UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION *Plaintiff*, vs. 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.*	Case No. 1:10-CV-457 (GLS/CFH))

RESPONDENT FRANK CHIAPPONE'S RESPONSE TO THE 3RD MOTION OF WILLIAM J. BROWN, AS RECEIVER, FOR AN ORDER DISALLOWING CERTAIN CLAIMS (BROKER CLAIMS)

PLEASE TAKE NOTICE, that Frank Chiappone, through his attorney, Roland M. Cavalier, does hereby contest the Third Motion of William J. Brown, as receiver (hereinafter "Third Motion") insofar as the Third Motion seeks to disallow the claim of Mr. Chiappone, in his capacity as a

purchaser of $50,000 of Third Albany Income Notes ("TAIN") for his own account. The details of his purchase are set forth in Exhibit A of the Receiver's Third Motion.

The essence of the Receiver's Third Motion is that the brokers who bought McGinn Smith & Co. private placement securities should not be allowed to participate in the partial payments to be made to all other investors, because the Chief Administrative Law Judge ("ALJ") who presided over the civil proceeding instituted by the Securities & Exchange Commission's Division of Enforcement (herein, "SEC" or "Division"), has found that the brokers who are the subject of the Third Motion "knowingly or recklessly" recommended unregistered private placements securities to their clients, with no reasonable basis for such recommendations.[1]

The ALJ's findings are found in her Initial Decision, dated February 25, 2015. The reasons that we believe that the motion should be denied, or at the least, put in abeyance pending completion of the decision of the Commissioners (and pending appeal to the applicable Circuit Court of Appeals, should the Commissioners ratify the ALJ's Initial Decision) are set forth below.

1. **The ALJ's Initial Decision Has Not Been Ratified.** The ALJ's Initial Decision is not the same as the decision of a trial court judge. Pursuant to 17 C.F.R. § 10.84 the Initial Decision may become the decision of the Commission within 30 days after it is served, unless it is appealed by a party. Mr. Chiappone did appeal the Initial Decision, as did most other brokers. The appeal is to the commissioners of the SEC. Briefs were filed to the Commissioners, and oral argument was held at the SEC's Washington, D.C. office on August 15, 2017. However, no decision has been rendered by the Commissioners, so the ALJ's Initial Decision still has no effect, and it cannot serve as the basis for the Receiver's position that Mr. Chiappone should not be entitled to a proportionate share of the proceeds available for distribution to customers who purchased these private placement securities. Because of such appeal, Mr. Chiappone and the other respondent brokers have the right to continue to practice their profession pending the outcome of the appeal to the Commission. As of this date, no decision has been rendered by the Commissioners, and therefore the findings of the ALJ have no legal effect.

2. **ALJ's Decision May be Moot due to Constitution's Appointments Clause.** The Receiver's motion is based solely on the Initial Decision of the ALJ. However, the respondent brokers have challenged the authority of the ALJ to preside over the administrative hearings, as she is an inferior officer, and she was not appointed in compliance with the Appointments Clause

[1] See Receiver's Declaration, at page 4.

of the U.S. Constitution (Constitution, Art. 2, Clause 2). The U.S. Court of Appeals for the Tenth Circuit in *Bandimere v. U.S. Securities & Exchange Commission* has held that SEC administrative law judges are inferior officers, and as such, they were not appointed in compliance with the U.S. Constitutional appointments clause.[2] In *Raymond James Lucia v. SEC,* the D.C. Circuit held that SEC ALJ's were not subject to the appointments clause. However, on January 12, 2018, the US Supreme Court granted Certiorari in the *Lucia* case and that court will be specifically address the issue of whether the SEC ALJ's were appointed in compliance with the Constitution. Accordingly, this court should either allow Mr. Chiappone to receive his proportionate share of the distribution or, at the least, direct the Receiver to set aside the amount Mr. Chiappone would receive until such time as he has completed all of his appeals, including his petition to the Commissioners and any subsequent appeal to the 2nd Circuit Court of Appeals. If his proportionate share of the funds is disbursed to the non-broker investors, he would be unable to recover even if he prevailed on his appeals.

3. **Mr. Chiappone Played No Role In, And Was Unaware of McGinn and Smith's Fraud (Ponzi Scheme).** No proof was submitted and no finding was made that Mr. Chiappone knew of the fraud perpetrated by Messrs. Smith and McGinn. Moreover, there was written proof that Smith and McGinn deliberately withheld from the brokers the fact that they were paying investors in insolvent offerings with money from new investors in more recent offerings. This proof can be found in the document colloquially known as the "Dave Smith Confession." [3] While bearing no date, that document can be dated to late 1999 or early 2000 by its contents.[4] Written by Mr. Smith and intended for Mr. McGinn, but apparently never delivered, the document contains the following admissions:

> "I believe that we are at risk for the continual raising of investment dollars that are now clearly unlikely to be repaid in full. … More recently, those dollars for the most part are used to fulfill the investment promised to earlier investors. While you have previously rejected my characterization of these acts as similar to a "Ponzi Scheme" because new dollars being raised are in fact buying new product, and only "profit dollars" are being used to cover shortfalls, I believe that our actions could be defined otherwise. ***The reason for my belief is that we are now in possession of indisputable empirical evidence that the new investments have no chance of being repaid in***

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[2] See, *Bandimere v. Securities and Exchange commission,* 844 F 3d 1168, 1179-1187 (10th Cir. 2016).
[3] See, Livingston Exhibit 31. A typed version is also in evidence as Livingston Exhibit 32.
[4] For testimony establishing the time frame of the undated document, see Chiappone testimony, Tr., pp. 5613 – 5615.

> ***full.*** Whether less than 100% collections (66%) is due to normal attrition, fraud, billing errors, or poor credit judgment, it really does not matter. The facts are that we will never collect 100% or close to it. Therefore, our "profits" which we use are not profits at all, but rather monies that should be held in reserve to allow for the deficit collections for the protection of the new investors. For us not to allow for these deficits by setting up adequate reserves is, in my judgment, bordering on fraud. Certainly, by not disclosing in the prospectus our poor history of collections, we are not providing the prospective investor an accurate picture of his risk. ***We both know why we don't make that disclosure – because such disclosures would cause our salesmen to cease selling and investors to cease buying. Thus we are misleading both our own employees and customers.*** *... We knew the poor collection history, and yet continued to raise money as if we were ignorant of our own collection experience."* (emphasis supplied).

Despite the fact that this document (in evidence) makes it crystal clear that Messrs. Smith and McGinn made every effort to hide the fact that they were using investor's money from recently issued deals to prop up failing prior offerings, the ALJ premised her finding that Mr. Chiappone violated securities laws on the theory that he should have discovered the fraud committed by his superiors.

5. <u>The ALJ Ignored that the SEC and NASD failed to Discover the Fraud During Their Own Investigations.</u> The concept that Mr. Chiappone should have discovered the fraud is preposterous. There was testimony that the SEC, and NASD (now called FINRA) conducted routine investigations of MS & Co. over the years, which is common practice for brokerage firms and investment advisors. Yet, these organizations, whose duty it is to periodically investigate companies that serve the investing public, all failed to discovery that MR & Co. was engaged in a Ponzi scheme over a long period of time. Nevertheless, the ALJ held that the brokers employed by that company should have known of the fraud.

6. <u>ALJ's Decision on Liability Erroneous-Hanly & Progeny Misconstrued</u>. While Mr. Chiappone understands that this court does not have any ability to countermand the decision of the ALJ, it is important to understand that Mr. Chiappone and the respondent brokers believe that the chief flaw in the ALJ's Initial Decision was her determination that the brokers were responsible for not having discovered the fraudulent Ponzi-like activities of Messrs. Smith and McGinn. There was no finding that Mr. Chiappone had ever <u>participated</u> in the fraudulent activities that lead to the collapse of the MS & Co. organization and the related investor losses. In fact, there was no factual finding that Mr. Chiappone was even <u>aware</u> of the fact that Messrs. Smith and McGinn were

propping up failed investments by applying customer funds received in more recent offerings. Rather, the ALJ determined that Mr. Chiappone *should have known* of the fraud committed by his superiors.

This is quite an unusual finding, since The SEC's key witness, forensic accountant Kerri Palen, testified at length about the considerable time and attention she spent in discovering and documenting the fraud. Ms. Palen, a CPA who performed fraud examinations for three accounting firms before her employment by the SEC, testified that she had extensive experience in fraud investigations, both at her prior employers, and at the SEC.[5] She worked on the McGinn Smith case from May, 2011 until January of 2014, a period of 33 months or almost three full years, during which time she spent almost 50% of her time on the McGinn Smith case.[6] In spite of the fact that it took Ms. Palen almost three years to fully unearth and document the fraudulent acts of Smith and McGinn, the SEC attorneys argued and the ALJ ruled that the brokers, including Mr. Chiappone, could or should have discovered the fraud before the government investigators raided the MS & Co. offices and shut down MS & Co. operations. This ruling defies logic and ignores the realities of how brokerage firms operate. Within the McGinn Smith organization, there was a division of labor that is similar to any firm that marketed private placement securities. That division of work is as follows:

1. Messrs. Smith and McGinn researched and initially investigated the underlying investments (McGinn primarily as to the trust offerings and Smith as to the Four Funds).

2. The due diligence team, then also conducted due diligence on the trust offerings.

3. Private Placement Memorandums (PPM's") were prepared by the firm's in-house attorney and accountant, sometimes with assistance from outside law firms.

4. The PPM's were distributed to the brokers to read and pass along to potential customers.

5. Meetings were held with the brokers in which the features of the investments were discussed and brokers could and did ask questions.

6. The brokers would then conduct "customer-specific due diligence" to verify that a newly minted offering was or was not suitable for each particular customer.

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[5] See Palen testimony at Jan 28th Transcript pp. 389-390.

[6] See Palen testimony, at Jan. 28th Transcript pp. 392-393.

Ms. Palen testified that she found that McGinn & Smith used moneys from the Four Funds offerings to redeem failed alarm offerings of earlier vintage, a classic feature of Ponzi schemes. However, under cross-examination, she admitted that she found no documentary evidence that Mr. Chiappone (or any of the other brokers) participated in the misuse of customer funds to prop up earlier offerings. She further admitted that she found no documentary evidence that Mr. Chiappone or other brokers were even aware of this misuse of customer funds. She also admitted that she found no other (i.e., non-documentary) evidence that Mr. Chiappone was aware of the Ponzi-like activities of Messrs. Smith and McGinn, or that he had any connection whatsoever to the misuse of customer funds.[7]

Notwithstanding this testimony by the SEC's own forensic accountant, the ALJ ruled that the brokers should have duplicated the work done by their bosses, the due diligence team, the in-house accountant, the in-house and outside legal counsel. This runs contrary to the manner in which any brokerage firm finds, vets, researches and structures offerings of private placement securities.

The ALJ also ignored the fact that NASD (now FINRA) and the SEC conducted their own periodic investigations of McGinn Smith & Co., and they totally failed to discover the fact that McGinn Smith & Co. was propping up failed or troubled offerings with monies from new investors, even though they had the time and expertise to make such an investigation.

Because the ALJ's decision ignored that key testimony, and because that decision relied in significant part on the holdings of *Hanley v. SEC* and subsequent cases citing to that decision, it is our belief that the ALJ's Initial Decision will be overturned by either the Commissioners or, should they uphold the Initial Decision, by the applicable circuit court of appeals (in Mr. Chiappone's case, the 2nd Circuit Court of Appeals).

7. Analysis of Hanly and its Progeny. Again, we understand that this court cannot overturn the Initial Decision, but to understand the flaws in the ALJ's determination of liability, one must understand why we believe the ALJ misconstrued relevant case law.

A. Mr. Chiappone Was Not Involved in the Fraudulent Activity. The SEC's claims against Chiappone are not based not upon affirmative untruths, misstatements or intentional non-disclosures. Instead, the SEC's claims are anchored in the broker's "duty to inquire" or "duty

[7] Feb. 28th Transcript pp. 393-400. In fact, Ms. Palen admitted that she saw nothing in the SEC's

to investigate." The ALJ made no finding that Mr. Chiappone was involved in the fraudulent acts or was even *aware* of the fraud committed by Smith and McGinn at the time he sold the securities at issue. Rather, she premised her finding of liability on an alleged failure to discover the fraud, claiming that he did not comply with a "duty to investigate," a concept found in *Hanley v. SEC* (hereinafter "*Hanly*") and its progeny.[8]

A number of cases do hold that when a broker makes a recommendation, he must have an adequate basis for the recommendation (*Hanley*, 415 F2d 589, 597; *SEC v. Milan Capital Group,* 2000 U.S. Dist. Lexis 16204 (SDNY 2000), *SEC v. Hasho*, 784 F Supp 1059 (SDNY 1992)). Brokers are under a duty to investigate and a broker cannot recklessly state facts about matters on which he has no knowledge. He has to read available sales literature and cannot blindly accept recommendations made in sales literature *if he has reason to know otherwise*. In making a recommendation, a registered representative implies that a reasonable investigation has been made and his recommendation relies on that investigation. However, even a failure to inquire does not rise to the level of fraud under the securities laws, without a showing of knowledge or recklessness.

Mr. Chiappone fulfilled his duty to inquire by independently reviewing and analyzing the terms and risks of the various investments and by making his own individualized assessments of the suitability of the investments for each client. He read the private placement memorandums, attended meetings at which the MS & Co. due diligence team explained each offering, asked questions when he wanted additional information, and personally conducted calculations on debt service coverage.[9] The due diligence on the viability of each product offering for the Trust Offerings (reasonable basis due diligence) was done by the due diligence team at MS & Co, as was testified to in great detail by Mary Ann Cody, in-house legal counsel.[10] MS & Co. had a first-rate due diligence team that vetted the pre-2003 alarm deals. That team returned to MS & Co. in 2006, and conducted similar diligence on the alarm and triple play deals offered from late 2006 through 2009.

Mr. Chiappone did his own customer-specific due diligence in compliance with NYSE Rule 405. Based on the collective efforts of the MS & Co. due diligence team and his own

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[8] See, *Hanley v. SEC*, 415 F2d 589, 597 (2d Cir. 1969)

[9] Chiappone testimony, Tr. pp. 5559 – 5560 (as to reading PPM's); 5479 – 5481 (as to debt service calculations); and Tr. pp. 5426 – 5427 (as to attendance at due diligence presentations).

[10] Cody testimony, Tr. pp. 4545 – 4552.

work, Mr. Chiappone had a reasonable basis on which to recommend the investments to a select group of his clients for which he determined the investment would be suitable.

B. The Hanly Decision. The duty of a registered representative does not require the representative to duplicate due diligence that has already been performed by the brokerage firm on the underlying investments of any offering, as the ALJ ruled. Instead, the applicable standard as set forth in *Hanly* is as follows:

> "By his recommendation, he [a securities salesman] implies that *a reasonable investigation has been made* and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information." (emphasis supplied) *Hanly*, 415 F.2d 589, 597 [2d Cir. 1969]).

Hanly requires that a reasonable investigation has been made; it does not require that individual brokers must perform every step in the due diligence process personally. The factual context of *Hanly* is critical in understanding why *Hanly* was misconstrued by the ALJ. The facts in *Hanly* are markedly different from those in this matter. First, *Hanly* involved equity securities in an unseasoned high tech company. This matter involves a series of fixed income (debt) offerings created and run by the same management team, which was seasoned in such offerings, and had a track record that (at the time of the offerings) was thought to be exemplary.[11] In *Hanly*, the representatives made a number of affirmative statements guaranteeing the meteoric success of an over-the-counter stock they were selling, despite knowing that "[f]rom its inception the company operated at a deficit" potential merger negotiations with two major companies had failed, the US Navy had cancelled orders, and the company had been adjudicated a bankrupt.[12] Critically, despite knowing of those past failures, the representatives nonetheless made affirmative statements of sure success, such as claiming that the stock price "would go from 6 to 12 [dollars per share] in two weeks."[13] The brokers in the *Hanly* case had no factual basis on which to base any predictions of success, and had nothing other than pure speculation as to price increases. Accordingly, the court properly held that the brokers had acted recklessly.

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[11] Chiappone testimony, Tr. pp. 5466 (as to reliance on MS & Co. track record).
[12] *Hanly*, 415 F2d at 592-593.
[13] *Hanly,* 415 F2d at 593.

To the contrary, the issuers/managers of the Four Funds and Trust Offerings were not strangers to Chiappone. Chiappone had extensive personal familiarity with the prior success of the MS & Co. structured investments, had known and worked with MS & Co. management for years, and had personally sold scores of private placement investments structured or underwritten by MS & Co. that had yielded good returns for investors. He had a more than a reasonable basis on which to recommend MS & Co. private placements, particularly those which were based on recurring monthly revenue streams, such as alarm monitoring receivables and triple-play (Phone, Internet & Cable TV) receivables. In recommending these notes, he relied on what he believed to be a seasoned issuer of privately placed debt. That the principals of MS & Co. were in fact involved in systemic fraud was not known to anyone (including the SEC and NASD) until early 2010. This was because the fraud had been concealed by Messrs. McGinn and Smith, as was admitted in the handwritten document authored by Mr. Smith.[14] While *Hanly* may impose a duty on brokers, it does not alter the requirements of *scienter* imposed by relevant case law, and that case law requires more than simple negligence for fraud-based securities statutes. Hence, it is submitted that the holding in *Hanly* is based on facts that are clearly distinguishable from the facts in the present case.

It is also important to note that *Hanly* requires only that *"a reasonable investigation has been made"* and that the broker's recommendation rests on conclusions based on such investigation. It does not require that the broker *himself* make that investigation. That duty was imposed on the individual broker in *Hanly* because no one else made such an investigation, rendering Mr. *Hanly's* representations without any foundation. To the contrary, Mr. Chiappone was entitled to rely on the very real and substantial investigations made as to the Trust Offerings, as testified to by Ms. Cody and himself.[15] In the case of the MS & Co. private placements, the due diligence was assigned to the firm, which employed a substantial due diligence team. This was set out in the 2007 and 2008 Compliance Manuals introduced into evidence:

> "Due Diligence Procedures. When McGinn Smith acts as underwriter in connection with limited partnership and/or private placement offerings, *it will make a reasonable investigation of the project* to include inspection of completed projects, conversations with in-house counsel where applicable, a complete examination of financial documents and any

[14] See the so-called "Dave Smith Confession," SEC Ex. 350, and also; Livingston Ex. 31 (see Tr. 5619), mistakenly marked as Livingston Ex. 30 (see Tr. 5613). A typed version is also in evidence as Ex. Livingston-32 (Tr. p. 5619).

[15] Ms. Cody testified as to the due diligence procedures for the pre-2003 alarm deals (Tr. pp. 4545 – 4549) and Mr. Chiappone testified that the due diligence team returned to MS & Co. in 2006 and vetted all Trust offerings sold after their return (Tr. pp. 5430 & 5447).

other documents deemed necessary to deal fairly with the investing public. Paperwork recording the due diligence will be kept in the legal files."[16]

It is submitted that Mr. Chiappone was entitled to rely on the investigations made by the due diligence team, which had the education and background to conduct due diligence on the Trust Offerings.

C. SEC Holding Expands Hanly & its Progeny Beyond Its Scope.

The key problem with the ALJ's application of *Hanly* and its progeny is that it turns the actual manner in which the brokerage industry is structured on its head. Almost all brokerage houses employ analysts whose duty it is to study the markets and individual securities and make recommendations. The registered representatives then sell what the analysts and investment committees recommend. In fact, to do otherwise is itself a prohibited practice, known as "selling away." Similarly, MS & Co. had its private placement Trust Offerings structured by the investment bankers and vetted by a due diligence team that was substantial.[17] The Four Funds investments were structured by the investment bankers at MS & Co. Application of the *Hanly* line of precedent to this situation would require Chiappone to ignore the work of the persons assigned to locate, structure and conduct due diligence on the investments, and duplicate the entire due diligence on his own, to make investment recommendations based upon his own analysis, a process in which he or virtually any registered representative utterly lacks the necessary education and training.[18] Yet, in this case, the ALJ held that an individual broker, who has nowhere near the resources of the SEC, NASD or any Self-Regulatory Organization, should have discovered what those same agencies failed to unearth during their routine audits of MS & Co.[19] The SEC's key witness (forensic accountant Kerry Palen) admitted that she was aware that the OCIE division of the SEC conducted an investigation of MS& CO. sometime around 2003, but she was not aware that they discovered any fraud.[20]

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[16] MS & Co. 2007 Compliance Manual, Guzzetti Ex. 2, at p.42 (in evidence at Tr. p. 2996); MS & Co. 2008 Compliance Manual, Division exhibit DIV – 329, at page 44.

[17] Testimony of Mary Ann Cody, Tr. pp. 4545 – 4552.

[18] For instance, the Division's theory suggests that it was the registered representative's responsibility to conduct their own due diligence on the Firstline Trusts investments. Ultimately, Firstline filed for bankruptcy and the Firstline Trusts investments failed because a creditor arguably possessed a superior claim to the assets that were supposed to generate revenues for the Firstline Trusts. The due diligence staff, which presumably included in-house and/or outside counsel, was unable to discern the risk that a creditor would have a priority claim to the assets, yet the Division posits that the registered representatives could have and would have discerned that risk.

[19] See NASD investigation dated May 14, 2007 (Exhibit Div-501).

[20] Palen testimony on cross-examination, Tr. pp. 475 – 477.

In conclusion, it is our belief that Mr. Chiappone was innocent of any unlawful conduct, and that he is entitled to the benefit of the doubt until all appeals are exhausted. To grant the Receiver's Third Motion without awaiting result of the appeals to the Commissioners and the Second Circuit, would be to make Mr. Chiappone's argument moot as to his right to share in the assets recovered by the Receiver that will be distributed to the investors.

Attached as **Exhibit "A"** to this Brief Replying to the Receiver's Third Motion are copies of the relevant pages of the hearing transcripts that are referenced in the footnotes and excerpts from any other documents so referenced herein. Exhibit "A" does not include the document referenced in footnote #1, as that document is in the Receiver's motion papers and cases cited herein.

Dated: April 13, 2018

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CERTIFICATE OF SERVICE

I, Roland M. Cavalier, hereby certify that on this 13th day of April, 2018, I served a true and complete copy of Respondent Frank H. Chiappone's Reply Brief opposing the Receiver's Third Motion, seeking to disallow payment of funds recovered by the Receiver to Mr. Chiappone and the other Respondent stock brokers who were the subject of the hearings held by the SEC's Administrative Law Judge. :

By Federal Express to:

Securities and Exchange Commission
Office of the Secretary
U.S. Securities and Exchange Commission
100 F. Street, NE
Mail Stop 1090
Washington, D.C. 20549
Facsimile (202) 772-9324

One (1) copy via Federal Express to:

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Roland M. Cavalier

Sworn to before me this
13th day of April, 2018.

Notary Public – State of New York

LINDSEY A. MEYER
Notary Public, State of New York
No. 01ME6336544
Qualified in Rensselaer County
Commission Expires 02/08/20

EXHIBIT "A"

EXCERPTS FROM HEARING TRANSCRIPTS AND OTHER DOCUMENTS REFERENCED IN THE FOOTNOTES OF THIS REPLY BRIEF

FOOTNOTE 4

Page 5613

F. Chiappone

been more focusing in on insurance-backed products for my clients.

Q. Have you sold a single private placement since you left McGinn Smith?

A. No.

Q. Have you offered a single private placement since you left McGinn Smith?

A. No.

MR. CAVALIER: Exhibit 48A, previously marked 48 but now has highlighted text to it.

Your Honor, I believe this exhibit is in evidence as a Livingston exhibit but I wasn't here that day it was put in evidence. I was here, however, last Friday when Mr. Stoelting read from it. I would like to ask questions so we can put a date on the email.

JUDGE MURRAY: I don't need all that. FC 48A.

MR. BIRNBAUM: It is Livingston 30 if that is helpful.

MR. CAVALIER: It is already in evidence as Livingston 30, your Honor. The only difference is I have highlighted some passages on this.

Page 5614

F. Chiappone

Q. You agree with me there is no date on this email. Correct?

A. Correct.

Q. Let's see if we can't figure out from the text its time frame. Would you turn to the page marked 4 of 28, please?

Are you there?

A. It is there.

Q. I will read you two passages and ask you a question. You understand this to be a letter that was written by David Smith to Tim McGinn but we don't know if it was delivered?

A. Correct.

Q. Reading from the first highlighted passage, "We have worked together for over 20 years." Then below, "Building and holding together a business for over 20 years is no small feat."

Now, do you know when McGinn Smith was formed?

A. I believe 1980.

Q. 20 years from 1980 would take us to the end of 1999?

A. Right.

Page 5615

F. Chiappone

MR. CAVALIER: Raymond, the page labeled 15 of 28?

Q. Do you see -- let me know when you have that?

A. Okay.

Q. Do you see some figures in a table on that page?

A. Yes.

Q. I am going to read a passage and ask you a question.

"Thus, we need to raise $48 million in 2000. 12,400,000 more than 1999, a 35 percent increase."

Do these two passages we have read from page 4 and page 15 tell you where this email or a time frame within which this letter may have been written?

A. Somewhere in '99 to 2000.

Q. Well, if they are talking about raising funds in 2000, could we conclude it was somewhere early in 2000?

A. Yes.

Q. Now I have a just a couple questions for you and then we'll be done.

Page 5616

F. Chiappone

Page 30? Again I will read and ask you a question.

"I have chosen to put my thoughts on paper rather than express them in our planned monthly meeting with Brian and Mary Ann on Wednesday evening for several reasons, first and foremost, the present crisis we are facing is really our crisis and our discussions should remain confidential."

Did Tim or Dave or anyone ever speak to you about a crisis that occurred sometime in the 1999-2000 time frame?

A. No, not at all.

Q. Did you ever become aware from any other source, prior to this proceeding, of any crisis in the 1999-2000 time frame?

A. None whatsoever.

Q. Page 6, please, of 28? I will read two passages and ask you a question.

A. Okay.

Q. "I am sure that you will agree that if our trusts go into default everything else will come apart. The business has become addicted to the cash flows from the trust business and

FOOTNOTES 5 & 6

the case. You can say I am going to show you something that you used to have, but that can't be the evidence in the case.

MR. MALONEY: Absolutely, your Honor. Absolutely.

JUDGE MURRAY: Let me see if I can function on this. Is the actual exhibit going in evidence the 4Q -- you know what that is?

MR. MALONEY: I do, your Honor. Just so the record is clear, the document that you saw up on the screen is the January 13th version, January 13, 2014, of Ms. Palen's declaration, and on Saturday, this past Saturday Ms. Palen revised those numbers and we received a revised version on Sunday afternoon.

So, due to just not having enough time to get the electronic version loaded up, that is the reason for the hiccough.

JUDGE MURRAY: Okay. And if you want to put something old in to show something, you can put it in. I don't have any problem. I just have to make sure that somebody reading this transcript who isn't here today can follow this. That is what I have to be sure of.

Sorry for the interruption.

Q. Ms. Palen, I have handed you a document that is marked Exhibit 420. Is that a trade ticket?

A. It looks like it is a trade ticket.

Q. It is a trade ticket for Mr. Hill's purchase of $270,000 in TAIN, 10.25 percent notes in December 2004?

A. I have no way of knowing if this is a final ticket or -- there is words on the top that says "Void, new number."

Q. The trade ticket does not list broker code 59, does it?

A. No.

Q. It lists broker code 700?

A. That's what it lists here.

Q. And broker code 700 does not appear on your chart at Exhibit 4Q; correct?

A. So it wasn't in the investor database.

Q. And broker code 700 is not Mr. Rabinovich?

A. Not that I know of.

MR. MALONEY: I have no further questions. I would move Exhibit 420 into

evidence.

JUDGE MURRAY: I am going to hold off on the exhibits until we finish the witness.

Is there somebody else that is going to cross?

MR. CAVALIER: I am going to go next if that is okay with the Court.

CROSS-EXAMINATION

BY MR. CAVALIER:

Q. Morning, Ms. Palen.

A. Morning.

Q. I am Roland Cavalier, here on behalf of Frank Chiappone. I will ask you some questions about your testimony under examination by the Division.

You are a certified public accountant; correct?

A. Yes.

Q. To do that you need to have a four-year degree in accounting from a college?

A. Yes.

Q. And you need to pass a very rigorous examination to become a CPA, don't you?

A. I am having a hard time hearing you.

MR. ABRAMSON: I as well. Can you speak up a little?

Q. You need to pass a very rigorous examination to become a CPA; correct?

A. Correct.

Q. Four or five different parts taken at different times?

A. I took the whole thing at one time.

Q. And you passed it?

A. Yes.

Q. You also have worked now for I think it is 11 years at Deloitte. Correct?

A. Deloitte.

Q. They are a very large, very well-reputed accounting firm. Correct?

A. Correct.

Q. Did you do fraud work for them, fraud investigations when you were at Deloitte?

A. Yes.

Q. Then you said you worked at Alvarez and Marsal. I think I got that correct?

A. Correct.

Q. You did litigation support for them?

A. Yes.

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K. Palen - Cross

Q. Would that include fraud investigations?
A. Yes.
Q. Identification of fraud and things like that?
A. Yes.
Q. Then with Markham LLC; correct?
A. Correct.
Q. Litigation support again?
A. Correct.
Q. More fraud examination with that firm?
A. Similar.
Q. Is that a law firm or accounting firm?
A. It is an accounting firm.
Q. After that you have been with the SEC for how many years now?
A. Three years.
Q. Pardon me?
A. Three years.
Q. And during that time you have done fraud examinations. Correct?
A. And provided accounting advice and assistance.
Q. So you have got a lot of experience in

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ferreting out fraud, spotting fraud when you see it in financial statements. Correct?
A. Yes.
Q. You said you worked on the McGinn Smith matter from April or May of 2011 until the present?
A. On and off.
Q. Correct –
A. On and off, yes.
Q. You worked during that period of time is all that I am asking?
A. On and off, yes.
Q. So you had other cases?
A. Correct.
Q. Do you have any idea of the percentage of your time that was spent on the McGinn Smith matter during the three years? And I will take your best guess.
A. Maybe -- I honestly have not thought about it.
Q. More than half?
A. Just give me a minute and I will think about it and I will give you an answer.
Q. Sure.

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(Pause.)
A. Maybe a little less than half.
Q. All right. But a significant portion of your time?
A. Yes.
Q. More than any other case that you were working on?
A. At times.
Q. As a result of that work you prepared the very comprehensive report, the declaration that is sitting in front of us. Correct?
A. As well as a lot of other reports for other matters.
Q. Okay. And that declaration lays out significant acts of wrongdoing on the part of Tim McGinn and David Smith. Correct?
A. Correct.
Q. I would like to discuss some of those acts of wrongdoing. First I would like to discuss the allegation or the category of acts that Four Funds money were used to redeem the pre-2003 alarm deals. All right?
A. Okay.
Q. Basically that is the allegation in

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paragraphs 25 through 50. There is a lot of details but basically what you are saying is that the Four Funds took money from investors and then they used that money to redeem or pay off notes issued earlier in the so-called alarm deals. Correct?
A. McGinn Smith notes; yes.
Q. I think you said they did that by two methods. One was by loaning money to one of the earlier alarm trusts and the other was by purchasing assets from that entity. Correct?
A. Correct.
Q. Did you see, in the course of your investigation, any document that indicated to you that Mr. Chiappone participated in any of the transactions described in that section of the declaration?
A. That wasn't something that I was working on.
Q. Well, the question was did you see any documents?
A. I don't see any.
Q. And the same question for the rest of the registered representatives. In the course

FOOTNOTE 7

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A. Yes.
Q. Identification of fraud and things like that?
A. Yes.
Q. Then with Markham LLC; correct?
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Q. You worked during that period of time is all that I am asking?
A. On and off, yes.
Q. So you had other cases?
A. Correct.
Q. Do you have any idea of the percentage of your time that was spent on the McGinn Smith matter during the three years? And I will take your best guess.
A. Maybe -- I honestly have not thought about it.
Q. More than half?
A. Just give me a minute and I will think about it and I will give you an answer.
Q. Sure.

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(Pause.)
A. Maybe a little less than half.
Q. All right. But a significant portion of your time?
A. Yes.
Q. More than any other case that you were working on?
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A. Correct.
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A. That wasn't something that I was working on.
Q. Well, the question was did you see any documents?
A. I don't see any.
Q. And the same question for the rest of the registered representatives. In the course

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of your investigation did you see any documents that indicated any of the registered reps that are respondents in this matter participated in any of the transactions in that section of your declaration?

A. The only thing that I can think of is -- and I don't know if you would consider this participation, but I do know that one of Mr. Rabinovich's clients was redeemed with the funds that were advanced to Pacific Trust.

Q. In the course of your examination, did you see any document that indicated that Mr. Chiappone even knew about any of the transactions set forth in that section of your declaration?

A. That wasn't part of what I was asked to look at.

Q. But the question is, did you see a document that indicated Mr. Chiappone even knew about those transactions --

A. Knew about the transactions? No.

Q. -- that are set forth in that section of the declaration, the use of the Four Funds money for the pre-alarm trusts?

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A. No.

Q. Did you see, with the exception of the redemption of the Rabinovich client, did you see any documents that indicated to you that any other registered representative even knew about the transactions as you have outlined at paragraphs 25 through 50?

A. No.

Q. Separate and apart from documents which we can talk about, did you come across any other evidence that Mr. Chiappone either participated, knew about any of the transactions in paragraphs 25 through 50?

A. We are still talking about the pre-2003?

Q. Yes. 25 through 50 is the use of Four Funds money to pay off pre-2003 alarm investors.

A. Correct.

Q. The question was, separate from documents, did you any other evidence come to your attention that indicated Mr. Chiappone knew about any of those transactions?

A. No.

Q. Did you come across any other evidence

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that indicated that any of the other respondents in this matter knew about any of those transactions setting aside the Rabinovich redemption?

A. No.

Q. There is nothing in your declaration, is there, that Frank Chiappone had any connection to any of the transactions that you have identified in your declaration as fraudulent transactions. Correct?

A. Correct.

Q. And that would be the same for other registered representatives. Correct?

A. Correct.

Q. I think we can agree that it is the SEC's position not so much that the respondents participated in the transactions or knew of the fraud but that they should have known of the fraud. Is that your understanding of what the Division's position is?

MS. MARLIER: Objection.

MR. MALONEY: She is looking at her counsel.

MS. MARLIER: Probably because I stood

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up. Ms. Palen is not here to testify about what the Division's litigation positions are on various issues.

JUDGE MURRAY: I think we were around on this with the Division yesterday, whether you all are being -- whether the allegation is that you knew or whether you were reckless or whether you were negligent.

Certainly they are accusing you of negligence, but the reckless and scienter, the case law as I understand it -- and I will have to do more research -- is basically the same. So, when you say did they know about, then you get into this were they reckless in not knowing about it.

So, the Division is not giving in that they didn't know, that they didn't have scienter.

Now, that is what I think their position is. I am sure they disagree with me but that is the way I read it.

But her objection, the Division's objection, is that this witness is not an attorney. Now, you have got where she said

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certain things in her declaration and you should be able to ask her about those. What exact question -- could you repeat your question or do you want us to have it --

MR. CAVALIER: Let me rephrase my question.

Q. Did you read the OIP as part of your investigative work?

A. Yes.

Q. Did you see any allegations in the OIP that Mr. Chiappone knew about any of the transactions in your entire declaration?

MS. MARLIER: Objection, your Honor. The OIP speaks for itself.

JUDGE MURRAY: No. I will overrule the objection. Do you understand the question?

THE WITNESS: I do.

A. You are asking me if I saw anything where -- I am sorry. Can you say it again?

Q. Not where you saw. I asked did anything that you read in the OIP state that Mr. Chiappone knew about any of the transactions you outlined in your declaration?

A. I don't think so.

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Q. All right. Would the same be true for the other registered representatives? There is nothing in there that says they knew about these transactions in your declaration?

A. In my declaration, correct.

Q. That is all I wanted to know.

Now, I see only two ways that a registered representative could know of these transactions. One would be if he saw a document and the other is if he was told something. Do you know of any other ways that they could have discovered this wrongdoing?

JUDGE MURRAY: Now, wait a minute. I think we are getting a little bit far afield here. Is there anything in the declaration that talks about what you are talking about? To ask a witness a big question like that --

MR. CAVALIER: She is a certified fraud examiner. She detects fraud. That is her job. She is very good at it. What I am wondering is, if they didn't see a document and they weren't told about it, how else would they know about it? I think she is competent to answer the question.

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JUDGE MURRAY: Okay. You are right, I am wrong. She is a certified fraud examiner.

Do you understand the question?

THE WITNESS: I understand the question. But I was summarizing the facts that I looked at during my -- I mean, I wasn't acting in that capacity of looking at the whole entire, you know, situation, to kind of make a very big conclusion like that.

JUDGE MURRAY: But do you have an answer to his question? Even if what you say is true and accurate, but he's got you under cross-examination and he is going to try to raise questions about your exhibit and he is going to ask you what he asked you.

Do you want to repeat it now? Is there any other way or how could they --

MR. CAVALIER: Let me preface that. Regardless whether the Division gives up on the proposition of whether they actually knew, part of their case, regardless of what their position is on that, is that they should have known.

So, I am asking her questions about what they should have known, how they could have

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known what they should have known. And I think they are relevant questions, your Honor.

A. They could have asked for the financial statements.

Q. I am going to get to that in a bit, all right? But that is a document. Other than seeing a document or being told, is there any other way that you know that they could have informed themselves of this fraud that was taking place that their bosses were perpetrating?

A. They could have asked for documents that showed what they invested in, they could have asked for financial statements.

Q. Right.

A. They could have asked questions of Mr. Smith. I mean, I am just...

Q. But the first categories come under the question of seeing a document. Correct? We'll get into that, the balance sheets and so on.

A. Okay. Then I am not clear on what you are asking me.

Q. I am sorry. I am just asking that,

FOOTNOTE 9

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R. Bove

advance of one of those letters and told you the letter was coming?
A. Yes.
Q. Other than that, do you ever remember Mr. Lex telling you about anything going on inside of McGinn Smith at the time?
A. I don't recall. I am sure if there was he would have talked to me about it.
Q. And that is because you relied on him and trusted him?
A. Oh, I do.
Q. And I think you said you -- you said that you got preferential treatment. I was wondering what you meant by that?
A. No. I thought the -- well, I am still under the understanding that what I purchased has a preferential treatment with the receiver. In other words, when he distributes the money, although he tells me that's not going to happen, that he should distribute the senior notes first before the junior notes. That is what I meant by preferential treatment.
Q. And who told you that?
A. That's what my understanding of what

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the senior notes are.
Q. But in terms of the treatment that that note would get in the course of the receiver's distribution, who told you -- did Mr. Lex tell you that senior notes would get preference when the receiver distributes money?
A. Actually, I talked to the receiver personally about it and he said yes, that's true but the judge doesn't go along with that.
Q. You have spoken to the receiver?
A. Oh, yes. At least twice.
Q. And you understand that there are nearly a thousand investors that the receiver is dealing with?
A. Sure.
Q. Do you understand the receiver sent a letter to investors saying that because of the number of investors, that all of the information relating to the receivership is on the receiver's website?
A. I don't believe all of it is, but yes. He has a website that I have looked at many times.
Q. All right. Thank you, Doctor.

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F. Chiappone

JUDGE MURRAY: Is there any redirect?
MR. ABRAMSON: No, your Honor.
JUDGE MURRAY: Then the witness is excused. Thank you, Doctor.
We'll take a couple minutes as the witness steps out.
Whereupon,
FRANK F. CHIAPPONE,
having been previously duly sworn/affirmed, was examined and testified further as follows:
JUDGE MURRAY: You remember you are under oath.
CONTINUED DIRECT EXAMINATION
BY MR. CAVALIER:
Q. Mr. Chiappone, before we get to the red flags, do you have a correction to make as to some testimony you gave yesterday with respect to reading the PPM's?
A. Yes.
Q. Go ahead and clarify if you would.
A. I believe I mentioned yesterday I read all the PPM's. For the record, went through the PPM's to state that I read each and every passage and every page in the PPM would most

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F. Chiappone

likely say that I did not read each and every word and every sentence throughout the PPM's.
Q. What did you read?
A. The risk factors associated with it, use of funds, assets that were in the PPM.
So, what I thought were the pertinent pieces. Things that, as I looked through them, I felt were boilerplate that I had seen before, most likely just went over those.
Q. Let's move on then to red flags.
Do you understand that one of the claims the SEC has is that after the restructuring of the Four Funds no more investments should have been sold or something to that effect?
A. Yes.
Q. Do you recall when the Four Funds were restructured?
A. The first notification of it was in January of '08.
MR. CAVALIER: Can I call up Division 243, please, Raymond?
Q. I am going to ask you to read from it looks like the email from yourself sent Tuesday,

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F. Chiappone - Direct

do you have up and above what is required to pay that asset's interest.

Q. What, if anything, did you do about performing asset coverage calculations on the private placements that you marketed?

A. If it was -- are you referring to the Four Funds notes or talking about --

Q. Let's do the Four Funds notes first.

A. Okay. One of the things that Mr. Smith mentioned when he was formulating the Four Funds notes was that he felt comfortable in sharing with us that the gross return that he felt he could achieve on the assets after expenses was going to be in the 12 percent range.

So we could then say, okay, if we are raising $20 million, 12 percent off $20 million, we would have $2.4 million.

We could then take a look at what was required to pay the debt service coverage on the senior tranche of paper, which was 25 percent of the 20 percent at 5 and-a-quarter or 5 and three-quarter percent.

So you would say, okay, you have

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F. Chiappone - Direct

2.4 million. Out of that, you would require -- say if it was $375,000 to pay the interest on the $5 million, how many times would the 375 go into the 2.4 million. So you had a multiple of how much cash was up and above required to pay the senior note holders.

You could then take what you needed to have interest payable for the junior note holders, add that to what was required for the seniors. Take that gross amount, divide that into the 2.4 million, and it gave you a ratio of how many times you had coverage to cover both the senior and senior subordinated.

Add the interest requirement for the junior note holders to those two other calculations, divide that into the 2.4 million, and that would give you a coverage ratio of what was available to pay for the junior note holders after the seniors and senior subordinated were covered.

Q. And did you make these calculations with respect to the Four Funds before you sold the Four Funds?

A. Yes.

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F. Chiappone - Direct

Q. With respect to each of them separately?

A. Yes.

Q. Did you reduce those calculations to writing?

A. I believe I did.

Q. But you don't have them anymore. Correct?

A. I don't believe I have them.

Q. Do you know where they went?

A. I don't recall. A significant number of my notes were at a prior law firm, and I think after a period of time they discarded my files.

Q. Did you continue to be as selective as to which clients you were offering private placements with the Four Funds as you had on previous deals?

A. Yes, I believe I was.

Q. What kind of clients did you offer the Four Funds to?

A. Again, primarily clients looking for income.

Your Honor, when we came out of the

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F. Chiappone - Direct

alarm notes, again with the successful history we had, we felt it was successful. The clients didn't see a hiccough, so they felt it was successful also.

When they formulated what ultimately became Integrated Alarm Services, they did a rollup of these investments and issued new bonds by Integrated Alarm Services when they acquired the old collateral that had been backing the prior alarm notes.

Ultimately, when they raised the $200 million from Integrated Alarm Services in the stock offering, they took that $200 million and a majority of it, a fair amount went to paying off all the bonds that had been issued to the prior noteholders.

So we had clients that were getting 11 percent, 12 and-a-half, 12 percent on their prealarm deals. We then gave them 12 percent in these new bonds.

When they cashed the bonds in and actually called in all the bonds -- the client didn't have a choice of still holding the 12 percent paper. They were getting cashed out.

FOOTNOTE 10

M. Cody

subscriber agreement.

Q. What was the other model? What did it morph to?

A. It shifted to the fact that we would actually acquire the subscriber contracts outright.

Q. Tell me about the due diligence process on the alarm deals.

A. On the alarm dealer we'd start out, one, with a site visit to his place. If he operated his own central station or to the central station which the security alarm dealer or entity used.

We would do a litigation lien and judgment search. We'd review all their financials. We'd look at their incorporation document certificate, good standing. There was also a UL certificate that the central station has to have to make sure it is properly authorized to monitor home alarm systems.

So we do a whole profile of the security alarm dealer or security alarm company as the case was.

Q. All right. --

M. Cody

A. And then --

Q. If you didn't finish, please continue.

A. The second part of the due diligence was actually on the contracts we were financing, or acquiring. We would have delivered the original contracts, every one of them sent to our offices, where we would --

Q. When you talk about contracts, talking about the individual homeowners?

A. Homeowner contract. And I had a team that worked under me that did contract review. Now this included examining every single subscriber agreement, making sure it was properly executed and had a term of a certain amount of years, everything was clearly stated and it was an enforceable agreement.

They would also make a telephone call to the subscriber, one, to check that the subscriber was actually connected to the central station, and, two, to see the subscriber had actually executed the agreement.

Now, as we continued in this mode, of course, you know, the numbers grew and we were financing thousands of contracts. So we

M. Cody

actually acquired from a company in Albany, New York, formerly known as KeyCorp Leasing, they had merged with Society Bank in Cleveland, Ohio, and were relocated.

So we acquired a due diligence team right out of KeyCorp Leasing and twelve of their personnel came over that worked under me to help me accomplish what I just said.

Q. KeyCorp was the parent company which ran KeyBank?

A. That's correct.

Q. KeyBank is a national bank whose footprints spans the entire northern tier of the United States from east coast to west coast and whose stock is traded on the stock exchange. Is that the same company?

A. That is the same company.

Q. When Key Leasing -- when KeyCorp discontinued its leasing arm, you hired how many people?

A. I would say about 12 or 13 from there.

Q. What was their background and why did you feel they would be an appropriate hire for --

M. Cody

A. Well, they were experts in terms of due diligence and leasing and in collections and billing. At some point we had decided that in order to make this run as best and as securely as we could, we would take on the actual billing function ourselves so that we would no longer rely on the security alarm dealer with whom we financed to do the billing. We would actually do the billing and the collection effort to ensure that we would have the greatest amount of -- or percentage of collections as possible.

Q. When you did your due diligence did you document it in paper?

A. Yes, we kept files. Actually hard copies on everything. We also --

Q. Where were they kept, the hard copies?

A. We had a room in our building downstairs where we installed a number of fireproof file cabinets. So all the original subscriber agreements, the monitoring contracts were in these fireproof safes as was the due diligence on the individual security alarm dealers and/or companies.

Q. You also kept some stuff upstairs

M. Cody

that --

A. Yes. Active files. Because there were covenants within the financing documents that the security alarm dealer would have to cooperate in the event there were subscriber defaults and they would have to replace that with performing contracts. So they did have an ongoing covenant.

Q. Just for clarity, the bidding you are talking about is the 99 Pine Street, Albany headquarters of McGinn Smith?

A. That's correct.

Q. Who prepared the Regulation D documentation during the time that you were general counsel?

A. I did for several years I did the Reg D offering work. And we would typically do a 506 exempt offering. And I filed the Form D until about the year 2001 when we had Gersten Savage. We were thinking about consolidating the whole business and creating one new company, and then Gersten took over.

Q. They are securities lawyers from New York City?

M. Cody

A. Yes, they are.

Q. I am going to go backwards a little to the due diligence team. You talked about hiring 12 or 13 people from KeyCorp. Who from McGinn Smith was part of that due diligence team? Start with you. You were part of the team; correct?

A. Yes. As counsel I oversaw the due diligence team.

Q. All right.

A. We also had our CFO at the time, Brian Shea, he worked primarily with the due diligence team, just overseeing the billing and collections department.

Q. Okay.

A. And we also hired Doug Keholtz, who wasn't part of the KeyCorp Leasing, he was a young RPI grad, to also assist us in the due diligence. He was there to do site reviews, go out and meet with the security alarm dealers, make sure they were doing what they were supposed to do.

Q. How about Tim?

A. Tim was actually the deal-maker. Tim

M. Cody

would be going to trade shows, be out there connecting with the industry to see who needed financing, who wanted to sell their paper, who wanted to expand their business.

We were, in essence, providing financing for the security alarm industry, and that included trade shows in Vegas, and I think there were a couple in New York as well.

Q. What, if anything, did Dave Smith have to do with the due diligence on the alarm deals?

A. He didn't.

Q. You were at the top of the team. What is the tier below you? Who would be on the tier below you?

A. Well, below me was a woman who came from KeyCorp Leasing, Pat Decker. She was my chief due diligence officer in terms of being responsible for all the contract review of the new contracts and the security alarm dealer review.

Then there was a gentleman named Joe Sinitsky, also a top employee from KeyCorp Leasing, that took over collections, billings and collections. He oversaw that end of the

M. Cody

operation.

So we expanded and took a portion of the third floor. McGinn Smith was located on the fifth floor, and we ended up needing a lot more space so we took space on the first floor and the third floor as well.

Q. Was the due diligence team kept separate from the brokers if you know?

A. Yes.

Q. You said that Tim was the deal-maker. Let me ask a couple questions. Who sort of decided which deal McGinn Smith would do and which deal McGinn Smith would pass on?

A. Tim.

Q. Who structured the alarm deals in terms of the offering, the interest rates and such?

A. Tim.

Q. Were any of the brokers involved in any way with creating or structuring the alarm paper?

A. Not at all.

Q. Was Cooper part of the due diligence team, as well, Brian Cooper?

FOOTNOTE # 11

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F. Chiappone - Direct

objectives of the clients and the funds because of the history that I had seen from working with McGinn Smith since 1988.

Q. What, if anything, did you know about Smith's qualifications to manage a multimillion dollar portfolio?

A. Again, going back on my history of the various transactions Mr. Smith had put together, being on the board of Empire State College, running the investment fund there, structuring of the project in the Saratoga City Center.

Q. What was the Saratoga City Center project, if you can give us a little detail?

A. The city constructed a complete -- let's call it a civic center in Saratoga Springs. And to raise capital for that, McGinn Smith structured a bond offering. It was before I joined the firm.

The way the transaction worked -- I believe it might have been a limited partnership, but the city actually leased the facility from the partnership. And every year there was a clause that the rent would go up every year. So the investors each year received

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an increasing dividend stream.

Ultimately, the city -- and they were depreciating the asset as it was on the books. Ultimately, the city acquired the facility from the private -- from the investors, and it happened right at the time when capital gain rates had gone back down to 15 percent. So all the recapture of those gains to the investors was taxed at the lowest tax rate. That was how the city center operation worked.

Q. What else did you know about -- withdrawn.

Were you aware of Dave's work with respect to medical facilities?

A. Yes. The firm had done a financing before I joined the firm with a group called Southern Tier Imaging. It's a diagnostic imaging facility across from the Wilson Hospital in Binghamton, New York. The radiology group leased the facility from the partners and eventually the radiology group acquired the facility, similar to the civic center.

The investors were again captured at a more favorable tax rate.

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F. Chiappone - Direct

Q. Anything else --

A. In addition to that, there were two facilities right in the Albany market. A same day surgical center with, I believe, six or eight -- excuse me, four operating rooms, where you could go for outpatient surgery, as well as a diagnostic imaging center right in the Albany market also.

Q. All done?

A. Last was a bond issue for a hospital in Gloversville, New York, looking to expand and almost double the size of the hospital. We did the financing for that particular hospital also.

Q. Did David Smith have a book of business that he had brokerage clients?

A. Yes, he did.

Q. Who managed those accounts?

A. Dave was managing them himself at the time.

Q. Do you have any idea of the size of Dave's book of business?

A. I do not.

Q. Taking into account all you just talked about, what was the level of confidence

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F. Chiappone - Direct

you had in Dave to select investments for the Four Funds?

A. Very, very strong at that time.

Q. At that time, you were not aware of any of the conduct that resulted in Mr. McGinn and Mr. Smith ending up in jail?

A. No, not at all.

Q. To what extent did you rely on the track record of the early offerings in selling the offerings that are the subject of the OIP?

A. I believe, again going back, the success was one thing that you could always fall back on. But I believe I viewed the success as a result of the people that were running the offerings prior to the OIP and basing it on their expertise at putting together transactions.

Again, going back to that time, myself, and I would probably say none of the other advisors knew of any of the problems that have been introduced since the OIP with any of the prior offerings.

Q. I think you said you offered something like 64 of the earlier offerings?

FOOTNOTE 14- EXCERPTS FROM
"DAVE SMITH CONFESSION"

DUE TO THE ILLEGIBILITY OF MR. SMITH'S HABDWRITING, WE HAVE PROVIDED TYPEWRITTEN EXCERPTS OF RELEVANT PASSAGES, TOGETHE WITH RELEVANT PORTIONS OF THE HANDWRITTEN DOCUMENT.

I have chosen to put my thoughts on paper rather than express them in our planned meeting with Brian and Mary Ann on Wednesday evening for several reasons. First and foremost, the present crisis we are facing is really our crisis, and our discussions should remain confidential.

Secondarily, I am sensitive to the fact that there may come a time when they may be asked to recount these discussions, and I would not want either of them to be in a position that forces them to choose between testimony harmful to us or perjury.

I am sure you will agree that, if our trusts go into default, everything else will come apart. The business has become addicted to the cash flow from the trust business, and without them will have a difficult time surviving.

The default of the trusts will drastically reduce revenues, cause us to lose brokers and at least their confidence in us, bring on crushing litigation and devastating publicity, and I am convinced prosecution by regulators or worse.

I, like you, feel that we are vulnerable to criminal prosecution. Aside from the probable violation of Reg. D as it relates to the accredited investors, I am not aware of any action that would be considered illegal.

I believe we are at risk for the continued raising of investment dollars that are now clearly unlikely to be repaid in full. As we do each transaction, we distribute every excess dollar back to C-4 or McGinn Smith/MS Partners. **More recently, those dollars for the most part are used to fulfill the investment promise to earlier investors. While you have previously rejected my characterization of these acts as similar to a "Ponzi Scheme ...."** (emphasis supplied.)

I believe that our actions could be defined otherwise. The reason for my belief is that we are now in possession of indisputable empirical evidence that the new investments have no chance of being repaid in full. Whether less than 100% collections (66%) is due to normal attrition, fraud, billing errors, or poor credit judgment, it really does not matter. The facts are that we will never collection 100% or close to it.

Certainly, by not disclosing in the prospectus our poor history of collectios, we are not providing the prospective investor an accurate picture of his risk. **We both know why we don't make that disclosure because such disclosure would cause our salesmen to cease selling and investors to cease buying. Thus, we are misleading both our own emplouyees and customers.** (emphasis supplied)

FOOTNOTE 14 – EXCERPTS FROM DAVE SMITH CONFESSION

Dear Tim,

I have chosen to put my thoughts on paper rather than express them in our planned meeting with Brian and Mary Ann on Wednesday evening for several reasons. First and foremost, the present crisis we are facing is really our crisis, and our discussions should remain confidential. We are the ones responsible for a plan, and any comments or ideas from Brian and Mary Ann will probably be more supplementary than structural. Secondarily, I am sensitive to the fact that there may come a time when they may be asked to recount these discussions, and I would not want either of them to be in a position that forced them to choose between testimony harmful to us or perjury.

I am hopeful that you are reading this prior to our meeting on Tuesday. I wanted to get together with just you, to express some things that should be addressed solely between partners; and, after our more personal discussions I am looking forward to

[redacted]

I am sure that you will agree, that if our trusts go into default, everything else will come apart. The business has become addicted to the cash flow from the trust business, and without it we will have a difficult time surviving, although, I believe that we are on the verge of being able to develop other investment banking businesses, just as the importance of the brokerage revenues are diminishing. But we need time, and I am not convinced we will be able to acquire that time. The default of the trusts will drastically reduce revenues, cause us to lose brokers and at least their confidence in us, bring on crushing litigation and devastating publicity, and I am convinced prosecution by regulators or worse. The impact on our employees, customers, friends, and family will be devastating. I am just overwhelmed by the thought of the financial losses, the humiliation, the perceived betrayal of trust. I am trying to be strong in face of all

[redacted]

of this, but I can't sleep, I am concerned I have developed an ulcer, and I am being driven to moods of depression. I am sure that you are feeling some of these things as well. I know Mary Ann is. I have not shared any of this with Lynn, I assume because I have determined that it won't be helpful.

Aside from the above, I, unlike you, feel that we are vulnerable to criminal prosecution. Aside from the probable violation of Reg D on it relates to accredited investors, I am not aware of any action that would be remotely considered illegal. However, I would never underestimate the zeal of local a state a even SEC prosecutors to make a story out of our failure. Convictions of fat cat financiers is a great stepping stone up the career ladder.

I believe that we are at risk for the continued saving of investment dollars that are now clearly unlikely to be repaid in full. As we do each

[redacted]

transaction we distribute every excess dollar back to C" or McGinn, Smith & his partners. More recently, those dollars for the most part are used to fulfill the investment promise to earlier investors. While you have previously rejected my characterization of these acts as similar to a "Ponzi Scheme" because new dollars being raised are in fact buying new product, and only "profit dollars" are being used to cover shortfalls, I believe that our actions could be defined otherwise. The reason for my belief is that we are now in possession of indisputable empirical evidence that the new investments have no chance of being repaid in full. Whether less than 100% collections (66%) is due to normal attrition, fraud, billing errors, or poor credit judgement, it really does not matter. The facts are that we will never collect 100% or close to it. Therefore, our "profits" which we use are not profits at all, but rather monies that should be held in reserve to allow for the default collections for the protection of the new investors.

[redacted]

For us not to allow for these defaults by setting up adequate reserves is, in my judgement, reckless or fraud. Certainly, by not disclosing in the prospectus our poor history of collections, we are not providing the prospective investor an accurate picture of his risk. We both know why we don't make that disclosure - because such disclosure would cause our salesman to cease selling and investors to cease buying. Thus, we are misleading both our own employees and customers.

I fully understand, as well as you, our need to continue raising money, and that a number of the collection defaults were isolated incidents of fraud or gross incompetence by one of our dealers. However, those incidents have not impacted the majority of collections. Most of the defaults are from poor credit risks. We now know that, and we continue to accept these contracts without adequate reserves, and treat the excess discounted cash flow as certain profit to be distributed as we see fit.

[redacted]

FOOTNOTE 15 - PART 1 AND FOOTNOTE 17

M. Cody

A. And then --

Q. If you didn't finish, please continue.

A. The second part of the due diligence was actually on the contracts we were financing or acquiring. We would have delivered the original contracts, every one of them sent to our offices, where we would --

Q. When you talk about contracts, talking about the individual homeowners?

A. Homeowner contract. And I had a team that worked under me that did contract review. Now this included examining every single subscriber agreement, making sure it was properly executed and had a term of a certain amount of years, everything was clearly stated and it was an enforceable agreement.

They would also make a telephone call to the subscriber, one, to check that the subscriber was actually connected to the central station, and, two, to see the subscriber had actually executed the agreement.

Now, as we continued in this mode, of course, you know, the numbers grew and we were financing thousands of contracts. So we

M. Cody

actually acquired from a company in Albany, New York, formerly known as KeyCorp Leasing, they had merged with Society Bank in Cleveland, Ohio, and were relocated.

So we acquired a due diligence team right out of KeyCorp Leasing and twelve of their personnel came over that worked under me to help me accomplish what I just said.

Q. KeyCorp was the parent company which ran KeyBank?

A. That's correct.

Q. KeyBank is a national bank whose footprints spans the entire northern tier of the United States from east coast to west coast and whose stock is traded on the stock exchange. Is that the same company?

A. That is the same company.

Q. When Key Leasing -- when KeyCorp discontinued its leasing arm, you hired how many people?

A. I would say about 12 or 13 from there.

Q. What was their background and why did you feel they would be an appropriate hire for --

M. Cody

A. Well, they were experts in terms of due diligence and leasing and in collections and billing. At some point we had decided that in order to make this run as best and as securely as we could, we would take on the actual billing function ourselves so that we would no longer rely on the security alarm dealer with whom we financed to do the billing. We would actually do the billing and the collection effort to ensure that we would have the greatest amount of -- or percentage of collections as possible.

Q. When you did your due diligence did you document it in paper?

A. Yes, we kept files. Actually hard copies on everything. We also --

Q. Where were they kept, the hard copies?

A. We had a room in our building downstairs where we installed a number of fireproof file cabinets. So all the original subscriber agreements, the monitoring contracts were in these fireproof safes as was the due diligence on the individual security alarm dealers and/or companies.

Q. You also kept some stuff upstairs

M. Cody

that --

A. Yes. Active files. Because there were covenants within the financing documents that the security alarm dealer would have to cooperate in the event there were subscriber defaults and they would have to replace that with performing contracts. So they did have an ongoing covenant.

Q. Just for clarity, the bidding you are talking about is the 99 Pine Street, Albany headquarters of McGinn Smith?

A. That's correct.

Q. Who prepared the Regulation D documentation during the time that you were general counsel?

A. I did for several years I did the Reg D offering work. And we would typically do a 506 exempt offering. And I filed the Form D until about the year 2001 when we had Gersten Savage. We were thinking about consolidating the whole business and creating one new company, and then Gersten took over.

Q. They are securities lawyers from New York City?

FOOTNOTE 15 - PART 2

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to say, "Dave, here is a question." Or, "Tim, can you tell me who vendor is? Who is the lead bank on this particular company?" It was very often in regard to asking and answering questions.

Q. Did brokers ask questions?

A. Absolutely.

Q. To your knowledge, were those questions answered?

A. Yes, I think so.

Q. What about you? Did you ask questions?

A. I did, throughout that period of time. I don't recall at any point walking away saying: I just didn't get an answer for that.

Q. To what extent -- when you did ask a question, to what extent were you satisfied with the answers you got?

A. I believe I was totally satisfied.

Q. Were the brokers given private placement memorandums before they were allowed to initiate a sale?

A. Yes, they were.

Q. What do you recall about the extent to

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which McGinn Smith set forth a summary of their due diligence process in PPM?

A. Can you repeat that?

JUDGE MURRAY: What did the PPM say about their due diligence?

MR. BIRNBAUM: On the 2000 PPM's.

MR. CAVALIER: Still on pre-2003. Pre-OIP.

A. I am glad I applied for my long-term care insurance two years ago because I don't exactly remember going back to 1998, '97, what was in the PPM relative to the due diligence.

But I am quite -- to my recollection, it explained -- it might have explained the history of the firm and what they were doing in the industry. I don't recall exactly on the older PPM's.

JUDGE MURRAY: Could we get up to the relevant period?

MR. CAVALIER: I am going to tie it all in because basically -- yes. Just a few more questions and then I am done with 2003.

Q. Do you recall Mary Ann Cody testifying the disclosures of the due diligence process in

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the PPM's was actually thought to be a selling point?

A. Yes.

Q. What information, if any, do you have that that was not accurate?

A. Nothing that would indicate that it was not accurate.

MR. CAVALIER: I didn't want to ask another leading question.

Q. From time to time in your career have you sold private placements that were not sponsored by a McGinn Smith affiliated organization?

A. Yes.

Q. Have presentations been made with respect to those?

A. Absolutely.

Q. How would you compare the scope and depth of the McGinn Smith presentations with those by outside companies?

A. I would think they were similar if not -- again, with McGinn Smith, because we had the close working relationships with the principals, I would assume that most of the

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F. Chiappone - Direct

advisors working at McGinn Smith at that time felt more comfortable in being able to ask questions of McGinn and Smith.

We also had the feature that after the sales meeting was over, if it was an outside private placement the parties left but McGinn Smith, they were right around the corner. If you have another question, you could bring it up in conversation.

Q. Now, fast forward to 2006. You agree Tim McGinn and his due diligence team left McGinn Smith and went to Integrated Alarm Services. Correct?

A. Yes.

Q. Did there come a time he returned to the McGinn Smith organization?

A. Yes.

Q. When was that?

A. I believe summer of 2006.

Q. Do you know whether or not his diligence team came with him?

A. Yes, they did.

Q. Were there presentations on, during and after 2006 with respect to the alarm and

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market the Four Funds?
A. That's correct.
Q. Did there come a time when IASG went public with an initial public offering?
A. Yes.
Q. Was it successful?
A. Yes.
Q. Did you sell it?
A. Yes.
Q. Did it make money?
A. Some did, some did not.
Q. When did Tim return to McGinn and Smith?
A. As we discussed earlier, I believe it was the summer of 2008.
Q. I may have --
A. Excuse me. The summer of 2006.
Q. If I asked this, forgive me, but did the due diligence team come back with him?
A. Yes. We discussed that already.
Q. Do you know if Brian Shea came back as well?
A. Yes. I believe his capacity was still working with Mr. McGinn in the alarm financing

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Division, but I don't believe he came back to his operational piece as CFO of the company until, I believe it was 2009.
Q. How about Keenholtz? Did he come back, too?
A. Doug came back with him also, yes.
Q. Are you aware of whether those people who were originally with KeyBank, which Mary Ann indicated came with the prealarm deals, do you know if they came back?
A. Yes.
Q. Ms. Cody didn't come back herself; correct?
A. No.
Q. Did McGinn Smith hire new inhouse counsel?
A. They did at some point. A gentleman by the name of Joseph Carr, Joe Carr. I couldn't recall exactly when Mr. Carr became employed by McGinn Smith.
Q. What did Tim do when he got back to McGinn Smith?
A. Started talking to us about doing receivable financing again, but this time in the

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Triple Play arena versus just individual home alarms.
Q. Did he also do alarm deals after he got back?
A. Some of the deals we did were alarm deals, yes.
Q. What did you think of the alarm deals?
A. I always felt very comfortable with the alarm deals. It was something that was -- I referred to it as a businessman's risk. I could talk to a businessman of any sort of background. It was something they could easily understand.
Many of them had alarm systems in their houses. They were paying monitoring fees. It was something they could easily understand.
They could understand the concept of companies, now their cash flow being spread out over a number of years, looking to sell the contracts at a discount. So it was a concept that was very easy to explain and share with clients.
Q. What about the Triple Play deals? What was your dealing about those?
A. Felt even more enthusiasm with the

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Triple Play deals. With the alarm contracts, if there was a thousand contracts in a transaction, that meant each month a thousand checks came in.
Triple Play, many were done with gated communities where checks were coming from homeowner associations, where instead of getting checks from a thousand homeowners each month, they get a check from one or two different homeowner associations.
Just thinking of my own household, with Cable television, internet as well as telephone service, if there wasn't Cable in the house for the little guy to watch his TV shows or the wife to watch her things she had on TV, all hell would break loose.
Most people, I felt, would be more inclined to continue to pay for their Cable, their television, more important than their home security system for their household. I felt it with a more secure collateral than just the alarm contracts by themselves.
Q. We talked about the due diligence a little and I won't belabor that. When it came time to explain the new 2006 alarm deals to the

FOOTNOTE 19

EXIT CONFERENCE

Firm Name: McGinn, Smith & Co., Inc.

Examination Number: 20070072125 – Albany, NY, Main Office
20070079082 – New York, NY Branch
20070079083 – Clifton Park, NY Branch

Date: 05/14/2007

Attendees: David Smith, Chief Compliance Officer
David Rees, Chief Financial Officer
Stephen Smith, Compliance Principal
Andrew Guzzetti, Vice President
Thomas Grygiel, Senior Compliance Examiner
Michael Paulsen, Staff Supervisor

Exit Conference Location: McGinn, Smith & Co., Inc.
99 Pine Street
Albany, NY

Areas Reviewed:

Form Filings
Electronic Storage Media
Regulatory Element of Continuing Education
Firm Element of Continuing Education
Supervisory Controls
Supervision
Bank Secrecy Act Compliance
Testing of AML Compliance Program
OFAC Compliance
Net Capital Verification
Customer Protection Rule Exemptions
Customer Grievances
Commissions
Hedge Fund Review
Best Effort and Contingent Offerings
Unregistered Offerings
Blank Check or Blind Pool Offerings
Research Analyst Conflict Review
Branch Office Activities
Correspondence and Institutional Sales Material
Operations

(3)

Items Noted:

1) **NASD Bylaws Art. IV, Sec. 1 - Application For Membership**

NASD Bylaws Art. IV, Sec. 8 - Registration Of Branch Offices

The Firm failed to update Form BR to reflect the Clifton Park branch as an Office of Supervisory Jurisdiction (OSJ) and Carl Nicolosi (CRD # 4298064) as the Branch Manager. As of March 8, 2007 Mr. Nicolosi acting in a principal capacity, was approving new account applications.

2) **NASD Bylaws Art. V, Sec. 2 – Application for Registration**

The Firm failed to amend the Form U-4 for Brian Mayer (CRD # 2640631) when he was named as a respondent to the arbitration case filed by Rom and Elaine Charmin.

3) **SEC Rule 17a-4 (f) - Records To Be Preserved By Certain Exchange Members, Brokers & Dealers**

a) The Firm failed to notify the NASD of the Firm's usage of electronic storage media.

b) The Firm failed to provide third party notification in compliance with 17a-4(f)(3).

4) **NASD Rule 1031 (a) – Registration Requirements**

The Firm maintained the registration for Carmen Loffredo (CRD# 311677) from 3/03/2006 to 12/15/2006 who was no longer active in the member's investment banking or securities business and was no longer functioning as a representative.

5) **NASD Rule 1120(b)(3) - Firm Element - Participation In The Firm Element**

The Firm failed to ensure four out of 28 covered registered representatives or 14%, attended the Firm's required Firm Element of Continuing Education training.

6) **NASD Rule 3010 (a)(7) - Supervisory System**

The Firm failed to have all registered representatives attend the 2006 Annual Compliance Meeting. A review of the attendance logs revealed that 11 out of 50 (22%) did not attend the meeting on December 13, 2006 and the Firm was unable to provide adequate evidence of any makeup meetings.

7) NASD Rule 3010 (b) (1) - Written Procedures

The Firm failed to establish Written Supervisory Procedures for the following areas:

a) Designation of Clifton Park, NY branch as an OSJ;

b) Designation of Carl Nicolosi as Clifton Park, NY Branch Manager;

c) Prohibition against guarantees of performance; and

d) Free-riding & Withholding.

In addition, the Firm failed to implement its Written Supervisory Procedures in the following areas:

e) Updating Form U-4 within 30 days after learning of the facts or circumstances giving rise to the amendment;

f) Registered representatives attending the Firm Element of Continuing Education required training;

g) Registered representatives attending the Annual Compliance Meeting; and

h) Branch Inspections containing the appropriate areas of review as outlined in the Firm's WSP's.

i) Upon receipt of checks for Private Placements at a branch location, the branch would forward payments to the Clifton Park branch for processing. The Firm's procedures state, "All customer funds for private placement offerings are deposited directly to a Federally Insured Bank Trust or Escrow Department."

8) NASD Conduct Rule 3010(b) In conjunction with Regulation D

With respect to the Vidsoft, Inc. offerings, SEC Form D was not filed timely within the required 15 days after first sale of securities in the offering as the first sale was August 18, 2006 and the filing was not made until October 23, 2006. In addition, with respect to the ExchangeBlvd.com, Inc. filing, the first sales were July 11, 2006 and the Form D filing was not made until August 4, 2006. As such, the Firm failed to enforce its procedures in conducting adequate due diligence to ensure the applicable SEC Form D filings were filed timely. This is a repeat violation from the previous exam # 20060038290.

9) NASD Rule 3010 (c)(2) - Internal Inspections

The Firm failed to conduct adequate branch inspections for two of the four (50%) branch offices reviewed. Specifically, Staff noted inadequate reports for the non-OSJ branches King of Prussia, PA and Pawlet, VT.

10) SEC Rule 17a-3(a)(11) - (untitled)

Staff conducted a review of the firm's net capital position for the period ending January 31, 2007 and determined that the firm computed its Net Capital to be $465,417 with a minimum statutory net capital requirement of $100,000 yielding excess net capital of $365,417. The staff independently calculated the firm's net capital to be $465,533 with the same statutory requirement yielding excess net capital of $365,533. The difference of $116, or 0.03%, is attributable to clerical error.

11) SEC Rule 17a-3(a)(2)

The Firm failed to maintain an accurate general ledger reflecting all liabilities. Specifically, the Firm failed to accrue two legal bills in the month of February, 2007, resulting in an increase in liability by $34,170, an incorrect balance in the Accounts Payable ledger and consequently, an inaccurate net capital calculation as of February 28, 2007.

12) SEC Rule 17a-3 – Records to be made by Certain Exchange Members Brokers & Dealers

The Firm failed to maintain adequate books and records in that a review of subscription agreements for the TDM Cable Trust 06 Private Placement revealed that 15 of 22, or 68% had indicated an incorrect date for the Offering Memorandum supplied to the subscribers. Staff noted the original Offering Memorandum was dated October 24, 2006. A subsequent Offering Memorandum was issued on November 16, 2006. All 22 subscription agreements indicated the client had received the October 24, 2006 Offering Memorandum, while 15 agreements were dated on or after the November 16, 2006 Offering Memorandum had been issued.

Other Matters/Additional Comments:

Staff to discuss procedural conflict between the Firm's Written Supervisory Procedures and the Branch Manual in regards to the frequency of branch inspections.

The purpose of the signature below is solely and exclusively to acknowledge that the matters noted in this form were reviewed with the Firm. No inference should be drawn that the signing of this form represents an acknowledgment by the Firm that a rule violation has been committed by the member or any of its employees.

The member understands that it will be further advised by NASD relative to open items, if any, recorded on this form or of other material regulatory matters, if any, not expressly stated herein which are contained in the completed examination report.

Any apparent violations noted above should be responded to in writing by a representative of the Firm and such response should be forwarded to the District Office Staff Supervisor Michael Paulsen, NASD, 581 Main Street, 7th Floor, Woodbridge, NJ 07095 so it is received no later than Tuesday, May 29, 2007.

Form Received By:

NAME TITLE DATE

This form does not in any way constitute a waiver of the notification prohibitions set forth in 31 U.S.C. 5318(g) with respect to any suspicious activity report discussed herein. Consequently, any references in this letter to a suspicious activity report or its existence are confidential, and may not be disclosed by you to the subject of the report, or otherwise disclosed in a manner outside your Firm that would lead to the subject of the report being notified. The improper disclosure of a suspicious activity report, either in contravention of section 5318(g) or of a related rule implementing that authority, is punishable by criminal and civil penalties. See 31 U.S.C. 5321 and 5322.

FOOTNOTE 20

annual audits?
A. No, I am not.
Q. Do you know if the OCIE Division ever investigated McGinn Smith?
A. I am aware.
Q. Prior to the investigation that led to your declaration?
A. Can you please repeat the question.
Q. Tell me what OCIE stands for.
A. I don't know what the actual letters stand for.
Q. Is it the investigative arm of the SEC?
A. I believe so. I don't know what that stands for.
Q. Were you involved in any examinations prior to the examination or the investigation that you did that resulted in the declaration?
A. Was I involved in the examinations?
Q. Any examination of McGinn Smith prior to the work that you did for the declaration?
A. I work for the Division of Enforcement.
Q. Correct. And the question was --

A. I said no, I work for the Division of Enforcement.
Q. Separate question, are you aware whether or not the OCIE Division ever investigated McGinn Smith prior to 2010?
A. Yes.
Q. Did they?
A. I believe so, yes.
Q. Do you know when those investigations were conducted?
A. I believe around 2003. I am aware of one that was maybe around -- actually, no, I don't know. I don't want to say because I am not positive.
Q. You are not positive as to the year?
A. Right.
Q. But you are aware that an investigation was conducted around 2003?
A. Correct -- I don't -- I actually don't know the date. I am sorry. I became aware of it, yes.
Q. How did you become aware of it?
A. I saw a -- I recently saw a letter, a piece of a letter.

Q. Do you know if that investigation uncovered any of the frauds that are outlined in your declaration?
A. I don't know. I only read a piece of the letter.
Q. All right. Do you have any other knowledge, separate from the letter, as to whether or not that examination uncovered any of the frauds that you are talking about?
A. No, I don't.
Q. At paragraph 10 you list some of the people that you did speak to and I just want to address a few of those. You spoke to Brian Shea. Correct?
A. Correct.
Q. Was he the chief financial officer of McGinn Smith at some point?
A. You know, I -- they didn't really use the titles according to him, so I just really can't answer that question. He did work in the accounting department and he does have a lot of knowledge now, especially about the transactions, but his exact title, I don't know.
Q. Without regard to his title, was he

head of the accounting department, if you know?
A. Not for the entire time period.
Q. No. For the period he was there.
A. I think when he returned from McGinn Smith alarm Traders he was --
Q. Correct.
A. I think he was working in that capacity.
Q. That capacity being the head, by whatever name, the head of the accounting department?
A. I don't know if he was working like a special project or if he was the head. I really don't know.
Q. And I think you testified -- correct me if I am wrong -- that you formed an opinion that he became aware of the frauds. Correct?
A. At some point, yes, he definitely did.
Q. And he didn't tell FINRA -- withdraw that.
Do you have any knowledge that he told FINRA about it?
A. I don't know.
Q. Do you know if he is a CPA?