many investors sitting in money market accounts (fear of higher interest rates) who are losing return (cost of waiting). Our FAIN’S offer a way of locking in higher returns with \$ sitting in money markets waiting for the ‘top’ in interest rates.”

64. Guzzetti learned of the Redemption Policy by December 2006, when he received an email from Smith stating that Rabinovich “needs to replace the \$100,000 before doing the trade. I am running on fumes with all of these redemptions and cannot afford any[.]more.” In November 2007, Guzzetti received an email from Smith stating that “I do not have the liquidity. Any redemptions have to have replacement sales beforehand. . . My preference is for there to be no redemptions.” Guzzetti instructed the brokers to adhere to the Redemption Policy.

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

H. VIOLATIONS

66. As a result of the conduct described above, Anthony, Chiappone, Feldmann, Gamello, Lex, Livingston, Mayer, Rabinovich and Rogers willfully violated Sections 5(a) and (c) of the Securities Act.

67. As a result of the conduct described above, Anthony, Chiappone, Feldmann, Gamello, Lex, Livingston, Mayer, Rabinovich and Rogers willfully violated Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

68. As a result of the conduct described above, Guzzetti failed reasonably to supervise Anthony, Chiappone, Feldmann, Gamello, Lex, Livingston, Mayer, Rabinovich and Rogers, pursuant to Section 15(b)(6), incorporating by reference Section 15(b)(4)(E) of the Exchange Act, with a view toward preventing and detecting their violations of Sections 5(a) and (c) and 17 of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondents an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 15(b) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

C. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 203(f) of the Advisers Act including, but not limited to, disgorgement and civil penalties pursuant to Section 203 of the Advisers Act;

D. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 9(b) of the Investment Company Act including, but not limited to, disgorgement and civil penalties pursuant to Section 9 of the Investment Company Act; and

E. Whether, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, Respondents Anthony, Chiappone, Feldmann, Gamello, Lex, Livingston, Mayer, Rabinovich and Rogers should be ordered to cease and desist from committing or causing violations of and any future violations of Sections 5(a), (c) and 17(a) of the Securities Act, and Section 10(b) and Rule 10b-5 of the Exchange Act, whether Respondents should be ordered to pay a civil penalty pursuant to Section 8A(g) of the Securities Act, Section 21B(a) of the Exchange Act, Section 203(i) of the Advisers Act, and Section 9(d) of the Investment Company Act, and whether Respondents Anthony, Chiappone, Feldmann, Gamello, Lex, Livingston, Mayer, Rabinovich and Roger should be ordered to pay disgorgement pursuant to Section 8A(e) of the Securities Act, Sections 21B(e) and 21C(e) of the Exchange Act, Section 203 of the Advisers Act, and Section 9 of the Investment Company Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not

later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondents fail to file the directed answer, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondents personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary

Exhibit B

INITIAL DECISION RELEASE NO. 745
ADMINISTRATIVE PROCEEDING
FILE NO. 3-15514

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of

DONALD J. ANTHONY, JR.,
FRANK H. CHIAPPONE,
RICHARD D. FELDMANN,
WILLIAM P. GAMELLO,
ANDREW G. GUZZETTI,
WILLIAM F. LEX,
THOMAS E. LIVINGSTON,
BRIAN T. MAYER,
PHILIP S. RABINOVICH, AND
RYAN C. ROGERS

INITIAL DECISION
February 25, 2015

APPEARANCES: David Stoelting, Michael D. Birnbaum, and Haimavathi V. Marlier for the Division of Enforcement, Securities and Exchange Commission

Roland M. Cavalier, Tuczinski, Cavalier, & Gilchrist, P.C., for Frank H. Chiappone

Loren Schechter and Justin Joseph D'Elia, Duane Morris LLP, for William P. Gamello

Mark J. Astarita and Michael D. Handelsman, Sallah Astarita & Cox, LLC, for Andrew G. Guzzetti

Gilbert B. Abramson and Michael B. Tolcott, Gilbert B. Abramson & Associates, LLC, and Russell G. Ryan, King & Spalding LLP, for William F. Lex

Matthew G. Nielsen, Spencer C. Barasch, and Crystal L. Jamison, Andrew Kurth LLP, for Thomas E. Livingston

M. William Munno, Brian P. Maloney, and Michael B. Weitman, Seward & Kissel LLP, for Brian T. Mayer, Philip S. Rabinovich, and Ryan C. Rogers

BEFORE: Brenda P. Murray, Chief Administrative Law Judge

On September 23, 2013, the Securities and Exchange Commission (Commission) issued an Order Instituting Administrative and Cease-and-Desist Proceedings (OIP), pursuant to Section 8A of the Securities Act of 1933 (Securities Act), Sections 15(b) and 21C of the Securities Exchange Act of 1934 (Exchange Act), Section 203(f) of the Investment Advisers Act of 1940 (Advisers Act), and Section 9(b) of the Investment Company Act of 1940 (Investment Company Act). I found Donald J. Anthony (Anthony) in default on December 4, 2013, for not answering the OIP and not defending the proceeding. *Donald J. Anthony*, Admin. Proc. Rulings Release No. 1081, 2013 SEC LEXIS 3808, at *2-3 (citing OIP at 15; 17 C.F.R. §§ 201.155(a), .220(f), .221(f)). Eighteen days of public hearing, in which all Respondents, with the exceptions of Anthony and Richard D. Feldmann (Feldmann), participated, concluded on February 24, 2014. The Division of Enforcement (Division) and all Respondents who participated in the hearing thereafter filed post-hearing briefs, the last of which was filed on June 13, 2014.¹ On April 3, 2014, the Commission issued an Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order as to Feldmann. *Donald J. Anthony*, Securities Act Release. No. 9571, 2014 SEC LEXIS 1223.

Issues

The issues are whether Respondents, except for Andrew G. Guzzetti (collectively, Selling Respondents), violated antifraud provisions (Securities Act Section 17(a), Exchange Act Section 10(b), and Rule 10b-5) and registration provisions (Securities Act Section 5(a) and (c)) of the federal securities laws, and whether Guzzetti violated Exchange Act Section 15(b)(6) by failing to reasonably supervise the Selling Respondents.

Findings of Fact

Background²

Timothy McGinn (McGinn) and David Smith (Smith) formed McGinn and Smith Co. (MS & Co.) in 1980. Tr. 3272, 5614; Livingston Ex. 103 at 2. MS & Co. had its principal place of business in Albany, New York, and branch offices in New York City, New York; Clifton Park, New York; King of Prussia, Pennsylvania; and Pawlet, Vermont. Div. Ex. 329 at 40. The latter two

¹ On April 24, 2014, the Division filed a letter seeking to admit three new exhibits and another exhibit to replace a prior exhibit. The Division explained that the three exhibits were discussed at the hearing but I held off on ruling on their admission, and that the replacement exhibit, Division Ex. 9B, is merely the more up-to-date version of Division Ex. 9. Respondents did not file an objection. Accordingly, I hereby admit Division Exhibits 648-50, and Division Exhibit 9B (as a replacement for Division Exhibit 9).

² Respondents had a standing objection to any evidence of transactions that occurred before September 23, 2008, five years before the OIP was issued on subject matter grounds under 28 U.S.C. § 2462. As discussed *infra*, I overrule this objection because 28 U.S.C. § 2462 does not bar the consideration of evidence that occurred five years before the OIP was issued.

offices were not under MS & Co.'s Office of Supervisory Jurisdiction. Tr. 3229; Div. Ex. 329 at 40.

By the mid-2000's, MS & Co. had a national reputation in alarm financing, and had about fifty registered representatives, some of whom sold private placements. Tr. 712, 4229, 4649-50; Livingston Ex. 103 at 2. However, McGinn and Smith turned out to be running a Ponzi scheme through MS & Co. – a fact that the Commission's civil proceeding against MS & Co. and related entities, *SEC v. McGinn, Smith & Co., Inc.*, No. 10-cv-457 (N.D.N.Y.) (Civil Case), as well as a criminal proceeding against McGinn and Smith, *United States v. McGinn*, No. 12-cr-28 (N.D.N.Y.) (Criminal Case) – have made clear.³ See, e.g., Tr. 137, 167, 2316, 4159. In the Civil Case, William J. Brown (Brown or Receiver) was named Receiver over MS & Co.'s and related entities' assets.⁴ See Civil Case, Dkt. No. 5. Brown is still the Receiver as of the date of this Initial Decision.

In early 2013, a jury found McGinn and Smith guilty of conspiracy to commit mail and wire fraud, mail fraud, wire fraud, securities fraud, and filing false tax returns. Div. Exs. 453, 454, 455, 460. On August 7, 2013, McGinn was sentenced to fifteen years in prison and ordered to pay a \$100,000 fine, and Smith was sentenced to ten years in prison and ordered to pay a \$50,000 fine. Div. Exs. 459, 460. McGinn and Smith were ordered to jointly and severally pay \$5,748,722 in restitution to 841 investors deemed victims of their fraud.⁵ Div. Exs. 459 at 6; 460 at 6. In related criminal cases, guilty pleas were also entered by Ronald Simons, the outside accountant to MS & Co. who worked at Piaker & Lyons; Brian Shea (Shea),⁶ the former CFO of MS & Co.; and Matthew Rogers (M. Rogers), an MS & Co. employee. Tr. 4055-56, 4140; Div. Exs. 447, 448, 449, 450, 451, 456, 457, 458.

³ I take official notice of the docket sheets and records in the Civil Case and Criminal Case pursuant to 17 C.F.R. § 201.323. The Civil Case named as defendants: Smith; McGinn; MS & Co.; McGinn, Smith Advisers, LLC; McGinn, Smith Capital Holdings Corp.; First Advisory Income Notes, LLC; First Excelsior Income Notes, LLC; First Independent Income Notes, LLC; and Third Albany Income Notes, LLC. Complaint, Dkt. No. 1. McGinn, Smith Capital Holdings Corp. was the trustee and servicing agent for the MS & Co. private placements at issue in this proceeding. Tr. 1924, 1927, 2238; see, e.g., Div. Ex. 5 at 6, 10.

⁴ McGinn and Smith owned MS & Co. equally until 2004, after which Smith owned 50%, McGinn owned 30%, and Thomas E. Livingston (Livingston) owned 20%. Div. Exs. 273; 329 at 48-49. Another related entity was McGinn, Smith Holdings, LLC (MS Holdings). Div. Ex. 5 at 1, 11.

⁵ The criminal indictment was narrower than the civil action and the Receiver's broad claims process. Tr. 2561.

⁶ Shea, a graduate of Union College, was MS & Co.'s controller, and later CFO, from 1992 until 2002, when he joined Integrated Alarm Services Group; Shea returned to MS & Co. in April 2009. Tr. 2358-61, 2412-13. Based on conduct from April 2009 until the end of 2009, Shea pled guilty to one count of corruptly interfering with the administration of IRS laws in the Criminal Case on March 7, 2013; he was sentenced to two years of probation and paid a fine of \$5,000. Div. Ex. 456; RMR Ex. 827. He admitted to creating false accounting entries and submitting backdated notes to FINRA. Tr. 2416-17; RMR Exs. 826, 827. Shea was a cooperating witness in the Criminal Case, and has been employed by the Receiver since 2010. Tr. 2362; RMR Exs. 826.

From the late 1990s to 2003, MS & Co. offered private placement trust certificates about four times a year, and each offering raised between \$2 and \$4 million. Tr. 2366. The trust certificates represented investments in alarm contracts, consisted of senior and junior position tranches, had maturities of three to five years, and paid between ten and twelve percent annual interest (pre-2003 offerings). Tr. 2366. MS & Co. considered these to be unregistered offerings made under Regulation D of the Securities Act (Regulation D).⁷ Tr. 3262-63. The trusts securitized alarm contract cash flows. Tr. 2131, 2523, 3263. The pre-2003 offerings were considered successful because they generally paid interest on time. Tr. 1549, 1928-29, 2692. In reality, while Respondents and others considered MS & Co.'s pre-2003 offerings a success, the combination of high interest and attrition rates on the alarm contracts, i.e., the erosion of asset value, caused revenue shortfalls and the loss of asset value on maturity. Tr. 2367-71. By 2001-2002, the MS & Co. model was unsustainable. Tr. 2367-71, 2431-32.

In 2003, McGinn left MS & Co. and became CEO for Integrated Alarm Services Group (IASG). Tr. 1921. IASG, headquartered at MS & Co.'s address, resulted from an MS & Co.-sponsored IPO, effective July 24, 2003, through which a high percentage of the pre-2003 alarm contract trust certificates were exchanged for promissory notes of IASG and other trust certificates were repaid out of the IPO proceeds.⁸ Tr. 1552-54, 3677-78, 4253; Div. Ex. 373. IASG's assets comprised of forty-one pre-2003 alarm contracts. Tr. 2403-04. Smith became the primary individual responsible for running MS & Co. from 2003 until 2006, when McGinn returned. Tr. 1766, 2304. 2644-46, 4257.

Frank H. Chiappone (Chiappone), William P. Gamello (Gamello), Andrew G. Guzzetti, (Guzzetti), William F. Lex (Lex), Thomas E. Livingston (Livingston), Brian T. Mayer (Mayer), Philip S. Rabinovich, (Rabinovich), and Ryan C. Rogers (Rogers) were all associated with MS & Co. Chiappone Answer at 2; Gamello Answer at 1; Guzzetti Answer at 3; Lex Answer at 1; Livingston Answer at 2; Mayer Answer at 10; Rabinovich Answer at 10; Rogers Answer at 10; Tr. 1733. Mayer, Rabinovich, and Rogers were also affiliated with McGinn, Smith Advisors, LLC (MS Advisors), a registered investment adviser majority owned by McGinn and Smith. Mayer Answer at 10; Rabinovich Answer at 10; Rogers Answer at 10. Selling Respondents were the top sellers of the MS & Co. private placements at issue in this proceeding. Tr. 246; Div. Ex. 2, Ex. 4 (as attached to Div. Ex. 2). Respondents worked from the Clifton Park, New York, office, except for Rabinovich, Mayer, and Rogers, who worked at the New York City office, and Lex, who worked from an office in King of Prussia, Pennsylvania. Tr. 1534, 1737, 2684, 2961, 3005, 3245, 5409-10, 5494, 5662.

The Division's expert had no reason to believe that Respondents were aware of McGinn and Smith's fraud. Tr. 1220.

⁷ Regulation D under the Securities Act of 1933 provides an exemption from the registration requirements of Section 5 for private placements under certain conditions.

⁸ The IPO received favorable analyst commentary. Tr. 4250-53; RMR Exs. 7-9.

MS & Co. Offerings

Four Funds

Beginning on September 15, 2003, Selling Respondents offered and sold unregistered notes issued by First Independent Income Notes, LLC (FIIN), First Excelsior Income Notes, LLC (FEIN), Third Albany Income Notes, LLC (TAIN), and First Advisory Income Notes, LLC (FAIN) (collectively, Four Funds), all single purpose New York State limited liability companies. Div. Exs 1 at 8, 5 at 7, 6 at 7, 9B at 7, 12 at 7. The Four Funds were completely different from the pre-2003 offerings in structure. Tr. 2239-40. All Four Fund entities had offices at 99 Pine Street, Albany, New York, and from late 2003 until the end of 2007, Smith controlled them all and chose all the investments. Tr. 2238, 2246-47.

Four Funds Offerings	Offering Date	Interest Rate	Amount Raised
FIIN (First Independent Income Notes, LLC)	9/15/03	5%-10.25%	\$19,845,000
FEIN (First Excelsior Income Notes, LLC)	1/16/04	5%-10.25%	\$20,050,000
TAIN (Third Albany Income Notes, LLC)	11/01/04	5.75%-10.25%	\$29,361,000
FAIN (First Advisory Income Notes, LLC)	10/01/05	6%-10.25%	\$16,704,000

Tr. 262; Div. Ex. 2, Ex. 3 (as attached to Div. Ex. 2).

The Four Funds were private placements and non-conventional investments. Tr. 978. For each of the Four Funds, MS & Co. was the placement agent; McGinn, Smith Capital Holdings Corp. (MS Capital), an affiliate of MS & Co., was the trustee and servicing agent; and MS Advisors was the sole managing member. Div. Exs. 5, 6, 9, 12; Tr. 1930. The Four Funds were non-specific asset offerings in which Smith chose the investments and set the interest rates. Tr. 3331-32, 4085, 4147. Each offering had three tranches: Secured Senior Notes, Secured Senior Subordinate Notes, and Secured Junior Notes, which all had different maturities and interest rates. Div. Exs. 1 at 8, 132.

Each of the Four Funds offerings had an almost identical private placement memorandum (PPM); and investors received a package that included a PPM, a subscription agreement, and customer purchaser questionnaire. Tr. 318, 1589, 1929-30, 1999, 2001-02, 2716; Div. Ex. 2, Ex. 3 (as attached to Div. Ex. 2). The subscription agreement required the investor to attest that he or she was an accredited investor, and that the investor also “has such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of an investment in

the Notes.”⁹ *See, e.g.*, Div. Ex. 5 at 39; Div. 9B at 40. The customer purchaser questionnaire contained financial information and required the undersigned to attest to and support his or her accredited investor and knowledgeable investor status. *See, e.g.*, Div. Ex. 10; Tr. 1998, 2000-02. All the investor witnesses acknowledged receiving the documents; most, if not all, testified to not reading and/or not understanding what they had signed. Tr. 56, 60-61, 110-11, 173-76, 185, 4378.

Disclosures in the PPMs

The PPMs for the Four Funds were almost identical. The stated business purpose was

[the issuer] has been formed to identify and acquire various public and/or private investments, which may include, without limitation, debt securities, collateralized debt obligations, bonds, equity securities, trust preferreds, collateralized stock, convertible stock, bridge loans, leases, mortgages, equipment leases, securitized cash flow instruments, and any other investments that may add value to our portfolio (individually an “Investment” and collectively, the “Investments”). We may acquire such Investments directly, or from our managing member or an affiliate of us or our managing member that has purchased the Investment. If the Investment is purchased from our managing member or any affiliate, we will not pay above the price paid by our managing member or such affiliate for the Investment, other than to reimburse our managing member or such affiliate for its costs and any discounts that it may have received by virtue of a special arrangement or relationship. In other words, if we purchase an Investment from our managing member or any affiliate, we will pay the same price for the Investment that we would have paid if we had directly purchased the Investment. We may also purchase securities from issuers in offerings for which [MS & Co.] is acting as underwriter or placement agent and for which [MS & Co.] will receive a commission.

Tr. 264; *see, e.g.*, Div. Ex. 5 at 7.

The Four Funds notes were to be paid on maturity or rolled over.¹⁰ Tr. 234. The PPMs contained several cautionary statements, including:

An investment in the notes involves significant risks and is suitable only for persons of adequate financial means who have no need for liquidity with respect to their investment and who can bear the economic risk of a complete loss of their investment. This offering is made in reliance on exemptions from the registration

⁹ The PPMs also stated that “[t]he undersigned is aware that the purchase of Notes is a speculative investment involving a high degree of risk and that there is no guarantee the undersigned will realize any gain from this investment, and that the undersigned could lose the total amount of the undersigned’s investment.” *See, e.g.*, Div. Ex. 5 at 38, Ex. 9B at 39.

¹⁰ “We are obligated to pay the entire principal balance of the outstanding notes upon maturity.” Tr. 1777; *see, e.g.*, Div. Ex. 6 at 9. “Rolling over” means to extend the maturity date.

requirements of the Securities Act and applicable state and foreign securities laws and regulations.

Div. Ex. 5 at 23, Div. Ex. 6 at 23, Div. Ex. 9B at 23; Div. Ex. 12 at 23.

Each investor must represent in writing that it qualifies as an “accredited investor” as such term is defined in Rule 501 (a) of Regulation D under the Securities Act, and must demonstrate the basis for such qualification.

Div. Ex. 5 at 23, Div. Ex. 6 at 24, Div. Ex. 9B at 24, Div. Ex. 12 at 24.

We intend to use the net proceeds to acquire various public and/or private investments, which may include, without limitation, debt securities, collateralized debt obligations, bonds, equity securities, trust preferreds collateralized stock, convertible stock, bridge loans, leases, mortgages, equipment leases, securitized cash flow instruments, and any other investments that may add value to our portfolio (individually an “Investment” and collectively, the “Investments”).

We may acquire such Investments directly, or from our managing member or an affiliate of us or our managing member that has purchased the Investment. If the Investment is purchased from our managing member or any affiliate, we will not pay above the price paid by our managing member or such affiliate for the Investment.

Div. Ex. 5 at 15, Div. Ex. 6 at 15, Div. Ex. 9B at 15, Div. Ex. 12 at 15.

The Four Funds’ PPMs all provided, “[a]t the request of the holder, our servicing agent will provide to the holders of the notes our annual statement of the operations consisting of a balance sheet and income statement.” *See, e.g.*, Tr. 1629-30; Div. Ex. 5 at 21.

Trust Offerings

Beginning on November 13, 2006, Selling Respondents offered and sold certificates in the following MS & Co. specific purpose entities (Trust Offerings), which raised amounts ranging from \$25,000 to \$3.7 million.¹¹ Div. Ex. 2, at Ex. 3 (as attached to Div. Ex. 2).

	<u>Date</u>	<u>Interest Rate</u>	<u>Amount Raised</u>
TDM Cable Trust 06	11/13/06	7.75-9.25%	\$3,575,000
TDM Verifier Trust 07	02/23/07	8.25%	3,725,000
Firstline Trust 07	05/19/07	11%	1,892,000
Firstline Senior Trust 07	05/19/07	9.25%	1,850,000

¹¹ The Division’s Proposed Findings of Fact lists Cruise Charter Ventures, LLC, a \$400,000 offering on September 25, 2009, as a Trust Offering, but the Declaration of Kerri L. Palen, a Division accountant, does not identify it as a Trust Offering. Compare Div.’s Proposed Findings of Fact at 5, Div. Ex. 2, Ex. 3 (as attached to Div. Ex. 2).

TDM Luxury Cruise 07	07/16/07	10%	3,625,000
Firstline Senior Trust 07 Series B	10/19/07	9.5%	1,415,000
Firstline Trust 07 Series B	10/19/07	11%	1,810,000
TDM Verifier Trust 08	12/17/07	8.5-10%	3,740,000
Cruise Charter Ventures Trust 08 ¹²	02/14/08	13%	
Integrated Excellence Sr. Trust 08	05/30/08	9%	900,000
Integrated Excellence Jr. Trust 08	05/30/08	10%	270,000
Fortress Trust 08	09/24/08	13%	3,060,000
TDM Cable Trust 06	11/17/08	10%	320,000
TDM Verifier Trust 09	12/15/08	10%	1,290,000
TDMM Cable Sr. Trust 09	01/19/09	9%	1,560,000
TDMM Cable Jr. Trust 09	01/19/09	11%	1,290,000
TDM Verifier Trust 07R	02/02/09	9%	800,000
TDM Verifier Trust 08R	07/06/09	9%	450,000
TDMM Benchmark Trust	08/20/09	8-12%	2,500,000
TDM Verifier Trust 11	09/03/09	9%	25,000
Total			34,097,000

Div. Ex. 2, Ex. 3 (as attached to Div. Ex. 2). TDM stands for “Timothy, David, and Matthew,” the first names of McGinn, Smith, and M. Rogers. Tr. 3159.

MS & Co. entities controlled the activities of each of the Trust Offerings. Tr. 1060. MS Capital was trustee for all the Trust Offerings. *See, e.g.*, Div. Ex. 73 at 4. McGinn was chair of the trustee’s board, Smith was president and director, and Livingston was treasurer. Tr. 1337; Div. Ex. 73 at 16. The trust certificates had fixed interest rates and maturities. Div. Exs. 27-28, 59, 63, 68-69, 73, 202, 264-269, 438-41, 463-64.

Thirteen Trust Offerings stated in their PPMs that the offering proceeds would be invested in burglar alarm contracts; broadband, cable, and telephone services contracts (triple play offerings); or luxury cruise bookings.¹³ Tr. 293; Div. Ex. 2, Ex. 5 (as attached to Div. Ex. 2). Net proceeds from each of the Trust Offerings went from the escrow account to a conduit entity controlled by MS

¹² Division accountant Kerri L. Palen stated that Cruise Charter Ventures Trust 08 and another entity, Cruise Charter Ventures, LLC, were offerings for a total of \$3.7 million, but funds were returned to investors when the offerings did not reach minimum offering levels. Div. Ex. 2 at 22. A Division expert, Robert Lowry, characterized Cruise Charter Ventures, LLC, as a related offering to the twenty trust offerings, and puts the total raised from the twenty-one offerings at \$44.17 million. Div. Ex. 1 at 9.

¹³ The PPMs of four trusts created November 17, 2008, through September 3, 2009, disclosed that the funds would be used to redeem investors in earlier trusts, i.e., the November 17, 2008, offering of TDM Cable Trust 06, TDM Verifier Trust 07R, TDM Verifier Trust 08R, and TDM Verifier Trust 11. Tr. 291-92; Div. Ex. 2 at Ex. 5.

& Co., which entered into agreements with third parties for the underlying investment.¹⁴ Tr. 289-90; Div. Ex. 2 at 21, Ex. 17 (as attached to Div. Ex. 2).

The Trust Offerings' PPMs stated they could be offered to thirty-five unaccredited investors. Div. Ex. 1 at 9; *see, e.g.*, Div. Ex. 27 at 3. The PPMs of the Trust Offerings stated that MS & Co. or a related entity had performed a due diligence examination. *See, e.g.*, Div. Ex. 27 at 13, Div. Ex. 28 at 14.

The Offering Trusts' PPMs stated in their Conflicts of Interest sections, that because of various conflicts, "its due diligence review cannot be considered independent." *See, e.g.*, Div. Ex. 27 at 13, Div. Ex. 28 at 14, Div. Ex. 63 at 10, Div. Ex. 202 at 9-10.

alseT IP Management

alseT IP Management (alseT) was a venture capital start-up company in which Smith and Livingston had indirect equity interests; Livingston was President and received compensation. Tr. 284, 2275.¹⁵ Beginning in 2005, TAIN, FAIN, and FIIN loaned funds to alseT and by 2007, their loans totaled \$8.8 million. Div. Ex. 2 at 27, Ex. 14 (as attached to Div. Ex. 2). Four Funds investors were not informed that Smith and Livingston had ties to alseT, which ultimately did not repay any of the Four Funds' loans; on December 2, 2007, the Four Funds investment in alseT was considered to have no net realizable value.¹⁶ Tr. 286, 2275, 2282-83; Div. Exs. 2, at 17, 408. According to Smith, on January 6, 2008, alseT had no assets and a negative net worth of at least \$10 million. Tr. 2299-300; Div. Ex. 624.

¹⁴ The two main conduit entities were McGinn, Smith Funding LLC (MSF Conduit), and TDM Cable Funding, LLC (TDM Conduit). Tr. 291. Others were NEI Capital, LLC; TDM Cable Funding; LLC, TDMM Cable Funding, LLC; and McGinn, Smith Transaction Funding, LLC (MSTF). Div. Ex. 2 at 21, Ex. 17 (as attached to Div. Ex. 2). MSTF is a New York corporation that offered \$10 million worth of notes through MS & Co. on April 22, 2008. Div. Ex. 2 at Ex. 3, Div. Ex. 590 at 1. MS & Co. received \$6.4 million in fees from the sale of the Trust Offerings between June 15, 2007 and March 31, 2009. Div. Ex. 2 at Ex. 6. The Trust Offerings' PPMs provided that MS & Co. would receive just less than \$3.2 million in fees. Tr. 297; Div. Ex. 2, Ex. 5 (as attached to Div. Ex. 2).

¹⁵ alseT IP Associates LLC was composed of Steve Wilson, David Kennedy, and Newton Advisors, each with 24.1 percent ownership[, all of whom were managing partners. Tr. 2280-81, Div. Ex. 674. The non-managing partners owned the rest. Smith and Livingston owned 30 and 70 percent, respectively, of Newton Advisors LLC (Newton Advisors). Tr. 2280-81. Livingston signed the resignation of Newton Advisors as a managing member of various alseT entities on February 4, 2008. Div. Ex. 274.

¹⁶ Livingston testified that Smith told him that MS & Co. counsel represented that appropriate disclosures had been made. Tr. 2276, 2283-84. Livingston did not have a copy of a written opinion and was not sure there was one. Tr. 2283-85.

Respondent Donald J. Anthony, Jr.

Anthony is in default, so I find the allegations of the OIP true as to him.¹⁷ 17 C.F.R. § 201.155(a).

Anthony, sixty years old, is a resident of Loudonville, New York. OIP at 2. He was registered with MS & Co. from November 1997 to December 2009 and with MS Advisors from February 2006 to December 2009.¹⁸ *Id.* Anthony was among the top-selling brokers at MS & Co. *Id.* at 5. Anthony sold approximately \$2.2 million of the Four Funds, and approximately \$630,000 of the Trust Offerings. *Id.* at 12; Div. Ex. 2, Ex. 4 (as attached to Div. Ex. 2).¹⁹ He earned approximately \$104,000 in commissions relating to these sales. OIP at 12.

Anthony made eleven sales of MS & Co. offerings after September 23, 2008. Div. Ex. 2, Ex. 4a (as attached to Div. Ex. 2). These included a \$30,000 sale in April 2009 of the Trust Offerings. *Id.*; *see* OIP at 4. Anthony's last sale of a Four Funds offering was on January 15, 2008. Div. Ex. 2, Ex. 4a (as attached to Div. Ex. 2); *see* OIP at 3-4. His last sale of the Trust Offerings was on October 13, 2009. Div. Ex. 2, Ex. 4a (as attached to Div. Ex. 2).

Respondent Frank J. Chiappone

Chiappone attended college for two years. Tr. 5399. He has been in the securities business for thirty-three years; holds Series 7, 24, 63, and 66 licenses; is a certified retirement counselor; and is licensed to sell life, accident, and health insurance. Tr. 2567-68. Chiappone worked as a registered representative at MS & Co. from August 1988 until December 2009.²⁰ Tr. 2568-69; Div.

¹⁷ I admit into the record, pursuant to 17 C.F.R. § 201.235(a)(5), prior sworn statements by Anthony in his August 17, 2011, deposition (Anthony Deposition) in connection with the Civil Case, which is Exhibit A to the Division's Brief in Support of Sanctions Against Defaulted Respondent Anthony (Sanctions Brief), filed January 28, 2014. I also take official notice, pursuant to 17 C.F.R. § 201.323, of the FINRA BrokerCheck Report on Anthony (Anthony BrokerCheck).

¹⁸ Anthony is not currently associated with a broker-dealer; until at least February 2011, he was associated with Dinosaur Securities LLC (Dinosaur); he had also been associated with DLG Wealth Management LLC (DLG). Anthony BrokerCheck at 4.¹⁸ Anthony was associated with Mony Securities Corp. from 1982 to 1990 and Merrill Lynch from 1991 to 1997. *Id.* at 4. Merrill Lynch fired Anthony in 1997 in connection with allegations against Anthony of unauthorized trading in client accounts. *Id.* at 10-13.

¹⁹ Pages forty-nine through fifty-nine of Division Exhibit 2 encompass Palen Exhibit 4a, much of which constitutes Exhibit B to the Sanctions Brief.

²⁰ Chiappone testified that he was with First Albany Corp. before joining MS & Co. Tr. 5461. FINRA shows that Chiappone was registered with First Jersey Securities, Inc., and Sherwood Capital, Inc. Div. Ex. 479. Chiappone is now associated with broker-dealer Dinosaur Securities, LLC, and investment adviser DLG Wealth Management. Tr. 2569-70.

Ex. 479. Chiappone was a personal friend of McGinn and socialized with him and his family. Tr. 5414-15.

When MS & Co. had only an Albany office (in the late 1990s), Chiappone began assisting Smith and became a sales manager with the title Vice President. Tr. 2572-73, 5405, 5409. As part of that position, he would keep registered representatives apprised of the amount of offerings that were outstanding. Tr. 5409. Beginning in the 2000s, he was only managing his own clients. Tr. 2572-74. In 2011, when MS & Co. acquired Mercer Company, Chiappone transitioned to working with the new investment adviser representatives in New York City. Tr. 2575, 5408. Chiappone began working out of MS & Co.'s Clifton Park office in 2005. Tr. 5410.

Chiappone estimated that MS & Co. issued seventy pre-2003 offerings and he sold sixty-four of those offerings. Tr. 5440. He testified that the pre-2003 alarm contracts “panned out for the clients except for one transaction, that I owned,” which he identified as SAI, an alarm receivable that had problems with attrition; he later testified that investors did not receive full repayment in three or four of the pre-2003 offerings. Tr. 2644-45, 5467.

Whenever MS & Co. had a new offering, it would convene sales meetings at which Smith, for the Four Funds, or McGinn, for the Trust Offerings, would explain to registered representatives in generalities the types of investments that would be made and the terms and risks of the offering. Tr. 5424-26. Items discussed included the fact that alarm contracts were diversified into more than one zip code, and that UCC-1s were put in place to protect collateral, price discounts for the contracts, debt servicing, and cash flows. Tr. 5422-26, 5441, 5450-52, 5457. Registered representatives were allowed to ask questions. Tr. 5426-27. Chiappone does not recall any mention of reserves. Tr. 5424-25. Chiappone believes the PPMs for the Trust Offerings described the assets in the offerings. Tr. 5441. He considered the Four Funds to be blind pools and knew that investments had not been selected at the time of the offerings. Tr. 5462. At the Four Funds meetings, Smith stated that he expected returns as high as 10.25%. Tr. 5475-77. Smith never told Chiappone what specific investments he was going to make with the Four Funds' offering proceeds. Tr. 2665-66, 2718.

Chiappone relied on others at MS & Co. to perform due diligence on whether the offerings were suitable investment products; he did not do any independent due diligence on or investigation into the offerings. Tr. 2601, 2657. Chiappone took client suitability rules into account when recommending private placements to clients. Tr. 5433-34. He was not aware of any requirement that he conduct diligence on an investment product that he recommended. Tr. 5435-36. He believed that he performed due diligence by “talking to the sponsors of the product, getting my arms around it, feeling comfort after having those discussions to be able to recommend it.” Tr. 5436. Chiappone read what he considered to be the pertinent parts of the PPMs – e.g., the risk factors, the use of funds, and the underlying assets; he never viewed the Four Funds or Trust Offerings as being from a new issuer because the issuer had always been MS & Co. Tr. 5439, 5452, 5559-60.

In recommending the Four Funds, Chiappone gave weight to the successful performance and good reputation of the pre-2003 alarm contracts.²¹ Tr. 2692. If investors asked, Chiappone told them what Smith told him about the nature of the Four Funds' investments, explaining that they: were blind pools, which were different from the pre-2003 contracts; had checks and balances, i.e., attorneys, accountants, and bookkeepers reviewing them; had conflicts of interest that were the same as in many other MS & Co. offerings; and that each of the Four Funds had different investments. Tr. 2671-73, 2680-82, 2687-88, 5484-85. He later learned that the Four Funds were not diversified. Tr. 2687-88.

Chiappone recommended the Four Funds as suitable for retirement accounts because of their high yield. Tr. 2688-89. Chiappone was not concerned whether the Four Funds could achieve the rates of interest promised, as the alarm notes had delivered on similar rates. Tr. 5476-77. He believed that MS & Co.'s lending to borrowers with poor credit, causing them to pay higher-than-market rates, supported the high interest payment rates promised to Four Funds' investors. Tr. 5477.

Chiappone believed private placements made sense for investors who had other investments, would be able to withstand losses, and were looking for high-yield alternatives to equities. Tr. 5437-38. Chiappone never recommended that a client's entire portfolio be invested in private placements. Tr. 5438. No one ever told him that the limit of thirty-five unaccredited investors for any one offering had been reached. Tr. 5493.

Chiappone understood in November 2007 that MS & Co. was looking for replacement investors before it would honor redemption requests. Tr. 2702, 5596-98; Div. Ex. 427. He believed that MS & Co. took such an approach because it did not want to sell assets to cover redemptions in an illiquid market. Tr. 2702-03. On November 15, 2007, around 9:00 a.m., Guzzetti wrote Chiappone that his clients had redeemed \$45,000 in FAIN notes and MS & Co. had not received any replacement tickets. Tr. 5598; Div. Ex. 427. Chiappone responded that he was "working on it." Tr. 5598; Div. Ex. 427. Later, Chiappone emailed Guzzetti, "I just placed \$25,000." Tr. 2699; Div. Ex. 428. Chiappone did not think this exchange of emails should be interpreted as a red flag. Tr. 5502. Chiappone testified that the first time a client questioned a redemption was in late 2009. Tr. 5570, 5604.

Chiappone's mother, a close family friend of Chiappone, and Chiappone himself invested in the Four Funds. Tr. 2706, 5385. He testified that if he believed the Four Funds' investments were not strong or secure, he would not have invested his or a family member's money in them. Tr. 5653. He stated that he would have explained the risks to clients but is not sure he would use the term "risky." Tr. 5653-54.

The record shows that in November 2007, Chiappone called McGinn, representing that he spoke for other brokers, complaining that commissions on FAIN were being scheduled for December. Tr. 3058; Div. Ex. 120.

²¹ Chiappone testified that he did not know until participating in this proceeding that the Four Funds' offering proceeds were used to redeem pre-2003 alarm contracts. Tr. 5468.

Chiappone testified that he attended the January 8, 2008, meeting during which Smith announced that the interest on the Four Funds' junior notes would be reduced. Tr. 5560-61. He recalled that at the meeting and in a letter to investors, Smith described a lack of liquidity in the Four Funds' investments caused by the market meltdown, and that interest rates would need to be restructured. Tr. 2630-31, 5562. Chiappone believed that his customers relied on the interest from their Four Funds holdings for income, and he became emotional when he heard about the interest reduction, because his clients had broad exposure to the junior notes. Tr. 2637-38, 5565-66. Chiappone testified that he realized, later in 2008, that Smith's explanation of a market meltdown was "just a screen." Tr. 2631, 5635.

Chiappone testified that he did not sell a Four Funds offering after the January 8, 2008, meeting; however, he continued to sell Trust Offerings where Smith was trustee and MS & Co. was responsible for due diligence. Tr. 2638-39, 2646, 5566. Chiappone did not view the Four Funds' restructuring, announced in January 2008, as a red flag for the Trust Offerings because the Trust Offerings had identifiable collateral. Tr. 5566. He believed Trust Offerings held triple play contracts and remembered that the pre-2003 alarm contacts continued to pay interest through market difficulties in 2001 through 2003. Tr. 5566-67. Chiappone testified that, in January 2008, he did not know that Four Funds' offering proceeds had been used to pay pre-2003 contract investors, intercompany loans, or loans to McGinn, Smith, and M. Rogers. Tr. 5568.

Chiappone had some concerns about Smith in 2008. Tr. 2624. Chiappone wrote, but did not send, the following message to Smith, which appears to have been written in late August 2008:²²

As I sit frozen in place at my desk I am having trouble even finding the words to write. This is about the commissions due to us for the notes. The market meltdown has been a nice screen for the fact that that you have mismanaged the assets that my clients and I entrusted in your care. The fact that the notes hold all the same investments including Coventry (CMS) is incomprehensible to me.²³ The commissions due were dollars that I was relying on to supplement my income as I try to rebuild my business. This is due to the fact that after being here for twenty years just about every one of my clients has been [a]ffected by what has happened to the notes. I understand that the firm is not taking any fees from the notes but these commissions were McGinn Smith obligations to us not obligations of the notes. We as brokers raised the capital for you to invest. We deferred getting paid

²² When he first testified at the hearing and in his investigative testimony, Chiappone stated that he shared his message with others in the Clifton Park office, perhaps Gamello or Guzzetti, and they persuaded him not to send it. Tr. 2534, 5636-37. When he testified the second time, he stated that it was his significant other who convinced him he would likely be fired if he sent the message, not Gamello or Guzzetti. Tr. 5397-98, 5636-37.

²³ Chiappone had investors with large holdings in Coventry and was angry to find out that Coventry was held by all of the Four Funds. Tr. 2635.

up front to help the portfolio's get off the ground as well as annuitize our business. It is not our fault that you mis-managed the investments.

Tr. 2629; Div. Ex. 231. Chiappone denies he wrote the email in August, but he concedes that at some point in 2008, he and other registered representatives were becoming aware they had been misled by Smith. Tr. 2633, 2653.

Prior to December 30, 2008, Chiappone had not requested from any of the Four Funds an operating statement, balance sheet, income statement, or list of assets. Tr. 2691-92. On December 30, 2008, Chiappone requested from Smith a list of entities TAIN had invested in and the dates of those investments. Div. Ex. 511. Smith replied:

Frank, I have repeatedly told all those who previously requested this information that this is confidential. Borrowers have a strong aversion to anyone outside knowing their business and we represent to them that it is confidential. In addition, this information in the hands of the wrong people will lead to second guessing at best and legal challenges at worst. I have stated several times that brokers need to point out the confidentiality if customers ask. Once you open the door to a single party you are subject to providing it to all. The only thing available to investors is a copy of the balance sheet. Who is requesting and for what purpose? By not responding initially as I have instructed, you open the door to criticism that we have something to hide. Is this coming from someone questioning the SAI investment? Andy said someone was chall[e]nging how SAI could be in our portfolio since TAIN was offered post the initial offering of SAI I know of no hedge funds or private equity funds that open their books to clients or outsiders.

Div. Ex. 425. Chiappone's reaction to Smith's refusal to provide information was that Smith was staying "with the same response he has had all along and I just left it at that." Tr. 2663.

Chiappone was unaware that the Firstline PPMs disclosed a conflict regarding MS & Co.'s performance of due diligence when he recommended that customers purchase Firstline notes. Tr. 2605. At some point Chiappone came to learn – and was surprised to learn – the Firstline investors were being paid out of others trusts' money.²⁴ Tr. 2606. Chiappone called McGinn before he sold Firstline in April 2008 and was assured that the deal was proceeding as it was when the notes were first offered in 2007. Tr. 5572. Chiappone sold a total of \$80,000 in Firstline notes on May 15, 2008. Tr. 5573; Div. Ex. 2, Ex. 4c (as attached to Div. Ex. 2).

On September 8, 2009, Joseph Carr (Carr), MS & Co.'s in-house legal counsel, recounted to Smith a phone conversation in which Chiappone expressed concern about Firstline and its lack of diversification. Tr. 2591-92; Div. Ex. 431. Carr wrote:

I just got off of a long call with Frank Chiappone. He is not only distressed about Firstline but also is equally distressed about the lack of diversification on the investments made by the Funds. He has clients with Firstline, CMS, and the Funds

²⁴ He was, however, aware that funds were being raised to redeem investors in Firstline. Tr. 2607.

and they ended up with duplicates of the same investments. [Chiappone] assured clients that their investments were okay even though [Smith and Carr] have known about Firstline for a lengthy period of time. If you have a few minutes it might be a good idea for you to call him and try to soothe him. I did the best that I could but it would be better coming from you.

Div. Ex. 431. Chiappone testified he was concerned when he learned of the Firstline bankruptcy, and he reached out to investors and shared the information McGinn had provided the registered representatives, including when Firstline had filed for bankruptcy, and that MS & Co. was now purchasing assets out of bankruptcy. Tr. 2597-98, 5502.

Chiappone made only one sale after he first learned of Firstline's bankruptcy: a Benchmark note, on November 3, 2009.²⁵ Tr. 2578; Div. Ex. 2, Ex. 4c (as attached to Div. Ex. 2). Chiappone knew that only \$1.95 million of the \$3 million raised in the Benchmark offering would go toward assets, but he recommended the investment based on McGinn's statements that market conditions allowed the purchase of assets at distressed prices, that markets would eventually recover, and that the assets could possibly be sold at higher prices. Tr. 2618-20. Chiappone believed that people inside and outside MS & Co. conducted due diligence on the Benchmark offering. Tr. 2625-26. While he recognized there were conflicts of interest in the Benchmark offering, any concerns he had were ameliorated by the fact that had worked at MS & Co. for twenty years, during which things worked out well for clients, and that McGinn was a trusted friend.²⁶ Tr. 2625-28.

Between October 3, 2003, and November 3, 2009, Chiappone sold \$13,522,000 of the Four Funds and Trust Offerings, by which he earned \$531,844 in commissions. Div. Ex. 2, Exs. 4c, 4d (as attached to Div. Ex. 2).

Witnesses who Purchased Securities from Chiappone

Gary Ardizzone (Ardizzone) is a seventy-three year old resident of Hudson, Florida, where he moved in 2005 from Broadalbin, New York. Tr. 2759-60. After working for General Telephone & Electronics, a phone company, for twenty-five years, Ardizzone became co-owner of a telecommunications business with a friend in 1985; he retired from that business in 1996. Tr. 2760. Following retirement, Ardizzone invested, through Chiappone, in MS & Co.'s pre-2003 alarm contracts and other investments such as mutual funds and bank stocks. Tr. 2763-66. Ardizzone became a client of Chiappone after Ardizzone reached out to Chiappone about his interest in the pre-2003 alarm contracts; a friend of Ardizzone had recommended the alarm contracts product to him. Tr. 2761-62.

²⁵ In his Wells submission, Chiappone stated that MS & Co.'s push of Firstline sales following its bankruptcy filing prompted him to consider that the prior interest payments to Firstline holders had come from investors in other MS Co. offerings and not a "white knight," as he had been led to believe. Tr. 2581-95.

²⁶ Chiappone explained that "from the clients' point of view, they had five, six, seven, eight years of McGinn Smith-sponsored receivables or private placement transactions that paid when they said they were supposed to." Tr. 2669.

Chiappone recommended the following investments with purchase prices totaling \$232,000:

Date	Investment
May 17, 2004	\$30,000 in FEIN 7.5%
May 23, 2005	\$82,000 in TAIN at 10.25%; and \$50,000 in TAIN 5.75%
December 15, 2006	\$30,000 in FEIN 7.75%
May 2, 2007	\$15,000 in TDMVER 12%
October 7, 2008	\$25,000 in FORT 13%

Tr. 2767-73; Div. Ex. 2, Ex. 4c (as attached to Div. Ex. 2).

According to Ardizzone, he told Chiappone that he was a retiree with conservative investment goals and low risk tolerance. Tr. 2763-64. Ardizzone said that he learned about the alarm contract investments from Chiappone and relied on his advice on them. Tr. 2762-63, 2766-70, 2794-95. Chiappone had worked with Ardizzone for a number of years, and Ardizzone trusted him. Tr. 2794-95. Ardizzone testified that Chiappone told him that he and his family had invested in similar products to the alarm notes Ardizzone was investing in, and that Chiappone never voiced any concern about MS & Co. to Ardizzone. Tr. 2775-76.

Ardizzone understood that all these investments were driven by the alarm business in some form. Tr. 2766, 2770-72, 2796, 2798. He testified that he was never told that funds were being used to buy out old investors. Tr. 2774. Ardizzone did not do any independent due diligence because he counted on Chiappone, the person selling the product to him, to do the due diligence. Tr. 2774. Ardizzone signed subscription agreements for his investments in the alarm contracts, but never read the PPMs carefully, in part because they were difficult to understand. Tr. 2768-69.

Bruce Becker (Becker) owned a telecommunications company for eighteen years and retired in 2000. Tr. 2895-96. Becker was a successful business man, with expertise in technology and limited knowledge of securities markets.²⁷ Tr. 2896-97, 2910-14. Becker has a medium tolerance for risk and made the investments for his retirement. Tr. 2913-14. Becker, an accredited investor, began investing with Chiappone at MS & Co. in the mid-1990s, primarily in alarm contracts. Tr. 2898-99, 2909, 2920-21, 2927-28. Becker was introduced to Chiappone by Ardizzone, who was his business partner. Tr. 2897-98. The following notes, purchased by Becker and his wife, are at issue in this proceeding:

Date	Investment
June 4, 2007	\$30,000 in Firstline

²⁷ Becker has some college education and a sense of humor; he identified his previous work experience as including a paper route. Tr. 2897.

November 5, 2007	\$55,000 in Firstline
March 6, 2008	\$50,000 in TDM Verifier
September 26, 2008	\$50,000 in Fortress
December 22, 2008	\$50,000 in TDM Verifier

Tr. 2901-03; Div. Ex. 2, Ex. 4c (as attached to Div. Ex. 2). Becker's filing with the Receiver is for \$235,000. Tr. 2936.

Becker learned about the offerings from Chiappone, who called him when there was an offering. Tr. 2903. Becker did not remember ever discussing the details of the investment with Chiappone, but he always received the offerings' PPMs. Tr. 2904. Becker did not read the PPMs thoroughly because he understood the offerings involved alarm contracts, which he had become familiar with, and the interest was always paid on schedule. Tr. 2904, 2920. Chiappone never sat down and went over the PPM with Becker. Tr. 2905. Becker cannot recall Chiappone describing any of the offerings as different or discussing whether they presented conflicts of interest. Tr. 2905-07. Becker counted on Chiappone to perform due diligence. Tr. 2908. Chiappone never told Becker that he had any concerns about the trustworthiness of McGinn or Smith. Tr. 2908. Becker still does some business with Chiappone and considers him an honest broker. Tr. 2946.

Witnesses in Support of Chiappone

Mary Ann Cody (Cody) holds a bachelor's degree from the University of Vermont, a law degree from Albany Law School, and a master's in business administration from Rensselaer Polytechnic Institute. Tr. 4541. Cody was general counsel at MS & Co. from 1989 to October 2002, when she left to become counsel to IASG. Tr. 4542-43, 4557, 4559, 4562. Cody married McGinn in 1990 or 1991, they separated in 2003, and later divorced. Tr. 4542-43. Cody left IASG in November 2004. Tr. 4559.

In 1999, Cody was concerned about the low level of collections from alarm contract customers and attrition in the number of contracts. Tr. 4570-71, 4581-83. To address the issue, IASG assumed the billing and collection function and hired a dozen or so people experienced in doing due diligence on alarm contracts. Tr. 4547-48, 4550-52, 4570-71, 4581-83.

Jerry Mirochnik (Mirochnik) is a graduate of Syracuse University; he spent thirty years working as a public accountant, and he is now co-owner and CFO of Security Integrations in Albany, New York. Tr. 3112-13. Mirochnik, an accredited investor, purchased private placements from Chiappone from at least 2001. Tr. 3114, 3121. Mirochnik always received a PPM, subscription agreement, and investor questionnaire from Chiappone, and Chiappone always discussed the risks associated with private placements with him. Tr. 3117-19.

Mirochnik testified that in 2004, he purchased \$25,000 worth of FEIN notes, which he redeemed on their due dates, however his name is not on the list of Chiappone's sales in evidence. Tr. 3123-26; Div. Ex. 2, Ex. 4c (as attached to Div. Ex. 2). Mirochnik considers Chiappone an honest broker, and he testified that Chiappone never misled him, always explained investment opportunities, and has always been honest with him. Tr. 3131-32.

Leanne Sweet (Sweet) is a retired graduate of Skidmore College. Tr. 5362-64. Sweet, an unsophisticated investor, inherited her father's account at MS & Co. in 1991. Tr. 5364-65. Sweet maintained that account and made purchases of MS. & Co. private placements through a broker who passed away in 2000. Tr. 5362-63. Eventually, she moved the bulk of her account to Merrill Lynch, except for the MS& Co. private placements, which Merrill Lynch would not accept. Tr. 5372-73. In 2002, Sweet's broker at MS & Co. became Chiappone.

Between May 2002 through May 2005, Sweet made eleven private placement purchases recommended by Chiappone: \$26,000 of purchases of RTC Trust 02, \$150,000 of purchases of Coventry Carelink Holding Corp., a \$20,000 investment in FEIN 7.5%, a \$30,000 investment in FEIN 10.25%, \$50,000 in purchases of TAIN 5.75%, and an \$80,000 purchase of TAIN 10.25%. FC Ex. 107.

Chiappone would generally propose investments to Sweet via telephone, often after one of her holdings had been redeemed and her account had some cash. Tr. 5379-80. Chiappone described some of the investments as high risk but with good interest. She received the documentation but never read the PPM; she relied on her prior experience. Tr. 5380, 5382. Sweet believes Chiappone treated her fairly. Tr. 5386.

Respondent William P. Gamello

Gamello attended, but did not graduate from, Marist College, in Poughkeepsie, New York. Tr. 1731. Gamello previously held Series 7, 24, and 63 licenses, and recently received a New York State insurance license.²⁸ Tr. 1732. He began working in the securities industry in 1987, and was associated with Wachovia Securities for about four years before joining MS & Co., where he worked out of the Clifton Park office from April 1, 2005, until mid-December 2009. Tr. 1733, 5931-32; Div. Ex. 480. Gamello was drawn to MS & Co. by Guzzetti's vision of expanding retail operations and offering clients expanded service. Tr. 5933.

In 2005, the Clifton Park office had no branch manager; Smith was in charge of the firm and Guzzetti was the head of retail sales. Tr. 1736-37. Carmello Nicolosi (Nicolosi) became manager of Clifton Park in 2006. Tr. 1738. Gamello considered Guzzetti above Nicolosi in the supervisory hierarchy, and Guzzetti was one of Gamello's multiple managers. Tr. 1738. Gamello sold \$2,888,000 of the Four Funds and Trust Offerings between June 30, 2005, and August 27, 2009, which yielded him \$108,250 in commissions. Div. Ex. 2, Exs. 4g, 4h (as attached to Div. Ex. 2). Gamello knew that the Four Funds and Trust Offerings were private placements and were high risk investments. Tr. 1897.

²⁸ Gamello passed the examination for a Series 66 license in August 2013. Tr. 1732. The OIP caused Ameriprise Financial Services, Inc., to terminate Gamello, so his security licenses became inactive. Tr. 1732-33, 5956. As of February 2014, Gamello had been an investment adviser representative on a limited basis at DLG Wealth Management for about a month. 1732-33; Div. Ex. 480. This proceeding has caused financial and professional burdens for Gamello. Tr. 5956-58.

Gamello managed clients with a total of about \$25 million in assets – most of their assets were in stocks, bonds, and mutual funds; about 25% of Gamello’s clients were in wrap-fee accounts; and about 10% of his clients had investments in private placements. Tr. 5937. Gamello considered many factors in determining customer suitability. Tr. 5938-39.

FIIN, FAIN, and TAIN were issued before Gamello joined MS & Co. Tr. 1760-62, 5975. According to Gamello, when he began at MS & Co., “there was already [\$]70 million outstanding of these notes. They had been around for 25 years. Dave Smith was in charge of them completely.”²⁹ Tr. 1760. Gamello believed the Four Funds were blind pools at their outlets. Tr. 1760. Gamello made at least one sale in each of the Four Funds. Tr. 1760-62, 5975; Div. Ex. 2, Ex. 4h (as attached to Div. Ex. 2). Those sales were mostly unsolicited transactions: wealthy customers familiar with MS & Co. investments would approach Gamello, asking to purchase Four Funds notes. Tr. 1750-51, 1764, 1774-75, 5939-40. Gamello learned about the Four Funds offerings mainly from two other experienced registered representatives in his office: Pieter VanDerze and Feldmann. Tr. 1742.

Gamello understood that the Four Funds contained loans Smith made to local people or entities under confidentiality agreements; he believed the loans were supported by collateral. Tr. 1743-44, 1748, 1757. Even so, Gamello thought that he could obtain information about underlying assets because the PPMs for the Four Funds articulated that information would be made available upon inquiry. Tr. 1747. Gamello testified that he told clients when recommending the Four Funds that Smith controlled everything and that Gamello had no idea what the Four Funds held; nevertheless, Gamello’s clients chose to make investments in the Four Funds.³⁰ Tr. 1764-65.

Gamello believed the Four Funds did not have books to review. Tr. 1773-74. Gamello’s general practice of familiarizing himself with offerings included reading the PPMs, attending due diligence meetings, and asking questions about the PPMs and the offerings before presenting the information he gathered to clients. Tr. 1779. He said that he followed such a practice with FAIN, which was the only one of the Four Funds that was issued after Gamello joined MS & Co. Tr. 1778-79, 5940. Gamello was quite specific that he also read the earlier Fund PPMs because wanted to warn the clients who made unsolicited purchases, “Hey, you don’t know what you are buying, look at the risks.” Tr. 1779-80.

When he sold the FAIN offering, it had no investments, and Gamello described this as a blind pool. Tr. 5940. In recommending FAIN, Gamello relied on Smith’s apparent success in managing \$70 million worth of similar funds; he committed about 5% of his clients’ assets in FAIN notes. Tr. 1768, 5941-42.

²⁹ Gamello was presumably including the pre-2003 alarm contracts in his estimation, with which he had nothing to do. Tr. 5950.

³⁰ Of Gamello’s fifty-nine sales of the Four Funds, twelve were purchases by Mr. Boni and Mr. Morrell, both of whom Gamello testified sought him out to make these investments. Div. Ex. 2, Ex. 4g (as attached to Div. Ex. 2); Tr. 1750-51.

On March 24, 2006, one of Gamello's clients, who had \$60,000 invested in equities and mutual funds, and \$40,000 invested in FAIN, emailed him:

[W]ould we be more beneficial moving **\$60K** into the **3 & 5 year FAIN's**? I remember you saying that it is best to be d[i]versified but the nearly guaranteed dividends outweigh[] the lack of li[q]uidity of the principal, yes_no??? I am probably wrong but the gain from these **FAIN** accounts is so tempting.

Tr. 5966; Div. Ex. 178 (emphasis in original). Gamello testified that he never told this client that FAIN had guaranteed dividends. Tr. 5967, 5971-72.

On December 20, 2007, Gamello emailed Guzzetti about a redemption: "Andy, any info on my FAIN for martino?" Div. Ex. 184. Guzzetti replied that he had sent an email to Smith for him to approve the redemption. Tr. 5972-74; Div. Ex. 184.

In a deposition taken by the Division,³¹ Gamello testified that he did not gather specific information on the investments Smith was making to determine whether borrowers could repay their loans to the fund. Tr. 1765. He assumed that Smith or the firm had done due diligence. Tr. 1765-67. Up to the first restructuring of the Four Funds, he had been satisfied because the notes appeared to be performing and National Financial Services (NFS) had reviewed the books. Tr. 1769-71. Before then, Gamello did not ask to see or review any of the Four Funds' books or request financial statements. Tr. 1769-70. Gamello knew that the National Association of Securities Dealers (NASD, now FINRA) had examined MS & Co. before 2005. Tr. 1772-73. Gamello did not communicate with the NASD, the outside accountants, or NFS about their reviews of the Four Funds. Tr. 1771-73.

Gamello talked with McGinn about the Trust Offerings and was impressed with McGinn's facility with numbers and his implementation of structures to capture and sell revenue streams.³² Tr. 5942-43. Gamello familiarized himself with the Trust Offerings as he had with the Four Funds: he read the PPMs, attended "due diligence meetings" led by McGinn and others at MS & Co. about the offerings, and listened to questions about the structure of the offerings and cash flows, among other things.³³ Tr. 1851, 1903, 5943-46. MS & Co.'s potential conflicts of interest in conducting due diligence did not concern Gamello. Tr. 1850-51. Gamello never sought to verify the information on the Trust Offerings because he trusted and relied on McGinn, as well as the

³¹ Gamello takes issue with the Division's use of his deposition testimony, where he testified without any records and in the belief he was called to assist the Commission's case against McGinn and Smith. *See, e.g.*, Tr. 1778-89, 1839-44.

³² Gamello considered himself a "numbers" person like McGinn. Tr. 5942.

³³ Gamello testified that "Rabinovich, Mayer and Rogers . . . would really hammer on Tim McGinn and go through all the numbers and everything when they were presenting the deals, when they were having these due diligence meetings." Tr. 5959. Gamello added he would present any questions he had at these meetings as well. Tr. 5959.

investment bankers and others who performed the due diligence on the offerings. Tr. 1845, 1851-52, 1903. Gamello was not concerned by the PPM's disclosure that MS & Co.'s due diligence review could not be considered independent. Tr. 1858-61. Gamello was never denied information about the offerings. Tr. 1775, 5950, 5976. He also testified that he only recommended the Trust Offerings as alternative investments to suitable clients. Tr. 5946-49. All of his clients who invested in the Four Funds or the Trust Offerings were accredited investors. Tr. 5959; *see also* Div. Exs. 531-36.

On September 25, 2008, Gamello sold to two sisters, each with the last name Reich, a \$200,000 Fortress note, after discussing the risks associated with the notes with them. Tr. 1861-62; Div. Ex. 2, Ex. 4g (as attached to Div. Ex. 2). Gamello did not know any more about what Fortress was buying than what was stated in the PPM and discussed at the due diligence meetings. Tr. 1871-75. He testified these were sound investments for the time – the middle of a credit crisis when others were selling – because these investors were sitting on a lot of cash and it made sense to take advantage of high yields. Tr. 1867-70. Between September 25, 2008, and August 27, 2009, Gamello sold to the Reich sisters a total of about \$1 million of Trust Offerings. Div. Ex. 2, Ex. 4g (as attached to Div. Ex. 2).

When he sold Benchmark, Gamello did not perform an independent investigation into the expected cash flows or ask for cash flow statements. Tr. 1876. Gamello did not recall at a deposition, but he now remembers, thinking at the time that Benchmark's expenses were a little high, over \$1 million out of \$3 million raised, but he and other registered representatives were told that the assets were being acquired "real cheap." Tr. 1877-79. Gamello testified that the figures surrounding the Benchmark offering were discussed in detail at due diligence meetings, and he discussed expenses with customers who purchased Benchmark. Tr. 1878-83. He believed the Benchmark note tranche with 12% interest made economic sense to purchase and the interest rate was achievable even with the high expenses. Tr. 1880-83.

Gamello testified that no one ever told him that he had to find a new investor to redeem an existing investor until he received an email from Guzzetti in November 2007. Tr. 1791, 1801; Div. Ex. 181. Gamello responded to Guzzetti's email with "I'm required to have replacement tickets??? That's news to me." Div. Ex. 181. Gamello further responded to Guzzetti: "I don't really have replacement at this time . . . so feel free to have [L]ex or whomever snap them up . . . for the future I'll look to have replacement set up." Div. Ex. 182. Gamello testified that Guzzetti then explained that Smith preferred that registered representatives requesting redemptions find new purchasers so that the positions were not liquidated at depressed prices because of the credit crisis. Tr. 1803-04, 1807. Gamello never had a client be denied redemption and was not aware that MS & Co. had a redemption policy. Tr. 5950. Gamello never had a client be denied a redemption and was not aware that MS & Co. had a redemption policy per se. Tr. 5950.

On December 19, 2007, Gamello emailed Guzzetti that a client that redeemed \$30,000 in a FAIN note on November 15, 2007, and he wrote a replacement ticket but the client still had not been cashed out of the note. Tr. 1812-13; Div. Ex. 183. On December 21, 2007, Gamello further inquired of Guzzetti, copying Nicolosi, why that client had not been redeemed. Div. Ex. 185.

Guzzetti passed the inquiry up to Smith with a note that “Fc had replaced the money.”³⁴ *Id.* Smith replied, “Bill should tell the client the truth that we were hit by a wave of redemptions and we have to sell investments to get liquid.” *Id.* Though Gamello did not believe replacement was required, he did find them because getting replacements made sense to him, due to market conditions that made it untimely to liquidate assets.³⁵ Tr. 1804-05, 1809, 1814.

Gamello was not invited to the January 8, 2008, meeting and testified he did not know about the meeting until he saw it mentioned in the OIP. Tr. 5951.

After the first restructuring of the Four Funds was announced in January 2008, Gamello thought, “[o]h, I better take a look, see what is going on in here, just for my own thoughts and for the clients.” Tr. 1776. After the first restructuring, because he had a client with an investment in junior notes, Gamello requested a copy of the investments. Tr. 1830-31. Once he had a copy of the investments, he and his client looked at the investments and researched them, determined that what Smith was saying about the investments being illiquid was true, and determined Smith’s advice as to cutting the interest rates was sound. Tr. 1831-32. Gamello’s clients were invested in FAIN more than any of the other Four Funds, and after the first restructuring, he requested and received a list of FAIN investments. Tr. 1838.

Gamello was at the September 2009 meeting, where the Firstline bankruptcy was disclosed. Tr. 5952. He developed distrust in the firm and its leaders after that meeting, and left in December 2009. Tr. 5953, 5977.

On November 23, 2009, Gamello questioned Shea’s instruction that 2009 Fortress Trust payments would be characterized as principal:

The logical conclusion is that the investment never had enough cash flow to pay any interest, much less 13% from day 1. Is that the case? And if not, please explain to me how you can classify payments as return of principal when in fact some was interest earned. I can see how it would be advantageous to the company to wipe out 10% of their debt by reclassifying payments. I do not however see how that it in any way benefits investors.

Div. Ex. 437. Gamello copied Chiappone, Guzzetti, Lex, Mayer, McGinn, Rabinovich, Rogers, and Smith on this email. *Id.*

³⁴ Gamello testified that, at the time, he knew that “FC” stood for financial consultant, but did not know what Guzzetti meant by “Fc replaced the money.” Tr. 1794-95, 1800-01.

³⁵ Gamello sold one replacement note for \$75,000 to his mother-in-law. Tr. 1805, 1811.

Respondent Andrew G. Guzzetti

Guzzetti, a graduate of Utica College, former athletic coach, teacher, and restaurant owner, has been in the securities industry since 1983;³⁶ he holds representative and supervisor securities licenses.³⁷ Tr. 2958, 4587-94. Guzzetti joined MS & Co. in September 2004, when he began working with Mayer in the new New York City office. Tr. 2971, 4597-98, 4601. Guzzetti held titles of managing director in the Private Client Group and vice president for retail while at MS & Co., but he described his position as national sales manager. Tr. 3101, 4612, 4663-64; Div. Exs. 80, 114. All the retail sales force reported to him on products and finding new clients, among other things. Tr. 4808. Guzzetti held the title of branch manager for the Clifton Park office starting in October 2008.³⁸ Tr. 1137-38, 2961, 2965; Div. Ex. 329 at 48. Guzzetti testified that supervision is divided up among different people and in the broad sense he was one of those supervisors. Tr. 3223.

Prior to becoming branch manager, Guzzetti did not have supervisory responsibility for approving order tickets or for reviewing the books. In his Answer, Guzzetti admitted that “after October 2006 he was a supervisor for some of the MS & Co. brokers for their general securities activities,” but denied that he had “any supervisory responsibility for the Four Funds and the [Trust Offerings].” Tr. 2970; Guzzetti Answer at 9. At the hearing, Guzzetti admitted to being a supervisor of brokers on the “wealth management part of the business,” which he defines as fee-based or advisory business, as opposed to transactional stocks, bonds, and private placements-based business. Tr. 2962-69, 2971. Guzzetti headed MS Advisors from February 2006 until April 2009, when his responsibilities included recruiting registered representatives to work with MS Advisors. Tr. 2961-63, 2967, 2984.

Guzzetti testified he recruited and hired registered representatives who were going to work on commission-based business, but he would always talk first with the branch manager where the person was going to be assigned. Tr. 2961-62, 4602, 4605, 4624. Smith had to sign off on hiring whenever the new employee was going to receive a salary, as opposed to just commissions, or a forgivable loan. Tr. 4623-24. Guzzetti believes that between thirty-five and fifty registered representatives reported to him on retail sales. Tr. 2963-64. Guzzetti did not conduct performance

³⁶ Guzzetti worked for Shearson & Company and its predecessors for twenty years. Tr. 2950, 2958, 4588-89.

³⁷ Guzzetti earned his Series 24 license in February 2006, which permitted him to act as a supervisor. Tr. 2965, 2999, 4627. Guzzetti began considering leaving MS & Co. in late 2008. Tr. 3177. He has been associated with broker-dealer Dinosaur Securities, LLC, since January 2010. Tr. 3216; Div. Ex. 481 at 3.

³⁸ Guzzetti’s salary was \$150,000 in 2004 and \$75,000 in 2008 and 2009. Tr. 3212, 3238. He did not receive overrides on broker sales or bonuses. Tr. 3238. The initial FIIN and FEIN offerings occurred before Guzzetti joined MS & Co. Guzzetti sold \$270,000 of trust offerings in seven sales to three persons between March 2007 and May 2009, and received commissions of \$7,800. Tr. 3008; Div. Ex. 2, Ex. 4i (as attached to Div. Ex. 2).

evaluations of registered representatives, but he advised the branch managers who did. Tr. 2984-85, 4624. Guzzetti conducted firings of registered representatives with the assistance of branch managers. Tr. 4625. Guzzetti was involved in discussions on the compensation structure of registered representatives. Tr. 2985-88.

MS & Co.'s 2007 Supervisor Compliance Manual (2007 Manual) and 2008 Supervisor Compliance Manual (2008 Manual) both reflected, in a section showing supervisory personnel, that Guzzetti was responsible for all outside registered representatives.³⁹ Tr. 2979, 2999; Guzzetti Ex. 2 at 37; Div. Ex. 329 at 40; RMR Ex. 112. Guzzetti testified that sections of the 2008 Manual listing him as a supervisor and giving him supervisory authority over the Clifton Park office do not make sense, as the Manual is dated April 2008, but he did not become branch manager for Clifton Park until October 2008.⁴⁰ Tr. 2966, 2997-98, 3003-04; Div. 329 at 34, 47-48. The 2008 Manual also, confusingly, stated that “[Carl] Nicolosi is the Office Manager for [Clifton Park] and is responsible for the supervision of all brokers in the office.” Div. Ex. 329 at 40. The branch office procedures section of the 2008 Manual stated:

Review and approval of daily trades ensure that all transactions are suitable for customers and that no unusual sales practice activities are occurring. In connection with the review of daily trading, the Branch Manager should concentrate on the following areas:

Review for general suitability of transactions. Such review considers the client's investment profile and objectives.

...

The Branch Manager or Designated Principals will review and approve all assigned transactions on a timely basis.

Tr. 3005-06; Div. Ex. 328 at 13 (formatting altered).

Guzzetti testified he was brought into MS & Co. to develop fee-based business for the firm, which he claimed he did. Tr. 2970, 4597. MS & Co. had just opened a New York City office. Tr. 4597. Guzzetti maintained he had nothing to do with creating the private placements at issue and that he was a mere conduit between Smith, and occasionally McGinn, often through Patricia Sicluna (Sicluna), an employee and office manager at MS & Co. Tr. 1215-17, 3228-29. Sicluna copied McGinn and Guzzetti on Sicluna's daily emails to Smith listing Four Funds redemptions. Tr. 3070-

³⁹ Guzzetti defined an outside registered representative as an independent registered representative, identified Lex and three others, and testified there were maybe five or six outside registered representatives. Tr. 2981.

⁴⁰ The 2008 Manual states that “All brokers in the Clifton Park office are under Andy Guzzetti's direct supervision” and “Brian Mayer and Andy Guzzetti are under David L. Smith's supervision.” Tr. 3004; Div. Ex. 329 at 48.

71; Div. Exs. 122, 500. Guzzetti explained, “It just evolved that everything came through me.” Tr. 2967, 2990, 3016, 3035, 3049, 3068-69, 3072.

Guzzetti testified that: Smith approved all purchases of Four Funds and Trust Offerings; Guzzetti did not review the paperwork; Smith answered questions on Four Funds offerings; and McGinn answered questions about the Trust Offerings. Tr. 3006-08, 3227-28, 4629. Guzzetti denied at the hearing that he was a supervisor with respect to the private placements at issue in this proceeding. Tr. 2968-69, 2976. He said that if he talked about private placements at a sales meeting, Guzzetti would point out that there can be no cold calling, investors had to be accredited, and sales points had to be based on the PPM. Tr. 3000-02. He said that at sales meetings, Smith discussed the Four Funds and McGinn answered questions on the Trust Offerings. Tr. 2976.

Guzzetti testified that he never heard the term “red flags” in the context of the brokerage industry, and he never heard that registered representatives were obliged to conduct due diligence on a new private placement, beyond reading the PPM, listening to the investment bankers or sponsors of the new securities, and considering the issuer’s track record. Tr. 2953-58, 3139-40, 4650. Guzzetti believes a suitability review looks at the client’s risk tolerance, goals, and objectives. Tr. 3145. Guzzetti acknowledged that a registered representative: is responsible to understand the product he was recommending; is obliged to satisfy himself that the product he was recommending is suitable for the customer; and has a duty to look at the PPM and to listen to those presenting on the product. Tr. 3148, 4650. Guzzetti never thought that MS & Co.’s and its affiliates’ playing multiple roles as to the Four Funds and Trust Offerings caused a conflict of interest. Tr. 3158-59.

Guzzetti testified that he knew some of the companies the Four Funds and Trust Offerings invested in from conversations with Rabinovich and Rogers, and that most of the fund investments were with non-public companies. Tr. 4642, 4648. Guzzetti was not concerned that he did not know full details of what the Four Funds and Trust Offerings had invested in because he was not a money manager, did not invest his clients’ money in these offerings, and rarely talked about these offerings with registered representatives. Tr. 4648-49.

Guzzetti sent out “morning call notes,” almost daily, which he testified “morphed into putting up the deal availability” information that he received from Sicluna or Smith. Tr. 4619, 4621; Div. Exs. 19, 111, 130; Guzzetti Ex. 31. On February 4, 2008, after the disclosure of problems with junior notes, Guzzetti sent an email with “morning call notes” stating that FIIN and TAIN notes maturing December 15, 2008, were available. Tr. 1685-86; Div. Ex. 4. Guzzetti often would specify in his many morning call notes, and other emails sent to all of MS & Co.’s registered representatives, the availability of private placements. Tr. 3023-24, 3041; *e.g.*, Div. Exs. 83, 84. For example, on February 2, 2006, Guzzetti wrote to all the registered representatives that “WE HAVE \$24,000,000 SITTING IN MONEY MARKET ACCOUNTS. GET ON THE PHONE AND SHOW THE FAINS.” Tr. 3025; Div. Ex. 83. Then on February 22, 2006, he wrote:

OUR CLIENTS HAVE \$24,000,000 IN MONEY MARKET ACCOUNTS. THEY SHOULD BE LOOKING AT FAIN’S[.] WE HAVE THE FOLLOWING:

1YR 6%	\$1,720,000
3YR 7.75%	\$2,975,000

5YR 10.25% \$5,915,000
ATTACHED YOU WILL FIND REVISED FAIN DOCUMENTS[.]
TAKE A LOOK – MAKE THE CALL

Div. Ex. 84. In February 2006, Scott Weisman (Weisman), the director of capital markets at MS & Co., who was involved in investment banking, cautioned Guzzetti that his equating private placements with money market investments might cause problems. Tr. 3028-30. Guzzetti responded:

I would never suggest that we take \$ that have to stay liquid (true money market \$) and put them in an investment that is tied up for a longer term with higher risk. You can question my investment and compliance knowledge any time you want, but make sure it never happens again in front of an FC. And frankly, until you attend my sales meetings on a regular basis DON'T EVER QUESTION ME ABOUT MY KNOWLEDGE OF THE RETAIL BROKERAGE BUSINESS. I HAVE EXTENDED YOU THE SAME COURTESY WHEN IT COMES TO THE INVESTMENT BANKING BUSINESS.

Tr. 3028-30; Div. Ex. 114.

Guzzetti did not think the way MS & Co. treated redemptions was alarming given the market climate, and there was still demand for notes being redeemed in any case. Tr. 4639-40. Guzzetti thought MS & Co.'s position on redemptions was reasonable given that in 2007 and 2008, some companies ended redemptions. Tr. 4636-4039; Guzzetti Ex. 17.

In November 2006, Sicluna told Guzzetti by email that Lex was going to replace his redeeming FAIN 6% clients, and asked whether Chiappone, Feldmann, Mayer, and Rabinovich were also going to replace their redeeming clients. Div. Ex. 155; Tr. 3030-31. Guzzetti then asked Chiappone, Feldmann, Mayer, and Rabinovich by email, copying Sicluna "WE HAVE TO KNOW ASAP WHAT YOUR CLIENTS ARE GOING TO DO WITH THE MATURING NOTES(MATURE TOMORROW). PAPERWORK MUST BE IN ASAP. ARE THEY GOING TO REDEEM OR ROLL." Div. Ex. 16; Tr. 3032. Guzzetti saw an email string where on December 21, 2006, Smith noted that Rabinovich "needs to replace the \$100,000 [TAIN 7.75%] before doing the trade," because he was "running on fumes with all these redemptions and cannot afford any more." Tr. 3033-34; Div. Ex. 17. Guzzetti did not consider a requirement that there be a replacement purchaser before a redemption inconsistent with the PPM. Tr. 3034-35. In prior testimony, however, Guzzetti understood Smith to be saying in the December 21, 2006, email that TAIN did not have sufficient funds to do the redemption and that a requirement of a replacement was inconsistent with the PPM. Tr. 3036-37.

Guzzetti did not consider the "running on fumes" comments alarming because financial institutions everywhere were suffering liquidity crises in 2006 through 2009, and, in fact, everyone was getting redeemed on their investments. Tr. 3149, 3152-55. Guzzetti said he made an effort to talk to McGinn and Smith, and others, to really understand what was going on. Tr. 3154-56. He never suspected that McGinn and Smith were committing fraud. Tr. 3150. Guzzetti testified that he

believes that the alarm contract-related Trust Offerings cannot be called a Ponzi scheme, because alarm contracts were actually sold, as the Receiver testified. Tr. 3169.

Guzzetti said that he was not concerned when he was forwarded a February 2, 2007, email string in which Jennifer Spinner, who was an accountant at MS & Co., wrote that “[w]e do not have the funds ava[iliable] unless you have cks/pmts that come in todays mail, we would need 125K to come in to cover this request,” in response to a request to redeem a \$200,000 FEIN note. Tr. 2740, 3037-38; Div. Ex. 118. Guzzetti believed that the funds had a liquidity problem. Tr. 4640.

On March 8, 2007, Guzzetti sent an email to all registered representatives announcing the MS & Co. 2006 rankings of registered representatives and those who made it onto the “Directors Council” for 2006 because of their strong performance; on this list were: Lex as the “leader in fee based assets and net new assets,” Chiappone, Rabinovich, Feldmann, Gamello as the “leader in new accounts,” Anthony, Rogers, and one other person. Tr. 3039; Div. Ex. 255. Guzzetti made a similar announcement by email on February 4, 2008, as to the 2007 sales year, and on August 24, 2009, as to the 2008 sales year. Div. Exs. 4, 256, 257. The 2007 sales year announcement named Lex, Rabinovich, Chiappone, Rogers, Mayer, Gamello, and Feldmann as top performers. Div. Exs. 4, 256. The 2008 sales year announcement named Lex, Rabinovich, Rogers, Anthony, Chiappone, Gamello, and two others as top performers. Tr. 3100; Div. Ex. 257.

On June 26, 2007, Guzzetti urged all brokers to ask their private placement clients for the names of investors like them who were looking for “above market fixed rate of return with no correlation to this shaky stock market”; he maintains that at the time, he believed MS & Co. private placements offered such rewards. Tr. 3041-43; Div. Ex. 111 (formatting altered). On August 1, 2007, Lex requested updates on the assets and amounts in each of the Four Funds notes. Tr. 3046; Div. Ex. 112. Guzzetti told Lex many times that he did not know what assets were in the Four Funds. Tr. 3047. Smith advised Guzzetti to tell Lex that he would try to respond by the following week. Div. Ex. 112; Tr. 3047. Contrary to his prior testimony, at the hearing, Guzzetti testified that on reflection, he remembers conversations with Rabinovich and Mayer where they discussed the Four Funds’ investments, so he was aware of some of the investments. Tr. 3014-15.

Guzzetti testified that the market was bad and illiquid in late 2007 and early 2008. Tr. 4636-37; *see* Guzzetti Ex. 17. On November 10, 2007, Smith informed Guzzetti in an email that Feldmann and Gamello were redeeming Four Funds’ investments to roll the money into Firstline, and he wanted “it clear to all [registered representatives] that [this] is not permiss[i]ble.” Tr. 3048; Div. Ex. 278. Smith plainly stated in the email that “I do not have the liquidity” and “[a]ny redemptions have to have replacements sales before hand.” Tr. 3048; Div. Ex. 278. Guzzetti explained that he was concerned about Smith’s concern about redemptions and replacements, but he was also concerned about the whole market at the time. Tr. 3052. Guzzetti reported to Smith in a November 12, 2007, email that he had relayed Smith’s information about redemptions and replacements, but was “not sure they believe us about redemptions”; he added, “I have a feeling they are thinking if push comes to shove we have to redeem.” Tr. 3057-58; Div. Ex. 120.

On November 14, 2007, Guzzetti told Smith that certain Four Funds notes were either being rolled over or redeemed effective December 15, 2007, and he needed information on the applicable interest rates for those being rolled over and consent letters for the rollovers. Tr. 3061; Div. Ex.

131. Later the same day, Sicluna informed Guzzetti what redemptions were not being rolled over so that he could tell brokers what was “available” to be sold. Tr. 3064; Div. Ex. 279. At the time, most redemptions were being paid for with new incoming funds. Tr. 3064-65.

On November 15, 2007, Guzzetti wrote Chiappone: “Your clients have redeemed \$45,000 of [a FAIN note]. We have not received any replacement tickets. Please advise.” Tr. 3065; Div. Ex. 242. Chiappone responded, “I am working on it.” Tr. 3065; Div. Ex. 242. The same day, Guzzetti advised Gamello, “Your clients redeemed \$100,000 of [a FAIN note] and we have not received any replacement tickets. Please advise.” Tr. 3067-68; Div. Ex. 181. Gamello responded, “Andy, I’m required to have replacement tickets??? That’s news to me...call me to clarify.” Tr. 3068; Div. Ex. 181 (ellipses in original). Guzzetti testified that he did speak with Gamello, and Gamello said that, in the future, he would try to have replacements in place. Tr. 3069; Div. Ex. 182.

On November 28, 2007, Guzzetti emailed all the registered representatives, telling them to show a FAIN note to qualified investors who can have money tied up for one year. Tr. 3069-70; Div. Ex. 130. The email also mentioned Firstline notes. Tr. 3069-70; Div. Ex. 130. Guzzetti testified that when he sent this email, he was not thinking back to Smith’s email from almost a year earlier where he stated he was running on fumes. Tr. 3070; *see* Div. Ex. 17.

Guzzetti sent a similar email to all the registered representatives on December 7, 2007, directing, “Make sure you replace any redemptions promptly,” and stating what notes were available. Div. Ex. 19 (formatting altered). Chiappone questioned Guzzetti about the February 27, 2008, email asking whether the FIIN and TAIN notes should be listed as available for resale since the offerings were restructured in January 2008. Tr. 3089; Div. Ex. 134. Guzzetti sent out a similar message urging sales of a Firstline line note on May 27, 2008. Div. Ex. 378.

Guzzetti initiated regular phone calls with all registered representatives after the market closed each Monday afternoon. Tr. 1205, 1645-46, 2982-83; Div. Ex. 82. After these meetings, Guzzetti prepared an agenda of the subjects discussed. Tr. 3073; Div. Exs. 82, 90. At the meeting of registered representatives on December 17, 2007, the subject of “FIIN, TAIN funky interest payments” was discussed and McGinn was on the call. Tr. 3072-73; Div. Ex. 90.

Guzzetti had no recollection of several emails that he received in December 2007 about redemptions by Lex and Gamello. Tr. 3074-81; Div. Exs. 123, 125, 126, 160, 183, 281, 282. On December 21, 2007, Smith sent an email to Guzzetti, stating, “[Gamello] should tell the client the truth that we were hit by a wave of redemptions and we have to sell investments to get liquid. Those investments are not liquid and take time.” Tr. 3080-81; Div. Ex. 126.

Guzzetti does not recall being present at the January 8, 2008, meeting where Smith announced the reduction of the interest in the Four Funds’ junior notes. Tr. 3178. At a meeting of the Directors Council in September 2008, at which he was present, Smith and McGinn announced a restructuring of the Four Funds; they explained the restructuring was a result of the financial meltdown and said that interest rates would be reduced. Tr. 3179-81. Even after the restructuring, Guzzetti thought the Trust Offerings issued in 2008 and 2009 were sound investments for MS & Co. clients. Tr. 3185-88.

On January 16, 2008, Guzzetti wrote Anthony, “[Smith] is not changing his position . . . if a client wants out of a 1 yr piece of paper[, w]e must have the fc replace it.” Tr. 3082; Div. 262. In an email sent on January 16, 2008, to all brokers regarding “DEAL AVAILABILITY,” Guzzetti wrote, “IF YOU DO NOT HAVE A ‘MUST PROSPECTING DISCIPLINE’ TO INCREASE YOUR ASSET BASE . . . TOUGH NEWS HURTS YOU . . . **MAKE THE CALLS.**” Div. Ex. 133 (emphasis in original). Then on January 23, 2008, Guzzetti learned that a bank was considering suing MS & Co. because of nonpayment of \$30,000 due to a Chiappone client in December 2007. Tr. 3084-85; Div. Ex. 127. Smith wrote Guzzetti that he would “deal with the bank” and that “[t]hey [were] only entitled to redemption if there is sufficient asset co[v]erage [and] liquidity to cover.” Div. Ex. 127. Smith continued, “I am going to seek a legal opinion . . . , but until clarification is received there will be no redemptions.” *Id.* On January 25, 2008, Lex wrote Smith, copying Guzzetti, complaining that the fiduciary duty to clients had been breached and that four clients who purchased TAIN notes had been misled about the material characteristics of the investments. Tr. 3085-86; Div. Ex. 161.

On April 8, 2008, Guzzetti sent all brokers copies of the letters being sent to FIIN and TAIN investors. Div. Ex. 26. On May 2, 2008, Guzzetti inquired when Rabinovich could expect money from his Firstline sales, which was in fact repayment of a bridge loan. Tr. 3090; Div. Ex. 547. Guzzetti did not know why the loan was structured as a sale of securities. Tr. 3090-91. On May 9, 2008, Guzzetti wrote Smith and David Rees (Rees), who was CFO of MS & Co, that the FAIN PPM provided that MS & Co.’s servicing agent will provide to investors an annual operating statement, consisting of a balance sheet and income statement, and that Gamello’s client had made a request. Tr. 3091; Div. Ex. 189. Rees responded that “we’ll get it together,” but that it would be unaudited and available for FAIN as of December 31, 2007. Tr. 3092; Div. Ex. 189.

Guzzetti emailed McGinn on January 16, 2009, that Lex was “questioning [a TDM note] that [was] rolling on [February 15]” and “want[ed] to know whether alarm contracts are backing the deal.” Div. Ex. 393 (formatting altered). Guzzetti added in his email to McGinn that it “sounds like [Lex] may not want to roll,” but that Guzzetti was “trying to keep the number of redemptions down.” *Id.* (formatting altered). On February 17, 2009, Guzzetti sent talking points to all the registered representatives that promoted sales of a TDM note. Tr. 3096-97; Div. Exs. 147-48. Guzzetti testified that the talking points were drafted by McGinn and that Guzzetti was merely passing them along. Tr. 3097. Sales promotion occurred after January 5, 2009, when Guzzetti was told that for the same TDM note, McGinn was “working on getting the funds in place to pay out” interest payments. Div. Ex. 136. Guzzetti sent an email on January 5, 2009, expressing that he was “getting questions about deals not getting paid interest payments this month.” Tr. 3094; Div. Ex. 136 (formatting altered).

In May 2009, a new registered representative asked Guzzetti, on behalf of a client who was considering a TDM investment and had some concerns including that “[TDM] and [MS & Co.] being in business together (conflict of interest?)” and “[w]hat happens if either [TDM] or [MS & Co.] go out of business during the duration of this deal?” Tr. 3098; Div. Ex. 252. Guzzetti answered that MS & Co. has “a long history of cash flow deals” and if TDM “goes under,” the

investors “have the guarantee from [MS & Co.]”⁴¹ Tr. 3098-99; Div. Ex. 252. In a July 27, 2009, email to all of the registered representatives, Guzzetti mentioned a “new” TDM “cable deal,” informed the registered representatives that MS & Co. had \$34 million in money market funds, and advised that they cannot ignore existing clients. Tr. 3188-89; Div. Ex. 141 (formatting altered).

On April 21, 2009, regarding redemptions of Verifier notes, Smith notified Guzzetti that \$30,000 was being collected the following day and asked, “Which squeekey wheel should we take care of? Zapelta or Kohl?” Tr. 3101; Div. Ex. 77. Guzzetti replied, “Probably Kohl, only because he can do other deals.” Tr. 3102; Div. Ex. 77. Lex asked Guzzetti on June 2, 2009, “Where are the June 1st Firstline payments?” Div. Ex. 138. Guzzetti did not ask Smith why he needed new money to redeem holders of trust instruments. Tr. 3173.

In June 2009, in response to an inquiry from Rabinovich as to whether he was going to be able to redeem \$250,000 in a TDM note, Guzzetti advised,

\$150,000 came in yesterday. We are waiting on Bill Lex for \$100,000 should be in by July 1st. If you want the \$150,000 call Patti and we will put a sell ticket in for \$150,000 then put another in for \$100,000 when it comes in.

Tr. 3102-03; Div. Ex. 71. Guzzetti testified that either Sicluna or Smith told him that Rabinovich was being redeemed with new investor funds. Tr. 3103, 3175. On August 7, 2009, while Guzzetti still was sending out emails to all of the registered representatives promoting MS & Co. private placements, including Trust Offerings, Gamello emailed that “[c]lients still not paid on [a TDM note].” Tr. 3100; Div. Ex. 210.

Guzzetti testified that he lost trust in McGinn and Smith on September 3, 2009, when McGinn and Smith revealed to all of the registered representatives that Firstline, the main asset underlying the Firstline Trust Offerings, had declared bankruptcy over a year earlier in January 2008. Tr. 3199-00. Guzzetti, however, sent emails out on September 25, 2009, and September 30, 2009, to all the registered representatives, continuing to urge sales of private placements, including Trust Offerings. Tr. 3201-03; Div. Exs. 143, 144.

Respondent William F. Lex

Lex graduated from St. Joseph’s College with a degree in Business Administration in 1971. Tr. 1532, 4835. After college, Lex opened an insurance business, Lex and Smith, in King of Prussia, Pennsylvania. Tr. 1534, 1620. Lex began by selling malpractice insurance to hospitals; he then transitioned to also offering hospital administrators and employees tax deferred annuities. Tr. 4839. Around 2003, Lex had about 2,200 active customers, the bulk of whom worked in the medical field; many were retirees and most had been customers for fifteen years or longer. Tr. 1595, 1693, 4852, 4900, 4909. Lex holds a license to sell insurance in Pennsylvania,

⁴¹ Guzzetti knew that there was no guarantee. Tr. 3160-61. At hearing, he testified that he told the new registered representative there were no guarantees and go talk to McGinn if he is saying there are guarantees. Tr. 3165.

and he was a registered representative with MS & Co. from 1983 to December 2009.⁴² Tr. 1532-34, 1561-62; Div. Ex. 482. From September 25, 2003, to July 17, 2009, Lex sold \$45,536,000 worth of MS & Co. private offerings and from October 31, 2003, to September 15, 2009, received nearly \$1,776,000 in gross commissions for those sales. Tr. 1582-83, 1586-87; Div. Ex. 2, Exs. 4k, 4l (as attached to Div. Ex. 2).

From the 1990s to 2003, Lex sold MS & Co. pre-2003 private placements, i.e., the alarm notes, which he considered successful.⁴³ Tr. 4849-51. Lex did not know that in November 2003, Smith took \$2 million from FIIN and used it to redeem investors in earlier MS & Co. offerings. Tr. 1593.

Lex testified that he was not aware of any “duty of inquiry” applicable to registered representatives, but he knew representatives had a duty to determine whether the product was suitable for the client. Tr. 1560-61, 1592. He believed that MS & Co. had an extensive due diligence department. Tr. 1713.

Lex knew in 2003 that FIIN was a new limited liability corporation, and that this offering was totally different than the earlier alarm note offerings that McGinn ran and in which Smith had limited involvement. Tr. 1566, 1568, 1573-74. Lex knew that McGinn had done the due diligence for the pre-2003 alarm notes and that McGinn had taken the due diligence team with him to IASG, but that, with FIIN, he relied on Smith to conduct the due diligence. Tr. 1590, 4939-41. Lex maintained that he spent significant time telling clients that the Four Funds were not like the pre-2003 alarm contracts, but were uninsured debt offerings put together by Smith. Tr. 4873. To Lex, it is basic, when you buy a private placement you are depending on the manager’s expertise. Tr. 4874. Lex described his role as assisting clients in gaining access to MS & Co.’s private placements; he distinguishes this role from that of a financial planner who would work for fees instead of commissions. Tr. 4874-76. Lex maintained he never knowingly sold anything that he did not think was going to benefit the customer. Tr. 4877.

Lex testified that he read the PPM for FIIN, but he did not question Smith about the affiliated transactions noted in the PPM. Tr. 1567, 1575, 4853-54. Lex also testified that he participated in a conference call on FIIN during which Smith described the product, and had a subsequent conversation with Smith in which Smith explained that he intended to have ten to twelve investments of \$2 million each. Tr. 4853-54. In his investigative testimony, Lex testified that he did not recall what information he received from Smith about FIIN initially, but when he testified for the second time at the hearing, Lex maintained that he recently found materials on potential FIIN investments that Smith had sent him in 2003. Tr. 4855-58; Lex Exs. 141-44. Lex

⁴² Lex began as an insurance agent in 1971; in 1973, the insurance company wanted him to get a securities license to sell mutual funds. Tr. 4835-36. Lex earned a Series 1 license in 1973, which grandfathered him in to act as a securities representative similar to having earned a Series 7 license; he earned his Series 63 license in 1982. Tr. 1561-63; Div. Ex. 482.

⁴³ Lex testified that almost all the sales at issue were to customers who had purchased pre-2003 alarm contracts. Tr. 4862-64; Lex Ex. 154.

also testified that when he asked for information on any of the private placements at issue, Smith told him that it was confidential, which Lex accepted. Tr. 1608-09, 1629, 4885, 4936.

Lex testified that Smith visited Lex's office a couple of times a year; during these visits, Smith met with Lex's clients and discussed the Four Funds with them. Tr. 4904-05. Lex testified that he knew that the value of the Four Funds depended on the quality of the underlying assets, but from 2003 through 2006, Smith revealed the names of only two companies and Lex did not ask for financial information about either; Lex did not request financial statements or a statement of operations for any of the Four Funds during this four-year period.⁴⁴ Tr. 1596-600, 1625-26, 1629. However, Lex also testified that he talked with Smith on average once a week and during those calls, Lex "ke[pt] up to date with him on what was going on with [the private placements]." Tr. 4857-58, 4881, 4921. Lex said that, on these phone calls, Smith gave him information on the holdings underlying notes and that "eventually I got a list of everything in the notes." Tr. 4881. At the hearing, Lex produced handwritten notes, one dated February 16, 2004, and the other undated, which he said he wrote during conversations with Smith about investments that were being considered for FIIN.⁴⁵ Tr. 4859-61; Lex Exs. 145-46. Lex also testified that he once, at an unidentified point in time, asked Smith to identify the private placements' underlying assets in writing. Tr. 4884-85.

Lex denied that he ever advised customers not to read the PPM or that he ever told customers that the Four Funds or the Trust Offerings were safe or secure investments. Tr. 1567-68, 4882. Lex only sold senior and senior subordinated notes – never junior notes. Tr. 1578, 1597, 4854. Lex believed these notes had a "five-year life expectancy," and people who bought for shorter periods had the option of reinvesting. Tr. 1580. Most of his clients were in one-year notes and according to Lex, they "really loved the products, the cash flow, et cetera, and they really didn't want to redeem." Tr. 1678-79. Senior note holders received their last interest payment on April 15, 2010. Tr. 4918.

In March 2006, Lex received information in response to requests for information on which sectors the Four Funds were invested. Tr. 4887; Lex Ex. 25. Lex testified that he had conversation with in-house counsel and he may have had some interaction with an in-house research department, but he did not specify the dates of the contacts. Tr. 1611-12. In August 2007, in response to his requests, Lex received a list of investments in the Four Funds from Rees.⁴⁶ Tr. 1612, 1657, 1672, 4887-89, 4942-43; Div. Ex. 407; Lex Exs. 39-40, 63, 78, 125.

⁴⁴ In testimony to FINRA in 2009 and in a deposition to the Commission in 2011, Lex stated that he did not know specific companies that Smith invested Four Fund assets in. Tr. 4933-38. In his investigative testimony, Lex stated that he did not know the types of businesses Smith was lending trust proceeds to, and he depended on Smith's expertise. Tr. 1604-05.

⁴⁵ Lex testified that he did not produce these materials in response to a Commission subpoena in June 2011 because at that time he did not search the attic. Tr. 4928-33.

⁴⁶ Division Exhibit 407 shows that Lex, through his assistant, received an August 9, 2007, email from Rees with an attachment listing the underlying investments in FIIN and TAIN. Lex also received a separate document – Lex Exhibit 63 – listing the underlying investments in the Four

This was the first time Lex received, in writing, a complete list covering all the assets in the Four Funds.⁴⁷ Tr. 4942-43; Lex Ex. 63. In a follow-up conversation, Rees assured Lex that the investments were performing and that there were no defaults or other problems. Tr. 1577, 4890; Lex Exs. 41, 63.

Contrary to Rees's representation, FIIN, TAIN, and FAIN's total \$8.8 million investment in alseT never performed; further, two investments on the list were MS & Co. affiliates and another investment was the issuer of one of the pre-2003 alarm notes.⁴⁸ Tr. 1652-56; Div. Ex. 2 at 17, Exs. 12-14, 23 (as attached to Div. Ex. 2); Div. Exs. 408, 522; Lex Ex. 63. Lex testified that when he received the list, it did not cause him any concern, and he did not ask Rees or Smith any questions even though the list showed: investments in MS & Co. affiliates and in pre-2003 alarm notes; large investments in alseT; and investments by different offerings in the same assets in more than one fund when Lex, based on information from Smith, had represented that owning more than one fund gave investors diversification. Tr. 1655-58, 4945-52. At another point, however, Lex testified that he questioned Smith about a \$400,000 investment by TAIN to FEIN, the lack of diversification among Four Fund investments, and investments in affiliates. Tr. 4952-58. Even so, Lex testified there was never a reason not to believe Smith. Tr. 1631-32.

Lex knew in late 2007 and early 2008 that the Four Funds had liquidity problems, but he considered it a temporary cash flow problem or hiccup. Tr. 4906-07. On January 25, 2008, Lex emailed Smith, copying to Guzzetti and Sicluna, complaining as such:

I strongly object to the cancellation of the alarm notes and request you do whatever has to be done to get the clients into the investments they were promised.

I think the fiduciary responsibility to the clients has been breached since none of these clients were aware of the pending problems in [TAIN].

I have been talking to clients about the liquidity problems of the notes and clients have expressed concern that they were misl[ed] about material characteristics of these investments. I was not aware that the same investments were put in each note. I went out of my way to make sure clients were spread amongst the various notes so that they would have DIVERSIFICATION.

Funds; however, he did not recall if he received that document by hardcopy, email, or fax. Tr. 4942.

⁴⁷ Lex could not remember if he shared the information with other registered representatives. Tr. 4943.

⁴⁸ In a FINRA proceeding, Lex testified that he did not recall asking about specifics on underlying investments for FIIN. Tr. 1614-15.

I strongly request that a game plan be mapped out to correct the problem and, again, strongly request that these clients be redeemed and put in the alarm notes that they were promised.

Div. Ex. 161; Tr. 1673. Then, on January 28, 2008, Lex wrote to Smith looking for a solution to the liquidity problem for his clients who had \$24 million in Four Funds notes. Tr. 1678; Div. Ex. 162. Lex continued to advise clients of the availability of Four Funds notes after January 2008. Tr. 1687.

On September 23, 2008, Lex wrote Smith that one of Lex's clients would be calling Smith to seek reassurance about the receipt of interest and principal. Tr. 1681-83; Div. Ex. 164. The client was living off the interest from Four Funds and Firstline notes and Social Security payments. Tr. 1681-83; Div. Ex. 164. Lex testified that he sold this client the notes, as opposed to less risky investments, because the client insisted on investments in the private placements. Tr. 1682-83.

Lex thought the Trust Offerings were alarm notes like those offered pre-2003. Tr. 1637, 4897. Lex began selling the Trust Offerings in March 2007. Tr. 1606-07; Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2). Lex approached the Trust Offerings in the same way he approached the Four Funds: he read the PPMs and listened to McGinn talk about them. Tr. 1632, 1635. He also had confidence in the offerings because of information he learned from third parties about their interactions with MS & Co. Tr. 1632-36. Lex testified, "I don't know why I felt that I had to investigate." Tr. 1636.

On December 17, 2007, Lex emailed Smith that he would be willing to extend the offerings of his FIIN note and TAIN note, which would be redeemed in mid-December, to January 15, 2008, to help MS & Co. with its cash flow. Tr. 1661; Div. Ex. 159. In his email, Lex stated, "[i]f new money comes in prior to 1-15-08, then I would expect to be redeemed earlier." Tr. 1661; Div. Ex. 159. On May 5, 2008, Lex inquired of Guzzetti, "[w]ith the money that has come in, will I be redeemed for any of my [one-year] FIIN and/or TAIN?" Tr. 1689; Div. Ex. 163. On January 6, 2009, Lex wrote to McGinn:

It is disturbing that it will be January 6th before people receive their money. I had three calls Monday and expect more calls today. It is tough making excuses for the inexcusable! It is getting harder to make repeat sales to clients that are skeptical and unnerved.

Can you assure the [financial consultant] that their clients will start receiving interest payments on time? January 15th and January 30th are the next quarterly due dates for the notes. HELP!

Tr. 1691, 1794; Div. Ex. 137.

Lex was not invited to the meeting of registered representatives on January 8, 2008, and no one called and told him what transpired at the meeting. Tr. 4895-97. On January 23, 2009, a Lex client, David Shannon (Shannon), who is now a retiree and had invested in FEIN and TDM,

told Lex that he and his wife had “decided to redeem the notes” because “[t]he \$1500/yr gain is not worth the risk . . . of getting burned again as we were with the B shares.” Tr. 1694; Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2); Div. Ex. 165. Lex continued to sell Trust Offerings after this conversation, as he explained at the hearing, because he did not believe there were “any problems of substance” with the offerings. Tr. 1696.

On February 16, 2009, Lex asked McGinn, “[w]ill 2/15/09 TDM 07 redemptions be made to client accounts on 2/17/09?” Div. Ex. 166. McGinn responded, “[d]epends on how much is collected on roll offering.” *Id.* Lex replied, “[w]rong answer,” to which McGinn countered, “[w]hat do you expect me to do?” *Id.* Lex responded,

Lend money to TDM 07 until the new sales come in. If it were my deal, that is what I would do. Please don’t think I’m being a smart ass. I am just desperate to keep some credibility with my clients so they will keep investing in [MS & Co.] products.

Id.; Tr. 1696-98.

Lex and Smith exchanged emails on March 17, 2009, about TDM Verifier 07 redemptions. Tr. 1698; Div. Ex. 20. Lex testified that it was in this email exchange that Smith first mentioned that redemptions would occur if Lex made enough sales to cover the amount of redemptions.⁴⁹ Tr. 1700. Lex thought McGinn was pursuing replacements over liquidating assets as it was easier for him. Tr. 1700-01. Lex made eleven or twelve sales of TDM Verifier and TDM Cable notes after this email exchange. Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2); Tr. 4187.

On April 7, 2009, Lex emailed McGinn, Smith, and Guzzetti on the subject of Shannon’s complaining to Lex about being unable to redeem TDM for two months now:

[Shannon] is one of many people who refer to our deals as a Ponzi Scheme. I try to reassure my clients that [MS & Co.] does not run Ponzi Schemes but the uproar is getting louder and louder from clients whose patience is worn thin by having their money tied up in these TDM notes. Most of the people whose money is tied up in TDM are still upset about what happened with [the Four Fund] notes.

This is just another cry from the wilderness to try to get this log jam broken so we can move forward with new business. I’ve even taken Dave’s prior suggestion and bought some of it myself to help with the log jam, but I am having a hard time putting off a client who agreed to a two[-]week extension when we are now almost 8 weeks out.

⁴⁹ Lex testified he was only asked to replace shares once when a customer asked to redeem in a TDM offering. Tr. 1641-42, 1700. Lex was upset in a conversation with McGinn and “squashed” the replacement request immediately. Tr. 1640-44. Lex has no recollection of discussing with Guzzetti the requirement of replacing customers who wanted to redeem. Tr. 1644.

Div. Ex. 167; Tr. 1702-03. Smith responded the same day: “Send me the complete list of your redemptions and the priority of each. If I find a way to take them out, please remove them from your customer list.” Div. Ex. 167.

On July 15, 2009, in an email to Guzzetti, copying Smith and McGinn, Lex questioned when a \$25,000 TDM Verifier note redemption requested by a client would be honored. Tr. 1704-06; Div. Ex. 169. Lex explained that the client had renewed a \$75,000 note and was a candidate for more investments, and Lex was concerned the client might lose confidence in MS & Co. private placements. Div. Ex. 169. Lex concluded, “LET[']S NOT BLOW IT. WE NEED TO MAINTAIN INVESTOR CONFIDENCE IN MCGINN SMITH DEALS!!!!!!!!!!!!” *Id.*

On September 8, 2009, Lex emailed Smith, copying to McGinn, Guzzetti, and Mayer, stating:

I applaud the firm for working diligently to bring the Firstline debacle to a somewhat favorable conclusion for the investors. We can only pray that the offer is accepted and approved by the bankruptcy judge.

Div. Ex. 97; Tr. 1706-08. The email also states that many investors in Firstline notes are “elderly, retirees, or baby boomers approaching retirement,” and that “[m]ost, if not all, of [Lex’s] clients who purchased [Firstline notes] also have [Four Funds] notes and worry daily about not getting their principal returned from the [Four Funds] notes.” Tr. 1708; Div. Ex. 97. Lex testified that he wrote in his email that he applauded the firm because he did not understand from the phone call with McGinn and Smith that they had committed a serious violation of the Firstline PPM and honestly thought they had taken commendable steps “to hold the thing together until the assets could be bought through the Bankruptcy Court.” Tr. 1712-13. Lex does not think that he and other registered representatives were personally responsible to find out more on the Firstline trusts before selling them, because he believed that was the due diligence team’s duty; he never considered whether registered representatives themselves should have learned more about the Firstline trusts before selling them. Tr. 1713-14. Lex testified that MS & Co. was a sophisticated operation and many people working with McGinn on these offerings. Tr. 1637-39. “To this day, I’m still blown away [by] what happened.” Tr. 1636.

Lex made his last sale of an MS & Co. private offering on July 17, 2009, because he decided at that time that the offerings were not worthy of reliability anymore. Tr. 1680, 1705; Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2). Lex was part of an effort to buy the Firstline assets out of bankruptcy; the effort ended when the Receiver was appointed and took control of those assets. Tr. 4919-20. The Receiver’s website shows Lex and family members have claims of almost \$1.4 million in connection with the MS & Co. receivership. Tr. 4880-81; Lex Ex. 153.

When discussing the FIIN PPM, Lex said that he interpreted the following “suitability requirements” language as merely boilerplate that needs “to be in there,” just as “an aspirin can kill you” warning must be on a “bottle of aspirins.” Tr. 1587-88:

The risks associated with an investment in the notes and the lack of liquidity makes this investment suitable only for an investor who has substantial net worth, no need for liquidity with respect to this investment and who can bear the economic risk of a complete loss of the investment.

Div. Ex. 5 at 3. Lex believed his client Barbara Monahan, who was unaccredited, was allowed to purchase Four Funds and Trust Offering notes under Regulation D language allowing thirty-five unaccredited investors to invest in a Regulation D offering; he also believed that the Four Funds and Trust Offerings would benefit Monahan by supplementing her income so she could take the vacations she enjoyed. *Id.*; Tr. 1588-89.

Lex testified that his clients received their interest payments on time and were able to redeem their private placement investments from 2003 through 2007. Tr. 4890-91. Lex sold MS & Co. private offerings into July 2009. Tr. 1583; Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2). In 2010, FINRA suspended Lex's right to associate with a FINRA member firm; he was suspended for failing to pay an arbitration award owed to his former client Duckkyu Chang (Chang). Tr. 1538-39; Div. Ex. 482 at 10. In December 2009, a FINRA arbitration panel found Lex, along with MS & Co. and Smith, jointly and severally liable for \$805,110 in compensatory damages following Chang's customer complaint. Div. Ex. 514; *see also* Div. Ex. 444. The arbitration panel concluded that there was "some definitive fault by . . . Chang and some fault by . . . Mr. Lex, Mr. David Smith, and [MS & Co.]," and derided Lex for failing to diversify Chang's holdings. Div. Ex. 514 at 3-4.

Witnesses who Purchased Securities from Lex

Dr. Alice Forsythe (Forsythe) is a graduate of Las Pinas College and Jefferson Medical College in 1974.⁵⁰ Tr. 1474. Forsythe first met Lex in the late 1970s and Lex began managing funds in her and her husband's retirement accounts, as well as the retirement accounts of Forsythe's colleagues. Tr. 1475-77. Forsythe instructed Lex to choose conservative investments in managing her retirement funds. Tr. 1476. Forsythe did not read subscription agreements and other papers closely because she knew that the early MS & Co. investments had performed well and Lex had personally invested in them and recommended them to his family. Tr. 1514-15.

Forsythe has experienced serious health issues since 2004 and has been on disability for some time. Tr. 1479-80, 1490. On Lex's recommendation, Forsythe made the following investments in MS & Co. private placements between 2004 and 2009:

Date	Investment
December 17, 2004	\$120,000 in TAIN
December 28, 2004	\$45,000 in TAIN
January 23, 2006	\$65,000 in FAIN
March 23, 2006	\$55,000 in FAIN

⁵⁰ Due to a medical condition, Forsythe was permitted to testify by telephone from her home. Tr. 1473.

January 9, 2007	\$15,000 in FAIN
February 23, 2007	\$50,000 in FIIN
April 24, 2007	\$10,000 in TDM Verifier
July 10, 2007	\$55,000 in Firstline
August 1, 2007	\$35,000 in FEIN
August 7, 2007	\$65,000 in Firstline
December 19, 2007	\$20,000 in TAIN
January 7, 2009	\$35,000 in TDM Verifier
February 17, 2009	\$30,000 in TDMCable

Tr. 1477-83, 1485-88, 1497-98; Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2).

Forsythe trusted Lex and went along with his investment recommendations, relying on him to manage her retirement money. Tr. 1495, 1515, 1517. Forsythe kept “less of an eye on Mr. Lex because [she] trusted that [her] retirement account was reasonably secure.” Tr. 1505. Forsythe’s investment goals for her retirement account remained conservative. Tr. 1478. Forsythe liked the interest payments she received on her investments with MS & Co., but she believed that the investments were safe, with low to medium risk. Tr. 1478-79, 1508-10. Forsythe could not remember Lex ever telling her investments were high risk or that she could lose her entire investment, or that he did not know about the investments underlying the notes. Tr. 1480-81, 1484. Forsythe described Lex as always confident that the notes would be paid on maturity. Tr. 1479, 1484-85, 1488-90.

Forsythe only became concerned about her investments in 2009, but Lex assured her that things would settle down and she would not lose her principal. Tr. 1489-91. The loss of her investment forced Forsythe to sell real estate at a short sale for a loss and move to Florida. Tr. 1490.

Barbara Monahan (Monahan), a retired nurse, met Lex in 1988 when she began working for a hospital at which Lex was advising hospital employees about saving for their pension accounts. Tr. 780-83, 800. She began investing an amount from each paycheck into a pension account in the mid-1980s, through a program started at the hospital where she was working. Tr. 782-84. She carried her pension account over when she transferred hospitals in 1988, and Lex began handling the account. Tr. 782-84. By the time she retired from full time work in 2001, Monahan was saving \$250 from each paycheck. Tr. 783. Monahan knew nothing about investments; she considered Lex a friend and trusted him and did what he recommended. Tr. 784-85, 789-90, 800-01.

On Lex’s advice, Monahan invested in the following:

Date	Investment
January 12, 2006	\$125,000 in FAIN
July 31, 2007	\$30,000 in Firstline
August 1, 2007	\$80,000 in Firstline

January 16, 2008	\$12,000 in FAIN
July, 2008	\$15,000 in INEX

Tr. 786-87, 789; Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2). Monahan intended these investments to be for her retirement. Tr. 787. Monahan remembers telling Lex that she did not want high risk investments because she needed these funds to live on. Tr. 787.

Monahan has never heard the term accredited investor. Tr. 791. However, Lex's office sent her various forms to sign, including a Purchaser Questionnaire with questions relating to net worth, income, and investment experience. Tr. 793; Div. Ex. 154 at 32. Monahan signed the questionnaire, which is dated December 27, 2005, but does not know who filled it out and did not read it thoroughly before signing. Tr. 790-93, 796; Div. Ex. 154 at 33. She did not remember Lex ever explaining the document to her. Tr. 793. Monahan's initials appear next to a statement affirming that she had knowledge and experience in financial and business matters, and she speculated that she signed it because she was instructed to by Lex. Tr. 795-96.

Monahan still has her retirement account with Lex but there is not much left in it, and she believes Lex is working hard to recover her funds, but her losses have been substantial. Tr. 797-98. At Lex's suggestion she joined a lawsuit against NFS and received \$20,000. Tr. 802. Monahan feared she would lose her home if she did not recover some of her lost funds. Tr. 798. She has suffered from tension, anxiety and loss of sleep.⁵¹ Tr. 798.

Lex acknowledged that Monahan relied on his advice, but believes she is educated and experienced and that he made clear to her that these securities were not insured and had no guarantees. Tr. 1543. Lex testified that Monahan accurately represented that she was "capable of evaluating the merits and risks of an investment" on the Purchaser Questionnaire. Tr. 1544; *see* Div. Ex. 154 at 33. Lex sold notes to Monahan, even though he knew she was an unaccredited investor and the notes' PPMs limited sales to accredited investors, because MS & Co. told him that Regulation D, permitting sales to thirty-five unaccredited investors, was applicable. Tr. 1544-46. Lex offered no evidence to support his claim that he often called Sicluna to check whether there were fewer than thirty-five unaccredited investors already participating in an offering before soliciting other unaccredited investors. Tr. 1617-19.

Dr. Marvin Weiner (Weiner) is a family physician and was previously a teacher and Peace Corps volunteer. Tr. 730-31. He has an undergraduate degree from Rutgers University, a master's in broadcasting from Boston University, and has been a physician for almost thirty years. Tr. 731. Weiner has scant experience in investments and had never heard of a private placement. Tr. 736-37. He first met Lex in the late 1980s or early 1990s. Tr. 732.

By the late 1990s, Weiner had approximately \$500,000 in his retirement accounts, and Weiner discussed with Lex his desire to have his retirement nest grow through conservative investments. Tr. 735-36. Lex sold Weiner:

⁵¹ Monahan rose at 1:00 a.m. on January 29, 2014, the day that she testified. Tr. 798.

Date	Investment
July 7, 2004	\$85,000 in FEIN
June 2, 2005	\$120,000 in TAIN
June 10, 2005	\$150,000 in TAIN

Tr. 738, 743-47; Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2). Lex recommended the investments because they paid higher interest than Weiner's retirement funds were earning. Tr. 737. Lex told Weiner that the FEIN offering proceeds would be loaned to small companies that had good cash flow and that interest would be paid and Weiner would be repaid the principal on maturity. Tr. 739-40. Lex did not characterize these investments as risky or inform Weiner he could lose all his funds. Tr. 744.

Weiner put the interest earned on the notes into an IRA account, and Lex periodically called him and suggested investments Weiner could make using money from that account. Tr. 744-45. After receiving such calls, Weiner made the following purchases:

Date	Investment
January 1, 2006	\$10,000 in FAIN
March 5, 2007	\$15,000 in FEIN
November 20, 2007	\$20,000 in FAIN
June 26, 2008	\$20,000 in INEX

Tr. 744-47; Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2). Lex referred to the PPMs of these offerings as "stuff that the lawyers want in there just to protect themselves," and he did not call Weiner's attention to disclosures in the PPMs about risk. Tr. 748, 778-79. In late 2008, Lex told Weiner that MS & Co. was sending out letters explaining its financial problems and that interest payments on the notes would be delayed. Tr. 749-50.

Weiner was awarded \$270,000, plus six percent interest compounded annually from October 8, 2008, to February 1, 2013, as the result of an arbitration action against Lex. Tr. 753-54; Div. Ex. 520. As of January 31, 2014, Lex had not made any payment on the award and had filed a motion to vacate. Tr. 756, 1539.

Witnesses in Support of Lex

Dr. Richard Bove (Bove), a medical surgeon and medical director of Independence Blue Cross, has known Lex for forty years and has bought many types of insurance and securities through him. Tr. 5544-45. Bove has invested his profit-sharing plan and IRA with Lex. Tr. 5545; Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2).

Bove was an accredited investor and purchased MS & Co. pre-2003 alarm contracts. Tr. 5546, 5548-49. Bove invested:

\$75,000 in FIIN on October 14, 2003

\$30,000 in FIIN on October 23, 2003
\$210,000 in FEIN on March 3, 2004
\$50,000 in FIIN on January 13, 2005
\$35,000 in FAIN on January 23, 2006
\$50,000 in TAIN on April 19, 2006
\$50,000 in FAIN on July 18, 2006
\$15,000 in FAIN on July 19, 2006
\$15,000 in FIIN on February 1, 2007
\$10,000 in Verifier on May 25, 2007
\$15,000 in FAIN on November 19, 2007
\$10,000 in Integrated Excellence on June 30, 2008
\$10,000 in Verifier on January 5, 2009

Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2).⁵² Bove estimated that he lost about \$400,000 in these investments. Tr. 5555.

Before MS & Co. went into receivership, Lex told Bove that MS & Co. was having problems, and that he would receive a letter and to call him when it was received.⁵³ Tr. 5551-52, 5556-57. Bove said he relies on and trusts Lex, and testified that if Lex was aware of problems with FIIN, FEIN, TAIN, or FAIN, Lex would have told Bove about the problems. Tr. 5556-57.

Bove considers Lex a “wonderful friend,” honest, generous, and conscientious about helping his clients invest and make money. Tr. 5545, 5554. He has received at least fifteen letters from Lex with information and advice since MS & Co. entered receivership. Tr. 5552-54. Bove has talked with the Receiver at least twice. Tr. 5558.

Respondent Thomas E. Livingston

Livingston attended Canisius College. Tr. 2223. He holds Series 7 and 63 licenses and has been in the securities industry for thirty-five years.⁵⁴ Tr. 2224, 5164. Livingston testified that he brought an institutional client base to MS & Co. in October 1988 and eventually began a syndicate

⁵² I have not included a \$55,000 in TAIN on July 31, 2007, in the name of Lynn A. Bove Tod Charles Austin Pickens. Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2).

⁵³ It is not clear when this occurred. Tr. 5551.

⁵⁴ Livingston began his career with Fitton Cunningham and then was with Bache Halsey Stuart Shields. Tr. 5166.

department.⁵⁵ Tr. 5167-68; Div. Ex. 483. In December 1995, Livingston became senior vice president, Syndicate Manager – Institutional and Retail Sales at MS & Co.⁵⁶ Tr. 5182; Div. Ex. 272. On January 2, 2004, Livingston purchased twenty percent of MS & Co. for \$400,000. Tr. 2233, 5196; Div. Ex. 273. Livingston testified that as an owner he had no role in the firm's management, and he never received any firm profits. Tr. 5196-97. Livingston was treasurer and director of MS Holdings, which was involved in most of the private placements, and his name appeared in the PPMs. Tr. 2304-06.

Livingston's office was ten feet from Smith's office in Albany, and Livingston paid attention to the major events at MS & Co. Tr. 2260, 5172. Livingston testified that Smith was his supervisor and that he had no supervisory responsibilities. Tr. 5178. Livingston testified his salary in 1995 was \$110,000 and increased over time to \$140,000; in addition, he received a percentage of MS & Co.'s commission on syndicate transactions, and he was compensated by alseT.⁵⁷ Tr. 2311, 5178-88; Div. Ex. 272. Later he agreed that after he became a shareholder his salary increased to about \$264,000 a year, but in the spring of 2009, his compensation changed to straight syndicate commissions. Tr. 5186-89, 5335-37; Div. Ex. 625. Livingston agreed that his salary from MS & Co. and alseT had been about \$66,000 a month. Tr. 5326.

Livingston denied that alseT was an affiliate of MS & Co. Tr.5320. For a while, alseT paid Livingston \$40,000 a month; Livingston put his total salary received from alseT at about \$800,000. Tr. 2311, 2318-19. Livingston's capital contribution to alseT was the personal guaranty he gave on any loans taken out by alseT, which was canceled when he was forced out of alseT.⁵⁸ Tr. 2300-01, 5312-14.

Livingston testified that he had no role in creating the Four Funds, which were Smith's idea; he considered Smith a qualified portfolio manager based on Smith's reputation, experience, and successes, specifically in banking and municipal finance. Tr. 5202-07. Livingston was aware that MS & Co. and its affiliates acted as placement agent, trustee, servicing agent, and the sole managing member for the FIIN notes issued in September 2003.⁵⁹ Tr. 2238.

⁵⁵ Since October 2009, Livingston has been employed by Halliday Financial Group or HRC Investment Services, Inc., a broker dealer, where he runs the syndicate department. Tr., 2225, 5172-73; Div. Ex. 483.

⁵⁶ According to Livingston, he interfaced with Wall Street firms and got MS & Co. involved in quite a few institutional transactions. Tr. 2230. He is on the board of the National Syndicate Association. Tr. 5176-77.

⁵⁷ Livingston settled a law suit, *Brown ex rel. McGinn, Smith & Co. v. Livingston*, No. 1:10-cv-0739 (N.D.N.Y. June 24, 2010), concerning compensation during the period July 2008 through October 2009, for \$120,000, with interest at three percent over five years. Tr. 2350; Div. Ex. 579.

⁵⁸ Livingston signed the resignation of Newton Advisors as a managing member of various alseT entities on February 4, 2008. Div. Ex. 274.

⁵⁹ This was true for each of the Four Funds. Div. Exs. 5-6, 9B, 12.

Livingston stated he knew about a large number of the investments in the fund portfolios, but he did not know the extent to which the funds were investing in either MS & Co. affiliates or alarm contracts. Tr. 5209-11, 5225, 5346-47. Livingston claimed he did not know that Smith used \$2 million of the FIIN offering proceeds to redeem investors in a pre-2003 alarm note and claimed that he only discovered near the end of 2007 that the Four Funds were investing in affiliates and related parties. Tr. 2257-61, 2270. Livingston gave Smith a lot of investment ideas and attended meetings at which investments were considered. Tr. 5209, 5211-13. Livingston was adamant that he observed Smith doing due diligence on potential investments; as support, he referenced the availability of in-house lawyers, accountants, Weisman, and persons at Pine Street Capital Partners (Pine Street). Tr. 5214-16, 5222-24. Livingston testified that Smith called upon a wide variety of people to help him perform due diligence. Tr. 2247.

Livingston received Financial and Operational Combined Uniform Single (FOCUS) reports, which showed the financial condition of the firm, as well as other financial reports. Tr. 5199-5200. He testified that he did not ask for financial statements because he had a pretty good working knowledge of how much had been invested in some of the Four Funds' investments and how those investments were doing and could calculate the returns. Tr. 5226. From 2003 through 2005, Livingston did not ask Smith for the following information for the Four Funds because he did not think it was necessary: a list of investments held; an income statement or balance sheet; or whether the funds were engaging in transactions with affiliates. Tr. 2258-59, 2261, 2263-64, 2269. Livingston knew the Four Funds' PPMs provided that note holders could obtain an annual statement of operations consisting of a balance sheet and income statement, but never asked for that statement himself. Tr. 2263-64.

Livingston stressed that he was not a retail broker; he estimated that he had about twenty-five customers in his almost twenty years with MS & Co. Tr. 5171, 5245. He did not solicit retail clients, but persons came to him wanting to buy the private placements. Tr. 5171. Livingston sold some pre-2003 alarm notes. Tr. 2231. He denies that he sold all of the \$3,894,000 of MS & Co. offerings attributed to him in Palen's report. Tr. 5243-44; Div. Ex. 2, Exs. 4m, 4n (as attached to Div. Ex. 2). Palen's report shows Livingston making fifteen sales of FIIN notes, totaling over \$2.5 million from September 19, 2003, through March 4, 2004. Div. Ex. 2, Ex. 4m (as attached to Div. Ex. 2). Livingston testified that he did not expect to receive commission on the private placements at issue. Tr. 5239-40, 5260.

Livingston understood that as a broker recommending an unregistered private placement, he was obliged to determine whether the product he was recommending was suitable for any client. Tr. 2262. Livingston believes he did due diligence by talking to Smith, MS & Co.'s CFO, MS & Co.'s general counsel, and by looking at some of the fund investments. Tr. 2262. Later he testified he believed the funds were good for clients because he knew the funds' investments. Tr. 5227-28. Livingston conducted due diligence on FIIN by looking at the documentation, which was not much because FIIN was a new entity, and knowing the background of Smith. Tr. 2241-43.

Livingston stated that he did due diligence on the TDM Cable Trust 09 offering by making sure that assets were purchased and that the debt service return fund was in place and was being funded post-transaction. Tr. 5253. He also had a wide variety of conversations with a number of

people and kept a due diligence file. Tr. 5254. He also did fairly extensive due diligence of TDM Luxury Cruise. Tr. 5254-55.

Livingston does not recall receiving an April 23, 2007, email from Smith outlining the need to restructure the Four Funds “ASAP” so as to raise capital. Tr. 2264-67; Div. Ex. 623. Smith’s memorandum states, “[w]e need to find a way to extend maturities of existing notes so that the entity retains its capital base and gives the impression that it is an operating business.” Div. Ex. 623.

Livingston denied knowledge of having to replace customers who wanted to redeem shares. Tr. 2319. However, in May 2007, he had a customer who wanted to liquidate and Sicluna asked him if he had buyers for the customer’s TAIN investments. Div. Ex. 631. When he did not, Sicluna, copying Livingston, emailed Smith to ask if the notes should be sent out to the brokers to sell. *Id.*; Tr. 2319-20.

Livingston acknowledged that the funds’ PPMs did not disclose that the offering proceeds would be used to fund investments in which Smith had an ownership interest, though such a transaction was not precluded. Tr. 5322-24. In February 2007, *alseT*’s CEO asked Livingston about funding issues at *alseT*. Tr. 5300-02; Div. Ex. 666. Livingston testified that *alseT*’s CEO and Smith were in negotiations for funds. Tr. 5302. Smith wanted to cut back despite *alseT*’s need for funds. Tr. 5303-05. These negotiations between *alseT*’s CEO and Smith often went through Livingston. Tr. 5302-03, 5309. On February 28, 2007, Livingston told *alseT*’s CEO that funding was coming to *alseT* from three of the Four Funds. Tr. 5307; Div. Ex. 668. By this time, Livingston knew that the Four Funds’ investment in *alseT* was substantial, around 10% of the overall Four Funds’ portfolio. Tr. 5307, 5309. Livingston was not concerned about how *alseT* loans would impact investors in the Four Funds because *alseT* was so close to being funded from other sources. Tr. 5311-12.

On June 22, 2007, Livingston emailed *alseT*’s CEO stating that if *alseT*’s counsel believed that MS & Co.’s financing of *alseT* was a conflict of interest then it may raise disclosure issues. Tr. 5319-20; Div. Ex. 667. On June 29, 2007, *alseT*’s counsel emailed Livingston, stating that if *alseT* did not receive funding, and MS & Co. disclosed the loans to *alseT*, MS & Co. would potentially be open to lawsuits “under federal and state securities laws, as well as for breaches of fiduciary duties.” Tr. 5329-33; Div. Ex. 620. In the same email *alseT*’s counsel asked if investors in the Four Funds knew about the Four Funds’ interest in *alseT*, and Livingston replied that it was a loan consistent with other loans. Tr. 5333-34; Div. Ex. 620.

McGinn and Smith asked Livingston to leave *alseT* around December 20, 2007. Tr. 2271-72. Livingston maintains that this is when he learned that: there was a lack of cash flow from the Four Funds’ investments; the Four Funds were worth less than one half of what was owed to Four Funds’ investors; and the Four Funds’ investment in *alseT*, which he knew was \$8.8 million, amounted to ten percent of the Four Funds’ total invested capital. Tr. 2271-75.

In December 2007,⁶⁰ Livingston sent a memo to McGinn and Smith. Div. Ex. 585 at 4. Livingston stated that the funds under MS & Co.'s "control have combined losses approaching some \$45 million dollars," and highlighted the Four Funds' \$20 million dollar investment in Coventry, which he characterized as containing "HUGE conflicts." *Id.* Livingston also raised the issue of whether "obvious conflicts" between the Four Funds and alsoT should have been discussed before the loan was made. *Id.*; Tr. 2289-90. Livingston later testified that his memo did not mean \$45 million dollars in losses, but instead \$45 million dollars in non-performing assets, and he thought conditions were not caused by any wrongdoing on the part of Smith. Tr. 5249-50. Livingston did not share his concerns about MS & Co. and the Four Funds with any clients, prospective investors, or registered representatives. Tr. 2293-95, 2312-18.

Livingston received Guzzetti's emails to all brokers, but he did not consider himself a retail broker and did not usually attend meetings of brokers, including the meeting of January 8, 2008. Tr. 2294, 2321, 2328. However, in November 2008, he responded to Guzzetti's email with a message to all brokers:

Andy is right on one account now is the time to reach out to our clients and convey confidence and direction! To steal a phrase from Andy this is not a time to convey "bullshit" as the investing public is getting enough of that from the major firms!

Tr. 2329; Div. Ex. 135. Livingston stated that where his email referred to "confidence and direction," he meant that in reference to the markets in general, not to MS & Co. Tr. 2329-30.

Livingston denied knowing that McGinn and Smith were taking funds from the Trust Offerings' proceeds, but in testimony to FINRA he acknowledged that Rees told him they were "pulling money out of TDM or Verifier." Tr. 2308-10.

On February 24, 2009, Smith emailed Livingston:

I am forwarding this Friday's payroll, which is approximately \$182,000. Dave rees informs me that we have \$75,000 of payables that can't be put off. We have approximately \$30,000 to meet the above. I really don't know how we are going to survive.

Tr. 2331; Div. Ex. 396. Livingston testified that at that point, he knew that revenue had fallen off very sharply, but believed that Smith had vast wealth that he could inject into MS & Co. to fix short term problems. Tr. 2332.

Livingston denies receiving commissions on five sales of MS & Co. offerings in 2008 and 2009. Tr. 5180-81; Div. Ex. 2, Exs. 4m, 4n (as attached to Div. Ex. 2).

On March 19, 2009, Livingston resigned from the boards of MS & Co. and all affiliates and as secretary of MS & Co., but he continued his association as a broker and remained a shareholder.

⁶⁰ The memo is dated October 22, 2007, but Livingston testified that it was written in December 2007. Tr. 2286-88; Div. Ex. 585.

Tr. 2335-39; Div. Ex. 567. Livingston sold \$135,000 of TDMM Cable 09 11% to William Carroll on June 5, 2009, and did not mention any financial problems at MS & Co. Tr. 5338-41; Div. Ex. 2, Ex. 4m (as attached to Div. Ex. 2).

On October 15, 2009, Livingston resigned from MS & Co. and ended his association with all related entities. Tr. 2346-47; Div. Ex. 276.

Witnesses who Purchased Securities from Livingston

Daniel Ferris (Ferris) and his wife, using retirement funds, purchased a total of \$130,000 of FIIN notes on January 9, 2004, and a total of \$50,000 in TAIN notes on December 14, 2004, with Livingston, a close friend, as their broker. Tr. 28, 30-32, 34-35, 37, 44, 46, 53; Div. Ex. 2, Ex. 4m (as attached to Div. Ex. 2). Livingston did not tell Ferris that these were risky investments or that some of his funds would be going into an investment in which Livingston had an ownership interest. Tr. 32, 36, 59. Ferris received the PPM for the TAIN offering and signed a subscription agreement that stated he had read the PPM, even though he had not. Tr. 50, 54-56; Livingston. Exs. 63, 113. The subscription agreement, which he is not sure he actually read, stated that he was aware the purchase was a speculative investment involving a high degree of risk, and that he could bear the risk of loss. Tr. 49, 54-60; Livingston. Ex. 63. Ferris and his wife made the following purchases:

Date	Investment
January 9, 2004	\$130,000 in FIIN
December 14, 2004	\$50,000 in TAIN
January 27, 2006	\$60,000 in FAIN
November 14, 2007	\$25,000 in TDM Luxury Cruises
October 30, 2008	\$75,000 in McGinn Smith Transaction Funding (MSTF)

Tr. 37, 40, 42-43; Div. Ex. 2, Ex. 4m (as attached to Div. Ex. 2). Livingston did not tell Ferris in October 2008 that MS & Co. was experiencing financial difficulties, that the Four Funds had suspended redemptions, or that MSTF was created to invest in other McGinn Smith entities. Tr. 43-44.

David Lafleche (Lafleche) was a close friend of Ferris and Livingston, and Livingston was his broker at MS & Co. Tr. 88, 101-02. Lafleche trusted Livingston and told him several times that he wanted conservative, safe, and secure investments. Tr. 85, 89, 92-93, 107, 134. On December 10, 2004, at Livingston's suggestion, Lafleche invested \$10,000 of his IRA funds in a TAIN note paying 10.25%. Tr. 84, 89; Div. Ex. 2, Ex. 4m (as attached to Div. Ex. 2).

Lafleche went to Livingston's office and signed documents. Tr. 87. Livingston told Lafleche to change his net worth figure from \$250,000 to \$1 million on an application. Tr. 90-91, 128-29; *see* Div. Ex. 633 at 4. Lafleche assumes the change was made in order to allow him

to make the investment.⁶¹ Tr. 91, 129. Lafleche does not remember receiving the PPMs or reviewing the risk disclosures within the PPMs. Tr. 86-88, 113-14, 117. Livingston did not tell Lafleche that his investment was risky or that he could lose his investment. Tr. 84-85, 89. Lafleche remembers that Livingston told him at some point that interest on his notes was being suspended and delayed. Tr. 122. Lafleche did not question Livingston about this development because he trusted Livingston and had no investment experience. Tr. 124-25.

Lafleche also purchased a \$25,000 MSTF note on October 30, 2008, and a \$20,000 TDM Cable note on January 29, 2009. Tr. 42-43; Div. Ex. 2, Ex. 4m (as attached to Div. Ex. 2).

Witnesses in Support of Respondent Livingston

Andrew W. Halliday (Halliday), who has a law degree, is President of Halliday Financial, an Albany-based family wealth-management and investment firm. Tr. 5914-16. Halliday has worked with Livingston at Halliday Financial for about five years. Tr. 5914. Livingston generally does not handle retail sales at the firm. Tr. 5916. Halliday believes Livingston has integrity and a strong reputation for truthfulness among persons in the capital market community, where keeping your word is essential for success. Tr. 5922-23.

Thomas Richard Kendrick IV (Kendrick) is co-head of equity capital markets at brokerage and investment banking firm Stifel Nicolaus Financial. Tr. 5279, 5282-85. Kendrick had known Livingston for over ten years and trusted him; because of that trust, he did business with Livingston while Livingston was associated with MS & Co. including with a deal called Tortoise Energy Infrastructure. Tr. 5282-83. Kendrick has continued to work with Livingston even after Livingston joined Halliday Financial, and recently included Halliday Financial as a co-manager of underwriting for a deal, which is an unusual and noteworthy responsibility for a small firm. Tr. 5285, 5288. Kendrick believed that Livingston has “a wonderful reputation in the industry,” and they both are on the Syndicate Association of America’s board. Tr. 5289.

Yoav Millet (Millet) graduated from Tel Aviv University with a dual degree in economics and accounting. Tr. 5854. He worked for elseT from May 2005 to early 2008 and since 2013 has been a managing partner in the investment banking side of Halliday Financial, where he works with Livingston. Tr. 5852, 5865, 5910; Livingston Ex. 120. During his testimony, Millet explained Livingston’s role at elseT, and described Livingston as “incredibly important” in elseT’s establishment and dealings, which he characterized as sophisticated. Tr. 5863-65, 5874-75.

⁶¹ Livingston testified that Smith told him that a certain number of unaccredited investors could participate in the TAIN offering. Tr. 2352. Livingston acknowledges that Lafleche was not an accredited investor and denies marking the purchaser questionnaire to make it appear that he was or asking Lafleche to do so. Tr. 2352-56; *see* Div. Ex. 633 at 4-5.

Respondent Brian T. Mayer

Mayer, a 1995 graduate of the University of Rhode Island, holds several securities licenses.⁶² Tr. 3239; Div. Ex. 484. Mayer has participated in the securities industry since 1995. Div. Ex. 484. He became associated with MS & Co. in 2001 and MS Advisors in 2006.⁶³ *Id.* The 2008 Supervisory Manual lists Mayer as registered operations principal, supervisory principal, and manager of the New York City Office. Div. Ex. 329 at 47.

Mayer worked out of the New York City office and was branch manager and senior vice president from 2002 to 2009. Tr. 3245-46. As branch manager, Mayer supervised the registered representatives in that office, except as to sales of private placements. Tr. 3247-48. Mayer attended due diligence meetings on investments with Smith, and Smith asked him to represent a MS & Co. fund at a board meeting of that fund's investment, CMet. Tr. 4980-81, 5003. Mayer testified that Smith decided on all of the Four Funds' investments, but he had help from others. Tr. 3270-71, 4980.

In his investigative testimony, Mayer stated he always reported to Smith and after 2004, he also reported to Guzzetti for day-to-day activities. Tr. 3258-59. At the hearing, Mayer testified he only reported to Smith. Tr. 3255-56. Mayer was not a member of the MS & Co. board. Tr. 3397-98. Mayer sold some of the pre-2003 alarm contracts. Tr. 3263-64. Mayer sold \$3,042,000 of the Four Funds and Trust Offerings and received \$122,455 in commissions. Div. Ex. 2, Exs. 4o, 4p (as attached to Div. Ex. 2). Members of his family invested in the private placements at issue. Tr. 5016.

Mayer has known since he entered the industry that he had "to understand the product, the characteristics of the product, what its makeup is, what the risks are and rewards are, all the things that go into the product," and his understanding had to be extremely detailed. Tr. 4995-96, 5006-07, 5009. When asked to identify who besides Smith and MS & Co. persons presented information at the sales meetings, Mayer named Mario Bustamonti, a cable company operator, among others. Tr. 4997-5000. He also mentioned going to a Friedman Billings conference and being able to ask questions to a network of Wall Street connections. Tr. 4980-81, 4998. Mayer testified that he did the required analysis, but he did not understand that he was required to document all that he did. Tr. 4996-97, 5002.

⁶² Mayer uses "we" to refer to himself, Rabinovich, and Rogers. At the end of 2009, the three men joined Dinosaur, a current broker-dealer, and formed RMR Wealth Management. Tr. 1912-13, 2148, 3674.

⁶³ In 2002, Mayer's salary was \$100,000, later \$60,000, with a 2% override on retail commissions generated by the New York City office. Tr. 3260-61. Mayer worked in a training program at Oppenheimer & Co. after college and then was a representative registered with M.S. Farrell & Co.; Trautman, Kramer & Co.; Comvest Partners, Inc.; Mercer Partners Inc.; and Paulson Investment Co.; before joining MS & Co. in 2001. Div. Ex. 484 at 7; Tr. 3240-41. On November 24, 2003, Mayer settled a customer complaint with FINRA for \$20,000. Div. Ex. 484 at 15. The complaint was for failure to supervise an OTC equity. *Id.*

Mayer defines due diligence as what an investment banker does, i.e., background checks, review of financial statements, and looking at management, to determine if they want to recommend the product to clients. Tr. 5007-08. He believed that MS & Co. had conducted reasonable due diligence on the private placements. Tr. 5021. No one ever told him that a registered representative had to do the same level of due diligence as an investment banking department. Tr. 5008-09.

Mayer did not see any red flags in the FIIN PPM. Tr. 4990. He testified, however, that he did take extra time and was more cautious in examining the Four Funds offerings. Tr. 4994-95. He read the PPMs, he went to the sales meetings and took notes, and he spent endless hours in discussions about the Four Funds with Rabinovich and Rogers. Tr. 4994-95, 5055-68. When he presented any of the private placements to clients, he reviewed the PPM, pointed out the risks, and explained that higher interest meant higher risk. Tr. 5015. Mayer testified that he never claimed the private placement investment was guaranteed. Tr. 5015. Mayer believes that the interest on MS & Co.'s private placements was reasonable, given the returns on similar investments during 2003 through 2009. Tr. 5015.

Mayer testified that he saw some type of financial statements for the Four Funds in 2004 and 2005. Tr. 3327-28. In his investigative testimony, Mayer stated that he was never given a balance sheet for the Four Funds, and Mayer later confirmed that testimony at the hearing. Tr. 3328-29, 4982. Mayer testified that Shea sent him a FOCUS report in 2009. Tr. 5141. Mayer stated that Smith, Rees, and McGinn never refused his request for information about the Four Funds or the Trust Offerings. Tr. 5028. He did not recall seeing information regarding the total assets of any of the Four Funds as compared with its notes payable. Tr. 3329-31.

Mayer knew MS & Co. had been in business since 1980 and was successful in alarm and middle market type transactions. Tr. 3271. He knew the PPM allowed for investors to get copies of statements of operations consisting of balance sheets and income statements, but he does not recall any of his clients requesting the information. Tr. 3274. Mayer testified that cash flow information was very important and from time to time Smith or Rees would give some ideas of cash flow coming into the portfolio. Tr. 4981-82, 4987; RMR Ex. 229. Mayer testified that he saw the type of cash flow information in evidence, a 2004 FIIN income analysis, but he could not say he received the document. Tr. 4983. Mayer did not answer whether he ever asked Smith or Rees for cash flow statements. Tr. 4981-82. Mayer did recall seeing a balance sheet, which he did not consider helpful, and he did not see an income statement because he did not think them relevant. Tr. 4981-83, 4986. Mayer testified that a balance sheet value is only important at liquidation; it has nothing to do with whether investors get paid interest. Tr. 5117-18.

Mayer sold \$25,000 of FIIN 10.25% to Moshe Schwartz on October 15, 2003, and \$275,000 of FIIN 10.25% to Gary Von Glinow on October 18, 2003. Div. Ex. 2, Ex. 4o (as attached to Div. Ex. 2). When he made those sales, he was not sure if FIIN had made any investments. Tr. 3277.

Mayer stated that some answers he gave at his investigative testimony differ from his present testimony because at that time he was not familiar with the terms "independent investigation" or "due diligence" with respect to a registered representative. Tr. 3336, 3361. Mayer gave investigative testimony that clients asked him what the Four Funds were going to invest in but

that he did not provide them with information because he “didn’t have specific investments.” Tr. 3290. Mayer testified that he always gave clients examples of investments in an offering, but did not give them a list of specific investments. Tr. 3292. At the hearing Mayer testified that in the period from 2003 through 2007 he knew many of the Four Funds’ investments.⁶⁴ Tr. 3278-89.

In investigative testimony, Mayer testified that he would have been upset if he had known that the Four Funds were making loans to elseT because venture capital investments did not generate yields. Tr. 3323-24. He also testified that he did not know the structure of elseT or that funds had been loaned to elseT. Tr. 3462. However, at the hearing, Mayer testified that he did not consider elseT a venture capital investment because he understood that the partners gave personal guarantees and there were pledged assets.⁶⁵ Tr. 3322-23. Mayer also testified he knew MS & Co. funds were being invested in elseT. Tr. 3305-06. Mayer thought elseT was being backed by Deutsche Bank and that investing in elseT was within the guidelines of the PPMs of the Four Funds. Tr. 3306-09. Mayer testified that he knew the top holdings in the Four Funds and he was comfortable that Smith was going to be able to earn the promised interest. Tr. 3346, 3355. Mayer did not recall that one of FIIN’s top holdings in 2007 was a \$2.2 million investment in elseT, and he could not recall whether Smith had told him before January 8, 2008, that Smith had invested \$4 million of FAIN funds in elseT. Tr. 3349, 3352. Mayer did not learn that the Four Funds had \$8 million invested in elseT until the meeting on January 8, 2008. Tr. 5126.

In his investigative testimony, Mayer was asked about diversity of investments among the Four Funds’ holdings and he answered that he did not know the actual portfolios of the funds. Tr. 3354. At the hearing, Mayer testified that he told customers that the funds were making different investments. Tr. 3353. The basis of his statement was the information, including reports and lists of holdings that Smith provided. Tr. 3356. In his investigative testimony, Mayer testified that he had no information about the portfolios of the Four Funds when he sold notes to the Von Glinows, he represented they were diversified because brokers were told they were going to be diversified, and he did not independently investigate whether they were diversified but relied on the investment banking department. Tr. 3358.

Mayer defined redeeming as refinancing. Tr. 5097. In his view, at maturity, every fixed instrument offering has to be refinanced some way or another. Tr. 5103-04. Mayer testified that when these private placements reached maturity, like any other fixed instrument, they could be redeemed by (1) reselling the investment; (2) selling off assets to pay for the redemption; or (3) amortizing (paying down principal with earnings) over time. Tr. 5097-5104. The private placements at issue here were not structured to have earnings set aside for redemptions. Tr. 5098. In the past, MS & Co. had used reserve funds when attrition in contracts was expected to be high. Tr. 5066-68.

⁶⁴ The names of the investments Mayer mentioned are Dicania, Pali Capital, CMet Financial, Pine Street, CMS Financial, Palisades Pictures, Aquatic Development, elseT, Deerfield Capital, and GSC Capital. Tr. 3278-88.

⁶⁵ Mayer describes venture capital as an investment that has a higher degree of possibility of not working. Tr. 3322.

In his investigative testimony, Mayer testified that he viewed the conflicts of interest described in the Firstline PPM as similar to those in former MS & Co. offerings. Tr. 3442-44. Mayer knew the PPMs stated that the private placements were illiquid and that an investor could lose principal. Tr. 5029. Mayer testified that he never heard that a broker had to find a replacement investor before an existing investor could redeem; his clients were always able to redeem. Tr. 3373, 5028-29. In his investigative testimony, however, he acknowledged speaking to brokers about the instruction, and that if a client wanted to redeem the broker had to create a market. Tr. 3373-74. According to Mayer, close to maturity, Sicluna sent out letters to registered representatives asking whether the client wanted to redeem or roll the maturing notes over. Tr. 3376-78. If a client chose to redeem and the broker did not have another client, the security would be put out to the sales force; Mayer considered MS & Co.'s attempts to sell the private placements in the secondary market as an accommodation to investors; he insisted that a registered representative did not have to make a sale to redeem a security. Tr. 3376-84, 5028-29.

Smith targeted investments that yielded more than 12% interest; Mayer testified that historically the alarm contracts and Four Funds' investments achieved this return. Tr. 3333-34. When he sold the Four Funds, Mayer did not know that each fund had invested in Exchange Boulevard.⁶⁶ Tr. 3327; Div. Ex. 2, Ex. 14 (as attached to Div. Ex. 2). Mayer argues that he could not be expected to do a detailed examination of every investment held by a fund he recommended to a client and that at some point there has to be reliance on the fund manager's reports and the payment of regular interest. Tr. 3344-46.

Mayer considered the Four Funds offerings as Regulation D offerings, allowing up to thirty-five unaccredited investors despite language in the PPMs that "[t]he notes are being offered only to 'accredited investors', as that term is defined by Regulation D under the Securities Act." Tr. 3362, 3364; Div. Ex. 12 at 3. Mayer testified his practice is to focus on accredited investors. Tr. 3363.

Mayer did not consider the information he received at the meeting of January 8, 2008, as a red flag because at that time, all types of securities were having problems. Tr. 5030-31. Smith described areas where the portfolio was stressed or impaired, but Smith stated it was a temporary issue. Tr. 3384-85, 5030. Smith stated that cash flow was sufficient to pay interest on the Four Funds' senior and senior subordinate notes but not on the junior notes. Tr. 5030. Mayer does not remember learning of any intra-fund loans or that the Four Funds had purchased alarm contracts from the McGinn Smith Security Alarm trust at the meeting. Tr. 3386-87.

Mayer testified that he spoke to all his clients about the January 8, 2008, meeting.⁶⁷ Tr. 3391. On January 22, 2008, Renney Thomas (Thomas) asked Mayer if he could find "a match for \$16,000 worth of TAIN 10.25% Junior Debt." Div. Ex. 87. The five-year note had not matured. Tr. 5039. On January 29, 2008, Thomas informed Mayer that he was willing to sell TAIN for ninety cents on the dollar. Tr. 3392; Div. Ex. 88. On January 31, 2008, John Lawson (Lawson)

⁶⁶ Exchange Boulevard was a business run by Larry Tedesco involving golf. Tr. 3744.

⁶⁷ When Mayer testified the second time, he stated that he informed his junior note clients about the interest reduction. Tr. 5032.

emailed Mayer with questions about his holdings in FEIN, including whether the principal was in danger. Tr. 3392-94; Div. Ex. 91. Mayer did not recall how he responded to Lawson's questions, particularly about the principal. Tr. 3394-95.

Mayer was aware that Rabinovich's father loaned \$600,000 to Firstline. Tr. 3409. Mayer was told to structure it as an investment. Tr. 3410. On April 23, 2008, Mayer made three sales of Firstline 11B for a total of \$100,000. Div. Ex. 2, Ex. 4o (as attached to Div. Ex. 2).

Two clients informed the Division that they trusted Mayer and did not blame him for what happened on their private placement investments. Tr. 5075-76. Other clients have submitted affidavits supporting Mayer. Tr. 5075-76.

Witnesses who Purchased Securities from Mayer

Thomas Alberts (Alberts), a chemical engineer and graduate of Drexel University, retired in 1997 from his consulting and sales business; Alberts resides in Philadelphia, Pennsylvania. Tr. 3467, 3480. Alberts was a customer at MS & Co. for some years and in 2002 invested \$50,000 in a bridge loan for which he received interest and the return of his principal. Tr. 3483-86. On Mayer's recommendation, Alberts purchased a \$50,000 FAIN note on April 3, 2006, and a \$15,000 TDM Verifier note on March 15, 2007. Tr. 3468-71, 3477; Div. Ex. 2, Ex. 4o (as attached to Div. Ex. 2). On one purchaser questionnaire, Alberts followed instructions and indicated that his net worth was higher than it actually was, between \$500,000 and \$1,000,000, even though just a year earlier, he had indicated that it was only \$100,000 to \$250,000. Tr. 3501-02; RMR Ex. 733. He understood the exaggerated number to be necessary to confirm he was financially capable of investing in the note. Tr. 3501.

Alberts made the investments with a large portion of IRA funds; he believed they were a conservative, safe investment with minimal risk and would supplement his retirement. Tr. 3470-72, 3477-79. Albert testified that Mayer did not tell him that he could lose his investment, though he in fact lost the full amount of his principal investment, \$65,000, and it is not clear whether he took the interest or let it accumulate in his account. Tr. 3475, 3479, 3500, 3503. Alberts regarded the PPM disclaimers as standard boilerplate, relying instead on his broker. Tr. 3489-90. Alberts is angry with Mayer, who he never met in person before the hearing:

I can't believe he didn't know something was amiss. You can't work in [a] company or a situation and not get a smell, you know, something is a little strange going on. And if he had been a gentleman, maybe he would have called me I could have done something. Maybe I couldn't have done anything. I don't know.

Tr. 3511.

Vincent O'Brien (O'Brien), a retired newspaper editor, signed an investment management agreement with MS & Co. in 2008 with Mayer as his investment adviser. Tr. 891-92, 895-900; Div. Ex. 528. O'Brien did not disagree with a statement on the investor questionnaire that showed his net worth in 2008 as greater than \$1 million, and in 2009, O'Brien had a diversified income-

producing portfolio.⁶⁸ Tr. 934, 940. O'Brien's sister, Mary Ellen O'Brien, also retained Mayer as her investment adviser. Tr. 922. Mary Ellen O'Brien planned to testify, but she had a medical issue. Tr. 922. Another sister, Virginia, has a trust account with MS & Co. and is positive about her experience with Mayer. Tr. 930. O'Brien wanted moderate risk in his investments; he believed that Mayer would devise a solid market strategy that would grow his investments to supplement his pension and Social Security. Tr. 898, 900.

On Mayer's recommendation that these were safe investments with high interest, O'Brien and his sister made the following purchases, totaling \$190,000: on September 30, 2008, O'Brien purchased a \$50,000 Fortress note; on November 25, 2008, he purchased a \$40,000 TDM Verifier note; on January 29, 2009, Mary Ellen O'Brien purchased a total of \$50,000 TDMM Cable notes; on January 30, 2009, O'Brien purchased a total of \$50,000 of TDM Cable notes; on August 31, 2009, Mary Ellen O'Brien purchased a total of \$75,000 TDMM Benchmark notes; and on September 10, 2009, O'Brien purchased a total of \$50,000 TDMM Benchmark notes. Tr. 893, 901-02, 905, 907-08, 911-12, 925-26; Div. Ex. 2, Ex. 4o (as attached to Div. Ex. 2).

O'Brien had limited investment knowledge at the time he invested in MS & Co. private placements. Tr. 899. Based on Mayer's representations, O'Brien believed the offerings were outside the stock market but were all safe, because Mayer told him MS & Co. had been doing similar offerings for quite some time and the risk was equivalent to stocks. Tr. 902, 904-13. O'Brien testified Mary Ellen O'Brien told him that Mayer said he would swear on his father's grave that the private placement offerings were safe investments. Tr. 927-28.

O'Brien signed documents, including subscription agreements, for two of the offerings indicating that there would be no public market for the securities, he bore the economic risk of the investment for an indefinite period, the investment had substantial risks, and that he had an opportunity to ask questions. Tr. 934-39; RMR Exs. 428, 429.

O'Brien received the PPM for his investment in the TDMM Benchmark notes that showed the fees charged, however, he testified that he would not have invested if he had known that more than 30% percent of the offering proceeds would be used as fees. Tr. 913, 953-54. O'Brien estimates his loss at \$180,000. Tr. 928. He is not sure of his sisters' losses. Tr. 928.

Gary Von Glinow (Von Glinow) is a retired industrial psychologist from Lake Forrest, Illinois. Tr. 2806-07. In 2002, Von Glinow was an accredited investor. Tr. 2840-41. Von Glinow and his wife invested a total of \$665,000 in MS & Co. offerings, using IRA and pension money. Tr. 2810-12, 2836; Div. Ex. 2, Ex. 4o (as attached to Div. Ex. 2). He also recommended his mother-in-law to Mayer, and she invested another \$150,000 in MS & Co. offerings at Mayer's recommendation. Mayer also traveled to Chicago in 2005 and made a presentation to Von Glinow's family. Tr. 2855. Von Glinow, his family, and mother-in-law, made the following investments: on October 18, 2003, \$275,000 in FIIN; on February 20, 2004, \$100,000 in FEIN; on March 25, 2004, \$50,000 in FEIN; on December 1, 2004, \$55,000 in TAIN; on December 8, 2004, \$155,000 in TAIN; on November 7, 2005, \$50,000 in FAIN; on November

⁶⁸ O'Brien is only shown as an unaccredited investor on purchasers of TDMM CAB. Div. Ex. 535

22, 2006, \$30,000 in FAIN; on November 27, 2006, \$90,000 in TDM Cable; and on December 6, 2006, \$10,000 in TDM Cable. Div. Ex. 2, Ex. 4o (as attached to Div. Ex. 2).

Mayer represented to Von Glinow that his investments in FIIN, TAIN, and FEIN resulted in diversification. Tr. 2817-19. Von Glinow testified that compared to his other investments he did not consider these purchases risky, in view of MS & Co.'s past performance and the variety of investments in the notes. Tr. 2822-24. Mayer told Von Glinow that he himself did not own any of these investments because to do so would be a conflict of interest. Tr. 2825-26. However, Mayer did not explain what the conflict of interest would be and did not mention any conflicts of interest with respect to due diligence on the securities at issue. Tr. 2825-26.

During the course of their business relationship, Von Glinow believed Mayer made positive contributions to his investments. Tr. 2843-47, 2870-71. However, Von Glinow's relationship with Mayer deteriorated in 2007 and he moved his account from MS & Co. in 2008. Tr. 2827-29, 2833, 2845. Von Glinow estimated his losses from his investments with MS & Co. at over a million dollars. Tr. 2837-38.

Witness in Support of Respondent Mayer

William Strawbridge (Strawbridge), an engineering manager with Exxon and resident of Houston, Texas, has been Mayer's client for about ten years. Tr. 5512-13. His portfolio with Mayer consists of a wide variety of investments, not just private placements. Tr. 5514-15. Strawbridge invested in the pre-2003 alarm contracts through Mayer. Tr. 5518. He was attracted by the guaranteed 12% interest on those investments, and developed an understanding of the investments before putting money into them. Tr. 5518-19. Strawbridge made the following investments:

\$50,000 in TAIN on December 6, 2004
\$20,000 in TDM Cable on December 12, 2006
\$50,000 in Firstline on November 28, 2007
\$50,000 in Fortress on September 25, 2008
\$10,000 in Verifier on November 25, 2008
\$10,000 in Verifier on January 23, 2009
\$20,000 in Benchmark on August 27, 2009

Div. Ex. 2, Ex. 4o (as attached to Div. Ex. 2).

Strawbridge is frustrated by the MS & Co. receivership because, although four years have passed since the receivership was formed, distributions to investors have not been made, no portion of his investments in the Four Funds and Trust Offerings have been returned to him, and it is difficult to get a hold of the Receiver. Tr. 5525-28. Strawbridge described his relationship with Mayer as "trusting" and "respectful," and he testified that he was surprised when news of fraudulent practices at MS & Co. broke out in April 2010. Tr. 5540. Strawbridge considers Mayer a forthright and effective investment professional. Tr. 5527; RMR Ex. 606.

Respondent Philip S. Rabinovich

Rabinovich holds a bachelor's degree from Tufts University and studied at Oxford. Tr. 1911, 4215. Rabinovich has been active in the securities industry since 1996. Tr. 4215. He holds Series 3, 7, 24, 63, and 65 licenses. Div. Ex. 485 at 6. Rabinovich was associated with Bear, Sterns & Co. from July 1996 to March 1999; he then joined Mercer Partners, Inc. (Mercer), which was acquired by MS & Co. in 2001. Tr. 4216-21; Div. Ex. 485 at 7. While at Mercer, Rabinovich developed a clientele of mostly high net worth customers. Tr. 4220-21. From 2006 to 2009, Rabinovich was a senior vice president, registered representative, and an investment adviser representative associated with MS Advisors. Tr. 1912-15, 4442-43. He has never been the subject of a customer complaint. Tr. 4215; Div. Ex. 485.

Rabinovich began selling the MS & Co. private placements at issue in February 2004. Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2). Rabinovich sold \$16,206,500 of private placements, earning \$587,000 in commissions on those sales. Div. Ex. 2 at 48, Ex. 4q (as attached to Div. Ex. 2).

Rabinovich viewed MS & Co. as having a strong reputation with particular success in fixed income securities, specifically alarm contracts. Tr. 4225-27. Rabinovich testified that when he joined MS & Co., he toured MS & Co.'s Albany offices, met staff, became aware of Smith's many civic and philanthropic activities, and attended horse races at Saratoga. Tr. 4226, 4234, 4258-59, 4264.

Rabinovich testified that his primary responsibility while employed at MS & Co. was managing his clients' portfolios, mainly comprising equities; he also acted as Smith's assistant. Tr. 4313-14, 4443-44. Rabinovich often visited Smith's office. Tr. 4230, 4521. Rabinovich was paid only on commissions and fees; he did not receive a salary, and was not compensated for his extra duties. Tr. 4444-45.

For the Four Funds, MS Advisors was responsible for selecting investments. Tr. 1927. Rabinovich believed that Smith was the ultimate decision maker on Four Funds investments, but that he had a diligence team assisting him.⁶⁹ Tr. 1926-28. The diligence team included Smith, investment bankers, lawyers, and accountants. Tr. 2167-74, 4263-64, 4267-69. Rabinovich described due diligence as the bailiwick of investment bankers, not registered representatives, and involving the "nitty gritty, accounting and legal and all of the aspects that go into understanding of what you are buying." Tr. 4307-08.

Rabinovich described his own responsibilities as including determining product suitability, which he satisfied by understanding the private placements, attending management presentations on the products, reading the PPMs, asking management questions, and understanding the underlying financials, revenue drivers, and debt schedules, among other things. Tr. 4265-66, 4304-05, 4347-

⁶⁹ He believes that nearly twenty people were involved in the due diligence on the Trust Offerings. Tr. 4236-37.

38. Rabinovich testified that when he spoke with clients about products, he would tell them about any risks. Tr. 4329. He also said that before rolling over a client's existing Four Funds investment, he would discuss the products with Smith and others. Tr. 4305-06. He said a registered representative is also responsible for determining customer suitability, which involves discussing with the client his finances, investment objectives, and risk tolerance. Tr. 4266.

Rabinovich's position is that from September 2003 until late 2008, he was aware of the major investments made by the Four Funds; he testified that Smith never declined to tell him the assets underlying the Four Funds or how those assets were performing. Tr. 4272-73, 4309, 4512. Smith included Rabinovich in discussions of potential and actual Four Funds investments.⁷⁰ Tr. 4313-15, 4443-45. Rabinovich was aware prior to January 2008 of Four Funds investments in alseT, Caribbean Clubs International, and Pine Street, which were indeed Four Funds investments. Tr. 1948, Div. Ex. 2, Ex. 14 (as attached to Div. Ex. 2). For the Four Funds' investments, Rabinovich did not perform independent examinations of cash flows and he believed PPM statements about asset classes. Tr. 1962-63. Rabinovich testified that at the time of a 2006 sale of a FIIN note, he was aware of some investments in the FIIN portfolio; his knowledge came from Smith. Tr. 1938-40. In his investigative testimony, Rabinovich was unsure whether he saw Four Funds' balance sheets before January 2008, but he received schedules on how investments were performing. Tr. 1953-54, 4519-20. Rabinovich testified that he saw some type of financial statements for the Four Funds before January 2008, and said, "I just know that I had frequent discussions with Mr. Smith about the performance . . . and from time to time would see how those – how those positions were doing." Tr. 1945-46, 1951. Rabinovich recalled that the financial statements showed assets at cost or at par. Tr. 1945, 4520. Rabinovich knew, before 2008, that the Four Funds were purchasing security alarm contracts. Tr. 1952. Until 2009 or 2010, Rabinovich was unaware that that notes under the Four Funds in fact invested in each other. Tr. 1946-47. In prior testimony, Rabinovich stated that he never received any information about the Four Funds' total assets as compared to the notes payable. Tr. 1947-48.

As of 2006, Rabinovich believed that the Four Funds had made a "decent size" investment of "a couple million dollars" in alseT; he never asked the specific amount invested in alseT, and found out on January 8, 2008, that the total investment was \$8.5 million. Tr. 1949, 2034, 2036, 2043, 4513, 4519. He understood that the PPM allowed the Four Funds to purchase investments from affiliates at prices not higher than the investment cost originally. Tr. 2035. At the hearing, he expressed an understanding that the alseT investment, as a bridge loan, was inconsistent with expected Four Fund investments; however, he insisted that the expectation was that a major investment bank would refinance alseT and that several major banks were seriously considering doing so until the financial crisis of 2007 and 2008. Tr. 2035-36, 2040-41, 2050-56.

Specifically as to FIIN, he did not regard any disclosures in the PPM as a red flag, and did not consider the disclosures unusual. Tr. 4274. Rabinovich testified that he did not believe risk factors disclosed in a PPM could be a red flag. Tr. 4510-11. He did not appear concerned that in

⁷⁰ Rabinovich testified that he worked closely with Weisman, who worked out of the New York office, and participated in a number of investments that Weisman brought to MS & Co. Tr. 4303. Two of these companies, Vigilant Privacy Corp. and Vidsoft Inc. were in the Four Funds' portfolios. Tr. 4271-72.

2003 FIIN was a new issuer; FIIN had no operating history; or that Smith was running MS & Co. and MS Advisors, and controlling FIIN's placement agent, servicing agent, and trustee. Tr. 1922-24. Rabinovich did not recommend FIIN at first because he wanted guidelines as to the types of investments that Smith would make. Tr. 1931-32. Rabinovich testified that he was not troubled by Smith's failure to disclose specific investments because he understood the need for confidentiality, and Smith told him the types of investments and large positions the Four Funds held. Tr. 1933-34.

In October 2006, Rabinovich sold a FIIN note to Arthur Saul Kornberg. Tr. 1938-39; Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2). Rabinovich said that at the time of the sale he knew some of the assets FIIN had invested in, because this information was provided in meetings. Tr. 1939, 1942-43, 1948.

Rabinovich knew that Four Funds notes were to be sold only to accredited investors as that term is defined in Regulation D and he understood that Regulation D allowed up to thirty-five unaccredited investors. Tr. 1993-95.

Rabinovich's father and his father's business partner invested in the Four Funds. Tr. 4308-09, 4367; Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2). In February 2004, Smith sent Rabinovich's father and his father's business partner a letter about customizing an investment vehicle for them. RMR Ex. 22. This letter discussed that a management fee would be charged for services such as due diligence and legal fees. *Id.* at 2. Language in this letter is similar to language used in emails from Rabinovich about Four Funds investments. Div. Exs. 15, 35, 37, 40, 43.

In June 2007, one of Rabinovich's clients who held a \$100,000 note complained that she had not received her return of principal. Tr. 1982; Div. Ex. 609. Rees told Rabinovich it was just a mistake. Tr. 1982-84. The client, however, complained again in February 2008, and Rabinovich responded to the client that her payment had been sent to MS & Co. by mistake. Tr. 1987-88. Rabinovich testified that he did not know that, in the end, Four Funds offering proceeds were used to redeem this customer; he agrees that paying the client in this way was inconsistent with the PPM. Tr. 1989. Rabinovich sold FAIN notes to a couple in January 2006; before making the sale, he did not question whether they were accredited investors, even though they included the requisite information for an accreditation determination on a subscription form that Rabinovich signed. Tr. 2005-08; Div. Ex. 613.

Rabinovich denied he was aware of a policy where a registered representative had to find a replacement investor before a customer could redeem, but acknowledged being concerned about redemption by December 2007. Tr. 2012-16, 4448-49. Rabinovich testified that MS & Co. tried to create a secondary market for private placements by circulating information about available inventory. Tr. 4452. The registered representative whose customer was redeeming had the right of first refusal to determine if another client had interest in purchasing the note. Tr. 4455. If the registered representative did not exercise his first option to resell, then the note went into inventory and others received notice of its availability. Tr. 4455. Rabinovich met with Smith, McGinn, and others on January 8, 2008, to discuss the financial condition of the Four Funds. Tr. 1955-56. In this meeting, Smith went over the largest investments; Rabinovich received a list of assets and their impairments; he requested balance sheets and later received copies of the balance sheets. Tr. 1955-58, 1985, 2065. At the January meeting, Rabinovich learned the Four Funds had serious

impairments. Tr. 1985, 2033-36. He was shocked to learn that Smith had not “line[d] up the cash flows to account for expiring maturities,” the lack of liquidity, the poor condition of the Four Funds’ investments, the size of the alsoT loan, and the bankruptcies of retailers that the Four Funds had extended loans to. Tr. 2033-36, 2060-61. He also learned of the loss of value in Deerfield Capital shares, and the underperformance of GSC Capital Corp.⁷¹ Tr. 2061-62. Either at this meeting or subsequent meetings, Rabinovich learned that there were overlapping investments and commingling of funds between the Four Funds. Tr. 2028-29.

At the January meeting, McGinn talked about driving revenues to the Four Funds, which Rabinovich took to mean that everyone should work hard and focus on raising assets. Tr. 2066, 2076. Rabinovich testified that he thought McGinn meant he was willing to put MS & Co. profits into the Four Funds. Tr. 2069, 2177-79. At other times, McGinn referred to a need to “pump out the swamp,” which Rabinovich thought referred to the large amount of firm revenues tied up in the Four Funds. Tr. 2076-77. Rabinovich said that he did not consider the problems the Four Funds were experiencing relevant to discussions with clients when presenting investments in the Trust Offerings after January 2008. Tr. 4458-59.

Following the January meeting, in early March 2008, Rabinovich told a Firstline investor: “The recent history of these notes is that we have had not had any defaults or late payments of interest of principal. They have all been retired on time according to each respective amortization schedule.” Tr. 2109; Div. Ex. 487. The Firstline11B notes had only been issued five months earlier so there had been no retirements. Rabinovich said he was referring to prior issues. Tr. 2110. In fact, Firstline made a bankruptcy filing in January 2008, which was a matter of public record.

Also, on February 22, 2008, Rabinovich told a client he could not sell \$16,000 worth of TAIN notes for ninety cents on the dollar, and it was tough to value the portfolio. Div. Ex. 50. In a letter to a customer on October 20, 2008, concerning TAIN and FEIN notes, Rabinovich opined that he thought a fifteen-year amortization was too conservative. Tr. 2062-63; Div. Ex. 58. Rabinovich based his opinion on information from Smith, his knowledge of the portfolio, and expected portfolio reconstruction. Tr. 2065. Rabinovich believed at the time that more than 50% of the Four Fund assets were not impaired. Tr. 2063.

Sometime after April 2009, Rabinovich visited Shea and asked how the Four Funds’ investments were performing. Tr. 2375-76. Shea explained that he could not provide much information because there were about seventy companies the Four Funds had invested in, and when Shea had returned to MS & Co., the books and records for the Four Funds were totally disorganized. Tr. 2376-81.

On December 21, 2006, Sicluna alerted Smith that Rabinovich had a client redeeming a \$100,000 TAIN note and purchasing a \$100,000 TDM note. Rabinovich was not on her email. Tr. 2019; Div. Ex. 17. Smith told Sicluna, in an email that Rabinovich was not on, that “[Rabinovich] needs to replace the \$100,000 before doing the trade,” adding, “I am running on fumes with all of these redemptions and cannot afford any more.” *Id.* Rabinovich’s client, Levy, redeemed her

⁷¹ Before January 2008, Smith never gave Rabinovich any indication that the Four Funds’ portfolios were underperforming. Tr. 2041.

\$100,000 TAIN note on or about December 21, 2006, and purchased a \$100,000 TDM note on December 28, 2006. Tr. 2018-24; Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2); Div. Exs. 7, 614, 615.

Rabinovich testified that his customers were able to redeem their Senior Four Funds notes from 2004 through 2009, and that no one ever told him that he needed a replacement before a client could be redeemed. Tr. 2175, 4301, 4448-49. Rabinovich denied he was aware of a policy where a registered representative had to find a replacement investor before a client could redeem, but acknowledged knowing the firm had concerns surrounding redemptions by December 2007, and that in early 2008 redemptions were not going through without a new buyer. Tr. 2012-18, 4448-49.

Rabinovich's father loaned Firstline \$600,000 in October 2007, because McGinn represented to Rabinovich that he needed funds desperately to purchase an asset for investors by the end of the month. Tr. 4450-51. The loan was repaid in about eight months.⁷² Tr. 2091-92; Div. Ex. 549. Rabinovich received an email on October 29, 2007, from McGinn thanking him for the \$600,000. Div. Ex. 549. Other emails in the string show that the \$600,000 and \$240,000 from TDM Luxury Cruise comprised part of a \$782,812.50 to Adirondack Trust Company, crediting to Stewarts Shops Corp. Rabinovich does not recall reading the full email. Tr. 2095, 2097-98. Rabinovich believed he gave either McGinn or Guzzetti notice that his father's shares should be put up for resale so that his father could be redeemed. Tr. 2106-07, 4451. Rabinovich sold Firstline notes after his father made the loan. Tr. 2103-04.

On January 30, 2009, Rabinovich's father loaned \$250,000 to one of the Trust Offerings to be paid back with interest because Rabinovich understood McGinn needed funds to get the deal done. Tr. 2115; Div. Ex. 70. Rabinovich understood that his father would be repaid upon receipt of the offering proceeds. Tr. 2117. On June 16, 2009, Rabinovich asked Guzzetti about repayment of the loan, and Guzzetti advised Rabinovich:

\$150,000 came in yesterday. We are waiting on Bill Lex for \$100,000 should be in by July 1st. If you want the \$150,000 call [Sicluna] and we will put a sell ticket in for \$150,000 then put another in for \$100,000 when it comes in.

Tr. 2121; Div. Ex. 71. Rabinovich's father was subsequently repaid for the loan. Tr. 2122.

Rabinovich knew in the second or third quarter of 2009 that MS & Co. faced a potential net capital violation. Tr. 2127-28. In August 2009, he was not sure MS & Co. was going to continue to support the New York office. Tr. 2123-24.

The Benchmark Trust Offering PPM is dated August 20, 2009. Div. Ex. 63. Rabinovich knew that \$1.95 million raised would go toward purchasing assets and that 30% of the offering

⁷² There was no question that this and a later transaction were loans paid back with interest, but they were structured as note purchases. Tr. 2105. Rabinovich recorded the sale of \$600,000 of investment in Firstline to his father on October 29, 2007. Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2). Repayment of the \$600,000 was in part from funds McGinn raised and from sales of Firstline. Tr. 2098-99.

proceeds would go to expenses, but he was not concerned because, in his analysis, the transaction had great merit. Tr. 2129-32. Specifically, Rabinovich believed Benchmark's assets were purchased very inexpensively, had low attrition rates and maintained good cash flow. Tr. 2155-57. One of Rabinovich's clients told him on August 25, 2009, that he believed the fees associated with Benchmark were too high. Tr. 2134-35; Div. Ex. 65.

Rabinovich made eleven sales of the TDMM Benchmark Trust Offering between August 24 and September 22, 2009. Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2). Two of those sales occurred after Rabinovich learned around September 3, 2009, that Firstline had gone bankrupt. *Id.*; Tr. 2146. However, Rabinovich testified that he actually had presented those investments before September 3, 2009, but were only recorded afterwards. Tr. 2142. Rabinovich was asked whether he contacted a specific investor in TDM who had agreed to invest before Rabinovich learned of the bankruptcy to encourage him to cancel his pending investment; Rabinovich did not believe that he had.⁷³ Tr. 2146-48. Rabinovich testified that he told his customers who had invested in Firstline of the bankruptcy in September 2009. Tr. 4459.

Rabinovich testified that in 2009, he and members of his family had \$4.5 million in assets invested in MS & Co. private placements. Tr. 2128-29, 4336. His family made various purchases, including a \$200,000 TDM investment by his father on July 24, 2007, and an in-law's \$25,000 TDM investment on December 31, 2008. Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2); Tr. 2088. On September 10, 2009, Rabinovich put \$25,000 of his own money into TDM. Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2). This was Rabinovich's first purchase of for his own account. *Id.*; Tr. 4492. Rabinovich testified he made the purchase because Rogers had a client, Shapiro, who needed to sell this security. Tr. 4495-96. Rabinovich testified he did not know that Rogers feared legal action by Shapiro if Shapiro was not able to redeem the \$25,000 note quickly. Tr. 4496-97; *see* Div. Ex. 647.

Rabinovich left MS & Co. at the end of October 2009, and became associated with broker-dealer Dinosaur Securities, LLC, and investment adviser RMR Wealth Management. Tr. 1912, 4221, 4223; Div. Ex. 485. Between November 2009 and March 2010, Rabinovich and others put financing together to purchase the Firstline assets out of bankruptcy, but "the SEC came in, shut it all down, and the money [was] all gone" as it had been claimed by the Receiver. Tr. 4343. Rabinovich understands that the Firstline Trust Offerings have performed well. Tr. 4344.

Witnesses who Purchased Securities from Rabinovich

Patricia Chapman (Chapman), a graduate of Rutgers University with a degree in psychology, worked as a systems engineer and certified project manager until she retired from that field in 2004. Tr. 2181, 2194. At one time, Chapman was an accredited investor and she had some success in her earlier investments with MS & Co. Tr. 2194-95; RMR Ex. 817. For example, she purchased a four-year IASG note in May 2003, received her interest, and was redeemed in full. Tr.

⁷³ It appears that the registered representative number on the trade was Smith's, but Rabinovich was paid a commission on the sale.

2194-95. Chapman has most recently worked minimum wage jobs at Marshalls and at Whole Foods. Tr. 2180.

Chapman lost a great deal of money in technology stocks, so she told Rabinovich that she had very little appetite for risks in her investments. Tr. 2186. Chapman invested \$55,000 of her IRA funds in a FEIN note on March 8, 2005.⁷⁴ Tr. 2190; Div. Ex.2, Ex. 4q (as attached to Div. Ex. 2); RMR Ex. 820. Chapman testified that Rabinovich, who represented that he was an officer at MS & Co., recommended the purchase and told her the investment was low risk. Tr. 2184-87. In connection with the purchase, Chapman received a PPM and signed a subscription agreement that stated she could lose her investment and was able to bear the financial loss. Tr. 2199-05; RMR Exs. 818, 820. Chapman received a letter from MS & Co. in April 2008 informing her that holders of junior securities would not receive interest, and a second letter in October 2008 announcing a restructuring and informing investors that repayments would be spread over fifteen years. Tr. 2188, 2209-10; Div. Ex. 632; RMR Ex. 822. Rabinovich explained to her that general market conditions were making it difficult for MS & Co. to restructure its debt, but did not mention any specific problems at MS & Co. Tr. 2191-92. Chapman lost her full \$55,000 investment. Tr. 2192.

Dr. Ketan Patel (Patel), a pathologist, lost \$45,000 in his MS & Co. investments.⁷⁵ Tr. 148, 167. Using Rabinovich as his broker, in 2008 and 2009, Patel purchased: a \$25,000 TDM Verifier note on March 5, 2008; a \$10,000 TDM Verifier note on March 26, 2009; and a \$10,000 TDM Benchmark note on August 31, 2009. Tr. 156-60, 183; Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2).

Patel was inexperienced in investments in the United States. Tr. 155-57. Patel trusted Rabinovich and he accepted his word that this was a safe investment; Patel told Rabinovich that the investment was to pay for his son's education and he wanted the 8% or 9% return for this purpose.⁷⁶ Tr. 155-159, 177, 194. Rabinovich did not tell Patel that his investment on March 26, 2009, would be used to pay back principal to other investors, and Patel believed that his August 31, 2009, investment was similar to his earlier investments. Tr. 162-64, 190. Patel did not know he could lose his funds in any of his three investments, that more than 30% of the funds raised in one of the offerings would go to fees, or that MS & Co. was having financial difficulties in August 2009. Tr. 162-65.

⁷⁴ Chapman also invested \$100,000 through Rabinovich in a MS & Co. private placement of Vigilant Privacy Corp. in about August 31, 2005, which she also did not recover. Tr. 2192, 2213-20; Div. Ex. 502; RMR Exs. 823, 824. The OIP does not mention Vigilant. Chapman declined Rabinovich's invitation to invest in TAIN. Tr. 2198.

⁷⁵ Patel left Binghamton, New York, at 4:00 a.m. in the snow to testify about the loss of his funds. Tr. 179. He wanted to testify by alternative means, but there were objections. Tr. 203-07.

⁷⁶ In July 2009, Patel rolled the \$25,000 note over and gifted it to his son. Tr. 178-80. Many investors rolled their notes over rather than redeeming them at maturity. Tr. 1342-43.

Witnesses in Support of Respondent Rabinovich

Michael Favish (Favish) of San Diego, California, has been investing with Rabinovich for about ten years. Tr. 5532. Favish began a public company in 1994, sold it in 2004, and has begun a health science company. Tr. 5532.

Favish made several investments that Rabinovich recommended; some worked and some did not. Tr. 5535-38. One was the purchase of \$100,000 of FEIN 10.25% on April 6, 2005. Tr. 5535; Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2); RMR Exs. 468, 469. Favish trusts Rabinovich and considers him a person of integrity and honesty. Tr. 5541; RMR Ex. 610.

Michael Kogan (Kogan) holds a number of securities licenses and specializes in international program trading. Tr. 4524-25. He is presently a managing director at J.P. Morgan, prior to which he was with Credit Suisse for twelve years. Tr. 4524-25. Kogan has known Rabinovich for twenty years and they are best friends. Tr. 4526-27; RMR Ex. 625. Kogan began investing in college and has been Rabinovich's client since the early 2000s. Tr. 4526. On February 15, 2005, Kogan purchased an \$80,000 FEIN note, and on February 22, 2006, he purchased a \$150,000 FAIN note. Tr. 4529; Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2). Kogan believes his income made him an accredited investor as to both of these purchases. Tr. 4531.

Kogan accepts his FEIN and FAIN losses as simply resulting from the risks of private placement investing, and described 2008 as a "black swan event" of financial meltdown across asset types. Tr. 4534-36; RMR Ex. 625. Kogan believes Rabinovich to be a person of high integrity. Tr. 4538; RMR Ex. 625.

Stanton Rowe (Rowe) is a resident of Southern California and has been Rabinovich's client since about 1999.⁷⁷ Tr. 4364-65. Rowe's purchases were made in his and his wife's name. At Rabinovich's recommendation, Rowe purchased a total of \$2,380,000 in FEIN notes in 2004. Tr. 4371; Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2). Rowe also purchased TDM notes on January 17, 2007 (\$10,000), January 25, 2007 (\$20,000), September 27, 2007 (\$50,000), and January 15, 2009 (\$75,000); a \$150,000 TAIN note on February 23, 2007; and a \$400,000 Fortress note on September 29, 2008.⁷⁸ Tr. 4371-73; Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2). These private placements comprised about ten percent of Rowe's portfolio with Rabinovich. Tr. 4373. Some of Rowe's investments in Trust Offerings are part of the assets in the hands of the Receiver. Tr. 4403.

⁷⁷ Rowe, a graduate of the University of Alabama in Huntsville, worked at Johnson & Johnson and later at Datascope Corp. as corporate vice president of business development. Tr. 4366. He then founded, with Rabinovich's father and others, Percutaneous Valve Technologies, Inc., at which Rowe was President and CEO; Rowe is now chief scientific officer and corporate vice president for advanced technologies at Edwards Lifesciences Corp. Tr. 4366-68.

⁷⁸ Rowe invested a total of \$3,085,000 in principal. Tr. 4373-74; Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2).

Rowe testified that he looks to Rabinovich to manage the riskier part of his portfolio, and he considers him a trusted partner who has performed dutifully. Tr. 4396, 4404; *see* RMR Ex. 616.

Respondent Ryan C. Rogers

Rogers graduated from Southern New Hampshire University in 1994 and holds three FINRA licenses. Tr. 3668, 5661; Div. Ex. 486 at 4. Rogers entered the securities industry in 1994; he was associated with A. R. Baron & Co., Whitehall Wellington Investments, Inc., William Scott & Co., Millennium Securities Corp., Mercer Partners Incorporated, and Paulson Investment Company, Inc., before becoming associated with MS & Co. in 2001 and MS Advisors in 2006.⁷⁹ He worked out of MS & Co.'s New York City office.⁸⁰ Tr. 3675; Div. Ex. 486. At MS & Co., Rogers was entirely compensated on commission, and the compensation he received from commissions on the MS & Co. private placements at issue here accounted for around eleven percent of his total compensation during that time period. Tr. 5736-37. His client base comprises high net-worth individuals. Tr. 5714. Rogers testified that a minority of his clients purchased MS & Co. private placements. Tr. 5737. Rogers testified that between 2004 and 2009 he reported primarily to Mayer; at times, he reported to Guzzetti, Livingston, McGinn, and Smith. Tr. 3675.

Rogers understood that he had a product suitability obligation, which was to understand the client and the product and match the two. Tr. 5685. Rogers informed himself about the Four Funds by attending meetings at MS & Co., reading the PPMs, and having discussions with Rabinovich and Mayer. Tr. 5685-86, 5698. Rogers denied that he simply relied blindly on information that McGinn and Smith offered about the private placements. Tr. 5828. Rogers testified he conducted research by talking to people associated with the transactions, speaking with a network of knowledgeable people about specific companies or investment areas, talking with Rabinovich and Mayer, and doing little things like looking at Google maps to see areas covered by contracts. Tr. 5689, 5828-29.

Rogers views making a product suitability determination and doing due diligence as two different requirements. Tr. 5691. He does not believe a registered representative is required to do due diligence, but he believes that his efforts exceeded what the Division's expert, Robert Lowry, would require of a registered representative. Tr. 5691-92.

As to recommending the Four Funds, Rogers relied on Smith's twenty years of achievements in the financial industry and his track record managing assets. Tr. 3690-93. Smith

⁷⁹ He held the title of senior vice president at MS & Co. Tr. 3675.

⁸⁰ Rogers's FINRA record shows that he was involved in a settled customer dispute in 1999; the customer alleged that the broker-dealer he was affiliated with at the time breached a fiduciary duty, omitted a material fact, and recommended unsuitable investments. Div. Ex. 486 at 14. Rogers testified that "almost a dozen" registered representatives were named in this customer's complaint, the customer was not Rogers's customer, Rogers was not working at the broker-dealer at the time the complaint was filed, and Rogers's attorney advised that the quickest way for Rogers to exit the proceeding was by contributing minimally to a settlement. Tr. 3671-72.

had a team supporting his investment decisions and Rogers depended on Smith and that team to do due diligence on Four Funds' investments. Tr. 3693.

Rogers testified at hearing that he became aware of some positions held in the Four Funds in November 2003; during a prior deposition, he testified that he did not recall becoming aware of any underlying positions prior to January 2008. Tr. 3685, 5780. Rogers testified that in 2007 he understood that underlying the Four Funds were high-quality institutional transactions Livingston was involved with, and certain deals that did not fit what Pine Street was looking to invest in but that were very good deals. Tr. 3688-89, 5670-71. Between November 2003 and July 2007, he was aware of "a very large portion of the investments in the [Four Funds]." Tr. 3835-36. Rogers represents that his personal notes, which were produced to the Division (*see* RMR Ex. 279), "have lists of actual securities that the [Four Funds] notes were invested in." Tr. 3684, 5670-71. Rogers says that Smith told him about transactions underwritten by Friedman Billings Ramsey and Deutsche Bank or some other "top 5 Wall Street underwriter." Tr. 3684. At his deposition in the Civil Case, Rogers stated that he did not think he ever asked anyone at MS & Co. for information on what the Four Funds were being invested in, and that he relied on Smith's expertise and track record and relied on Smith to conduct the necessary due diligence. Tr. 3694-95. Also in his deposition, Rogers stated that he did not believe he requested information about specific investments before January 2008. Tr. 3685. At the hearing, Rogers maintained that while he did not request information as to dollar amounts, he absolutely knew positions in the Four Funds were performing because he investigated certain investments by talking to people involved with them, and he knew that the Four Funds largest investment, Pine Street, was doing well.⁸¹ Tr. 3696-99, 5692; *see* Div. Ex. 2, Exs. 11, 12 (as attached to Div. Ex. 2). Rogers named Pine Street, Coventry Resources Corp., Deerfield Capital Corp., CMS Financial, Palisades Picture, and elseT, among others, as Four Funds' investments he was aware of when selling the Four Funds. Tr. 3696-97, 3749, 5799-80; *see* Div. Ex. 2, Exs. 11, 12 (as attached to Div. Ex. 2).

Rogers testified that his requests, made to Smith and Rees between the end of 2003 and the beginning of 2008, for information about the Four Funds were never denied. Tr. 5673-74. Rogers acknowledged that Smith would not disclose specifics about assets in the Four Funds, citing confidentiality, but maintained what was confidential was only a small group of local investments. Tr. 5673-75. Rogers insisted that he, Rabinovich, and Mayer understood what assets were in the Four Funds. Tr. 5672-73, 5675. Rogers was aware that Smith took trips with individuals at Pine Street to look at prospective investments. Tr. 5678-79.

Rogers never saw any documents specifically evidencing alarm contract purchases, with purchase prices, by the Four Funds; he felt comfortable with the purchase of alarm contracts by the Four Funds because of MS & Co.'s history with alarm contracts and their network within the industry. Tr. 5796-98. Before 2010, Rogers was not aware that Smith was investing Four Funds

⁸¹ As of December 31, 2006, the Four Funds balance sheet shows an investment of \$5 million in Pine Street out of total investments of \$72.7 million. As of December 31, 2007, the Four Funds had \$2.9 million invested in Pine Street out of total investments of \$74.1 million. Div. Exs. 13,14.

money in MS & Co.-related entities or that some MS & Co. funds were invested in other MS & Co. funds. Tr. 5798-99, 5804.

Rogers did not see any red flags in the Four Funds PPMs, which were prepared by outside counsel. Tr. 5681, 5718. He did not consider it unusual that: the investment manager owned and controlled the issuer; the issuer had no operating history; or the placement agent and trustee were related. Tr. 5681-82. Rogers testified that he did exactly what the Division claims he should have done for a private placement where these conditions existed: Tr. 5684. Rogers was not aware of a policy at MS & Co. whereby a registered representative was required to find a replacement investor before an existing investor could be redeemed; he testified that his investors were able to be redeemed in 2006 and 2007. Tr. 5720. Rogers knew the Four Funds were Regulation D offerings, and thus could be sold to no more than thirty-five unaccredited investors. Tr. 5717-18.

Rogers's notes that he took at the January 2008 meeting discussed above reflect that Smith informed the registered representatives about losses in the Four Funds, but represented that they were manageable, and discussed about \$30 million dollars in illiquid investments, including \$10 million in elseT. Tr. 5768-70; RMR Ex. 279 at RMR 142. Rogers acknowledged a large investment in elseT, which was a related entity, was not specifically disclosed to Four Funds' investors, but he said the PPMs allowed for investments in related entities. Tr. 5773. He knew that at least one of the Four Funds was invested in elseT before January 2008. Tr. 5800.

Rogers testified that when selling a Four Funds investment, he would review the PPM and go over the investment risks with the client – including that the investments were illiquid and not guaranteed, and that principal could be lost. Tr. 5698-701. He stated that he never told an investor that Four Funds were guaranteed and believed his clients understood the investment risks. Tr. 5699.

Rogers testified that in November 2003 Smith provided him with cash flow information on FIIN. Tr. 5760-63, 5800-01; RMR Ex. 279 at RMR 72. Rogers thought the cash flows for the other Four Funds investments were similar. Tr. 5803-04.

When Rogers sold a TAIN note to Peggy Loscalzo on January 26, 2007, he believed she was an accredited investor, in part because he valued her house as “a million dollar home on the Long Island Sounds.” Tr. 5745-50; Div. Ex. 2, Ex. 4s (as attached to Div. Ex. 2).

Rogers was extremely disappointed by Smith's announcement in January 2008 that interest on junior Four Funds notes would be reduced; he, however, did not consider the reduction in interest to be a red flag. Tr. 5722-23. Rogers simply believed the Four Funds were experiencing a liquidity problem, which was happening in all sorts of assets at that time in the middle of the financial crisis. Tr. 5722, 5728. Rogers credited Smith's claims that the Four Funds' inability to pay interest to junior note holders was due to the financial crisis. Tr. 5820-22, 5826.

Rogers testified that he was aware that the Four Funds' PPMs provided that failure of a fund to pay interest on a note within a certain number of days of the due date was a default event,⁸² and

⁸² The PPMs provided that the fund had to pay interest within thirty days, but Rogers had thought it was sixty days. Tr. 5805, 5807; *e.g.*, Div. Ex. 5 at 13.

acknowledged that, with the reduction in the junior notes' interest rate, a default had occurred. Tr. 5805-08. After January 2008, Rogers recommended and sold Trust Offerings. Div. Ex. 2, Ex. 4s (as attached to Div. Ex. 2). Rogers did not mention the restructuring of the Four Funds when he sold Trust Offerings to investors after January 2008; he said this was because the Four Funds and Trust Offerings held "entirely separate assets." Tr. 5733. Rogers also recalls being aware that Four Funds' PPMs also provided that if a default occurred and continued, the trustee or a majority of the note holders for that particular tranche could declare the unpaid principal and any accrued interest due and payable immediately. Tr. 5809-10; *e.g.*, Div. Ex. 5 at 13. Rogers sold some junior Four Funds notes before 2008, but after January 8, 2008, did not bring this provision in the PPMs to the attention of his clients who had invested in junior notes because, he was comfortable with the plan MS & Co. was putting together a plan to protect all investors. Tr. 5810; Div. Ex. 2, Ex. 4s (as attached to Div. Ex. 2).

On August 12, 2009, Guzzetti emailed McGinn and Smith, copying Rogers, stating that Rogers had a client, Ronald Shapiro (Shapiro), who wanted to redeem a \$25,000 Verifier note. Div. Ex. 2, Ex. 4s (as attached to Div. Ex. 2); Div. Ex. 647. In that email, Guzzetti states that Rogers wants the redemption to go through within five days, and continues: "[Rogers] IS VERY CONCERNED ABOUT SHAPIRO WHO OWNS \$200,000 OF OUR NOTES [. . .] IF THAT VERIFIER MONEY IS NOT IN THE ACCOUNT BY MONDAY [Rogers] FEARS POSSIBLE LEGAL ACTION WITH THE NOTES." Div. Ex. 647. Rogers testified that Shapiro sent an email to him venting and gave Rogers "a hard time," but never said anything about possible legal action. Tr. 5744-45.

On September 10, 2009, Rabinovich bought a \$25,000 Verifier note for his own account. Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2); Div. Ex. 646. This was Rabinovich's first personal purchase of either the Four Funds or the Trust Offerings. Tr. 4492-93; Div. Ex. 2, Ex. 4q (as attached to Div. Ex. 2). Rabinovich testified he purchased the note in part because Rogers's client Shapiro needed to sell his \$25,000 Verifier note. Tr. 4495-96. Reviewing the August 12, 2009, email from Guzzetti, discussed above, Rabinovich said he was unaware that Rogers feared possible legal action if Shapiro was not able to quickly redeem. Tr. 4493-97.

Rogers had family members, including his parents and brother, who purchased MS & Co. private placements. Tr. 5699; RMR Ex. 215C. Between February 24, 2004, and September 1, 2009, he sold a total of \$6,527,500 in the Four Funds and Trust Offerings, which yielded him commissions totaling \$251,000. Div. Ex. 2, Exs. 4, 4s, 4t (as attached to Div. Ex. 2).⁸³ Rogers left MS & Co. in 2009, and since 2010 has been associated with Dinosaur and RMR Wealth Management. Tr. 3669-74, 5661; Div. Ex. 486.

Rogers was shocked when he learned in September 2009 that Firstline had declared bankruptcy in January 2008; learning this, he "lost quite a bit of confidence" in McGinn and Smith. Tr. 5735-36. Rogers considered himself, and the other MS & Co. registered representatives, to be among the victims of McGinn and Smith. Tr. 5792.

⁸³ Exhibit 4 of Div. Ex. 2 lists Rogers's commissions totaling \$251,000, while Exhibit 4t lists them totaling \$251,443. Given this discrepancy, I accept Exhibit 4's lower calculation as reflecting Rogers's commissions.

Witnesses who Purchased Securities from Rogers

Stephen Fowler (Fowler) is a retired management consultant and bought the following private placements at Rogers's recommendation, totaling over \$3 million:

On March 8, 2007, \$500,000 in FIIN 7%
On May 15, 2007, \$500,000 in TDMVER12
On June 22, 2007, \$500,000 in Firstline11
On January 18, 2008, \$250,000 in TDMVER18
On June 12, 2008, \$1,000,000 in MSTF
On December 24, 2008, \$100,000 in TDMVER0910%
On September 1, 2009, \$300,000 in TDMBEN

Div. Ex 2, Ex. 4s (as attached to Div. Ex. 2); Div. Ex. 704 at 4-5, 8. Fowler was an accredited investor when he made the purchases, and he has a tolerance for high risk investments. Div. Ex. 704 at 32, 42. He testified that based on conversations with Rogers, he considered these private placements lower risk investments and like bonds. *Id.* at 34-35. Fowler made substantial money from investing in pre-IPO Bodel, which he considered high risk and thus "at the other end of the spectrum." *Id.* at 11, 34. According to Fowler:

We certainly were not going to put all of that money into similarly high risk speculative investments, and that was when we talked about the private placements as a way of generating a better income than you could get from putting the money on some kind of long-term deposit or investing in bonds, but they were acknowledged to be substantially lower risk, so for example I would never have expected that I might lose the entirety of the capital sum invested.

Id. at 42-43.

Peggy Loscalzo (P. Loscalzo) is a resident of Wading River, New York. Tr. 3516. She has been a real estate agent since 1992, following twenty-five years as a nurses' aide. Tr. 3530. P. Loscalzo called Rogers after he made a presentation on financial planning and retirement at her place of work, and he visited her home and talked with her and her husband on two occasions. Tr. 3519-21, 3533. P. Loscalzo remembers explaining to Rogers that: (1) they could not afford to lose any retirement funds because a \$25,000 IRA and a \$3,000 or \$4,000 annuity in New York Life was their total retirement; (2) her husband had lost retirement funds in a Ponzi scheme so they were cautious; and (3) that they would like to make money on her savings because they were getting older.⁸⁴ Tr. 3520, 3523-24, 3599. Rogers recommended TAIN, which P. Loscalzo thought was a mutual fund with moderate risk. Tr. 3520-21, 3525. According to P. Loscalzo, Rogers told them there was a risk in everything, but this was the best possible investment for P. Loscalzo and her husband and that they would not lose principal. Tr. 3521-22. P. Loscalzo testified that Rogers said

⁸⁴ P. Loscalzo had come out of a prior marriage with debts that took her seven years to pay off. Tr. 3525. It took her the next five years to build her IRA to \$25,000. Tr. 3525. She generously refers to the investment as "our" investment. Tr. 3547.

he would personally guarantee that they would not lose on the investment. Tr. 3524, 3537. There is nothing in writing that evidences Rogers's commitment. Tr. 3537-38, 3554-57. P. Loscalzo had little experience in investments and had never before invested in a private placement. Tr. 3518. On January 26, 2007, at Rogers's recommendation, P. Loscalzo invested \$25,000 of her IRA funds in a TAIN note. Tr. 3517-18; Div. Ex. 2, Ex. 4s (as attached to Div. Ex. 2).

P. Loscalzo acknowledges signing a great deal of paperwork that Rogers presented to her, including a document that put her net worth at between half a million and a million dollars. Tr. 3534-37; RMR Ex. 853. After she made the investment, her husband handled most of the communications with Rogers and MS & Co. Tr. 3531-32, 3539-40. No interest has been paid on her TAIN note since January 2008. Tr. 3617.

P. Loscalzo remembers her husband telling her that after MS & Co. had disclosed problems, Rogers promised that he would take care of it. Tr. 3542. She also heard from her husband that Rogers suggested they file a FINRA mediation by which Rogers could make a payment to them, but the company with which Rogers had his securities license did not want to get involved. Tr. 3558. Later, Rogers's lawyers sent a settlement which would have paid her \$23,000 over a thirteen month period, but her husband's attorney advised against signing it. Tr. 3558-59, 3567-68, 3624, 3632.

James Loscalzo (J. Loscalzo), P. Loscalzo's husband, is a veteran living on disability. Tr. 3524, 3581-82, 3596. He and a friend created Split Rock Trading in about 2010 to buy and sell motorcycle parts on the internet, but it was not successful. Tr. 3597-98. J. Loscalzo was present when Rogers recommended to P. Loscalzo that she invest \$25,000 in a TAIN note, and heard Rogers personally guarantee against a loss of principal. Tr. 3582-83, 3589-90, 3594. J. Loscalzo never asked Rogers to put the guarantee in writing. Tr. 3600-01. After P. Loscalzo received a letter from MS & Co. dated January 15, 2008, J. Loscalzo spoke to Rogers and noted on the letter, "Spoke to Roger. Want to pull my account. He said he is working on something to get my money." Tr. 3587, 3601; RMR Ex. 854. The TAIN note had not matured but, according to J. Loscalzo, he told Rogers he wanted to close the account and Rogers advised him they just had to get through a period of market distress and not to worry. Tr. 3601-04.

After a conversation with Rogers concerning MS & Co.'s August 11, 2010, letter to P. Loscalzo, J. Loscalzo wrote on the letter "8/16 - spoke to Ryan. He will make up difference after we collect from the receiver. 8 months to 1 year. \$25,000." Tr. 3588-89, 3619-20; RMR Ex. 857 (formatting altered).

J. Loscalzo is very angry with Rogers and has cursed at him on the telephone, hung up on him, and called him a Ponzi scheme artist on the internet. Tr. 3594-95, 3632, 3640; RMR Exs. 842, 846. The Loscalzos filed a claim with the Receiver; and in November 2011, they filed a fraud claim against Rogers and RMR Wealth Management with the Attorney General of the State of New York; and on November 2, 2011, they filed a complaint with the Federal Trade Commission. Tr. 3635, 3650, 3577; RMR Exs. 841, 847.

Witness in Support of Respondent Rogers

Abraham Garfinkel (Garfinkel) has been an investor since 1967; he has been a client of Rogers for about eleven years. Tr. 5150; RMR Ex. 609. With respect to Four Funds and Trust Offerings, Garfinkel invested \$25,000 in TAIN on September 29, 2005; \$50,000 in Firstline on June 22, 2007; and \$25,000 in Fortress on September 29, 2008. Tr. 5156-57; Div. Ex. 2, Ex 4s (as attached to Div. Ex. 2). Garfinkel testified that Rogers was thorough in explaining investment risks to him and never guaranteed results for the Four Funds or the Trust Offerings. Tr. 5154-55; RMR Ex. 609. Garfinkel does not hold Rogers responsible for his losses. Tr. 5161; RMR Ex. 609.

Division's Summary Witnesses

Kerri L. Palen (Palen) is a staff accountant with the Division. Her declaration (Div. Ex. 2) and testimony contains summary information about Respondents' sales and commissions of the relevant offerings from 2003 through 2009, as well as how investor funds for the relevant offerings were used.⁸⁵ Tr. 218, 300, 472-73; Div. Ex. 2. Palen's testimony pertains to both the Four Funds offerings and the Trust Fund conduits. The Trust Fund conduits are a term created by the Division to refer to certain entities created by MS & Co. Tr. 289. The Trust Fund conduits are specific entities that received the pooled money collected from several Trust Fund offerings. Tr. 290. The two relevant Trust Fund conduits in this proceeding are McGinn Smith Funding LLC (MSF) Conduit and TDM Cable Funding LLC (TDM) Conduit. Tr. 291; Div. Ex. 2, Ex. 18 (as attached to Div. Ex. 2).

Palen concluded that from about September 2003 through April 2010, MS & Co. and issuers owned or controlled by McGinn and Smith raised a total of approximately \$127 million through twenty-six debt offerings, and that Respondents collectively earned nearly \$4 million in commissions from selling these offerings. Tr. 257; Div. Ex. 2 at 7, Exs. 3-4 (as attached to Div. Ex. 2). Palen's review shows that the offering proceeds were used to: (1) pay investor interest and redemptions on other MS & Co. offerings; (2) enrich McGinn, Smith, and M. Rogers, a senior vice president at MS & Co.; (3) make loans to other entities controlled by McGinn and Smith; (4) invest in other assets; and (5) support MS & Co., none of which were the purposes stated in the Use of Funds section of the PPM. Div. Ex. 2 at 7.

Four Funds Investor Money used to Rescue Pre-2003 Alarm Trusts

Palen represented that ten years prior to creation of the Four Funds, McGinn and Smith sold "Participation Certificates" in dozens of pre-2003 alarm trusts with the "disclosed purpose" of

⁸⁵ Palen earned a Bachelor of Science in Accounting from Florida Atlantic University and is a certified public accountant in New York and New Jersey and a certified fraud examiner. Tr. 216. Palen joined the Division in 2010, after providing litigation support for sixteen years at three private firms. Tr. 216-17, 389-91. Palen's primary source material was MS & Co.'s investor database, payroll records, and bank records. Div. Ex. 2 at 2. Palen included the following securities in her analysis: were the Four Funds, the Trust Offerings, and notes from Cruise Charter Ventures, LLC, and MSTF. Div. Ex. 2, Exs. 1-23 (as attached to Div. Ex. 2).

investing in security alarm contracts. Div. Ex. 2 at 8. Brokers thought these were successful, but in reality they were only “successful” on paper because MS& Co. paid off most investors with proceeds from an IPO (IASG) and the remaining alarm contracts were purchased using Four Funds offering proceeds. *Id.* at 8-9, Div. Ex. 373; Tr. 1339-43.

Palen testified that the PPMs failed to disclose that the Four Funds’ offering proceeds would be used quickly to redeem investors in the pre-2003 alarm trusts, and the Four Funds misused investor assets because the assets they received were not sound investments.⁸⁶ Tr. 278-79, 519-20, 584-86; Div. Ex. 2 at 8-16. According to Palen, the Four Funds paid the pre-2003 alarm trusts \$10.7 million for alarm contracts that the alarm trusts had purchased for \$7.1 million just a few years before, and as of December 2, 2007, MS & Co. valued those alarm contracts at \$2 million. Div. Ex. 2, Ex. 9 (as attached to Div. Ex. 2).

Palen testified that FIIN paid Special Participation Trust (SPT) 1⁸⁷ \$2,090,000 for alarm contracts that SPT 1 had paid approximately \$1.2 million for in the period January 2001 through May 2003. Tr. 278; Div. Ex. 2 at 10, Ex. 9 (as attached to Div. Ex. 2). FEIN paid SPT 2 approximately \$4.7 million for alarm contracts that SPT 2 had purchased for approximately \$3.9 million from March 2001 through April 2003. Div. Ex. 2 at 11, Ex. 9 (as attached to Div. Ex. 2). FEIN paid SPT 3 approximately \$1.98 million for alarm contracts that SPT 3 had purchased for approximately \$1.1 million from October 2001 through May 2003. *Id.* at 11-12, Ex. 9 (as attached to Div. Ex. 2). FEIN paid SPT 4 approximately \$1.95 million for alarm contracts that SPT 4 had purchased for approximately \$943,000 from November 2001 through May 2003. *Id.* at 12, Ex. 9 (as attached to Div. Ex. 2). The combined purchase price of these transactions was the amount needed to redeem the investors in each SPT trust. *Id.* at 13.

Palen stated that from November 5, 2003, through April 1, 2008, the Four Funds supported alarm trusts with \$12,812,516 to pay interest or redemptions. Div. Ex. 2, Ex. 8 (as attached to Div. Ex. 2).

Investor Money used to Invest in McGinn and Smith Affiliates went Undisclosed

Palen argued that the Four Funds’ PPMs did not disclose that the Four Funds would invest in McGinn and Smith affiliates. Div. Ex. 2 at 16-17. Palen also asserted that by December 31, 2007, the investments by the Four Funds in MS & Co. affiliates amounted to over half their total investments. Div. Ex. 2 at 17, Ex. 14 (as attached to Div. Ex. 2). Palen pointed to FIIN, TAIN and FAIN’s more than \$8.8 million investment from 2005 through 2007 in *alseT*, in which Smith had an indirect equity interest, as an example of a failed affiliated entity investment. Tr. 286; Div. Ex. 2 at 17, Ex. 23 (as attached to Div. Ex. 2). As of October 31, 2006, *alseT*, which had no income, owed TAIN and FAIN interest totaling \$198,759.47. Div. Ex. 522. According to Palen, FIIN paid the

⁸⁶ The trusts are so-named because the trusts’ disclosed purpose, when they were established prior to 2003, was to invest in security alarm contracts. Div. Ex. 2 at 8-16.

⁸⁷ Four of the pre-2003 alarm trusts constituted the four SPTs. The Four Funds purchased alarm contracts held by the SPT trusts. Div. Ex. 2 at 10.

interest that alsoT owed to TAIN and FAIN.⁸⁸ Tr. 285; Div. Ex. 2, Ex. 14 (as attached to Div. Ex. 2). MS & Co. considered its investment in alsoT to be worthless as of December 2, 2007. Tr. 578; Div. Ex. 2 at 17, Div. Ex. 408.

Four Funds Ran Cash Deficits

Palen concluded that each of the Four Funds had negative net income every year from 2003 through 2007, except for FIIN in 2004 and 2006, for a cumulative loss of \$6.4 million. Tr. 287; Div. Ex. 2 at 19, Ex. 15 (attached to Div. Ex. 2). Thus, the Four Funds borrowed from each other and the Trust Offerings to pay investor interest and redemptions and FEIN used \$184,500 from the Fortress Trust to pay interest to its investors. Div. Ex. 2 at 18-19. By the end of 2007, the Four Funds owed investors approximately \$84 million while only holding investments worth approximately \$37 million. Tr. 287-88; Div. Ex. 2 at 19; Div. Ex. 408.

Trust Offerings

According to Palen, the proceeds from the Trust Offerings were misused and deviated from the PPMs in many ways. The Trust Offerings' PPMs represented that on average 85% of the offering proceeds would be invested in contracts for burglary alarm services, cable services, or luxury cruise cabin bookings, but, in fact, only 58% of the proceeds were invested in that manner. Div. Ex. 2 at 22-23, Ex. 18 (as attached to Div. Ex. 2). According to the PPMs, the combined aggregate fees payable to MS & Co. could total \$3.2 million, yet from October 2006 through December 2009, MS & Co. received over \$6.4 million in fees. *Id.* at 23, Exs. 5-6 (as attached to Div. Ex. 2). McGinn, Smith, and M. Rogers were paid approximately \$4.7 million from the Trust offering proceeds, but the PPMs did not mention payments to individuals. *Id.* at 23-24, Ex. 7 (as attached to Div. Ex. 2). Total payments to MS & Co. from the Trust and MSTF offerings were almost \$6.9 million. *Id.*, Ex. 6 (as attached to Div. Ex. 2). Twelve of the trusts used investor funds raised by other Trusts to cover their principal and interest payments to investors. *Id.* at 25.

Involvement of Respondents

Palen did not see any evidence that Respondents, with the exception of Rabinovich and Livingston, knew of the fraudulent actions of McGinn and Smith.⁸⁹ Tr. 499-501. Palen did not review any evidence that showed that any Respondent participated in the fraud conducted by McGinn and Smith and entities they controlled. Tr. 395-400.

Olumiseun Ogunye (Ogunye), a paralegal with the Commission, testified as a summary witness that Respondents made the following sales to unaccredited investors. Tr. 1347-48, 1373-74.

⁸⁸ According to Palen, FIIN accounted for payment of interest that alsoT owed by increasing the amount it showed as its investment in alsoT. Tr. 285.

⁸⁹ Investor proceedings were used to redeem Rabinovich's father's trust holdings, and Livingston was knowledgeable about alsoT's situation. Tr. 499, 2087; Div. Ex. 2 at 28, 30-31, Ex. 21 (as attached to Div. Ex. 2); Div. Ex. 524.

The source of the information was the MS & Co. database, purchaser questionnaires, and additional, limited information about investors provided by Division counsel. Tr. 1349-56. Ogunye relied heavily on the questionnaires.⁹⁰ Tr. 1375, 1383. Based off these sources, Ogunye created exhibits showing the number of sales made by each Selling Respondent to unaccredited investors for the following funds:

	FIIN	FEIN	TAIN	FAIN	MSF COND.	TDM COND.
Chiappone	10	11	15	4	1	3
Gamello						
Guzzetti	2	2	5			1
Lex	3	11	15	8	13	15
Livingston	2	1	3			
Mayer			1	1	1	4
Rabinovich		2		3	1	1
Rogers		1	2	1		

See Div. Exs. 531-36; Tr. 1366, 1414-20. Ogunye found that each of the Four Funds had between forty-two and seventy-two unaccredited investors. Div. Exs. 531-534.

Ogunye also found that the TDM Conduit and the MSF Conduit had forty-four and thirty-nine unaccredited investors each, and she relied on the allegations in the OIP to determine which trust fund offerings were to be consolidated into which conduit. Tr. 1368-69; Div. Exs. 535-36. However, each of the individual offerings that made up the MSF Conduit and the TDM Conduit had fewer than thirty-five unaccredited investors. Tr. 1445-47; RMR Exs. 813, 814, 815.

As to the TDM Conduit list, RMR's counsel made the representation, in questioning Ogunye, that twenty-three of the unaccredited investors closed their purchases no later than September 16, 2007, and of the remaining twenty-seven investors on that list, those offerings began no earlier than November 16, 2008. Tr. 1449-51; RMR Ex. 812. RMR's counsel also made the representation that thirty-three of the unaccredited investors on the MSF Conduit list concluded their purchases before April 30, 2008, and the remaining ten investors on that list purchased offerings that did not begin until December 15, 2008. Tr. 1447-52; RMR Ex. 816.

MS & Co. Receiver

William J. Brown (Receiver) is a graduate of Le Moyne College and Boston College Law School. Tr. 2454. He has been with the law firm Philips Lytle since 1979, specializing in workouts, bankruptcy, and creditors' rights. Tr. 2454-55. In April 2010, the Receiver found that MS & Co. had \$450,000 to \$480,000 in equity accounts. Tr. 2464. At the hearing, on February 5, 2014, the

⁹⁰ However, occasionally the questionnaires could be trumped by better information. For instance, Joann Zepp was listed as unaccredited even though her questionnaire indicated she was accredited, based on the Division's conversation with Zepp. Tr. 1356, 1389-92.

Receiver estimated about \$104 million in investor net claims for the MS & Co. entities in receivership, and a potential recovery of \$28 million.⁹¹ Tr. 2466-68. The vast majority of claims are from investors in the Four Funds and Trust Offerings. Tr. 2554-56.

The Receiver found MS & Co.'s underwriting on investments to be very poor and that some of the investments would never have sufficient cash flow to repay investors. Tr. 2479, 2518-20.

One of the funds under control of the Receiver is Benchmark, which held triple play contracts, i.e., contracts for cable, internet, and phone service, purchased for \$1.95 million in some southeastern states. Tr. 2472-73. The Benchmark assets had been on the market for quite a while before MS & Co. purchased them. Tr. 2476. The Receiver sold the assets for close to \$500,000; in his opinion, the cash flow generated by the assets never supported the amount needed to repay investors. Tr. 2472-73.

The Receiver testified that the TDM and TDMM offerings were also triple play contracts, and that another entity had a forty to forty-five percent interest in those assets, which he did not think was disclosed in the PPM. Tr. 2473-74.

The Verifier offerings consisted of "a so-called guaranteed payment unit plus some common stock," however, interest was not actually guaranteed. Tr. 2479-80. The contract for the underlying investments gave Verifier's board the ability to cease making interest payments, which it did. Tr. 2480. The Verifier offerings raised at least \$7 or \$7.5 million, but the Receiver sold the assets for only \$4 million. Tr. 2480; Div. Ex. 2, Ex. 3 (as attached to Div. Ex. 2).

TDM Luxury Cruise and Cruise Charter Ventures Trust consisted of a travel agency and an adult-themed cruise. Tr. 2481. The Receiver disposed of both at a loss. Tr. 2481-82.

The alarm contracts, including those in the Firstline and Integrated Excellence offerings, were also disposed of at a significant loss. Tr. 2483-84. The Firstline transactions had problems. For instance, MS & Co. had made a loan to a Firstline entity but MS & Co. did not perfect the collateral necessary for the loan. Tr. 2484-85. Also, the Firstline contracts, sold door-to-door in Utah by college students, were low quality contracts with much higher attrition rates. Tr. 2486-88. The Receiver saw evidence that the litigation risk, which eventually led to the bankruptcy of Firstline, came up during due diligence, but he did not see anything in the due diligence materials indicating that the litigation risk was followed up on and thinks it was dismissed. Tr. 2489-90.

The Receiver believed, based on his examination of the record and communications by McGinn and Smith, that the brokers could not redeem shares for clients unless they found another investor. Tr. 2560-61.

Expert Witnesses

Division Expert Robert J. Lowry

⁹¹ The Receiver is dealing with seventy-nine MS & Co. related entities, entities that McGinn or Smith controlled or had ownership in, more than are mentioned in the OIP. Tr. 2458, 2504, 2526.

Lowry, an expert on the duties of registered representatives, testified that a person associated with a broker-dealer who recommends a security must have conducted a sufficient investigation to support the recommendation they make to a customer, citing *Hanley v. SEC*, 415 F.2d 589, 595-96 (2d Cir. 1969).⁹² Tr. 659, 665, 845, 1094, 1331; Div. Ex. 1 at 4-5. The extent of a registered representative's investigations varies with the nature of the security and the amount of publicly available information. Div. Ex. 1 at 5. A more thorough investigation is required for securities where information is not publicly available, newly created issuers with no previous operating history, or where there are red flags that call for additional investigation.⁹³ *Id.* at 6; Tr. 1222, 1239, 1320-22. Lowry based his opinions, in part, on industry custom and practices. Tr. 961-62.

Lowry insisted that a registered representative must perform a due diligence investigation before he or she sells a security and also must understand the nature of the product. Tr. 669. Lowry stated that the registered representative can either rely on the firm's due diligence file, if available, or conduct his own due diligence in order to have a basis to determine whether the securities were suitable. Tr. 669, 869-70, 873, 984-85, 1000. Lowry testified that Respondents did not comply with their obligation to perform due diligence as to the offerings mentioned in the OIP, and that they failed to meet their due diligence obligations when offering securities. Tr. 887-90; Div. Ex. 1 at 11. Lowry found no indication that any Respondents reviewed due diligence files. Div. Ex. 1 at 10.

In addition to case law, Lowry finds authority for a registered representative's duty to investigate in NASD (now FINRA) Rule 2310, the suitability rule, and Notice to Members (NTM) 03-07 and 03-71 (November 2003), read with NTM 10-22, which was prepared in 2010. Tr. 644-51, 665. Lowry believes that FINRA's 2010 specific announcement, that the obligation of the broker-dealer as to suitability applied to the registered representative as well, was not a new concept. Tr. 1328-29. According to Lowry, FINRA has used the term "due diligence" in its NTMs from 2003 through 2009, to describe the broker's duty to investigate. Div. Ex. 1 at 6; Tr. 965.

Lowry admits that Rule 2310 does not contain the word "investigate," and that from 2003 to 2009 there was no FINRA notice calling for individual representatives to investigate a private placement offering. Tr. 648-49. Lowry acknowledged that Rule 2310 refers to a member, not a registered representative, and does not mention doing due diligence about the investment. Tr. 657, 864. According to Lowry, a literal interpretation of Rule 2310's discussion of "members" as only referring to broker-dealers makes no sense because it is the registered representatives that

⁹² Lowry has a degree in Business Administration from the University of Maryland. Div. Ex. 1, App. A at 3. Lowry was employed in the Commission's Division of Market Regulation for twenty-three years and conducted regulatory examinations, assisted in enforcement matters, and became familiar with private placement offerings and the obligations of supervisors of registered representatives. Tr. 621. He was a director in the Corporate Compliance department at Prudential Insurance Company of America in 1995-1996. Tr. 621. Since 1996, Lowry has operated RL Consulting Services, Inc. Div. Ex. 1, App. A; Tr. 621.

⁹³ Lowry defined a red flag as "a warning or notice of potential concerns or violations of the securities laws that require a heightened response and investigation." Div. Ex. 1 at 6.

communicate with customers. Tr. 972-74. His view is that Rule 2310 refers to the duty of the broker's registered representatives. Tr. 973. Lowry testified that this Rule and NTMs cover persons associated with brokers; "[i]t applies to everybody." Tr. 665-66. In the 2003-2009 period, the Commission did not have specific rules that required a broker to investigate a private placement offering. Tr. 658. Lowry agrees that the word investigate is not used in any Commission or FINRA rule or regulation. Tr. 678.

In Lowry's opinion, the fact that a security is making interest payments is not determinative or indicative that the underlying assets are performing:

That can't be the sole basis for the comfort. They – I mean, they have – they had to do due diligence before they offered the product. They had to understand the product. They had to understand the risk. And they had to make sure that they knew how the trust worked.

Tr. 842, 845-46, 1067.

In the case of a private placement, Lowry testified that, at the very least, the investigation must include verifying the information in the PPM and, depending on the type of security, the person recommending the security may need to do more. Tr. 660, 664. Lowry does not think that Respondents performed adequate due diligence merely by attending meetings where MS & Co. provided information about the offering, or by accepting that information directly from Smith. Tr. 706, 997. Lowry's opinion is that "[Respondents] have got to conduct independent investigation, verification of the information that is in the [PPM]." Tr. 719.

Lowry testified that Respondents should have recognized significant red flags in the Four Fund PPMs and should have verified the information. Div. Ex. 1 at 12. According to Lowry, the following red flags were present in the Four Funds offerings: (1) the placement agent, MS & Co., had not independently verified the information in the PPM; (2) the refusal to provide the registered representative with information about the composition of the portfolios; (3) the size and complexity of the income notes; (4) MS & Co.'s failure to provide its due diligence files; (5) the conflicts of interest among various MS & Co. entities; (6) Smith's control over distribution of funds; and (7) indications of MS & Co.'s financial problems with meeting its obligations to Four Funds investors. Div. Ex. 1 at 11-12, 15-21; Tr. 716-18, 1110, 1226-27. Respondents should have been able to verify whether the basket of securities generated sufficient income to pay the promised interest. Tr. 1245-46. Lowry testified that investments like the Four Funds typically make their underlying investments available to registered representatives selling the securities. Tr. 1285. He noted that the FIIN PPM specifically provided that it would provide information to the trustee and that "[u]pon request of a prospective investor, we will make available to such investor the opportunity to ask questions of and receive answers from us concerning the terms and conditions of the offering." Div. Ex. 5 at 005-24; Tr. 1286-87.

Lowry testified that anyone looking at the Four Funds' balance sheets as of December 31, 2004, would know that a significant portion of fund assets were invested in the SPT trusts and in MS & Co. affiliates. Tr. 1290-91; Div. Ex. 2, Ex. 11 (as attached to Div. Ex. 2).

Lowry asserts that another red flag was that at least by December 7, 2007, all brokers knew that MS & Co. required a broker to find a buyer for notes that an investor wanted to redeem (redemption policy). Div. Ex. 1 at 16, 22-23; Tr. 830. Based off redemption data, Smith's communication to Rabinovich, and Guzzetti's testimony, Lowry believes the redemption policy was in effect between 2006 and 2008. Tr. 1181. Lowry asserts that the redemption policy was a significant change from the language in the PPMs and placed the Respondents in a conflict of interest by favoring old investors over new investors who purchased without being told of the policy. Tr. 836-38. Lowry believes that Respondents were required to investigate the reasons Smith gave for the shortage of cash and inability to redeem customers without replacements. Tr. 1221.

Lowry's position that the Trust Offerings had Red Flags

MS & Co. began selling Trust Offerings on November 13, 2006. Div. Ex. 2, Ex. 18 (as attached to Div. Ex. 2). Lowry maintained that the Trust Offerings required investigation because the Respondents knew that MS & Co. was having serious redemption and funding issues with the Four Funds. Tr. 1073-76; Div. Ex. 1 at 20-21, 26. Lowry asserted that the PPMs for the Trust Offerings claimed that each offering would obtain its income from assets purchased from eight small unknown operating companies, but the PPMs contained almost no information about these eight companies.⁹⁴ Div. Ex. 1 at 10-11. According to Lowry, Respondents could not rely on the unverified representations of the issuer because MS & Co. entities were the trustee, placement agent, and issuer. *Id.* at 26. Lowry believes that the Trust Offerings had at least two other, obvious red flags: (1) high underwriting fees and expenses; and (2) a reliance on small, unknown companies for cash flow. *Id.* at 26-27.

For example, the PPMs for the four Firstline Trusts stated that a MS & Co. entity would invest up to \$7,267,000 in a Utah based company, Firstline Security Inc. Div. Ex. 1 at 28. The PPMs noted there were no assurances as to the financial worthiness or capabilities of that company, which filed for bankruptcy in early 2008. *Id.* at 28; Tr. 2417-18. MS & Co did not inform Respondents of the bankruptcy until September 2009, though Lowry notes that the bankruptcy was a matter of public record and that an October 4, 2007, letter to McGinn Smith Funding, LLC raised questions about its financial stability. Tr. 1090-93; Div. Ex. 1 at 28 & n.48.

As another example, the Fortress Trust 08 PPM stated that the sole business of the trust would be to lend NEI Capital LLC between \$235,000 and \$2,876,400. Div. Ex. 1 at 29. However, the PPM also revealed serious conflicts of interest in the transaction, and did not describe how the Fortress Trust would acquire the assets, how the price of the assets was determined, whether the assets were performing, or whether they produced income sufficient to pay thirteen percent interest. *Id.* at 30.

Lowry's position on Guzzetti

⁹⁴ In addition, three of the eight operating companies – Verified Capital, NEI Capital, and Cruise Charter Ventures – had ties to MS & Co., which raised conflict of interest issues Div. Ex. 1 at 11, 27 n.47.

Lowry concluded Guzzetti performed supervisory responsibilities vis-à-vis Respondents from 2004 until 2009, citing Exchange Act Section 15(b)(4)(E), FINRA Rule 3010, and MS & Co.'s 2008 Manual. Tr. 1134-37, 1180; Div. Ex. 1 at 30-32. According to Lowry, Guzzetti admitted he was a supervisor, and Respondents, except Rabinovich and Livingston, testified they reported to Guzzetti. Tr. 1135, 1146; Div. Ex. 1 at 33. Lowry acknowledged that the 2007 Manual named Smith and Mayer as responsible for reviewing purchase orders for private placements, that Smith approved the offerings at issue here, that Nicolosi was the Branch Officer at the Clifton Park office, and that Guzzetti was listed under supervisors as Managing Director Private Client Groups. Tr. 1159-62, 1164.

However, Lowry believes the evidence demonstrates that Guzzetti communicated daily with Respondents, provided information to them about the offerings, helped implement the redemption policy by instructing them to find new buyers for notes being redeemed, provided information about the number of notes redeemed and the status of replacement sales, and advised Respondents to recommend that customers invest money market funds in income notes. Tr. 1147-48, 1167, 1171-72; Div. Ex. 1 at 32-33. Lowry believes Guzzetti knew of MS & Co.'s redemption policy as early as December 2006, yet still urged brokers to sell MS & Co. investments. Tr. 1087; Div. Ex. 1 at 19.

Lowry opines that Guzzetti did not reasonably discharge his supervisory responsibilities. *Id.* at 33. For instance, Guzzetti testified that Smith was apparently using the replacement funds elsewhere than to redeem Gamello's client. *Id.* at 34. Lowry believes that Guzzetti should not have advised Respondents to continue to sell MS & Co. offerings if he was not sure where the redemption funds were going. *Id.* at 35.

Respondents Chiappone, Rabinovich, Mayer, and Rogers' Expert David J. Tilkin

Tilkin testified as an expert on the issues of suitability, the duty to investigate, due diligence, and so-called "red flags."⁹⁵ FC Ex. 90; RMR Ex. 350.⁹⁶ Tilkin's testimony was directed at whether registered representatives of broker-dealers are governed by a duty to investigate. RMR Ex. 350 at 5-6.

Tilkin testified that FINRA's articulation on suitability is contained in FINRA Rule 2111, which supplanted FINRA Rule 2310, the rule in effect between 2003 and 2009.⁹⁷ RMR Ex. 350 at 4; Tr. 3868-70, 3882-83.

⁹⁵ Tilkin has a Bachelor of Arts degree from Antioch College and a Master of Arts degree in from Brandeis University. Tr. 3861; FC Ex. 90, CV at 2. Tilkin has worked as a registered representative of a number of broker-dealers, including in supervisor roles, and more recently founded and worked at a company that provides compliance tools and consulting to broker-dealers. Tr. 3861-66; FC Ex. 90, CV at 1; RMR Ex. 350 at 2. Tilkin has testified in numerous proceedings and disputes. Tr. 3865-66; FC Ex. 90 at Case List; RMR Ex. 350 at 2.

⁹⁶ I cite to both exhibits because they are not identical.

⁹⁷ FINRA Rule 2310 had been NASD Rule 2310, and the retitling did not cause any substantive change. Tr. 3883. A copy was admitted as FC Ex. 91.

The suitability rules require that every firm and associated person “have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile”.

RMR Ex. 350 at 5; FC Ex. 90 at 6; FC Ex. 94 at 1.

Tilkin disagrees with Lowry that FINRA Rule 2111 (admitted as FC Ex. 94), in effect since 2011, codifies past practices. Tr. 3993-94. According to Tilkin, FINRA Rule 2111 was the first time that FINRA indicated reasonable basis suitability had to be done by the registered representative, as opposed to merely done by the broker-dealers they were associated with. Tr. 4012. Tilkin agrees that FINRA Rule 0140(a) states that FINRA rules apply to all members and persons associated with a member, but believes such a rule can have no real world applicability. Tr. 3889-90; Div. Ex. 603.

Tilkin references a series of NTM: NTM 11-02, NTM 12-25, and NTM 13-31. RMR Ex. 350 at 4. Tilkin disagreed with Lowry’s assertion that FINRA Rule 2111 and NTM 11-02 are codifications of rules that had already applied to registered representatives; instead, he considered them to be new rules, describing new duties. Tr. 3951-53, 3993-94. Tilkin notes that NTM 10-22, published in April 2010 regarding due diligence on a Regulation D offering, describes the duty to investigate as one attaching to the broker-dealer, not the registered representative. RMR Ex. 350 at 7. The first sentence of NTM 10-22 states that “FINRA reminds broker-dealers of their obligation to conduct a reasonable investigation of the issuer and the securities they recommend in offerings made under the . . . Commission’s Regulation D under the [Securities Act]—also known as private placements.” Div. Ex. 601 at 1; FC Ex. 90 at 8; RMR Ex. 350 at 7. Tilken testified that these “investigation” requirements only apply to broker-dealers, not the registered representatives. Tr. 3897-98; *see* Tr. 3952-53. Tilken gives little significance to an endnote in the NTM that reads: “any reference . . . to the obligations of a [broker-dealer] is also intended to cover the concomitant responsibilities of any registered representative who recommends a Regulation D offering.” Tr. 3964-67; Div. Ex. 601 at 10 n.1.

NTM 10-22 states further that

Courts have found that the amount and nature of the investigation required depends, among other factors, upon the nature of the recommendation, the role of the broker in the transaction, its knowledge of and relationship to the issuer, and the size and stability of the issuer. For example, the SEC and the courts recognize that a more thorough investigation is required for “securities issued by smaller companies of recent origin.”

Div. Ex 601 at 3 (internal footnote omitted). Tilkin indicated that these cautions did not apply because while the issuers were new, they were controlled by MS & Co. which was not a company of recent origin, but he acknowledged that new offerings deserve scrutiny and

review and brokers have to have a thorough understanding of the investments that they offer to clients. Tr. 3921-27, 3994-95.

Tilkin considers the operative concept in the suitability rules as “reasonable basis;” he acknowledges that, “[i]n addition to gathering information about the customer, the further expectation and requirement is that a registered representative should have an understanding of the security that is part of the recommendation.” FC Ex. 90 at 6-7; RMR Ex. 350 at 5. Tilkin believes that 2011 was the first time that registered representatives, as opposed to the broker-dealers they are associated with, were told to, themselves, conduct reasonable basis suitability reviews.⁹⁸ Tr. 3912, 4011-12. He describes reasonable basis suitability review as directed at the general suitability of the investment product, and he maintains that prior to 2011, a registered representative was only told to meet “know your customer” obligations or, in other words, to conduct customer-specific suitability determinations. Tr. 3885-87.

Tilkin sees a “significant distinction between client/investment suitability and the concept of ‘duty to investigate’ as it relates to the underlying investment recommendation.” RMR Ex. 350 at 5-7. Tilkin testified that “[t]here is no doubt that a registered representative must be knowledgeable of the investment recommended,” but the duty to investigate is “not part of the securities industry curriculum.” FC Ex. 90 at 8. Tilkin has not found any industry resource detailing a registered representative’s duty to investigate; a duty to investigate is not included in the subject matter of FINRA’s Series 7 and 63 exams; and the duty to investigate has not come up in his industry experience. Tr. 3895, 3970-71, 3901. In fact, Tilkin believes the phrase “duty to investigate” is a creature of case law. Tr. 3971-72. In Tilkin’s opinion, registered representatives are not hired to execute detailed due diligence; the Division here seeks to alter “the working day-to-day reality of the brokerage environment and the defined expectations and requirements of the registered representative.” FC Ex. 90 at 8; RMR Ex. 350 at 6.

Tilkin considered the Four Funds to be hedge funds or blind pools. Tr. 3928-29. Tilkin testified that the disclosure in a PPM that the offering might be refinanced or that the purpose of the transaction was to refinance a prior offering would not be cause for concern. Tr. 4017.

NTM 11-02, effective January 2011, constituted new FINRA Rule 2111 which was modeled after former NASD Rule 2310, pertaining to suitability and requiring that a firm or registered representative:

have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile.

FC Ex. 94; Tr. 3952-53. Tilkin believes that NTM 11-02 expresses a new standard. Tr. 3953. He also testified that in 2003-2009, it was not a registered representative’s responsibility to review due

⁹⁸ Tilkin testified that NTM 03-71 was the first time that NASD bifurcated the suitability concept into reasonable basis and customer-specific and that the former spoke to members and the latter to members and registered representatives. Tr. 3976-77; FC Ex. 69.

diligence files on private placements in the way that investment bankers do. Tr. 3958; *see* RMR Ex. 350 at 10. He also opined that what the Division deems “red flags” were not reasonably apparent to Respondents. Tr. 3930-31, 3996; *see* RMR Ex. 350 at 9-10. Tilkin notes that MS & Co. was a respected brokerage and investment banking firm, and NSF became MS & Co.’s clearing broker in 2005 and conducted a detailed examination of MS & Co. beforehand. FC Ex. 90 at 9; RMR Ex. 350 at 7-8. Tilkin disagrees that the Division’s purported “red flags” were events that should have caused concern. FC Ex. 90 at 10-12; RMR Ex. 350 at 9-10. In addition, Tilkin found no evidence of a standing policy that redemptions must be met with corresponding purchases. RMR Ex. 350 at 9-10. According to Tilkin, if such a policy were written, it could potentially be a red flag, but the practice is recognized in the SEC’s Regulation M and discussed in a number of FINRA NTMs. Tr. 3930; FC Ex. 90 at 11-12; RMR Ex. 350 at 9-10. Tilkin testified that he “didn’t reach an opinion about whether there was a de facto [redemption] policy,” but was confident that there was no written policy. Tr. 3949-50. If a registered representative was aware of a redemption policy, Tilkin testified it would be good practice for that registered representative to disclose that policy to any investor, even if the representative may not be required to do so. Tr. 3935. Tilkin testified that the conflicts of interest among MS & Co. and affiliates did not elevate the registered representative’s suitability determination because they were disclosed in the PPMs and conflicts of interest between issuers and broker-dealers are common. Tr. 3940-41.

In Tilkin’s opinion, Chiappone, Rabinovich, Mayer, and Rogers met a registered representative’s burden of conducting reasonable diligence of the offerings and “both executed reasonable suitability determinations for [their] clients and . . . had adequate knowledge and comfort with the underlying investments to advance recommendations to clients.” Tr. 3893, 3912; FC Ex. 90 at 7; RMR Ex. 350 at 5.

Respondent Guzzetti’s Expert Kevin A. Carreno

Carreno presented expert testimony for Guzzetti.⁹⁹ Guzzetti Ex. 71. Carreno noted Guzzetti’s position that he only acted as a supervisor to Anthony, Chiappone, Feldmann, and Gamello, and only after October 2008, when he became branch manager of the Clifton Park office. Guzzetti Ex. 71 at 2 & n.2. According to Carreno, Guzzetti functioned as a sales manager, which required him to transmit information about the availability of offerings to MS & Co. registered representatives, but not a supervisor of sales of the Four Funds or the Trust Offerings. *Id.*

Carreno testified that the term red flag is used by securities regulators and lawyers who practice in the area of securities law. Tr. 4803. Carreno believes that a supervisor aware of a red flag is required to elevate the issue to a higher level, but he or she is not required to determine if there is a violation. Tr. 4804-05. Carreno believes that a supervisor has a duty to prevent actions by employees that may violate securities laws when the supervisor is aware of wrongful conduct or has

⁹⁹ Carreno graduated from the United States Air Force Academy and has a Juris Doctorate from the University of Denver. Guzzetti Ex. 43. He holds many security licenses; has been in the securities industry since 1988; and presently is General Counsel/Chief Risk Officer of broker-dealer International Assets Advisory, LLC; President of Experts Counsel, Inc.; and a member of the FINRA Board of Governors. Guzzetti Ex. 43.

an indication that such conduct might be occurring. Tr. 4806. Carreno was retained to opine on whether information available to Guzzetti indicated issues that he should have elevated to someone higher at MS & Co.¹⁰⁰ Tr. 4811; Guzzetti Ex. 71 at 3. Carreno believes the adequacy of the disclosures in the various PPMs, which the Division characterized as a red flag, is not a red flag at all, and there is no requirement on sales supervisors to test disclosures in offering materials. Guzzetti Ex. 71 at 4. Carreno also opines that a disclosed problem with one MS & Co. offering does not require Guzzetti to restrict or halt registered representatives' sales of all other MS & Co. offerings. *Id.* at 4-5. Finally, Carreno opines that the Division's alleged "redemption policy" was not a red flag, because there was a liquidity crisis and economic downturn at the time that caused the Four Funds' and Trust Offerings' redemption issues. Tr. 4813-14; Guzzetti Ex. 71 at 5.

When shown a November 2007 email where Smith directs Guzzetti to ensure that all redemptions are preceded by replacement sales, Carreno opined that Guzzetti had no duty to ask Smith follow-up questions in response to the email. Tr. 4813-15; Div. Ex. 278. Carreno explained the direction from Smith was not necessarily unusual because, at that time, the industry was facing serious liquidity issues. Tr. 4813-14. Therefore, Guzzetti, who, according to Carreno, understood the products and the market conditions,¹⁰¹ would not need to investigate in response to that email. Tr. 4820. Carreno agreed that an actual redemption policy requiring registered representatives to provide a replacement customer as a condition to redeeming an existing customer would be a red flag to any registered representative with knowledge of the policy. Tr. 4816. Finally, Carreno said that Guzzetti did not supervise registered representatives in November 2007, and the 2008 Manual first delegated him supervisory responsibility in October 2008. Tr. 4831-33; Guzzetti Ex. 71 at 2.

Respondent Lex's Expert Charles L. Bennett

Bennett¹⁰² testified that a registered representative's duty to "reasonably understand the nature of the security being offered, and know your customer(s) well enough to ensure that a recommendation to them to buy the security is suitable" has not changed in fifty years. Lex Ex. 147 at 14; Lex Br. at 61; Tr. 4083; *see generally* Tr. 4029-4212. Bennett believes there is a distinction between the responsibilities of the broker-dealer and the registered representatives as to recommendations of securities, including private placements. Lex Ex. 147 at 5, 12-13. Bennett also testified that after the broker-dealer approves the security for sale, the registered

¹⁰⁰ Carreno was not shown any emails and did not review the PPMs. Tr. 4795-801; Guzzetti Ex. 71 at 2.

¹⁰¹ However, Carreno conceded that he did not have an understanding of what Guzzetti knew about the Four Funds' and Trust Offerings' underlying investments. Tr. 4823.

¹⁰² Bennett earned a Bachelor of Arts degree from the University of South Florida, a law degree from the University of San Francisco School of Law, and a Master of Laws in Securities from Georgetown University Law Center. Lex Ex. 147 at CV 8. Bennett has worked in the securities industry since 1979, holds various securities licenses, and has held supervisory positions. Tr. 4029-31; Lex Ex. 147 at 3-4, CV 8. Bennett has held positions at NASD and FINRA. Tr. 4029-30; Lex Ex. 147 at CV 6-7.

representative has a duty to take reasonable steps to understand the product that is being offered and ask any questions. Tr. 4133-34, 4194.

The duty to investigate is vested with the broker-dealer. The duty to understand the product, take reasonable steps to understand the product and make sure that the customer-specific suitability is appropriately identified, so that appropriate customers are given the opportunity to invest, rests with the [registered representative].

Tr. 4196. Bennett believes the duty to investigate lies with the broker-dealer, and it is industry practice to leave that diligence to the broker-dealer because firms are better equipped to handle such inquiries.¹⁰³ Tr. 4103-05, 4126, 4137-38, 4197; Lex Ex. 147 at 13. Bennett also believes that it has long been a registered representative's responsibility to "reasonably understand the security" being recommended. Tr. 4083; Lex Ex. 147 at 14. This responsibility includes determining whether the product is appropriate for at least some investors and taking reasonable steps to understand the securities being offered, including by reading the PPM for a private placement. Tr. 4132-34, 4138, 4194; Lex Ex. 147 at 5, 12.

Bennett testified that: for a private placement, it is not unusual for the issuer to be affiliated with the broker-dealer selling the private placement, Tr. 4039-40; it would be appropriate for a registered representative to ask no further questions after inquiring about underlying assets and being told that the information was not available because of confidentiality concerns, Tr. 4093-95, 4151-54; and tracking redemptions and replacements is not a red flag, as broker-dealers do this all the time, Tr. 4166-67, 4207-08. He further believes that some of the items the Division alleges as red flags cannot be red flags as they were disclosed in the PPM. Tr. 4085, 4143-44; Lex Ex. 147 at 17.

It is Bennett's position that the Four Funds notes were risky on their face and registered representatives fulfilled their product suitability obligation initially without knowing anything about the underlying investments in a non-specific asset program. Tr. 4086-89. Bennett concluded that Lex reasonably understood the private placements at issue, and his understanding of them was consistent with the level of understanding required by industry custom and practice. Lex Ex. 147 at 14. In so concluding, Bennett noted that Lex read the PPMs, understood the different tranches of notes, and asked for, and received, information about the underlying investments and their performance, among other things.¹⁰⁴ *Id.* at 10-11.

¹⁰³ He said it is unusual in industry practice for a registered represented to review a broker-dealer's due diligence file for a particular investment, and knows of no rule obligating a registered representative to ask the issuer of a private placement for financial statements mentioned in a PPM. Tr. 4102-03, 4200-02.

¹⁰⁴ Among other things, Bennett noted that Lex: reported to Smith since 1983 and always considered him an honest man, Lex Ex. 147 at 6; only offered safer tranches of notes, *id.* at 8, 18; received repeated assurances from Smith that underlying assets were performing well, *id.* at 9-11; and was reassured by investigations and examinations conducted by FINRA, the Commission, and the custodian/clearing house between 2002 and 2007, *id.* at 9.

Bennett testified that a registered representative cannot offer a customer information outside the PPM. Tr. 4197. Bennett believes that the representations in the PPM are the issuer's disclosures, and the PPM itself is a contract between the issuer and the customer, with the registered representative in the middle acting as an agent. Tr. 4198. Bennett disagrees that a registered representative should review the due diligence file as part of his reasonable basis suitability obligation. Tr. 4200.

Bennett has never encountered the registered representative's duty of searching inquiry mentioned in the OIP. Lex Ex. 147 at 5. In Bennett's opinion, registered representatives have a duty to take reasonable steps to understand the securities offered through their broker-dealer on behalf of an issuer in a private offering, and reasonableness is determined by the particular facts and circumstances. *Id.* Bennett considers that Lex "was not aware of, or in a position to uncover the abuses and illegal activities" because McGinn and Smith controlled all avenues of inquiry available to Lex. *Id.* at 6. In Bennett's opinion, Lex – and all the other registered representatives – had no one to go to get an independent, honest answer to questions about these private placements. Tr. 4106-07.

Bennett testified that the default of the Four Funds in October 2008 was a red flag that existed as of October 2008. Tr. 4076-77; Lex Ex. 147 at 18. Bennett also testified that the bankruptcy underlying the Alarm Trusts was a red flag as of September 2009. Tr. 4078; Lex Ex. 147 at 18. He notes that Lex stopped selling Four Funds' investments in March 2008, and stopped selling Alarm Trusts investments in July 2009. Lex Ex. 147 at 18; Lex Ex. 147a at 2.

On cross-examination, Bennett addressed the January 25, 2008, email in which Lex "strongly object[s] to the cancellation of the alarm notes," and complains that "the fiduciary responsibility to the clients has been breached since [no clients] were aware of the pending problems in [TAIN]. Tr. 4175-83; Div. Ex. 161. Bennett discussed this email with Lex, and Lex explained that any clients who subsequently put money into TAIN knew about the liquidity problems and were merely rolling over interest into the same investment. Tr. 4177. Later in his testimony, Bennett acknowledged that rollover and reinvestment re-triggers the suitability analysis duty of a registered representative. Tr. 4184.

Bennett testified on cross-examination that a "note [in the Four Funds] on its face was risky," and that the Four Funds PPMs made clear that Smith would choose the ultimate investments. Tr. 4086-87. Finally, Bennett described the private placements as "blind pools," while acknowledging that none of the PPMs used the language "blind pool." Tr. 4154-59; Lex Ex. 147 at 17-18. He explained: "in a blind pool offering you have to take it on faith that Mr. Smith is going to buy the assets that will produce the income necessary to pay the interest[;] [t]hat is exactly what happens in a blind pool." Tr. 4159.

Bennett testified that a registered representative who knew that MS & Co. suspended interest on the Four Funds junior notes on January 8, 2008, was obligated to inform later Four Funds note purchasers of the default. Tr. 4067-69. Bennett was not sure that a registered representative would be obligated to inform purchasers of Trust Offerings that there had been a default in the Four Funds even though both securities were controlled by MS & Co. because they were totally separate and segregated offerings. Tr. 4072-74. Bennett was not critical of Lex selling Trust Offerings after

his January 2008 complaint that FAIN investors had been misled because they were different investment vehicles. Tr. 4181-82. Bennett expected that some, if not all redemptions would occur with new money. Tr. 4205.

Arguments of the Parties

Division

First, the Division argues the Selling Respondents violated Section 5(a) and (c) of the Securities Act by offering and selling unregistered MS & Co. notes without any applicable exemption from registration. In particular, the Division argues that the exemption of Rule 506 of Regulation D requires fewer than thirty-five unaccredited investors and that the Four Funds and the Trust Offerings, once properly integrated, were sold to more than that number. Div. Br. at 3-7.

Second, the Division argues that Selling Respondents violated Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5 by knowingly or recklessly recommending MS & Co. unregistered offerings to customers: (1) with no reasonable basis for the recommendation and knowing of red flags; and (2) misrepresenting and omitting material information. Div. Br. at 8-25. The crux of the Division's position on the antifraud violations, stated on the first day of the hearing, is that is that the Selling Respondents were reckless because given the number of red flags present in these offerings, they should have known something serious was going on; in other words, there is no distinction between not knowing what you are supposed to know and knowing. Tr. 140-42; Div. Br. at 9-17. The Division charges that the Selling Respondents failed to investigate and resolve the following red flags:

- The Four Funds had a completely different investment mandate than the pre-2003 alarm contracts;
- Smith, in charge of Four Fund investments, had never served as a fund manager for anything like the Four Funds;
- Smith controlled the broker-dealer, issuer, placement agent, the trustee, and servicing agent for the Four Funds offering;
- The PPMs disclosed that the Four Funds could engage in transactions with affiliated entities;
- The PPMs limited sales to accredited investors only;
- Smith was secretive regarding on the investment of Four Fund offering proceeds and their performance;
- By at least December 2006, Smith instituted a redemption policy where to redeem a client's maturing note, a registered representative had to find a new buyer;
- The January 2008 default of the Four Funds' junior notes, combined with the prior red flags;
- The Trust Offerings that began in November 2006 had features that constituted red flags; and
- The September 3, 2009, revelation that McGinn and Smith concealed the Firstline bankruptcy filing in January 2008.

Div. Br. at 18-26.

As material misrepresentations and omissions, the Division contends that the Selling Respondents told prospective customers that MS & Co. had a reliable track record and their principal would be safe and failed to disclose adverse information that they knew or that was reasonably ascertainable. Div. Br. at 26. The Division argues that the Selling Respondents violated Exchange Act Rule 10b-5(a) and (c) and Securities Act Section 17(a)(1) and (a)(3) by being an integral part of a scheme to defraud investors. *Id.* at 29-30. It is also the Division's position that the Selling Respondents acted negligently in the offer and sale of securities by making material misrepresentations or omissions, thus violating Exchange Act Section 17(a)(2) and (a)(3). *Id.* at 30.

Finally, the Division argues that Guzzetti was the Selling Respondents' supervisor and as such, he failed to adequately supervise the Selling Respondents. Div. Br. at 31-37.

Respondents

Respondents advance many common arguments, including that the statute of limitations precludes most or all of the claims, that *Hanly v. SEC*, 415 F. 2d 589 (2d Cir. 1969) and the duty to investigate are inapplicable in this situation, and that the Four Funds and Trust Fund offerings were exempt from registration. Each Respondent's arguments are summarized here. The length and number of briefs make it impossible to discuss each contention, but all have been read and considered.

Chiappone

Chiappone argued that many, if not all, of the Division's claims are barred by the statute of limitations provision in 28 U.S.C. § 2462. Chiappone Br. at 20. Chiappone appears to concede that, if scienter is not required to be shown, he committed violations under Securities Act Section 5(a) and 5(c). *Id.* at 81. However, he argued that some showing of willfulness is either required to show a violation of Sections 5(a) and (c), or, in the alternative, a lack of willfulness should factor in as to the severity of the sanctions he receives for the violation. *Id.* at 83-86. Chiappone also argued that he was not aware that the Four Funds were sold to more than thirty-five unaccredited investors. *Id.* at 86.

Chiappone also contended that he did not violate Securities Act Section 17(a), Exchange Act Section 10(b), or Rule 10b-5 for numerous reasons. One, because he fulfilled his legal duty to inquire into the MS & Co. notes by reviewing and analyzing the investments and assessing the suitability of investments for each client. Chiappone Br. at 37-39. Two, because the duty to investigate under *Hanly* allowed Chiappone to rely on substantial investigations made by others. *Id.* at 43. Three, because the facts of *Hanly* and its progeny can be distinguished from the present facts. *Id.* at 44-47. Four, the Division failed to show that Chiappone possessed the requisite scienter, which requires a showing greater than mere recklessness. *Id.* at 48-53. Chiappone also argued that his failure to act on the "red flags" that Division described was justifiable given what he reasonably knew at the time. *Id.* at 56-70.

Gamello

Gamello argued that his sales of the Four Funds were minor and limited only to the fourth fund. Gamello Br. at 1-2. He disputed that he had any obligation to conduct independent due diligence on the Four Funds and argued that because the Four Funds were a blind pool, he would have been unable to conduct any due diligence. *Id.* at 2. Gamello also disputed the Division's characterization of receipt of an email from Guzzetti, which dealt with a potential replacement to facilitate a redemption as a red flag, and argues that his conduct after this event demonstrated that he acted in good faith. *Id.* at 3.

Gamello conceded that he sold Trust Funds. Gamello Br. at 3. But he argued that he was not under an obligation to conduct separate due diligence on the Trust Funds and that the Division offered no evidence showing he received any of the purported red flags, many of which predated his employment at MS & Co. *Id.* at 4. Gamello contended that he did not act with the requisite scienter, and that his actions at all times were in good faith. *Id.* at 5.

Guzzetti

Guzzetti argued that his duties and responsibilities at MS & Co. simply did not involve supervision. Guzzetti Br. at 12-14. Specifically, Guzzetti contended that he never supervised private placement investments, rather, he was a conduit passing information about the offerings between Smith and McGinn and the Selling Respondents, and that supervision of sales remained the responsibility of McGinn and Smith even after Guzzetti became branch manager at Clifton Park. *Id.* at 2. Guzzetti further argued that the Division has waived its claim for disbarment, cease and desist, or disgorgement against Guzzetti by not raising it in the prehearing brief. *Id.* at 3-4. Guzzetti also raised issues with the case law on which the Division relied, as well as the Division's expert witness. *Id.* at 9, 27.

Lex

Lex argued that this entire proceeding violates numerous provisions of the United States Constitution. Lex Br. at 4-8. He also argued that all the claims, or alternately, the vast majority of the claims, are time-barred under 28 U.S.C. § 2462. *Id.* at 15-27. Lex contended that none of the sales of the Trust Offerings violated Section 5 of the Securities Act, because they were subject to an exemption under Rule 506 of Regulation D of the Securities Act. *Id.* at 27-31. In particular, Lex took issue with the Division's aggregation of the Trust Offerings into two "conduits," which he claimed are fictitious entities created only to ensnare Respondents in Section 5 liability. *Id.* at 28-30. Lex also claimed that he made good-faith efforts to comply with Rule 506. *Id.* at 31.

Lex further argued that the Division's antifraud allegations fail due to lack of evidence regarding scienter and material misrepresentations. Lex Br. at 34-49. Lex claimed that *Hanly* has been overruled and that the duty to investigate lies with the member firm, not the individual registered representative. *Id.* at 56-70. Lex also argued that *Hanly* and its progeny can easily be

factually distinguished from the matters at hand and disputed the Division's characterization of certain facts as "red flags." *Id.* at 70-96.

Livingston

Livingston argued that the claims are time-barred under 28 U.S.C. § 2462. Livingston Br. at 8-14. He also argued that many of the "red flags" raised by the Division occurred prior to five years before the filing of this proceeding, and thus are time-barred from consideration. *Id.* at 7-8.

Livingston contended that he did not violate the antifraud provisions. Livingston claimed he did not misrepresent the safety of the investments or Smith and McGinn's track record, and that he did not omit disclosing the risk factors with these investments because the risks were disclosed in each investment's PPM. Livingston Br. at 14-16. Livingston asserted that a violation of the antifraud provisions requires actual knowledge or extreme recklessness, which the Division did not show. *Id.* at 16-18. He also argued that a broker-dealer only has a "duty to investigate," and that he satisfied that duty by investigating and being knowledgeable about each fund's investments. *Id.* at 19-22. Lastly, Livingston argued that the "red flags" identified by the Division were not sufficient to establish liability for failure to investigate, and that Division precedent can be easily distinguished. *Id.* at 22-29.

Livingston also argued that he did not willingly violate Securities Act Section 5, and that monetary penalties are not proper because the Division failed to establish Livingston's "willful conduct." Livingston Br. at 31-32.

Rabinovich, Mayer, and Rogers

Rabinovich, Mayer, and Rogers argued that liability under the antifraud provisions can only be imposed for intentional or reckless conduct, which is not present here. RMR Br. at 3. They contend that the securities industry has never imposed a generalized duty to investigate on individual representatives, as the Division argued. *Id.* at 8. Rabinovich, Mayer, and Rogers maintained that their duties as registered representatives were to conduct a suitability analysis between the investment and the prospective client, which they fulfilled by performing extensive customer suitability analyses. *Id.* at 6-7, 9-13. They argued that *Hanly* and other cases relied upon to establish a "duty to investigate" are factually distinguishable. *Id.* at 13-16. Rabinovich, Mayer, and Rogers contend that the Division failed to show that they were aware of any of the purported "red flags," which they contest were not really "red flags" at all. *Id.* at 17-24. They claimed that the Division has provided no evidence that they made any material misrepresentations or omissions. *Id.* at 27-30.

Rabinovich, Mayer, and Rogers argued that they did not violate Securities Act Section 5, because all the fund offerings were exempt from registration under Rule 506 of Regulation D. RMR Br. at 33. In the alternative, Rabinovich, Mayer, and Rogers argued that even if an exemption under Rule 506 did not apply, they were not aware, nor in a position to be aware, that the offerings violated Section 5. *Id.* at 37-40. Finally, like the other Respondents, they claim that 28 U.S.C. § 2462 bars the claims asserted. *Id.* at 40-42.

Division Reply

The Division argued that the Selling Respondents violated Section 5 by selling unregistered securities, and that no exemption to the registration requirement under Regulation D applied. Div. Reply Br. at 2-5. In particular, the Division argued that the exemption of Rule 506 of Regulation D required fewer than thirty-five unaccredited investors, which, once the sales of “the Trust Offerings constituting the TDM and MSF Conduits,” are properly integrated, were sold to more than that number. *Id.* at 5-6.

The Division also reiterated its argument that a duty to investigate existed and that the Selling Respondents violated this duty by having no basis for their recommendations and for recommending offerings to their investors while aware of red flags. Div. Reply. Br. at 7-19. The Division reiterated claims that Selling Respondents made material misrepresentations and omissions, regardless of what disclosure were made in the PPMs, and that Selling Respondents also engaged in a scheme to defraud their investors, and negligently violated Exchange Act Sections 17(a)(2) and (a)(3). *Id.* at 19-25.

Finally, the Division argued that Guzzetti was a supervisor for the Selling Respondents, failed to adequately supervise, and also had actual knowledge and involvement in the fraud. Div. Reply. Br. at 26-31. The Division contested Guzzetti’s claim that it waived certain relief against him by not including a request for that relief in the prehearing brief. *Id.* at 33-35.

Legal Conclusions

Before dealing with the allegations as to specific Respondents there are several issues of general applicability that require disposition.

General Legal Conclusions

Statute of Limitations

28 U.S.C. § 2462 provides:

[A]n action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued.

The Division concedes that Section 2462 bars civil monetary penalties for conduct occurring before September 23, 2008, five years before the OIP was filed. Div. Br. at 28. However, Respondents argue that *all* claims are barred by Section 2462. Their argument is twofold: (1) all the sanctions are subject to Section 2462, and (2) all the claims first accrued over five years prior to the filing of the OIP, and are therefore time-barred. Chiappone Br. at 20-34; Gamello Br. at 5; Guzzetti Br. at 4-8; Lex Br. at 15-27; Livingston Br. at 5-10; RMR Br. at 40-41. Respondents cite two cases in support: *Gabelli v. SEC*, 133 S. Ct. 1216 (2013), and *SEC v. Graham*, No. 13-cv-10011, 2014 WL 1891418 (S.D. Fla. May 12, 2014).

I reject Respondents' claim that all sanctions sought are subject to Section 2462. Civil monetary penalties are clearly subject to the five-year statute of limitations. So too are associational bars, when, as here, the bars would be imposed punitively rather than remedially. *Johnson v. SEC*, 87 F.3d 484, 489-92 (D.C. Cir. 1996). Cease-and-desist orders and disgorgement are not subject to Section 2462. *See Riordan v. SEC*, 627 F.3d 1230, 1234-35 (D.C. Cir. 2010) (as to cease-and-desist orders); *Johnson*, 87 F.3d at 491 (as to disgorgement). *Graham*, which nearly all Respondents discuss in support of their arguments that Section 2462 extends to all causes of action, is not controlling law and is an outlier, even among subsequent district court cases, including one in the Eleventh Circuit. *See SEC v. LeCroy*, No. 2:09-cv-2238, 2014 WL 4403147, at *1 n.1 (N.D. Ala. Sept. 5, 2014); *see also SEC v. Funinaga*, No. 2:13-cv-1658, 2014 WL 4977334, at *6 (D. Nev. Oct. 3, 2014).

I also reject Respondents' claim that all claims are barred by Section 2462 because the claims "first accrued" over five years prior to the filing of the OIP. The Commission has long permitted penalties to be sought for violations occurring within the limitations period, even when similar violations first occurred outside that period. *See, e.g., Guy P. Riordan*, Exchange Act Release No. 61153, 2009 SEC LEXIS 4166, at *74 (Dec. 11, 2009); *Edgar B. Alacan*, Exchange Act Release No. 49970, 2004 SEC LEXIS 1422, at *46 (July 6, 2004). Respondents have not offered any persuasive justification for deviating from Commission precedent. Nearly all Respondents cite *Gabelli v. SEC*, 133 S. Ct. 1216 (2013), in support of their argument, but *Gabelli* concerns the "discovery rule" and simply does not address the situation at issue here. Nor does it stand for the proposition that continuing or new violations are immune to action because the statute of limitations period runs from the first violation. *See generally id.*

Duty to Investigate

The Division argues that Selling Respondents willfully violated the antifraud provisions with scienter and negligence by failing to satisfy their "duty to investigate," as discussed in *Hanly*. Div. Br. at 11; Div. Reply Br. at 7. In *Hanly* and later cases, courts have found that registered representatives are "under a duty to investigate," and that when circumstances "raise enough questions . . . a person's failure to investigate before recommending that investment [may be considered] reckless." *Hanly*, 415 F.2d at 596; *SEC v. Milan Capital Grp.*, No. 00-cv-108, 2000 WL 1682761, at *5 (S.D.N.Y. Nov. 9, 2000).¹⁰⁵

Respondents advance many different arguments in support of the contention that registered representatives have no duty to investigate a security when recommending it to an investor. Respondents argue that: (1) *Hanly* and its progeny do not apply here; (2) *Hanly* is an outlier or has been overruled by subsequent court cases; (3) *Hanly* and its progeny are distinguishable for involving more serious broker misrepresentations or more glaring red flags; (4) any duty to investigate resides with the broker-dealer, not the registered representative; (5) the duty to

¹⁰⁵ *Hanly* was decided in 1969 before *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1975), which established a scienter requirement for violations of Securities Act Section 17(a)(1) and Exchange Act Section 10(b) and Rule 10b-5. Thus, although *Hanly* establishes a duty to investigate, it cannot be said that a failure to live up to that duty under *Hanly* compels antifraud liability under the provisions of the securities statutes that require a showing of scienter.

investigate is not mentioned in industry literature and that only a “duty of suitability” exists; and (6) *Hanly* requires only *reasonable* investigation and Respondents satisfied this requirement. Chiappone Br. at 13-14, 38-48, 56-70; Gamello Br. at 3; Lex Br. at 56-66-73, 76-96; Livingston Br. at 19-29; RMR Br. at 7-24.

I reject Selling Respondents’ arguments and find that it is an established principle that a registered representative has a duty to investigate the security she or he recommends to a customer to establish an adequate basis for their recommendation *Hanly* says:

Brokers and sales men are ‘under a duty to investigate, and their violation of that duty brings them within the term ‘willful’ in the Exchange Act.’ Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. He must analyze sales literature and must not blindly accept recommendations made therein.

Hanly, 415 F.2d at 595-96 (internal footnotes omitted); *see also SEC v. GLT Dain Rauscher, Inc.*, 254 F.3d 852, 857 (9th Cir. 2001) (securities professionals have a standard of due care that includes the “obligation to investigate the securities he or she offers to customers.”). Respondents have not shown that *Hanly* has been overturned or that it is inapplicable in this situation. Rather, the duty to investigate has been recognized by the Commission and numerous courts. *See, e.g., SEC v. Shainberg*, 316 F. App’x 1, 2 (2d Cir. 2008) (summary order); *Dain Rauscher*, 254 F.3d at 857-58; *Graham v. SEC*, 222 F.3d 994, 1006 (D.C. Cir. 2000); *SEC v. Hasho*, 784 F. Supp. 1059, 1107 (S.D.N.Y. 1992); *Brian A. Schmidt*, Exchange Act Release No. 8061, 2002 SEC LEXIS 3424, at *26 n.27 (Jan. 24, 2002).

Not every failure of the duty to investigate rises to the level of recklessness under the antifraud provisions. Only when “[a] variety of circumstances . . . raise enough questions” does “a person’s failure to investigate before recommending that investment [become] reckless.” *Milan*, 2000 WL 1682761, at *5. The extent of the duty of investigation depends on the facts and circumstances of each situation, though “[s]ecurities issued by smaller companies of recent origin obviously require more thorough investigation.” *Hanly*, 415 F.2d at 596-97. It is settled, however, that the registered representative must do more than read the PPMs, “blindly accept recommendations made therein,” and “rely blindly upon the issuer for information concerning a company.” *Hanly*, 415 F.2d at 596-97. The presentations that the Selling Respondents contend were a major part of their effort to understand the Four Funds were presentations intended to promote sales of MS & Co.’s private placements. No one from outside MS & Co. offered any divergent or cautionary views. The so-called tough questions on ratios of revenue to interest coverage for the Four Funds were all answered by optimistic revenue projections by Smith, who was responsible for creating the offerings and marketing them to investors. There is no testimony that anyone at any meeting questioned Smith’s optimistic views that he could earn 12% on the investments. Moreover, it is well established that:

[I]n recommending a company’s securities to investors, a broker may not rely solely on materials submitted by the company without independent investigation; this duty to investigate is even greater where promotional materials are in some way questionable, for example by promising unusually high returns.

Milan, 2000 WL 1682761 at *5

My reading of *Hanly* and *Milan* is that a registered representative must check the facts surrounding a security he or she recommends, cannot pass on the claims of the issuer as fact, and must resolve any red flags surrounding the offering.

Division's Alleged Red Flags

The Division claims that the Selling Respondents had no reasonable basis for their recommendations to buy the Four Funds and Trust Offerings, and failed in their legal duty to investigate a number of specific red flags. Div. Br. 8-25; Div. Reply Br. 7-19. Respondents insist that they had a reasonable basis for their recommendations, citing MS & Co.'s experience, the PPMs, and information from Smith and McGinn at MS & Co. presentations and argue: (1) what the Division characterized as red flags were not red flags; (2) if there were red flags, they were unaware of them; and (3) their actions were reasonable given what they knew at the time. Chiappone Br. at 56-70; Gamello Br. at 4; Lex Br. at 76-96; Livingston Br. at 22-29; RMR Br. at 17-24.

Each Selling Respondent's individual actions need to be examined separately to make a reasonable basis determination, but a few initial findings can be made about the red flag allegations. Webster defines red flag as (1) a warning signal and (2) something that attracts usually irritated attention. *Merriam Webster's Collegiate Dictionary* 979 (10th Ed. 2010). The record established that "red flag" is a commonly used term in the securities industry for unusual or out of the ordinary situations that bear examination. Tr. 1222, 1239, 1322, 4075-76.

I reject the Selling Respondents' position that they had no obligation to investigate any red flag or other subject that was mentioned in a PPM. I reach this determination because the PPMs are intended to explain the investment to investors, and are not intended to relieve registered representatives of their duty to investigate. The testimony of almost every single public witness, whether they testified for the Division or the Respondents, is that they received the PPMs but did not study them in detail. Further public testimony, again almost unanimous, is that investors trusted the registered representative and believed he had some reasonable basis that supported his recommendation. *Hanly*, 415 F.2d at 597 ("[A registered representative] cannot recommend a security unless there is an adequate and reasonable basis for such recommendation.").

Below I analyze several of the Division's purported red flags. I decline to discuss several of the purported red flags that I have determined to not constitute a red flag.

Conflicts of interest

The conflicts of interest that existed between the issuers and MS & Co. were a red flag. A conflict of interest is defined as "[a] real or seeming incompatibility between one's private interests and one's public or fiduciary duties." *Black's Law Dictionary* (9th ed. 2009). Smith controlled all the separate entities connected with the Four Funds offerings: broker-dealer, issuer, placement agent, trustee, and servicing agent. In addition, Smith was the compliance officer for the issuer.

There is no question that Smith and McGinn had a conflict of interest between their interest in the success and profitability of MS & Co., vis-à-vis investors in the Four Funds and the Trust Offerings.

I reject Respondents' positions that conflicts of interest were not a red flag because conflicts of interest are often present when major investment banks offer securities, and MS & Co.'s private placements, with the same conflicts of interest, appeared to have been successful in the past. The details of the conflicts present in offerings by major investment banks are not a part of this record and MS & Co. was not a major financial institution. MS & Co. was a small company creating newly formed entities. *See Hanly*, 415 F.2d at 597 ("Securities issued by smaller companies of recent origin obviously require more thorough investigation."). Moreover, courts have found that affiliations between the parties in an offering constitute a red flag under *Hanly*. *See SEC v. Platinum Inv. Corp.*, No. 02-cv-6093, 2006 WL 2707319, at *3 (S.D.N.Y. Sept. 20, 2006) (issuer and dealer run by same individuals triggered duty to investigate). Moreover, what occurred in the past cannot be the basis for discharging a present duty. Finally, at least one expert was never aware of a situation where the broker-dealer was both the issuer and the placement agent in a private placement. Tr. 4772.

Transactions with affiliates

Another red flag was the disclosed ability of the Four Funds to engage in related transactions. For example, the Four Funds

[could] acquire such Investments directly, or from our managing member or an affiliate of us or our managing member that has purchased the Investment. If the Investment is purchased from our managing member or any affiliate we will not pay above the price paid by our managing member or such affiliate for the Investment.

E.g., Div. Ex. 5 at 1 (all the PPMs contained the same disclosure). Transactions between related entities are viewed with skepticism in all areas of finance. *See McCurdy v. SEC*, 396 F.3d 1258, 1261 (D.C. Cir. 2005). No assets had been acquired at the time of the initial Four Funds offerings but for resales of the Four Fund notes, this information was a red flag that merited inquiry.

January 2008 default of the Four Funds' junior notes and other disclosures

The evidence is that on January 8, 2008, McGinn and Smith announced to certain registered representatives that the Four Funds' junior notes would have their interest payments reduced, an event that could trigger a default. Around this time, the registered representatives also learned that the Four Funds' holdings were not diversified as Smith had represented, and that the Four Funds' loans to alseT, on which they received no return, totaled \$8 million. On learning this information, the registered representatives had a duty to investigate the Four Funds' junior notes default before selling the Four Funds and to investigate Smith's misrepresentations as to the diversity of Four Funds' holdings and undisclosed investment in alseT before selling any Four Funds or Trust Offerings.

September 3, 2009, disclosure of Firstline bankruptcy

The parties agree that the September 3, 2009, revelation that McGinn and Smith concealed the Firstline bankruptcy filing in January 2008 was a red flag.

Redemption policy

The preponderance of the evidence does not support the claim that MS & Co. had a redemption policy that was, in these circumstances, a red flag that warranted investigation. As early as 2006, Smith, who controlled sales and redemptions, wanted registered representatives to make a new sale to replace their clients who redeemed at maturity. However, there is no evidence that a registered representative who did not find a new purchaser was ever unable to redeem a client. It was reasonable for the registered representatives to accept MS & Co.'s efforts to create a secondary market for illiquid securities and Smith's preference for resales rather than having to liquidate assets to meet redemptions.

Specific Legal Conclusions

The Selling Respondents violated Securities Act Section 5(a) and (c)

Securities Act Section 5(a) makes it unlawful, unless a registration statement is in effect as to a security, to (1) make use of any means or instruments in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or (2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale. 15 U.S.C. § 77e(a). Securities Act Section 5(c) makes it unlawful for any person, directly or indirectly, to make use of any means or instruments in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security. 15 U.S.C. § 77e(c).

To establish a prima facie violation of Securities Act Section 5(a) and (c), the Division must show that: (1) Selling Respondents, directly or indirectly, sold or offered to sell securities; (2) through the use of interstate facilities or the mails; (3) when no registration statement was in effect or filed as to those securities. 15 U.S.C. § 77e(a), (c); *see Ronald S. Bloomfield*, Securities Act Release No. 9553, 2014 SEC LEXIS 698, at *22 (Feb. 27, 2014) (citing *SEC v. Cavanagh*, 445 F.3d 105, 111 n.13 (2d Cir. 2006); *SEC v. Calvo*, 378 F.3d 1211, 1214-15 (11th Cir. 2004)). A showing of scienter is not required to establish a violation. *Ronald S. Bloomfield*, 2014 SEC LEXIS 698, at *22 (citing *Calvo*, 378 F.3d at 1215; *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044, 1047 (2d Cir. 1976)).

Once the Division has established a prima facie case for a Section 5 violation, the burden shifts to the Selling Respondents to show with evidence, "explicit, exact, and not built on [Selling Respondents'] conclusory statements," that an exemption from registration was available and applicable. *Ronald S. Bloomfield*, 2014 SEC LEXIS 698, at *23 (citing *Lively v. Hirschfeld*, 440 F.2d 631, 633 (10th Cir. 1971)); *see also Cavanagh*, 445 F.3d at 111 n.13 (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953)); *SEC v. Cont'l Tobacco Co. of S.C.*, 463 F.2d 137, 156 (5th Cir. 1972).

The Division has made a prima facie showing of a Section 5 violation. The Selling Respondents do not contest that no registration statement was in effect as to the Four Funds or Trust Offerings; that they sold or offered to sell these securities; and that they used interstate communication or mails in connection with the sale or offer of sale. *See, e.g.*, Chiappone Br. at 81-86; Livingston Br. at 31-32; RMR Br. at 33-35. In response, the Selling Respondents argue that the securities fell under exemptions to registration, or alternatively, that any Section 5 violations were not willful.¹⁰⁶ Chiappone Br. at 83-86; Lex Proposed Findings of Fact at 28; Livingston Br. at 31-32; RMR Br. at 33. Several Selling Respondents cite the PPMs of the Four Funds, which claimed exemptions from registration under Securities Act Section 4(a)(2) and Rule 506 of Regulation D of the Securities Act, and the PPMs of the Trust Funds, which claimed an exemption from registration under Rule 506. Chiappone Br. at 86; Lex FOF at 28; RMR Br. at 36-37; *see* Div. Exs. 5 at 9, 6 at 9, 9B at 9, 12 at 9; 15 U.S.C. § 77d(a)(2); 17 C.F.R. § 230.506.

Securities Act Section 4(a)(2)¹⁰⁷ provides that “the provisions of [Section 5] shall not apply to transactions by an issuer not involving any public offering.” 15 U.S.C. § 77d(a)(2). Whether this “private offering exemption” applies depends on “whether the particular class of persons affected needs the protection of the Act.”¹⁰⁸ *Ralston Purina*, 346 U.S. at 125. Rule 506 of Regulation D permits the offering and sale of unregistered conditions so long as (1) all terms and conditions of Rules 501 and 502 of Regulation D are met, including the provision of certain financial and non-financial information to unaccredited investors; (2) there are, or the issuer reasonably believes that there are, no more than thirty-five purchasers of securities who are non-accredited investors; and (3) each non-accredited investor meets the qualifications recited in Rule 506(b)(2)(ii). 17 C.F.R. § 230.506.

Several of the Selling Respondents argue that the Rule 506 safe harbor applies to sales of the Four Funds. *See, e.g.*, Livingston Br. at 31-32; RMR Br. at 36-37. The Division contends that Rule 506 does not apply to the Four Funds, because each offering was sold to more than thirty-five unaccredited investors. Div. Br. at 5; Div. Reply Br. at 2; Div. Exs. 531-34. None of the Selling Respondents proffered his own list of unaccredited investors for the Four Funds offerings to counter the evidence showing there were more than thirty-five unaccredited investors for each of the Four Funds. Some argue that they “reasonably believed” there were fewer than thirty-five accredited

¹⁰⁶ *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (a finding of willfulness does not require intent to violate the law, but merely intent to commit the act which constitutes the violation).

¹⁰⁷ The parties refer to both Section 4(2) and Section 4(a)(2). In the 2012 JOBS Act, Congress separated Section 4 into Sections 4(a) and 4(b). Jumpstart Our Business Startups Act, Pub. L. 112-106 § 201(c) (2012). With the statute’s enactment, Section 4(2) became Section 4(a)(2), but the text of Section 4(2) did not change. *Id.* References to Section 4(a)(2) should be understood to apply to both Section 4(a)(2) and 4(2).

¹⁰⁸ Factors commonly considered are the number of offerees, the sophistication and experience of the offerees, the nature and kind of information provided, and the size of the offering and precautions taken to prevent the offerees from reselling their securities. *See Feldman v. Concord Equity Partners, LLC*, No. 08-cv-4409, 2010 WL 1993831, at *3 (S.D.N.Y. May 19, 2010) (citations omitted).

investors. Rabinovich, Mayer, Rogers, and Livingston claim they were never told that the Four Funds were sold to more than thirty-five unaccredited investors, and Lex argues that he attempted to ensure that the Four Funds never exceeded thirty-five unaccredited investors. RMR Br. at 37; Livingston Br. at 31; Lex FOF at 93. Rabinovich, Mayer, Rogers, and Livingston do not explain how their supposed lack of knowledge of the number of unaccredited investors could be considered a “reasonable” belief that there were fewer than thirty-five unaccredited investors.¹⁰⁹ Even if Lex’s actions could lead to a finding of a reasonable belief there were fewer than thirty-five, any offering seeking a Rule 506 exemption must also comply with Rule 502, which requires the substantial disclosure of financial and non-financial information to all non-accredited investors. 17 C.F.R. §§ 230.502(b), 506(b). None of the Respondents make a showing of how they complied with the requirements that the sales comported with Rule 502 of Regulation D. I find Selling Respondents’ bare assertions, without any showing that the Four Funds offerings met all the requirements of Rule 506, insufficient to meet the Selling Respondents’ burden.

I find that the Four Funds offerings were not otherwise exempt from registration under Securities Act Section 4(a)(2) because the Selling Respondents do not contest or even address the Division’s position that each of the Four Funds were sold to hundreds of investors, including a sizable number of unsophisticated investors, and did not have access to the information normally provided in a registration statement. *See* Chiappone Br. at 86; RMR Br. at 36-37; Lex Br. at 31 n.18. Accordingly, I find that the Selling Respondents willfully violated Securities Act Section 5(a) and (c) with respect to the Four Funds.

Respondents also argue that Rule 506 applies to the sales of the Trust Offerings. The Division concedes that no single offering among the Trust Offerings exceeded thirty-five unaccredited investors; it argues, however, that the TDM Conduit Trusts and MSF Conduit Trusts should be integrated under Rule 502(a) of Regulation D, and that once integrated, each conduit was sold to more than thirty-five unaccredited investors and is therefore not subject to the Rule 506 exemption. Div. Br. at 4-7. The Division argues that integration of the two conduits is proper under the five-factor test contained in the notes of Rule 502.¹¹⁰ Div. Br. at 5-7 (citing the notes to 17 C.F.R. § 230.502(a)).

Selling Respondents respond that integration of the TDM Conduit Trusts and MSF Conduit Trusts is improper because certain offerings the Division seeks to integrate occurred more than six months apart, and Rule 502(a) creates a safe harbor expressly prohibiting integration of “offers and

¹⁰⁹ Selling Respondents were on notice that they had a duty to help ensure private placements complied with rules on sales to unaccredited investors. MS & Co.’s Supervisory Manuals have a section devoted to PRIVATE PLACEMENTS/LIMITED PARTNERSHIPS, which warns that “[t]here are certain rules which must be followed in making offers or sales of these products to be sure that the offering qualifies for exemption from SEC registration requirements.” Div. Ex. 329 at 44-45; RMR Ex. 112 at 39-40.

¹¹⁰ The five factors are: (a) whether the sales are part of a single plan of financing; (b) whether the sales involve issuance of the same class of securities; (c) whether the sales have been made at or about the same time; (d) whether the same type of consideration is being received; and (e) whether the sales are made for the same general purpose. *See* notes to 17 C.F.R. § 230.502(a).

sales that are made *more than six months* before . . . or are made *more than six months* after completion of a Regulation D offering.” 17 C.F.R. § 230.502 (emphasis added); *see* Lex Br. at 28; RMR Br. at 34. Without the integration of these certain offerings, both conduit trusts were sold to fewer than thirty-five unaccredited investors. Lex Br. at 28-29; RMR Br. at 34-37. Selling Respondents also argue that consideration of Rule 502’s five-factor test is inappropriate, because the test only applies *if* the six month safe harbor rule in 502(a) is not available, and that even if the five-factor test applied, integration would not be proper. *See* RMR Br. at 35.¹¹¹

The Division argues that the six-month safe harbor is calculated from when sales actually occurred, not when specific offering periods were set forth in the PPMs, and that the actual sales of the MSF Conduit offerings were never more than six months apart, and sales of the TDM Conduit offerings were never more than six months and three weeks apart. Div. Reply Br. at 5. The Division argues “the mere fact that two offerings are more than six months apart does not necessarily defeat integration,” and integration is still proper under the five-factor test. *Id.* at 6.

The Division appears to be correct that Rule 502(a)’s six month safe harbor counts actual sales, regardless of the sales periods described in the PPMs. *See* 17 C.F.R. § 230.502(a) (language discussing safe harbor for “offers *and* sales”) (emphasis added). The Selling Respondents appear to be correct that the five-factor test is only applied if “the safe harbor rule in paragraph (a) of this Rule 502 is unavailable.” *Id.* However, because the Selling Respondents have failed to show that the sales (rather than the offerings) of each conduit occurred more than six months apart, I find that the safe harbor is unavailable and that Section 502(a)’s five factor test will be applied to determine whether integration is appropriate.¹¹²

Applying the five factor test, it appears Selling Respondents have met their burden in showing that the Trust Offerings should not be integrated into the two conduits. The Trust Offerings were not made for the same purpose or under a single plan of financing, but were instead separate investments in a variety of assets. RMR Br. at 35-36; RMR FOF ¶¶ 604-07. Moreover, they did not involve issuances of the same class of security, but rather different classes of securities paying different rates of interest over different periods. RMR Br. at 36; RMR FOF ¶ 608.

However, as discussed *supra* any offering seeking a Rule 506 exemption must also comply with Rule 502, which requires the substantial disclosure of financial and non-financial information to all unaccredited investors. 17 C.F.R. § 230.502(b), 506(b). There is no evidence in the record

¹¹¹ Lex also argues he is exempt from Section 5 due to language in Section 4 limiting the registration requirements only to “issuers, underwriters, or dealers.” 15 U.S.C. § 77d(a)(1); Lex Br. at 32. This argument seemingly ignores the expansive definition of dealer, which Lex easily meets, as “any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person.” 15 U.S.C. § 77b(a)(12).

¹¹² The Division concedes that two sales within the TDM Conduit were made more than six months apart from each other, and as a result, one of those sales cannot be integrated with the rest of the TDM Conduit. Div. FOF at ¶ 191. The Selling Respondents fail to cite any evidence showing that, without this sale, the TDM Conduit falls under thirty-five sales to unaccredited investors.

that investors received such information in connection with the Four Funds or Trust Offerings.¹¹³ Thus the Selling Respondents have failed to carry their burden of proof.¹¹⁴ *See SEC v. Empire Dev. Grp., LLC*, No. 07-cv-3896, 2008 WL 2276629, at *8-9 (S.D.N.Y. May 30, 2008) (finding that Rule 506 exemption did not apply without proof that investors were given the information required under Rule 502). Accordingly, I find that the Trust Offerings were not exempt under Rule 506 from the registration requirements of Section 5 of the Securities Act.¹¹⁵ Accordingly, Selling Respondents willfully violated Securities Act Section 5(a) and(c).

Selling Respondents Violated Securities Act 17(a) and Exchange Act Section 10(b) and Rule 10b-5

Statutes and Rule

Securities Act Section 17(a)(1)-(3) makes it unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly:

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

¹¹³ Moreover, Rule 506 requires that all unaccredited investors in the Regulation D offering have, or the issuer “reasonably believes” they have, “such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment.” 17 C.F.R. § 230.506(b)(2)(ii). However, it is clear that many of the unaccredited purchasers, by any definition, were not the sophisticated investors required by Rule 506(b)(2)(ii). *See, e.g.,* Tr. 795-796 (Monahan testifying that despite signing a representation attesting that she was sophisticated, she had no knowledge and experience in financial and business matters, and speculating that she had been instructed by Lex to sign that attestation).

¹¹⁴ As previously noted, one claiming an exemption has the burden of proving the exemption is available, and must present evidence that is “explicit, exact, and not built on [Selling Respondents’] conclusory statements.” *Cont’l Tobacco Co.*, 463 F2d at 156.

¹¹⁵ I reject Selling Respondents’ arguments that their failure to meet the requirements of Rule 506 should be excused under Rule 508, which allows for “insignificant deviations” from the requirements of Rule 506. Lex FOF at 28; RMR Br. at 39; 17 C.F.R. § 230.508. Providing necessary financial and non-financial information is a key component of Rule 506. Furthermore, Rule 508 only applies if “the failure to comply *did not* pertain to a term, condition or requirement directly intended to protect that particular individual.” 17 C.F.R. § 230.508. Selling Respondents failure to provide the information *did* pertain to a requirement intended to protect investors.

15 U.S.C. § 77q(a).

Exchange Act Section 10(b) makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange:

To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

Exchange Act Rule 10b-5 makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. §240.10b-5.

Legal standard

Scienter is required to establish violations of Securities Act Section 17(a)(1) and Exchange Act Section 10(b) and Rule 10b-5. *Aaron v. SEC*, 446 U.S. 680, 695-97, 701-02 (1980); *SEC v. Yorkville Advisors, LLC*, No. 12-cv-7728, 2013 WL 3989054, at *2 (S.D.N.Y. Aug. 2, 2013). Scienter may be established through a showing of reckless disregard for the truth. *S. Cherry St. v. Hennessee Group LLC*, 573 F.3d 98, 109 (2d Cir. 2009). Conduct is reckless when it “is highly unreasonable and [] represents an extreme departure from the standards of ordinary care.” *Id.* Failing “to review or check information [an individual] had a duty to monitor, or ignor[ing] obvious signs of fraud . . . or [a]n egregious refusal to see the obvious, or to investigate the doubtful . . . may in some cases give rise to an inference of . . . recklessness.” *Id.* (emphasis omitted).

A showing of negligence suffices to establish violations of Securities Act Sections 17(a)(2) and 17(a)(3). *Dain Rauscher*, 254 F.3d at 856. To establish negligence, the Division must show

that Selling Respondents failed to conform the “standard of reasonable prudence, for which the industry standard is but one factor.” *Id.*¹¹⁶

Anthony

Anthony performed inadequate due diligence prior to recommending the Four Funds to clients. OIP at 8. The PPMs for the Four Funds, which he read or was reckless in not reading, made disclosures that should have caused him to conduct a searching inquiry prior to recommending the products to customers. *Id.* Smith provided Anthony with no specific information about how he had invested Four Funds’ offering proceeds, and Anthony never pressed Smith for specific information. OIP at 10; Anthony Dep. at 102. Anthony received a communication in January 2008 that made him question whether the Four Funds were operating as a Ponzi scheme. Anthony Dep. at 131-32. Despite his concerns, he “didn’t do anything about it, because,” as he said, “you know, what was I going to do? [sic]” *Id.* at 132. He also did not call FINRA regarding his suspicion of a Ponzi scheme because he “didn’t want to jeopardize [his] employment and everything else at that time.” *Id.* at 133. Anthony did not advise clients that they were rolling over investments in what he suspected might be a Ponzi scheme. *Id.* at 140.

As a result of this conduct, Anthony willfully violated Section 17(a) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act. OIP at 5, 13.

Chiappone

Between October 3, 2003, and November 3, 2009, Chiappone made over 360 sales of the Four Funds and Trust Offerings. Div. Ex. 2, Ex. 4c (as attached to Div. Ex. 2). Chiappone recommended these securities based on reading significant parts of the Four Funds’ PPMs and attending sales presentations. He did not perform any independent inquiry or investigation as to the offerings, the statements in the PPMs, or what he was told at the sales presentations. Chiappone knew of many red flags, e.g., that MS & Co.’s multiple roles in the offerings created conflicts of interest and that the offerings allowed transactions among related parties, but he did not investigate to provide some basis for his recommendations to his clients that they purchase the securities.

Most damning to Chiappone’s claim that he was an innocent bystander is that Chiappone drafted an email to Smith in August 2008, accusing Smith of mismanaging the Four Funds’ assets, arguing that Smith’s explanation of a market meltdown as the cause of the reduction in interest in the Four Fund junior notes was “a nice screen,” and stating that the Four Funds’ lack of diversification was “incomprehensible.” Div. Ex. 231. After these strong views took shape, Chiappone made about thirty-five sales of the Trust Offerings which Smith controlled and managed, without mentioning his concerns to clients. Div. Ex. 2, Ex. 4c (as attached to Div. Ex. 2).

¹¹⁶ Selling Respondents argue that only the “makers” of a material misstatement or omission can be held liable under Section 17(a)(2), but such an argument was recently dismissed by the Commission. *John P. Flannery*, Exchange Act Release No. 73840, 2014 SEC LEXIS 4981, at *34-35 (Dec. 15, 2014); *see* RMR Br. at 32-33.

In addition, in December 2008, Chiappone “left it at that” when Smith, a person with whom he had worked for about twenty years, refused on grounds of confidentiality to provide him with a list of TAIN investments and the dates of purchase. Chiappone did not sell additional Four Funds offerings after December 2008, but he continued to sell the Trust Offerings. Div. Ex. 2, Ex. 4c (as attached to Div. Ex. 2).

Both witnesses called by the Division, Ardizzone and Becker, relied on Chiappone to have done due diligence on the investments he recommended. The evidence is that Chiappone did not do so. Both men invested retirement funds and did not fully understand the investments. In addition, Ardizzone’s last purchase was one of the Trust Offerings on October 7, 2008, and Becker’s last purchase was one of the Trust Offerings on December 22, 2008. Chiappone did not mention any concerns that he had about MS & Co. to either Ardizzone or Becker.

The preponderance of the evidence is that Chiappone was reckless in offering and selling securities based on material misrepresentations and omissions that he made to the witnesses who purchased private placements.¹¹⁷ Ardizzone, based on his conversations with Chiappone, believed that all his purchases were alarm contract related offerings, which he was familiar with, yet FEIN and TAIN were not that type of investment. In addition, Chiappone recommended Fortress to Ardizzone in October 2008. This was after MS & Co. reduced interest in the junior Four Funds notes, Chiappone learned Smith had misled him on the Four Funds’ diversification and that that the Four Funds had invested \$8 million in elseT. Chiappone recommended the Fortress investment without investigating these red flags, and after he wrote the unsent letter to Smith about his mismanagement of the Four Funds. Chiappone did not mention any concerns about MS & Co. to Ardizzone. Chiappone’s material misrepresentations and omissions to Becker were similar to his conduct vis-à-vis Ardizzone. Chiappone offered and sold Trust Offerings to Becker in September and December 2008 without mentioning any misgivings about McGinn or Smith. Finally Chiappone sold one of the Trust Offerings nearly two months after he learned that MS & Co. had hidden the Firstline bankruptcy. Div. Ex. 2, Ex. 4c (as attached to Div. Ex. 2). Chiappone’s sales of MS & Co.’s private placements constituted a necessary part of MS & Co.’s fraud and were thus part of a device, scheme, or artifice to defraud in willful violation of Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5.

Chiappone willfully violated Securities Act Sections 17(a)(2) and (a)(3) because, acting at least negligently, he obtained money by means of untrue material statements, i.e., his recommendation of these private placements indicated to his clients that he had some reasonable basis for believing they were good investments when he had done no investigation of their worth. By simply repeating the issuer’s unchecked representations, he engaged in an act, practice, or course of business that operated as a fraud or deceit on his clients.

¹¹⁷ Material misstatements and omissions violate the antifraud provisions; the standard of materiality is whether a reasonable investor would have considered the information important in deciding whether to invest. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32, 240 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

Gamello

Gamello was a credible witness. I believe Gamello's testimony at the hearing did not conflict with any of his prior testimony, the testimony of any other witnesses, or any exhibit.

Gamello acknowledged that as to the Four Funds and Trust Offerings, he read the PPMs and attended the sales presentations. He relied on Smith's reputation and the Four Funds' past performance in recommending them. Gamello knew that the Four Funds PPMs allowed him to obtain information on Four Funds investments, but did not ask for such information; he also knew that the Four Funds had numerous confidential investments, but never inquired about them. These actions did not fulfill the obligations of a registered representative in these circumstances when recommending and offering private placements to customers.¹¹⁸

I do not find that Gamello violated the antifraud provisions of the federal securities laws. FIIN and FEIN were issued before he joined MS & Co. Twelve of Gamello's twenty-two FAIN sales occurred within three and a half months of the offering, which supports his testimony that when he sold the FAIN offering it was a blind pool with no investments.¹¹⁹ Tr. 5940. Gamello testified:

The funds that I actually recommended my clients purchased, they didn't have any investments. The funds he is talking about, the previous ones, they were basically unsolicited transactions where the clients came to me and, you know, wanted the info. I made them aware Dave Smith controls everything, we have no idea what he holds in there. You are depending on Dave Smith. They said, "Let's go with it." They were wealthy individuals and seemed to have familiarity with the investments Dave Smith was offering over the years. As far as those investments go, no, I felt the clients were basically making – they were aware of it and I let them know, "Look, I have no idea what is in there, you know." . . . [The clients] asked about performance. As far as I can tell they're doing well. But I really, make no representation. I don't know what is in there.

Tr. 1764-65 (formatting altered).

Additional facts to be considered in assessing Gamello's conduct are that Gamello only sold the Four Funds and the Trust Offerings to accredited investors. Div. Exs. 531-34. There is no evidence contesting Gamello's testimony that twelve of his sales were by two customers, Emilio Boni and John Morrell, who sought him out to make investments. Tr. 1750-51; Div. Ex. 2, Ex. 4g (as attached to Div. Ex. 2). After seeing the letter Smith wrote to customers about the restructuring of the Four Funds in January 2008, Gamello requested and received a list of FAIN investments, the

¹¹⁸ I do not interpret a FAIN customer reference in March 2006 to the "nearly guaranteed [FAIN] dividends" as showing that Gamello guaranteed to the customer that FAIN would be successful. Gamello testified that he represented to customers that the Four Funds had paid interest timely, which was true up to October 2008; he denied that he guaranteed FAIN interest payments. Tr. 1768, 5951.

¹¹⁹ The FAIN offering occurred in October 1, 2005. Gamello made twelve FAIN sales between October 26, 2005 and January 18, 2006. Div. Ex. 2, Ex. 4g (as attached to Div. Ex. 2).

offering in which most of his Four Funds customers were invested, and he researched and determined the information matched what Smith said in his letter. Tr. 1830-32.¹²⁰ Gamello did not sell any Four Funds investments after December 7, 2007. Div. Ex. 2, Ex. 4g (as attached to Div. Ex. 2). His last sale of any of the Trust Offerings was on August 27, 2009. *Id.* He did not sell the Four Funds or the Trust Offerings after September 2009 when he learned that MS & Co. had concealed the Firstline bankruptcy.

Gamello made sales of the Trust Offerings between November 2006 and August 2009. Div. Ex. 2, Ex. 4g (as attached to Div. Ex. 2). Just like with the Four Funds, he relied on the PPMs and sales presentations on the offerings. Tr. 1875. Gamello recognized that as private placements the Trust Offerings were higher-risk investments. Tr. 1897. Gamello's last sale of Firstline was on January 17, 2008, the same month that Firstline filed for bankruptcy, so it is not clear that, had he looked at publicly available information on Firstline, he would have discovered the bankruptcy. Div. Ex. 2, Ex. 4g (as attached to Div. Ex. 2).

Gamello made two sales of the Benchmark offering. Div. Ex. 2, Ex. 4g (as attached to Div. Ex. 2). Gamello knew the Benchmark expenses were high and he always went over expenses with his clients. Tr. 1878-79. Despite the Division's disbelief, it was not unreasonable for Gamello to have accepted McGinn's assertions that the contracts underlying Benchmark were bought at a low price, and that, if the economy improved, the contracts could likely be sold for much higher multiples and the offering could earn the projected returns. Tr. 1878-89.

There is no witness testimony that Gamello provided false material information or omitted material information. For the reasons stated, the preponderance of the evidence is that Gamello did not violate the antifraud provisions of the securities statutes. I am also not issuing a cease-and-desist order or civil penalties against William P. Gamello as to his violation Section 5(a) and (c) of the Securities Act of 1933 because it would likely severely impact his future participation in the securities industry and his violations do not warrant that.

Lex

Lex is wrong that he had no duty to investigate the securities he sold to clients. Tr. 1560. The issue here is whether Lex made material misrepresentations and omissions to his clients by not conducting an investigation in order to obtain a reasonable basis for recommending his clients buy the Four Funds and Trust Offerings.

Lex read the PPMs and participated in conference calls with Smith. Lex made over 440 sales of Four Fund notes from September 25, 2003, through 2006, and did not obtain any verifiable information about the status of the Four Funds, such as specific asset names or financial statements, even though the PPMs stated that financial information was available. Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2).

¹²⁰ Based on testimony by Guzzetti, the Division asserts that Gamello, Lex, Mayer, Rabinovich, and Rogers learned at a meeting in September 2008 that Smith had to restructure the Four Funds again. Tr. 3178-81; *see* Div. Proposed Findings of Fact at ¶ 819. I cannot find evidence, outside of Guzzetti's testimony, that Gamello was at the meeting.

Lex's credibility is highly suspect. Lex's client Monahan was a credible witness and never claimed to be an accredited investor as indicated by her documents, most of which were filled in by Lex or people in his office. In testimony to FINRA in 2009 and in a deposition by the Commission in 2011, Lex stated that he did not know the specific companies in which the Four Funds were invested. Tr. 4933-38. Yet when Lex testified at the hearing, he had found notes that he took during conversation with Smith and materials about fund investments that Smith had sent him. Tr. 4925. None of this had been produced in response to a Division subpoena served on Lex.

Lex began recommending and selling the Four Funds in 2003. His last sale of a Four Funds note was on March 18, 2008, and his last sale of one of the Trust Offerings was on July 17, 2009. Div. Ex. 2, Ex. 4k (as attached to Div. Ex. 2). He made all these sales without any investigation into the status of these investments, which were by their nature risky private placements involving conflicts of interest among MS & Co. entities, the dangers of transactions with affiliates, and without resolving whether the reasons offered for the January 2008 default of the Four Funds were reasonable. Lex does not represent that when he received "for the first time" a list of the Four Funds' investments in August 2007, that he used the information to investigate the status of the private placement investments. Tr. 4942-43. Lex also made sales after January 25, 2008, when he knew that Smith had misled him as to the diversity of the Four Funds' investments. Div. Ex. 161. In fact, Lex received the Four Funds' portfolio analysis in August 2007 and realized at that time that the Four Funds held similar investments. Tr. 1657-58.

Forsythe, Monahan, and Weiner, three credible witnesses who were unsophisticated investors, gave compelling, persuasive testimony that Lex recommended private placements for their retirement funds, which Lex knew they were going to need to live on. Lex did not inform any of these investors of the risky nature of private placements or investigate and resolve any of the other red flags surrounding the offerings. Without resolving the red flags that he learned about on or about January 8, 2008, Lex recommended and sold MS & Co. private placements: FAIN, TDM Cable, and INEX to Forsythe, Monahan, and Weiner, after January 8, 2008, and he did not disclose this material information to his clients. Tr. 746-52, 789-90, 1488, 1513.

The preponderance of the evidence is that Lex was reckless in offering and selling securities based on material misrepresentations that he made to the witnesses who purchased private placements. Lex's sales of MS & Co.'s private placements constituted a necessary part of MS & Co.'s fraud and were thus part of a device, scheme, or artifice to defraud in willful violation of Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5.

Lex willfully violated Securities Act Sections 17(a)(2) and (a)(3) because, acting at least negligently, he obtained money by means of untrue material statements, i.e., his recommendation of these private placements indicated to his clients that he had some reasonable basis for believing they were good investments when he had done no investigation of their worth. By simply repeating the issuer's unchecked representations, he engaged in an act, practice, or course of business that operated as a fraud or deceit on his clients.

Livingston

From September 19, 2003, through June 5, 2009, Livingston made thirty-four sales of Four Funds and seven sales of Trust Offerings, totaling almost \$3.9 million. Div. Ex. 2, Ex. 4m (as attached to Div. Ex. 2). For almost this entire period, Livingston owned 20% of MS & Co. and was an officer with MS Holdings. The overwhelming evidence is that Livingston knew or was reckless in not knowing that the Four Funds and the Trust Offerings had serious problems and he failed to disclose this information to investors when he recommended and sold these private placements. In addition, Livingston did not disclose to investors his ownership interest in alseT, which received substantial financial support from three of the Four Funds. Failure to disclose this information was a serious conflict of interest and material omission.

Livingston was not a credible witness. Livingston's office was ten feet from Smith's office, and by his own account, he was a guy who paid attention. Tr. 2260, 5172. Livingston had thirty-five years of securities experience and worked to bring institutional clients to MS & Co. Most of his positions, however, are so lacking in substance that for someone with his background, they are naïve, unprofessional, and implausible. For example, Livingston contended that he did not request financial data about the Four Funds' investments because he had a "pretty good working knowledge of how much, you know, had been invested" and knew from doing the math in his head the expected returns. Tr. 5226. Moreover, Livingston's assertion that Smith conducted due diligence on private placements was based, in large part, on having observed Smith interact with in-house lawyers, accountants, Weisman, and persons at Pine Street Capital. Tr. 2247, 5214-15.

Livingston's knowledge of the problems within the Four Funds is evident in his statements in a memorandum to Smith, dated October 22, 2007, but which Livingston testified he sent around December 2007. In the memorandum, Livingston acknowledged that funds controlled by McGinn and Smith had losses approaching \$45 million dollars, and that, unbeknownst to him, the Four Funds now owned 10% of alseT and had made huge investments in companies controlled by McGinn and Smith, which Livingston described as "HUGE conflicts" and that it was "unbelievable" such conflicts had not been disclosed. Div. Ex. 585; Tr. 5309. In addition, Livingston testified that at the end of 2007, he "really got a better understanding of what kind of catastrophe was going on within the Four Funds." Tr. 2271. Livingston did not mention these facts to the three customers he sold Trust Offerings to in 2008 and 2009.

Ferris and Lafleche invested in the Four Funds in 2004 and they together made a total of five purchases of Trust Offerings in 2008 through January 2009. Div. Ex. 2, Ex. 4m (as attached to Div. Ex. 2). Most of the investments were made using retirement funds. Livingston recommended the purchases and never disclosed the concerns set out in his October/December 2007 memorandum to Smith.

The conclusive evidence is that Livingston was reckless in offering and selling securities based on material misrepresentations and omissions that he made to the witnesses who purchased private placements. Livingston's sales of MS & Co.'s private placements constituted a necessary part of MS & Co.'s fraud and were thus part of a device, scheme, or artifice to defraud in willful violation of Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5.

Livingston willfully violated Securities Act Sections 17(a)(2) and (a)(3) because, acting at least negligently, he obtained money by means of untrue material statements, i.e., his recommendation of these private placements indicated to his clients that he had some reasonable basis for believing they were good investments when he had done no investigation of their worth. By simply repeating the issuer's unchecked representations, he engaged in an act, practice, or course of business that operated as a fraud or deceit on his clients.

Mayer

Mayer's credibility is highly suspect because Mayer gave very different testimony on the same subject at different times. In his investigative testimony, Mayer stated he "didn't have specific investments" as to what the Four Funds were going to invest in, and that he always gave clients examples of investments in an offering, but he did not give them a list of specific investments. Tr. 3290, 3292. In his investigative testimony, Mayer testified that: he had no information about the portfolios of the Four Funds when he sold notes to the Von Glinows; he represented that the portfolios were diversified because brokers were told they were going to be diversified; and he did not independently investigate whether the portfolios were diversified, relying instead on the investment banking department's representation. Tr. 3358. However, at the hearing, he testified that he knew many of the Four Funds' investments in the 2003-2007 period, including Dicania, Pali Capital, CMet Financial, Pine Street, CMS Financial, Palisades Pictures, Aquatic Development, alsoT, Deerfield Capital, and GSC Capital. Tr. 3278-89. Another such inconsistency involved his knowledge regarding the Four Funds' loans to alsoT: In his investigative testimony, Mayer stated he did not know that funds had been loaned to alsoT and would have been upset if he had known about loans to alsoT because venture capital investments did not yield revenue; but at the hearing he stated he knew about alsoT and did not consider it a venture capital investment. Tr. 3305-06, 3322-24, 3462.

Mayer's testimony during the hearing was also inconsistent. He acknowledged that as a registered representative he was responsible for having a detailed knowledge of the securities he recommended and sold to investors. He insisted he had that degree of knowledge with respect to the Four Funds, however, when it came to having reliable, objective information that would provide a reasonable basis for recommending the private placements at issue, Mayer was unable to come up with specifics.

There is no evidence in the record that Mayer did any serious, objective analysis or review of the private placements, which would provide a basis for recommending them to investors. Nowhere in the record is there any evidence that Mayer challenged or verified Smith's major assumption that in the period 2003 through 2009, Smith was able to achieve a 12% return on investments. Mayer testified that he did not recall seeing or receiving a balance sheet for the Four Funds; he only considered a balance sheet helpful in a liquidation; he did not see an income statement for the Four Funds because he did not think them relevant; he did not recall seeing any financial statements showing total fund assets as compared with notes payable; in 2004 and in 2005, when he was working to get a new clearing broker, he saw financial statements for the Four Funds; and he did not know the actual portfolios of the Four Funds. Tr. 3327-31, 3354; 4982-83, 4986, 5117-18. Mayer considered cash flow information important but there is no persuasive evidence that he asked for it or that he received it regularly. Tr. 4981-82. Mayer claimed that he did the level

of inquiry required, but he did not document his inquiries. The evidence is that Mayer passed Smith's representations about the Four Funds on to his customers with his recommendations without out any serious independent inquiry.

Mayer was wrong in not considering and further investigating the following as red flags to make sure they did not adversely impact the offerings: the conflicts of interests among the MS & Co. entities, the possibility of transactions between the Four Funds, and whether Smith's explanation of the Four Funds' January 8, 2008, default was valid.

Mayer's clients Alberts and O'Brien, smart people but not savvy investors, gave credible, persuasive testimony that Mayer did not mention material information to them when he recommended their private placement purchases. Both acknowledged receiving the PPMs, which contained warnings that they did not read thoroughly. Alberts testified that Mayer did not tell him that he could lose his investment, which consisted of a large portion of his IRA account. Tr. 3470-72, 3475-79. O'Brien and a family member made nine purchases of the Trust Offerings in 2009. Div. Ex. 2, Ex. 4o (as attached to Div. Ex. 2). O'Brien would not have invested in the Benchmark offering if Mayer had told him that 21% or 30% percent of the offering proceeds would be used to pay for fees. Tr. 910, 913.

The conclusive evidence is that Mayer was reckless in offering and selling securities based on material misrepresentations and omissions that he made to the witnesses who purchased private placements, and that he failed to investigate several red flags that were apparent to him by January 8, 2008. Mayer's sales of MS & Co.'s private placements constituted a necessary part of MS & Co.'s fraud and were thus part of a device, scheme, or artifice to defraud in willful violation of Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5.

Mayer willfully violated Securities Act Sections 17(a)(2) and (a)(3) because, acting at least negligently, he obtained money by means of untrue material statements, i.e., his recommendation of these private placements indicated to his clients that he had some reasonable basis for believing they were good investments when he had done no investigation of their worth. By simply repeating the issuer's unchecked representations, he engaged in an act, practice, or course of business that operated as a fraud or deceit on his clients.

Rabinovich

Rabinovich was confident and articulate, but his testimony was often inconsistent or contradicted by other evidence.

It is impossible to know how much Rabinovich knew about the Four Funds before a January 8, 2008, meeting with Smith and McGinn where, for the first time, Smith disclosed the largest Four Funds investments in detail.¹²¹ Tr. 1956. At various times Rabinovich testified that: (1) he was unsure whether he actually saw balance sheets for the Four Funds before January 2008; (2) he knew

¹²¹ At the meeting were Guzzetti, Mayer, Rabinovich, Rogers, and Shea. Tr. 1956. It is unclear whether this is the January 2008 meeting attended by most of the MS & Co. registered representatives.

some of the investments and registered representatives obtained schedules on how assets were performing; until 2009 or 2010; (3) when he sold a client a FIIN note in October 2006, he knew some of the FIIN assets from sales presentations; (4) it was possible he learned the Four Funds invested in each other on January 8, 2008; (5) he never received any information about the Four Funds' total assets as compared to the notes payable; (6) he saw some type of financial statements for the Four Funds before January 2008; (7) he was not troubled by Smith's failure to disclose specific investments; (8) he did not know until January 2008 that the Four Funds invested \$8 million in elseT; and (9) "I just know that I had frequent discussions with Mr. Smith about the performance of the funds and from time to time would see how . . . those positions were doing." Tr. 1933-34, 1945-47, 1951, 1954, 2036-37, 4519.

On January 8, 2008, Rabinovich knew that Smith had misled him and he was "shocked" as to the Four Funds' investments, in particular, that the Four Funds' investment in elseT, an investment not "consistent" with the expected Four Funds' investments, had grown from a couple of million dollars to about \$8 million. Tr. 2036, 2040.

By his own account, Rabinovich had continuous contacts with Smith, advised Smith on investments, and Smith called on Rabinovich for financial help to close deals. Despite his ability to obtain data to support Smith's representations about the private placements, there is no persuasive evidence that before January 8, 2008, Rabinovich requested balance sheets or factual information about the Four Funds or Trust Offerings. Tr. 1956-57. The preponderance of the evidence is that Rabinovich did not conduct a sufficient investigation into the Four Funds and Trust Offerings to support his recommendation to clients that they purchase the Four Funds and Trust Offerings. Rabinovich dismissed a number of red flags that surrounded the Four Funds and Trust Offerings and parroted Smith's optimistic statements about the Four Funds to his customers as fact. For example, Rabinovich testified that at the time of a 2006 sale of a FIIN note, he was aware of some investments in the FIIN portfolio; his knowledge came from Smith. Also, in a letter to a customer on October 20, 2008, concerning TAIN and FEIN notes, Rabinovich opined that he thought a fifteen-year amortization was too conservative. Tr. 2062-63; Div. Ex. 58. His opinion was based on information from Smith, his knowledge of the portfolio, and expected portfolio reconstruction. Tr. 2065.

Another example of Rabinovich's testimony contradicted by fact concerns an MS & Co. private placement, Charter Cruise Ventures. Rabinovich's father bought a \$100,000 note of Charter Cruise Ventures on August 24, 2009. Tr. 5981. Rabinovich testified he regularly checked on Charter Cruise Ventures' performance, and cabin bookings were doing quite well, and he understood that the offering should be successful. Tr. 4339, 5981-82. The Receiver directly contradicted Rabinovich with testimony that when he took control of the asset in April 2010, the October 2010 cruise had deposits of about \$33,000 for sixty-nine bookings, out of the 2,046 available. Tr. 5983-88; Div. Ex. 703.¹²²

¹²² The Charter Cruise Ventures is not one of the private placements at issue. Carnival Cruise Lines had been paid \$425,000 and was owed \$85,000, and MS & Co.'s last payment was in default. Tr. 5987. The Receiver negotiated cancelation of the contract and return of about \$222,000. Tr. 5989.

The preponderance of the evidence is that Rabinovich willfully violated Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5 because he was reckless in offering and selling securities in that he falsely represented to Chapman that FEIN was a low risk investment; he did not make Patel aware of material facts surrounding the Trust Offerings; and he failed to investigate several red flags that were apparent to him by January 8, 2008. Rabinovich's failure to investigate, or inquire into and resolve, the several red flags sufficient to "raise enough questions" surrounding the private placement offering make his failure to investigate reckless. *Milan*, 2000 WL 1682761, at *5. Rabinovich's sales of MS & Co.'s private placements constituted a necessary part of MS & Co.'s fraud and were thus part of a device, scheme, or artifice to defraud in violation of Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5.

Rabinovich violated Securities Act Sections 17(a)(2) and (a)(3) because, acting at least negligently, he obtained money by means of untrue material statements: his representations that he had some reasonable basis for recommending the securities and the omissions that he was simply repeating the issuer's representations. By so doing, he engaged in an act, practice, or course of business that operated as a fraud or deceit on his clients.

Rogers

Rogers was a credible witness for the most part, however, his conviction that he investigated the private placements to an extent over and above what the Division claims was required is inexplicable. The evidence is that Rogers chose to ignore red flags and his investigation of the private placements consisted of reading PPMs, listening to sales presentations by Smith and others at MS & Co., and talking to people he considered knowledgeable and important. Tr. 5685-87, 5689, 5698, 5828.

Rogers considered the Four Funds' senior notes to be "a very conservative investment."¹²³ Tr. 3720. However, the evidence demonstrates that they were risky investments. The PPMs stated that an investment in the notes involved significant risks and the subscriptions agreements stated that the notes involving a high degree of risk. Div. Exs. 5, 6, 9B, 13.

Rogers did not see any red flags in the Four Funds' PPMs. Tr. 5681, 5718. He took issue with the term red flag and maintained that he performed extra research on private placements as part of his duty on all investments.¹²⁴ Tr. 5683. Rogers did not consider it unusual that: (1) the investment manager owned and controlled the issuer; (2) the issuer had no operating history; and (3) the placement agent and trustee were related. Tr. 5681-82. As a result, there is no evidence he considered and resolved those red flags.

¹²³ The basis of Rogers's belief was Smith's optimistic projections of a "9 to 1 cash flow coverage ratio" and "75 percent asset coverage on the principal." Tr. 3720.

¹²⁴ I take Rogers's use of the term investment adviser to be a misstatement because the questions were all addressed to the duties of registered representatives. Tr. 5684.

Nothing indicates that when Rogers sold the Four Funds he had any hard independent factual data to support his recommendation. Rogers never saw a balance sheet for the Four Funds until early 2008, yet he began selling the Four Funds on February 24, 2004, and made thirty-seven sales before January 18, 2008. Tr. 3773-74; Div. Ex. 2, Ex. 4s (as attached to Div. Ex. 2). Rogers testified that from 2003 through July 2007 he had a good understanding of the major investments in the Four Funds, which he believed were a combination of high quality institutional investments that Livingston was seeing and deals that Pine Street Capital Partners passed on to Smith. Tr. 3687-90, 3835-36, 5671. When pressed for specifics Rogers named Pine Street, security alarm contracts, Coventry, CMS, Palisades Pictures and alseT as investments he learned about from Mayer and Rabinovich. Tr. 5799-80. Rogers was not aware that Smith was investing Four Funds money in MS & Co. related entities until the Commission initiated an action against MS & Co. Tr. 5798, 5804.

Rogers gave different testimony on several points, but it is not disputed that on January 8, 2008, he learned for the first time that Smith had invested \$30 million of Four Funds assets in illiquid investments, including \$8 million in alseT, a related entity the magnitude of which Smith had not previously disclosed. Given Smith's breach of faith, it was unreasonable for Rogers to accept Smith's excuses and not investigate whether the reasons Smith gave for the restructuring were valid.

The conclusive evidence is that Rogers was reckless in offering and selling securities based on material misrepresentations and omissions that he made to the witnesses who purchased private placements. Rogers made sixteen sales of Trust Offerings after January 8, 2008, when he learned that the Four Funds had to be restructured, Smith had misrepresented their diversification of investments, and three of the Four Funds had invested \$8 million in alseT. Rogers recommended these sixteen purchases to clients without investigating these red flags and the red flags that existed earlier. Fowler gave persuasive testimony that Rogers falsely represented that the Four Funds and Trust Offerings, in which Fowler invested over \$3 million, were not high-risk investments.¹²⁵ Roger's sales of the Four Funds and Trust Offerings constituted a necessary part of MS & Co.'s fraud and were thus part of a device, scheme, or artifice to defraud in willful violation of Securities Act Section 17(a)(1) and Exchange Act Section 10(b)(5) and Rule 10b-5.

Rogers willfully violated Securities Act Sections 17(a)(2) and (a)(3) because, acting at least negligently, he obtained money by means of untrue material statements, i.e., his recommendation of these private placements indicated to his clients that he had some reasonable basis for believing they were good investments when he had done no investigation of their worth. By simply repeating the issuer's unchecked representations, he engaged in an act, practice, or course of business that operated as a fraud or deceit on his clients.

¹²⁵ The testimony of P. Loscalzo and J. Loscalzo is not persuasive because there are too many contradictions and emotions involved. It appears likely that Rogers gave a personal guaranty to P. Loscalzo on her \$25,000 investment and that he tried to fulfill that obligation.

Guzzetti

Exchange Act Section 15(b)(6)(A)(i), in conjunction with Section 15(b)(4)(E), authorizes the Commission, if it is in the public interest, to impose sanctions including an industry bar against a person associated with a broker or dealer who “has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision.” 15 U.S.C. §§ 78o(b)(4)(E), (6)(A)(i).

No person is deemed to have failed reasonably to supervise any other person if:

- (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and
- (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe such procedures and system were not being complied with.

15 U.S.C. § 78o(b)(4)(E).

A supervisor is a person with a “requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.” *Ronald S. Bloomfield*, 2014 SEC LEXIS 698, at *39-40 (quoting *George J. Kolar*, Exchange Act Release No. 46127, 2002 SEC LEXIS 3420, at *13 (June 26, 2002)). “In each situation a person’s actual responsibilities and authority . . . will determine whether he . . . is a ‘supervisor’ for purposes of [Exchange Act] Sections 15(b)(4)(E) and (6).” *Id.* at *40 (quoting *John H. Gutfreund*, Exchange Act Release No. 31554, 1992 SEC LEXIS 2939, at *47 n.24 (Dec. 3, 1992)) (alterations in original).

Guzzetti was a supervisor of the Selling Respondents because based on these facts and circumstances he had the requisite degree of responsibility, ability, and authority to affect the Selling Respondents’ conduct. Guzzetti played a major managerial and authoritative role at MS & Co. For example, Guzzetti and Mayer worked for nine months to change MS & Co.’s clearing broker from Bear Stearns to NFS, a change which seems to have been prompted by Guzzetti’s plans to change the emphasis towards a fee-based business model. Tr. 4601-07. On March 17, 2009, when MS & Co. was facing serious difficulties, Guzzetti was at the board meeting with Smith, McGinn, Livingston, and Mayer to discuss the firm’s 2008 and current financials. Div. Ex. 80.

Guzzetti was the main transmitter of information between Smith and the Selling Respondents. Tr. 3068 (“It just evolved that everything came through me.”). MS & Co.’s 2007 supervisory compliance manual listed Guzzetti as responsible for all outside registered representatives, which included Lex, and the 2008 supervisory compliance manual additionally listed him as supervisor with responsibility for reviewing correspondence for the Clifton Park office. Guzzetti Ex. 2; Div. Ex. 329. I reject, as too fine a distinction, Guzzetti’s position that he “supervised the [registered representatives] on the wealth management part of the business. I did not supervise when it came to the products that we are talking about in this proceeding.” Tr. 2968.

Guzzetti agreed that as Clifton Park branch manager, beginning in October 2006, he supervised registered representatives working from that office, which would have included Anthony, Feldmann, Chiappone, and Gamello. Guzzetti Answer at 2; Tr. 3009, 3223. Rogers testified he was supervised by several people including Guzzetti.¹²⁶ Tr. 3675. Guzzetti played a significant role in hiring Gamello in 2005, and during the entire period he worked with branch managers to fire registered representatives.

Guzzetti's authority within the firm is evidenced by his warning to the head of capital markets: "[U]ntil you attend my sales meetings on a regular basis[,] DON'T EVER QUESTION ME ABOUT MY KNOWLEDGE OF THE RETAIL BROKERAGE BUSINESS." Div. Ex. 114.

The evidence is that Guzzetti was the Selling Respondents' supervisor, he knew about their activities, and he failed reasonably to supervise them, with a view to preventing violations of the registration and antifraud provisions of the federal securities laws. Guzzetti did not give credible testimony. It is implausible that someone with a college degree who taught at the college level, and worked in the securities industry for twenty years in supervisory and training capacities, had never heard the term red flag in the brokerage context. Tr. 3140. It is also implausible that as a sales manager he was not well acquainted with the Four Funds notes that he was urging his sales force to sell. Tr. 2955.

In five years, Guzzetti did not send any e-mails or conduct any sessions urging investigation, care, or understanding of the product by the registered representatives that he supervised in the selling of these private placements. He simply left that to others. I find that Guzzetti failed to reasonably supervise Respondents, pursuant to Exchange Act Section 15(b)(6), with a view toward preventing their violations.

Sanctions

The Division's recommendations

The Division seeks to bar Selling Respondents from working in the securities industry pursuant to Exchange Act Section 15(b) and Investment Company Act Section 9(b), to impose cease-and-desist orders against Selling Respondents pursuant to Securities Act Section 8A and Exchange Act Section 21C, to order Selling Respondents to disgorge the commissions they received on the private placements at issue, plus prejudgment interest, pursuant to Securities Act Section 8A(e) and Exchange Act Sections 21B(e) and 21C(e), and to order Selling Respondents to pay third-tier civil monetary penalties for each violation that occurred since September 23, 2008, pursuant to Securities Act Section 8A(g) and Exchange Act Section 21B(a).¹²⁷ Div. Br. at 39-51.

¹²⁶ I do not accord any weight to Lowry's testimony that all Selling Respondents except Rabinovich and Livingston testified in their depositions that they reported to Guzzetti because I have not read the depositions. Tr. 1135, 1146.

¹²⁷ The Division asks for a bar under Securities Act Section 8A but the OIP does not mention the possibility of relief under that section, nor does there appear to be any provision in that section concerning industry bars, so it will not be considered. OIP at 14.

The Division also seeks to order Guzzetti to cease and desist from committing violations of the securities laws, to bar Guzzetti from working in the securities industry pursuant to Exchange Act Sections 15(b)(4)(E) and 15(b)(6)(A)(i), and to order Guzzetti to pay third-tier civil monetary penalties for his failure to supervise Selling Respondents during all of their sales after September 23, 2008, pursuant to Exchange Act Section 21B(a)(1)(D). *Id.* at 51-53.

Respondents' contentions

Respondents advance a number of arguments in support of their position that no sanctions are warranted. A common claim is that they did not commit the violations alleged. *See, e.g.*, RMR Br. at 44-49. Chiappone raises a number of defenses including that the statute of limitation bars the proceeding, the relief the Division seeks is inappropriate, and if injunctive relief is ordered, it should be limited in scope. Chiappone Br. at 70-86. Guzzetti maintains that the Division is prohibited from seeking a bar, a cease-and-desist order, or disgorgement against Guzzetti because it did not state it would seek these remedies in its prehearing brief, and he also raises the statute of limitations as a bar on remedies against him. Guzzetti Br. at 3-8. Lex raises constitutional considerations involving separation of powers, and maintains that to the extent the Division's claims are viable at all, they first accrued far more than five years before issuance of the OIP. Lex. Br. 4-27, 96-109. Livingston insists the claims are time barred, and that the public interest factors, discussed *infra*, do not support imposition of a bar. Livingston Br. 40-45.

Ruling

Industry and Associational Bar

Section 15(b)(6) of the Exchange Act authorizes a temporary or permanent industry bar against a person associated with a broker-dealer who has willfully violated any provision of the Securities Act or Exchange Act, if the bar is in the public interest. 15 U.S.C. §§ 78o(b)(4)(D), (6)(A). Section 15(b)(6) also authorizes a temporary or permanent industry bar against a person associated with a broker-dealer who has failed reasonably to supervise, if the bar is in the public interest. 15 U.S.C. §§ 78o(b)(4)(E), (6)(A). Investment Company Act Section 9(b) authorizes the Commission to impose bars against a person from associating with an investment company or certain affiliated persons if that person willfully violated the Securities Act or the Exchange Act, and if the sanction is in the public interest. *See* 15 U.S.C. § 80a-9(b)(2); *John P. Flannery*, Exchange Act Release No. 73840, 2014 SEC LEXIS 4981, at *135-36 (Dec. 15, 2014). With respect to the failure to supervise, the Commission has articulated that supervisory obligations imposed by the federal securities laws require a vigorous response to indications of wrongdoing, and that red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review. *Ronald S. Bloomfield*, 2014 SEC LEXIS 698, at *43 & n. 66.

Industry bars are considered penalties under Section 2462, and thus cannot be assessed for violations that occurred prior to five years before the filing of the OIP, or September 23, 2008. *See Johnson*, 87 F.3d at 489-92. There are, however, multiple recurrent violations that occurred on or after September 23, 2008. I have found that all Selling Respondents violated Securities Act Section 5 by selling unregistered securities and that all Selling Respondents, except Gamello, violated the antifraud provisions by making multiple offerings and sales of the MS & Co. private placements at

issue in this proceeding after September 23, 2008. I have also found that Guzzetti's failure to supervise violations took place after September 23, 2008, and until he left MS & Co. in late 2009.

To determine whether a sanction is in the public interest, the Commission considers the *Steadman* factors: the egregiousness of the respondent's actions; the isolated or recurrent nature of the infraction; the degree of scienter involved; the sincerity of the respondent's assurances against future violations; the respondent's recognition of the wrongful nature of his conduct; and the likelihood that the respondent's occupation will present opportunities for future violations. *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). The Commission's inquiry regarding the appropriate sanction is flexible, and no one factor is dispositive. *Gary M. Kornman*, Exchange Act Release No. 59403, 2009 SEC LEXIS 367, at *22 (Feb. 13, 2009), *pet. denied*, 592 F.3d 173 (D.C. Cir. 2010). The Commission also considers the age of the violation, the degree of harm to investors and the marketplace resulting from the violation, and deterrence. *See Schield Mgmt. Co.*, Exchange Act Release No. 53201, 2006 SEC LEXIS 195, at *35 (Jan. 31, 2006); *Marshall E. Melton*, Exchange Act Release No. 48228, 2003 SEC LEXIS 1767, at *4-5 (July 25, 2003).

Violation of the antifraud provisions is considered particularly egregious, warranting "the severest of sanctions under the securities laws." *Peter Siris*, Exchange Act Release No. 71068, 2013 SEC LEXIS 3924, at *23 (Dec. 12, 2013), *pet. denied*, 773 F.3d 89 (D.C. Cir. 2014). The violations at issue here were recurrent and continued for up to a year. Despite the blatant failures by Respondents, no Respondent evidenced an understanding that their activities involved wrongdoing. The reaction was to blame McGinn and Smith for committing fraud and for FINRA and the Commission for not discovering McGinn and Smith's illegal activities sooner. Respondents view everyone at fault but them. However, the proceeding is about their obligation to investigate the private placements they recommend and sell and their supervisor's duty to attempt to make sure they do so.

With the exception of Lex, the Respondents currently work in the securities industry, so there appears to be a strong likelihood for recurrence. "Because the securities industry presents continual opportunities for dishonesty and abuse, and depends heavily on the integrity of its participants and on investors' confidence, it is essential that the highest ethical standards prevail in every facet of the securities industry." *Donald L. Koch*, Exchange Act Release No. 72179, 2014 SEC LEXIS 1684, at *86 (May 16, 2014) (internal quotations and footnotes omitted). The deterrence effect as to the whole securities industry is also heightened by the fact that several of the Respondents' experts testified that they believed the Respondents' violative conduct met industry norms.

Based on all considerations, including the other measures ordered in this Initial Decision, I find that Anthony, Lex, and Livingston should be permanently and collaterally barred, pursuant to Exchange Act Section 15(b)(6), and permanently prohibited from associating with the enumerated persons in Investment Company Act Section 9(b). Chiappone, Mayer, Rabinovich, and Rogers should be collaterally suspended for twelve months, pursuant to Exchange Act Section 15(b)(6), and prohibited from associating with the enumerated persons in Investment Company Act Section 9(b) for the same period. I find that Guzzetti should be collaterally suspended for twelve months pursuant to Exchange Act Section 15(b)(6). I decline to impose any bar on Gamello, because his

only violation was selling unregistered securities, and I find that the fact that he only sold those securities to accredited investors is a significant mitigating factor.

Cease and Desist Order

Section 8A of the Securities Act and Section 21C of the Exchange Act authorize issuance of a cease-and-desist order against any person who has violated the Securities Act or a rule or regulation thereunder, or the Exchange Act or rule or regulation thereunder, respectively. 15 U.S.C. §§ 77h-1(a), 78u-3(a). In determining whether to issue a cease-and-desist order, the Commission considers essentially the same factors as in *Steadman*; although there must be some likelihood of future violations whenever the Commission issues a cease-and-desist order, the required showing is “significantly less than that required for an injunction.” *KPMG Peat Marwick LLP*, Exchange Act Release No. 43862, 2001 SEC LEXIS 98, at *101, *114, *116 (Jan. 19, 2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002). Absent evidence to the contrary, a single past violation ordinarily suffices to establish a risk of future violations. *Id.* at *102-03, *114-15 & n.147. In addition, the Commission considers “whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceedings.” *Id.* at *116. The Commission weighs these factors in light of the entire record, and no one factor is dispositive. *Id.*; *Montford & Co.*, Advisers Act Release No. 3829, 2014 SEC LEXIS 1529, at *88 (May 2, 2014).

I have considered the *Steadman* factors and found that they weigh heavily in favor of sanctions. A cease-and-desist order against Respondents will serve the public interest by specifying that they can no longer engage in such misconduct, and will put them and others on notice that similar misconduct is unacceptable. A cease-and-desist order against the Selling Respondents, except for Gamello, is thus issued. A cease-and-desist order is not appropriate against Guzzetti, because a failure to supervise violation cannot be grounds for a cease-and-desist order. *Johnny Clifton*, Securities Act Release. No. 9417, 2013 SEC LEXIS 2022, at *61 n.109 (July 12, 2013).

Disgorgement

Securities Act Section 8A(e) and Exchange Act Sections 21B(e) and 21C(e) of the Exchange Act authorize disgorgement in cease-and-desist proceedings where civil monetary penalties may be imposed.¹²⁸ 15 U.S.C. §§ 77h-1(e), 78u-2(e), 78u-3(e). Disgorgement is an equitable remedy designed to deprive the wrongdoer of unjust enrichment and thereby deter violations of the securities laws. *SEC v. First Pac. Bancorp.*, 142 F.3d 1186, 1191 (9th Cir. 1998); *see also SEC v. Fischbach Corp.*, 133 F.3d 170, 175 (2d. Cir. 1997); *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1474 (2d Cir. 1996) (“The deterrent effect of an SEC enforcement action would be greatly undermined if securities law violators were not required to disgorge illicit profits.”). Disgorgement need only be a reasonable approximation of profits causally connected to the securities law violation, but the SEC must distinguish between legally and illegally obtained profits.

¹²⁸ The OIP also sought disgorgement under Section 203 of the Advisers Act and Section 9 of the Investment Company Act, OIP at 14, but in post-hearing briefing, the Division did not pursue disgorgement under those statutes. *See* Div. Br. at 39. Accordingly, I analyze disgorgement only under the Securities and Exchange Acts.

SEC v. First City Fin. Corp., 890 F.2d 1215, 1231 (D.C. Cir. 1989). Disgorgement is an equitable remedy not subject to the statute of limitations in Section 2462. *Johnson*, 87 F.3d at 491.

In accordance with these legal authorities, I order the Selling Respondents, except Gamello, to disgorge the commissions gained as a result of their sales of the Four Funds and Trust Offerings, which are a reasonable approximation of their ill-gotten gains and causally connected to their violations of the antifraud violations. I have considered the Selling Respondents' arguments regarding the appropriate disgorgement amount, and I find them unconvincing.

I find that all Selling Respondents, except Gamello, had requisite scienter to violate the antifraud provisions by at least February 1, 2008. This date is almost a month after Selling Respondents learned about the Four Funds' junior note default and that Smith had misled them regarding the Four Funds' diversification, investments in alseT, and conflicts. Selling Respondents, except Gamello, are ordered to disgorge all commissions earned on sales after that date, in the following amounts. Anthony shall disgorge \$18,904. Div. Ex. 2, Ex. 4b (as attached to Div. Ex. 2). Chiappone shall disgorge \$103,800. Div. Ex. 2, Ex. 4d (as attached to Div. Ex. 2). Lex shall disgorge \$335,066. Div. Ex. 2, Ex. 4l (as attached to Div. Ex. 2). Livingston shall disgorge \$1,120. Div. Ex. 2, Ex. 4n (as attached to Div. Ex. 2). Mayer shall disgorge \$34,962. Div. Ex. 2, Ex. 4p (as attached to Div. Ex. 2). Rabinovich shall disgorge \$158,542. Div. Ex. 2, Ex. 4r (as attached to Div. Ex. 2). Rogers shall disgorge \$137,942. Div. Ex. 2, Ex. 4t (as attached to Div. Ex. 2). I find that Gamello's only violation was selling unregistered securities, and sufficient mitigating factors render disgorgement inappropriate. Prejudgment interest from March 1, 2008, through the last day of the month in which disgorgement is paid, shall also be included. 17 C.F.R. § 201.600(a).

Civil Money Penalties

Exchange Act Section 21B(a) authorizes the Commission to impose civil monetary penalties against any person where such penalties are in the public interest and the Commission has found that such person (1) has willfully violated, or aided and abetted violations of, certain provisions of the securities laws; or (2) has willfully made or caused to be made a materially false or misleading statement, or omitted any material fact, in a report required to be filed with the Commission; or (3) has failed reasonably to supervise, within the meaning of Section 15(b)(4)(E), with a view to preventing violations by a person subject to his supervision, and in a cease-and-desist proceeding where a violation has been found.¹²⁹ 15 U.S.C. § 78u-2(a). Section 21B(a) sets out a three-tiered system for determining the maximum civil penalty for each act or omission. Second-tier penalties may be imposed if the misconduct involved fraud, deceit, or deliberate or reckless disregard of a regulatory requirement. *Id.* Third-tier penalties are applicable where the misconduct involved

¹²⁹ The OIP and the Division's brief cites as additional authority for imposition of a penalty Securities Act Section 8A(g), 15 U.S.C. § 77h-1(g). This section was part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), which was enacted after the conduct at issue occurred, I therefore decline to impose civil penalties under that provision. Additionally, although the OIP cited to Section 203(i) of the Advisers Act and Section 9(d) of the Investment Company Act as bases for potential civil penalty relief, the Division's brief cites only to Exchange Act Section 21B(a) and Securities Act Section 8A(g). *See* OIP at 14; Div. Br. at 40-41.

fraud, deceit, or deliberate or reckless disregard of a regulatory requirement and resulted in “substantial losses or created a significant risk of substantial losses to other persons” or “substantial pecuniary gain” to the respondent. *Id.* The D.C. Circuit has held that “to impose second-tier penalties, the Commission must determine how many violations occurred and how many are attributable to each person.” *Rapoport v. SEC*, 682 F.3d 98, 108 (D.C. Cir. 2012). Presumably, the same approach should be taken with respect to civil penalties at the third-tier level.

To determine whether a penalty is in the public interest, the statute calls for consideration of: (1) whether the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm caused to others; (3) any unjust enrichment; (4) any prior violations; (5) the need for deterrence; and (6) such other matters as justice may require. 15 U.S.C. § 78u-2(c).

The statute of limitations applies to civil monetary penalties, so only conduct occurring on or after September 23, 2008, can be assessed for penalty purposes. 28 U.S.C. § 2642; *Johnson*, 87 F.3d at 488.

Under the Exchange Act, the maximum amount of civil penalty for a violation by a natural person between September 23, 2008, and March 3, 2009, at the first tier is \$6,500, at the second tier is \$65,000, and at the third tier is \$130,000. 17 C.F.R. § 201.1003, Subpt. E, Table III. The maximum amount of civil penalty for a violation after March 3, 2009, at the first tier is \$7,500, at the second tier is \$75,000, and at the third tier is \$150,000. 17 C.F.R. § 201.1004, Subpt. E, Table IV.

I have previously found that except for Gamello, Respondents’ conduct encompassed the elements necessary for a penalty at the third-tier level, and that the *Steadman* considerations indicated a need for strong measures. I therefore assess, for violations of the antifraud provisions and Securities Act Section 5, one third-tier penalty of \$130,000 each for Anthony, Chiappone, Lex, Livingston, Mayer, Rabinovich, and Rogers. For failing to reasonably supervise, I assess one third-tier penalty of \$130,000 as to Guzzetti. I do not impose a penalty on Gamello.

Fair Fund

Pursuant to Commission Rule of Practice 1100, 17 C.F.R. § 201.1100, I require that the amount of disgorgement, prejudgment interest, and civil money penalties be used to create a Fair Fund for the benefit of Respondents’ clients harmed by the violations.

Record Certification

Pursuant to Commission Rule of Practice 351(b), 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the Record Index issued by the Secretary of the Commission on February 6, 2015.

Order

I ORDER that, pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934:

Donald J. Anthony, Jr., William F. Lex, and Thomas E. Livingston, are BARRED from association with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, and from participating in any offering of penny stock, which includes: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer, or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock; and

Frank H. Chiappone, Andrew G. Guzzetti, Brian T. Mayer, Philip S. Rabinovich, and Ryan C. Rogers are SUSPENDED for twelve months from association with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization, and from participating in any offering of penny stock, which includes: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer, or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

I FURTHER ORDER that, pursuant to Section 9(b) of the Investment Company Act of 1940:

Donald J. Anthony Jr., William F. Lex, and Thomas E. Livingston, are PERMANENTLY PROHIBITED from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and

Frank H. Chiappone, Brian T. Mayer, Philip S. Rabinovich, and Ryan C. Rogers are PROHIBITED FOR TWELVE MONTHS from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

I FURTHER ORDER that, pursuant to Section 8A of the Securities Act of 1933, and Section 21C of the Securities Exchange Act of 1934:

Donald J. Anthony, Frank H. Chiappone, Jr., William F. Lex, Thomas E. Livingston, Brian T. Mayer, Philip S. Rabinovich, and Ryan C. Rogers shall CEASE AND DESIST from committing or causing violations, and any future violations, of Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933; and Section 10(b) of the Securities Exchange Act of 1934 and Exchange Act Rule 10b-5.

I FURTHER ORDER that, pursuant to Section 8A(e) of the Securities Act of 1933, and Sections 21B(e) and 21C(e) of the Securities Exchange Act of 1934:

Donald J. Anthony shall DISGORGE \$18,904; Frank H. Chiappone shall DISGORGE \$103,800; William F. Lex shall DISGORGE \$335,066; Thomas E. Livingston shall DISGORGE

\$1,120; Brian T. Mayer shall DISGORGE \$34,962; Philip S. Rabinovich shall DISGORGE \$158,542 and Ryan C. Rogers shall DISGORGE \$137,942, plus prejudgment interest.

Prejudgment interest shall be calculated at the underpayment rate of interest established under Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), shall be compounded quarterly, and shall run from March 1, 2008, through the last day of the month preceding the month in which payment is made. 17 C.F.R. § 201.600.

I FURTHER ORDER that, pursuant to Section 21B(a) of the Securities Exchange Act of 1934:

Donald J. Anthony, Frank H. Chiappone, Andrew G. Guzzetti, William F. Lex, Thomas E. Livingston; Brian T. Mayer, Philip S. Rabinovich, and Ryan C. Rogers shall each PAY A CIVIL MONEY PENALTY in the amount of \$130,000.

I FURTHER ORDER that, pursuant to 17 C.F.R. § 201.1100, any funds recovered by way of disgorgement, prejudgment interest, or penalties shall be placed in a Fair Fund for the benefit of investors harmed by the violations.

I FURTHER ORDER that no remedial action is appropriate as to William P. Gamello, pursuant to Section 8A of the Securities Act of 1933, Sections 15(b), 21B and 21C of the Securities Exchange Act of 1934, and Section 9(b) of the Investment Company Act, and the proceeding is DISMISSED as to him.

Payment of disgorgement, prejudgment interest, and civil penalties shall be made no later than twenty-one days following the day this Initial Decision becomes final, unless the Commission directs otherwise. Payment shall be made in one of the following ways: (1) transmitted electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) direct payments from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or (3) by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order, payable to the Securities and Exchange Commission.

Any payment by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order shall include a cover letter identifying the Respondent and Administrative Proceeding No. 3-15613, and shall be delivered to: Enterprises Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Bld., Oklahoma City, Oklahoma 73169. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall

have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Brenda P. Murray
Chief Administrative Law Judge

Exhibit C

TAIN 7%08

Investment Register

CLT TYPE	COMNAME	INVEST REGISTRATION	PRD DESC	PRD DESC2	TOT PAID	TICKETED AMOUNT	CURRENT VALUE	TOT INVOICED	TOT OWED	TOT PAYMENTS	FIRST PAYMENT	LAST PAYMENT	INVEST STATUS	INVEST MATURITYDT	INVEST ORIG
JTWROS	William F & Kathleen C Lex	WILLIAM F. LEX & KATHLEEN C. LEX JTWROS	THIRD ALBANY INCOME NOTES LLC	THIRD ALBANY INCOME NOTES DUE 12/15/2008	0	5000	0	0	0	2	15-Dec-07	23-Apr-09	TRANSFERRED	15-Dec-08	NEWL
INDIV	Kathleen Lex	KATHLEEN C LEX	THIRD ALBANY INCOME NOTES LLC	THIRD ALBANY INCOME NOTES DUE 12/15/2008	5000	5000	5000	5000	0	1	23-Apr-09	23-Apr-09	OPEN	15-Dec-08	TRANSFER
JTWROS	William F & Kathleen C Lex	WILLIAM F LEX & KATHLEEN C LEX JTWROS	THIRD ALBANY INCOME NOTES LLC	THIRD ALBANY INCOME NOTES DUE 12/15/2008	0	10000	0	0	0	2	15-Dec-07	23-Apr-09	TRANSFERRED	15-Dec-08	NEWL
INDIV	Kathleen Lex	KATHLEEN C LEX	THIRD ALBANY INCOME NOTES LLC	THIRD ALBANY INCOME NOTES DUE 12/15/2008	10000	10000	10000	10000	0	1	23-Apr-09	23-Apr-09	OPEN	15-Dec-08	TRANSFER
JTWROS	William F & Kathleen C Lex	WILLIAM F. LEX & KATHLEEN C. LEX JTWROS	THIRD ALBANY INCOME NOTES LLC	THIRD ALBANY INCOME NOTES DUE 12/15/2008	25000	150000	0	25000	0	2	15-Dec-07	23-Apr-09	TRANSFERRED	15-Dec-08	NEWL
INDIV	Kathleen Lex	KATHLEEN C LEX	THIRD ALBANY INCOME NOTES LLC	THIRD ALBANY INCOME NOTES DUE 12/15/2008	125000	125000	125000	125000	0	1	23-Apr-09	23-Apr-09	OPEN	15-Dec-08	TRANSFER

FAIN 7.75%
Investment Register

CLT TYPE	COIN NAME	INVEST REGISTRATION	PRD DESC	PRD DESC2	TOT PAID	TICKETED AMOUNT	CURRENT VALUE	TOT INVOICED	TOT OWED	TOT PAYMENTS	FIRST PAYMENT	LAST PAYMENT	INVEST STATUS	INVEST MATURITYDT	INVEST ORIG
JTWROS	William F & Kathleen C Lex	WILLIAM F. LEX & KATHLEEN C. LEX JTWR0S	FIRST ADVISORY INCOME NOTES, LLC	SECURED SENIOR SUBORDINATE D NOTES DUE 11/15/2008	0	100000	0	0	0	2	03-Apr-06	10-Sep-09	TRANSFERRED	15-Nov-08	NEWL
INDIV	Kathleen Lex	KATHLEEN C LEX	FIRST ADVISORY INCOME NOTES, LLC	SECURED SENIOR SUBORDINATE D NOTES DUE 11/15/2008	100000	100000	100000	100000	0	1	10-Sep-09	10-Sep-09	OPEN	15-Nov-08	TRANSFER

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

-----X
SECURITIES AND EXCHANGE COMMISSION

Plaintiff,

vs.

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

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

Defendants,

LYNN A. SMITH and
NANCY McGINN,

Relief Defendants. and

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

Intervenor.
-----X

**ORDER APPROVING THIRD MOTION OF WILLIAM J. BROWN, AS
RECEIVER, FOR AN ORDER DISALLOWING CERTAIN CLAIMS
(BROKER CLAIMS)**

Upon the Third Motion of William J. Brown, as Receiver, for an Order
Disallowing Certain Claims (Broker Claims); and notice of the Motion having been given to
the Securities and Exchange Commission, each Broker listed on Exhibit A to the Motion,
Kathleen Lex, and Kimellen Lex, by first class mail, and all parties who have filed a Notice
of Appearance in this action by ECF, and all creditors of the McGinn, Smith entities and

other parties in interest via the Receiver's website, which notice is deemed good and sufficient notice; and the Court having deemed that sufficient cause exists; it is therefore

ORDERED, that the Motion is approved, and it is further

ORDERED, that each of the Broker Claims listed on Exhibit A to the Motion is disallowed; and the rights of the Receiver to object on any other basis to the claims of all investors or claimants is expressly preserved.

Dated: April ____, 2018

HON. CHRISTIAN F. HUMMEL

Doc #01-3106322.3

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

-----X
SECURITIES AND EXCHANGE COMMISSION

Plaintiff,

vs.

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

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

Defendants,

LYNN A. SMITH and
NANCY MCGINN,

Relief Defendants. and

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

Intervenor.
-----X

CERTIFICATE OF SERVICE

I, Karen M. Ludlow, being at all times over 18 years of age, hereby certify that on March 19, 2018, a true and correct copy of the Notice of Motion and Third Motion of William J. Brown, as Receiver, for an Order Disallowing Certain Claims (Broker Claims) (“Motion”) was caused to be served by e-mail upon all parties who receive electronic notice in this case pursuant to the Court’s ECF filing system, and by First Class Mail to the parties indicated below:

- **William J. Brown** wbrown@phillipslytle.com,khatch@phillipslytle.com
- **Certain McGinn Smith Investors**apark@weirpartners.com
- **Elizabeth C. Coombe** elizabeth.c.coombe@usdoj.gov, paul.condon@usdoj.gov, CaseView.ECF@usdoj.gov,kelly.ciccarelli@usdoj.gov
- **William J. Dreyer** wdreyer@dreyerboyajian.com, bhill@dreyerboyajian.com, lowens@dreyerboyajian.com,coconnell@dreyerboyajian.com
- **Scott J. Ely** sely@elylawpllc.com,shm@fwc-law.com
- **James D. Featherstonhaugh** jdf@fwc-law.com,jsm@fwc-law.com,cr@fwc-law.com,shm@fwc-law.com
- **James H. Glavin** , IVhglavin@glavinandglavin.com

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- **Andrew Park** apark@weirpartners.com, imarciniszyn@weirpartners.com
- **Thomas E. Peisch** TPeisch@ckrpf.com, apower@ckrpf.com
- **Terri L. Reicher** Terri.Reicher@finra.org
- **Richard L. Reiter** reiterr@wemed.com, richard.reiter@wilsonelser.com
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And, I hereby certify that on March 19, 2018, I mailed, via first class mail using the United States Postal Service, a copy of the Motion to the individuals listed below:

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Dated: March 19, 2018

/s/ Karen M. Ludlow
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