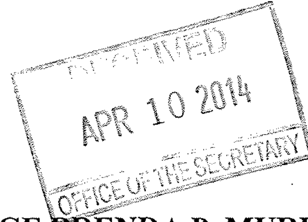
**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-15514**




**In the Matter of**

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

**Respondents.**

**CHIEF JUDGE BRENDA P. MURRAY**

# POST-HEARING BRIEF OF THE DIVISION OF ENFORCEMENT

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April 9, 2014

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The Division of Enforcement respectfully submits this Post-Hearing Brief.

## PRELIMINARY STATEMENT

The Ponzi scheme that brought down the Albany, NY-based broker-dealer McGinn, Smith & Co., Inc. ("MS & Co.) caused nearly 900 investors to lose a total of $80 million. The primary villains are MS & Co.'s owners, David Smith and Timothy McGinn, who are now serving long prison terms for orchestrating and perpetuating the scheme. But Smith and McGinn did a relatively small amount of sales themselves; instead, they relied upon MS & Co.'s in-house brokers to sell the fraudulent notes to their clients. The top-performing salesmen at MS & Co. during the years of the fraud were Donald J. Anthony, Frank H. Chiappone, Richard D. Feldmann, William P. Gamello, William F. Lex, Thomas E. Livingston, Brian T. Mayer, Philip S. Rabinovich and Ryan C. Rogers ("Selling Respondents").

Selling Respondents elevated themselves and their livelihoods above their duties to their customers and the securities markets. Confronted with red flags of increasing number and intensity, Selling Respondents declined to ask basic questions about the investments they recommended and sold to their customers. Instead, Selling Respondents looked the other way, continued to sell without question the many MS & Co. unregistered offerings that came their way, and betrayed the trust that their customers placed in them. Meanwhile, Andrew G. Guzzetti, the MS & Co. supervisor who should have been a primary line of defense against such fraudulent sales, failed to supervise properly the MS & Co. brokers and failed to ask questions in the face of glaring red flags. Respondents' conduct, proved by overwhelming evidence, including Respondents' own sworn testimony, caused enormous losses to investors.

After eighteen days of trial, the evidence is clear that Respondents committed serious violations of the federal securities laws.

*First*, Selling Respondents violated Section 5(a) and 5(c) of the Securities Act of 1933 ("Securities Act") by offering and selling unregistered MS & Co. notes without any applicable exemption from registration.

*Second*, Selling Respondents violated Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and Rule 10b-5 thereunder, by knowingly or recklessly recommending fraudulent MS & Co. notes to their customers; making material misrepresentations to their customers; engaging in a scheme to defraud or, at a minimum, acting negligently.

*Third*, Guzzetti failed to respond to indications of wrongdoing and red flags and, accordingly, failed to discharge his supervisory responsibilities.

These violations merit meaningful sanctions. Selling Respondents should be ordered to disgorge their ill-gotten gains – the commissions they received on the fraudulent sales – and to pay prejudgment interest on those commissions. All Respondents should be ordered to pay substantial civil monetary penalties, be ordered to cease and desist violations of the securities laws and, to protect the public interest, be barred from the securities industry.

## STATEMENT OF FACTS

The Division relies on and incorporates herein its Proposed Findings of Facts ("FoF"), filed herewith, as its statement of facts that support the allegations against the Respondents.[1]

[1] Abbreviations used in the FoF are incorporated herein.

## ARGUMENT

## I. Selling Respondents Violated Sections 5(a) and 5(c) of the Securities Act

The Division has submitted uncontroverted evidence proving that Selling Respondents are directly liable for Section 5 violations because they offered and sold Four Funds notes and Conduit Entity Trust Offerings, which had neither registration statements filed with the Commission nor exemptions from registration. Sections 5(a) and 5(c) prohibit the offer and sale of securities in interstate commerce unless a registration statement is filed with the Commission or is in effect, or the transactions are exempt or fall within a safe-harbor from registration. 15 U.S.C. §§ 77e(a), (c); *Matter of Kirby et al.*, No. 3-9602, 2000 WL 1787908, at *8 (Dec. 7, 2000). Thus, "registration [is required] for *any* sale by *any* person of *any* security, unless it is specifically exempted from the registration provisions." *Matter of Bloomfield et al.*, No. 3-13871, 2011 WL 1591553, at *24 (Apr. 26, 2011), *aff'd,* 2014 WL 768828 (S.E.C. Feb. 27, 2014) (citing Thomas Lee Hazen and David L. Ratner, *Securities Regulations in a Nutshell* § 10 (10th ed. 2009)) (emphasis in original).

### A. The Division Has Established a *Prima Facie* Case Against Selling Respondents

To establish a *prima facie* case, the Division must prove that: (1) the respondent offered to sell or sold a security; (2) the respondent used the mails or interstate means to sell or offer the security; and (3) no registration statement was filed or was in effect as to the security. *See SEC v. Cavanagh*, 1 F. Supp. 2d 337, 361 (S.D.N.Y. 1998), *aff'd,* 155 F.3d 129 (2d Cir. 1998). Scienter is not required to establish a Section 5 violation. *See SEC v. Softpoint, Inc.,* 958 F. Supp. 846, 859-60 (S.D.N.Y. 1997), *aff'd,* 159 F.3d 1348 (2d Cir. 1998). The burden of proof then shifts to the respondent to show that an exemption or safe-harbor from registration was available. *See SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953); *Bloomfield*, 2011 WL 1591553, at *25.

The uncontroverted evidence presented by the Division establishes a *prima facie* Section 5 violation by Selling Respondents. All Selling Respondents sold all of the Four Funds notes and the MSF Conduit and TDM Conduit Trusts. FoF ¶ 179. Selling Respondents recommended and sold these securities to investors located throughout the country, and used the means and instrumentalities of interstate commerce. FoF ¶¶ 179, 180. Finally, no registration statement was filed with the Commission or in effect with respect to the Four Funds or Conduit Entity Trust Offerings. FoF ¶ 181.

### B. Selling Respondents Have Offered No Evidence that the Four Funds or Conduit Entity Trust Offerings Were Exempt from Registration

Selling Respondents failed to meet their burden of proof to show that the Four Funds or Conduit Entity Trust Offerings qualified for an exemption from registration. *See Ralston Purina*, 346 U.S. at 126; *Bloomfield*, 2011 WL 1591553, at *25. Although the Four Funds' PPMs claimed exemptions from registration under Securities Act Section 4(2) and Rule 506 of Regulation D, *see* FoF ¶ 182, the evidence shows that neither exemption applies.

Section 4(2) provides an exemption for non-public offerings.[2] In considering whether this exemption applies, "the Supreme Court has held that courts must examine whether allowing the exemption is consistent with the promotion of 'full disclosure of information thought necessary to informed investment decisions' and whether 'the class of persons affected needs the protection of the [Securities] Act.'" *Matter of Giesige*, No. 3-12747, 2008 WL 4489677, at *24 (Oct. 7, 2008), *aff'd*, 2009 WL 1507584 (S.E.C. May 29, 2009) (citing *SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d. 1, 11 (D.D.C. 1998) & *SEC v. Ralston Purina Co.*, 346 U.S. at 124-25). The Court must consider "the number of offerees, the relationship of the offerees to each other and the

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[2] Section 4(2) has been re-designated as Section 4(a)(2) by the JOBS Act.

issuer, the manner of the offering, information disclosure or access, and the sophistication of the offerees." *Giesige*, 2008 WL 4489677, at *24 (citation omitted) (concluding that the offering was public given the number of investors).

Each of the Four Funds had hundreds of investors. FoF ¶ 27; *see also SEC v. Murphy*, 626 F.2d 633, 645 (9th Cir. 1980) (the more offerees, the more likelihood that the offering is public). The Division also proved that each of the Four Funds had more than 35 unaccredited, unsophisticated investors—including Division witnesses like Lex customer Barbara Monihan, Mayer customer Thomas Alberts and many others—who did not have access to the type of information normally provided in a registration statement, including audited financial information, which would allow them to make an informed investment decision. FoF ¶ 183; *see also, e.g.*, ¶¶ 397, 400-01 (Monahan), 580-81 (Alberts). Selling Respondents, although they highlighted the sophistication of a few investors, introduced no evidence showing that the Four Funds were offered to a small, discrete number of investors who had access to detailed financial information. Thus, the Section 4(2) exemption is unavailable.

For the Rule 506 exemption to apply, the Four Funds could issue securities up to only 35 unaccredited investors. *See* 17 C.F.R. § 230.506(b)(2). Each of the Four Funds, however, had more than 35 unaccredited investors, so the Rule 506 exemption does not apply. *See* FoF ¶ 183.

The Conduit Entity Trust Offerings claimed the Rule 506 exemption from registration in their PPMs. *See* FoF ¶ 182. Although no single Trust Offering exceeded 35 unaccredited investors, the MSF and TDM Conduits each exceeded the 35 unaccredited investor limit. FoF ¶¶ 184, 186-89. The Division's evidence compels the conclusion that the TDM Conduit Trusts and the MSF Conduit Trusts should be integrated under Rule 502(a) of Regulation D. Rule 502(a) requires consideration of five factors to determine if offering integration is appropriate: (1)

whether the sales are part of a single plan of financing; (2) whether the sales involve issuances of the same class of securities; (3) whether the sales have been made at or about the same time; (4) whether the same type of consideration is being received; and (5) whether the sales are made for the same general purpose. *SEC v. Cavanagh*, 445 F.3d 105, 112, n.17 (2d Cir. 2006) (quoting Non-Public Offering Exemption, Rel. No. 33-4552 (Nov. 16, 1962)).

The evidence shows that the Rule 502(a) factors are satisfied. The uncontroverted evidence shows that funds raised from investors in multiple offerings were routed to a single "Conduit Entity" account, and thus provided a single plan of financing for each conduit, which facilitated improper and fraudulent transfers of funds. FoF ¶¶ 66-69, 186-189. Once investor funds were deposited into the escrow account and transferred to the Conduit Entity disclosed in the PPM, the funds were used to enrich McGinn, Smith or Matthew Rogers personally or to support MS & Co. and related entities as liquidity needs dictated. FoF ¶¶ 66-69.

As to the second factor, the same class of security—a trust certificate with a fixed term and fixed interest rate—was issued in each Conduit Entity Trust Offering. FoF ¶ 15. As to the third factor, MS & Co. brokers' offers and sales of the Conduit Entity trust certificates were continuous and overlapping. Sales of MSF Conduit certificates were never more than six months apart, and sales of TDM Conduit certificates were never more than six months and three weeks apart. FoF ¶¶ 190-91; *see SEC v. Melchior*, No. 90-c-1024J, 1993 WL 89141, at *10-11 (D. Utah Jan. 14, 1993) (integrating partnerships into a single offering under Rule 502(a). Courts have integrated offerings not made at the same time where, as here, the other factors weigh heavily in favor of integration. *See SEC v. Murphy*, 626 F.2d at 646 (integrating partnerships even though the third Rule 502(a) factor, or the timing of the offerings, did not weigh in favor of integration). Moreover, Rule 502(a) focuses on *offers* and sales. Although there is a six-month, three-week

gap between sales in the TDM Conduit, it is reasonable to infer that an offer took place before each sale, reducing the amount of time between the previous sale and the next offer.

Fourth, the same consideration was received for each Trust Offering: customers paid in cash by check or wire. FoF ¶ 180. Fifth, and finally, the Trust Offerings, through their respective Conduit Entity, all were for the same stated purpose: to purchase "triple play" cable, internet, and phone contracts, security alarm contracts, and luxury cruise cabin rentals. FoF ¶ 66-69, 188-89.

Accordingly, the Trust Offerings constituting the TDM Conduit should be integrated (44 total unaccredited investors), as should the Trust Offerings constituting the MSF Conduit (39 unaccredited investors). *See* FoF ¶¶ 184-89. Thus, the Conduit Entity Trust Offerings do not qualify for any exemptions from registration.

**C. <u>Selling Respondents Are Strictly Liable for Their Section 5 Violations</u>**

Selling Respondents are liable for their sales of unregistered securities regardless of their knowledge or intentions. *See SEC v. U.N. Dollars Corp.*, No. 01 Civ. 9059 (AGS), 2003 WL 192181, at *2 (S.D.N.Y. Jan. 28, 2003) ("[D]efendants' lack of knowledge regarding the registration requirement does not provide them with a meritorious defense" to Section 5 claims); *SEC v. CMKM Diamonds, Inc.*, 729 F.3d 1248, 1256-57 (9th Cir. 2013) (affirming that Section 5 is a strict liability statute even where one relies on counsel); *Matter of Pinkerton*, No. 3-8805, 1996 WL 602648, at *6 (Oct. 18, 1996) (respondent was wrong to accept advice that securities were being offered only to accredited investors).

Moreover, Selling Respondents cannot isolate their individual sales and argue that they sold to fewer than 35 unaccredited investors and, therefore, did not violate Section 5. The registration requirements of the Securities Act apply to the "entire process in a public offering through which a block of securities is dispersed and ultimately comes to rest in the hands of the

public." *Matter of Carley et al.*, No. 3-11626, 2008 WL 268598, at *7 (S.E.C. Jan. 31, 2008) (affirming finding of Section 5 violation and rejecting respondents' attempt to "isolate certain components of the distribution") (citation omitted).

## II. The Selling Respondents Violated Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5 Thereunder

The Selling Respondents violated the antifraud provisions of the federal securities laws in numerous respects.

*First*, despite a clear-cut legal duty, Selling Respondents knowingly or recklessly recommended MS & Co. unregistered offerings to their customers without a reasonable basis to do so, despite numerous glaring red flags that raised questions about the offerings for which Selling Respondents never obtained, and rarely even sought, adequate answers.

*Second*, when recommending the MS & Co. unregistered offerings, Selling Respondents misrepresented and omitted material information, failed to disclose readily ascertainable information, concealed the fact that they knew almost nothing about what Smith and McGinn were doing with the offering proceeds, and instead pitched the notes as good investments.

*Third*, Selling Respondents played a crucial role in a widespread scheme to defraud. Absent Selling Respondents' unquestioning willingness to recommend MS & Co. notes to their customers, the scheme would have been far less damaging and widespread.

*Fourth*, at a minimum, Selling Respondents acted negligently.

### A. Selling Respondents Knowingly or Recklessly Recommended MS & Co. Unregistered Offerings Despite Having: (1) No Reasonable Basis for Their Recommendations and (2) Knowledge of Red Flags

Section 10(b) of the Exchange Act makes it "unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the

Commission may prescribe." To establish a violation of Section 10(b) and Rule 10b-5, the Division must show: (1) a materially false or misleading statement or omission or use of a fraudulent device, (2) in connection with the purchase or sale of securities, and (3) scienter. *See, e.g.*, *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999); *Basic Inc. v. Levinson*, 485 U.S. 224, 235 n.13 (1988).

Section 17(a) of the Securities Act prohibits fraud in the offer or sale of securities, using the mails or the instruments of interstate commerce. Section 17(a)(1), but not Sections 17(a)(2) or (3), requires proof of scienter. *Aaron v. SEC*, 446 U.S. 680, 697 (1980); *SEC v. Softpoint,* 958 F. Supp. at 861-62.

Rules 10b-5(a) and 10b-5(c), which also implement Section 10(b) of the Exchange Act, prohibit the use of any "device, scheme, or artifice to defraud" or any other "act, practice or course of business which operates . . . as a fraud or deceit" in connection with the purchase or sale of securities, with scienter. *See In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 335-36 (S.D.N.Y. 2004) ("[A] cause of action exists under [Rule 10b-5] subsections (a) and (c) for behavior that constitutes participation in a fraudulent scheme, even absent a fraudulent statement by the defendant.").

"Scienter 'may be established through a showing of reckless disregard for the truth.' 'Reckless conduct is, at the least, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary case to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *SEC v. Milan Capital Group, Inc.*, 2000 WL 1682761, at *5 (S.D.N.Y. Nov. 9, 2000) (*citing SEC v. McNulty*, 137 F.3d 732, 741 (2d Cir. 1998) and *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d Cir. 1978)).

When circumstances "raise enough questions," "a person's failure to investigate before recommending that investment [may be considered] reckless." *Milan Capital Group,* 2000 WL 1682761, at *5 (citing examples). Red flags require heightened investigation, and ignoring those flags is reckless. *Graham v. SEC*, 222 F.3d 994, 1006 (D.C. Cir. 2000) ("[R]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review."); *see also SEC v. Infinity Group Co.*, 212 F.3d 180, 193 (3d Cir. 2000) ("[I]gnorance provides no defense to recklessness where a reasonable investigation would have revealed the truth to the defendant.").

A broker violates the antifraud provisions of the securities laws by recommending a security without an adequate and reasonable basis. *Hanly v. SEC,* 415 F.2d 589, 596 (2d Cir. 1969). As this Court stated nearly twenty years ago:

It is black letter law that:

> Brokers and salesmen are "under a duty to investigate, and their violation of that duty brings them within the term 'willful' in the Exchange Act." Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. He must analyze sales literature and must not blindly accept recommendations made therein. The fact that his customers may be sophisticated and knowledgeable does not warrant a less stringent standard . . . .
>
> In summary, the standards by which the actions of each [securities salesman] must be judged are strict. He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he 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.
>
> A salesman may not rely blindly upon the issuer for information concerning a company, although the degree of independent investigation which must be made by a securities dealer will vary in each case. Securities issued by smaller companies of recent origin obviously require more thorough investigation.

*Pinkerton*, 1996 WL 602648, at *5 (*quoting Hanly*, 415 F.2d at 595-97).

The "black letter law" summarized in *Pinkerton* has been the standard for decades, and FINRA rules are fully consistent.[3] These standards mean that the securities licenses that allowed Respondents to build profitable businesses and successful lifestyles came with responsibilities. By virtue of Selling Respondents' positions as registered representatives, their customers were entitled to presume that recommendations were the result of reasonable investigation. *Hanly,* 415 F.2d at 596; *SEC v. Platinum Inv. Corp.,* 2006 WL 2707319, at *3 (S.D.N.Y. Sept. 20, 2006). Accordingly, when recommending the Four Funds, the Trust Offerings and MSTF, Selling Respondents had a duty to conduct an independent investigation and not rely solely on information from their employer, the very individuals and entities who owned and controlled the issuers. *See SEC v. Hasho,* 784 F. Supp. 1059, 1107 (S.D.N.Y. 1992); *Giesige*, 2008 WL 4489677; *Matter of Stires & Co., Inc.*, File No. 3-9120, 1998 WL 462230 (Aug. 11, 1998).

The *Hanly*, *Giesige, Pinkerton* and *Stires* cases are particularly relevant precedent. The oft-cited *Hanly* case concerned brokers who recommended an over-the-counter stock. When pitching the investment, the brokers emphasized a confidential research report, and discussions with the company's president, that predicted great success. The brokers did not disclose, however, "known or reasonably ascertainable adverse information." *Hanly*, 415 F.2d at 595. This was especially important because the brokers' customers "could not readily confirm the information given them" by the brokers given the stock was traded over-the-counter. *Id.* at 594-598. In affirming that the brokers violated Section 17(a) of the Securities Act and Section 10(b)

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[3] *See* Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings, FINRA Notice to Members 10-22; *see also* NASD Reminds Members of Obligations When Selling Non-Conventional Investments, NASD Notice to Members 03-71, 2003 NASD LEXIS 81, *5-6 (Nov. 11, 2003); *see also* NASD Notice to Members 04-30, NASD Reminds Firms of Sales Practice Obligations In Sale of Bonds and Bond Funds (Apr. 2004) ("NtM 04-30") (describing reasonable basis suitability as "[u]nderstanding the terms, conditions, risks, and rewards" of investment).

of the Exchange Act and Rule 10b-5, among other provisions, the Second Circuit recognized a "special duty" of brokers when recommending a security for which information is not publicly available. *Id.* Selling Respondents, who similarly failed to disclose known or reasonably ascertainable adverse information on securities for which there was no publicly available information, breached this "special duty."

In *Giesige*, a registered representative recommended a real estate company to her customers as a good investment opportunity. As part of her purported investigation, the broker received a PPM, a subscription agreement, a list of the company's claimed real estate properties, and a balance sheet and income statement showing projected profits of $5.6 million. The broker also visited a golf course owned by the real estate company, and even invested her own money. The company, however, much like MS & Co., "resembled a Ponzi scheme," and ended up in receivership. 2008 WL 4489677, at *6.

The broker's defense in *Giesige*—similar to the defenses of Selling Respondents—was that she simply repeated information received from the issuer, who "seemed credible." 2008 WL 4489677, at *19. The broker—again, similar to Selling Respondents—did not independently verify any of the information received from the issuer, including the information in the income statement and balance sheet she received. As a result, the Court found a "flagrant example of fraudulent conduct, done with scienter or, at a minimum, extreme recklessness," that constituted "multiple willful violations by [the broker] of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5." 2008 WL 4489677, at *22.

In *Pinkerton*, a registered representative sold securities issued by a company that was owned and controlled by the same person who owned and controlled the registered representative's broker-dealer. 1996 WL 602648, at *2. The registered representative failed to

verify the information given to him by the issuer, did little due diligence apart from reading the PPM, and ignored "'red flags' which he was required to resolve . . . [including] the fact that the person who owned and controlled [the broker-dealer] also owned and controlled the issuer and was the only source of information about [the issuer]." 1996 WL 602648, at *7. The Court found that the broker's conduct "involved blatant fraud, deceit, and a deliberate disregard of the law and regulatory requirements." 1996 WL 602648, at *11.

Finally, in *Stires*, a registered representative and his firm were found to have violated the antifraud provisions for, among other things, "[recklessly] soliciting investors for private placement transactions that involved millions of dollars without validating information supplied by third party promoters." 1998 WL 462230, at *7. There, as here, the broker "not only failed to perform a due diligence inquiry, he also failed to resolve the red flags[.]" *Id.*

1. Selling Respondents Knowingly or Recklessly Failed to Have a <u>Reasonable Basis for their Recommendations</u>

As the evidence uniformly demonstrates, Selling Respondents failed in their duty to have a reasonable basis for the recommendations they made. Any information they did receive was not verified and was simply accepted at face value. Moreover, important financial reports such as balance sheets and income statements were readily available – the PPMs for the Four Funds disclosed that those reports would be provided to investors upon request. FoF ¶¶ 140-42, 521. Five of the Selling Respondents admitted that they never reviewed or received—or even asked for—a balance sheet, income statement or annual statement of operations. FoF ¶¶ 208, 221 (Chiappone); 270 (Gamello); 316-317 (Lex); 437-441, 450 (Livingston); 534, 489 (Mayer); 703 (Rogers). Rabinovich claimed to have seen a balance sheet (though he did not produce one), yet this seems to be incredible when compared to his testimony that he never saw any documents sufficient to allow him to compare the Four Funds' assets to notes payable. FoF ¶ 609.

The evidence as to each Selling Respondent proves their violations. Chiappone admitted that he conducted no independent investigation of the Four Funds and simply "relied heavily on other people at McGinn Smith to investigate whether the Four Funds were suitable investment products." FoF ¶¶ 204-205. Gamello admitted that he never conducted any inquiry into the Four Funds' investments and that he never had "any specific information on the types of investments" in the Four Funds. FoF ¶ 281. Gamello further explained: "Really the only thing – main thing I went on, Dave Smith was managing it." FoF ¶ 286. Gamello also conducted no due diligence on the Trust Offerings other than read the PPMs and attend in-house meetings. FoF ¶¶ 295-300.

Lex knew that whether or not Four Funds investors were paid depended on the performance of the underlying investments; however, from 2003 through 2007 he sold tens of millions worth of the Four Funds without knowing anything about the underlying investments. FoF ¶¶ 318-320. When Lex, in August 2007, finally received a written list of the Four Funds investments showing that Smith had invested millions of dollars in McGinn Smith entities, including the pre-2003 alarm trusts, and also that the Four Funds had invested in each other, he did nothing. FoF ¶¶ 342-345. Despite these glaring red flags, and although he testified to being "concerned" and "disappointed," Lex failed to undertake any additional due diligence and instead kept the information confidential. FoF ¶ 346. Lex also did no due diligence of the Trust offerings based on his belief that "McGinn was in control" and that was "an extensive amount of people behind the scenes." FoF ¶¶ 351-354.

Livingston admitted that he did not "do a deep dive as far as the whole due diligence," but said that he was "aware of" some of the Four Funds investments. FoF ¶¶ 445-447. He did not think it necessary to obtain more information because it "[d]idn't occur to me that there was a problem with the investments [Smith] had made." FoF ¶¶ 452. Livingston, however, did know

about problems. In December 2007, McGinn and Smith told him about a "catastrophe": the Four Funds had lost $45 million and there was a "lack of cash flow from a big chunk of the funds." FoF ¶¶ 458-459.

Despite this knowledge, and despite being an owner of MS & Co., Livingston did nothing to either find out the reasons for the "catastrophe" or to investigate whether the series of Trust Offerings in 2008 and 2009 also had problems. FoF ¶ 480. Instead, Livingston recommended and sold additional MS & Co. offerings to his customers in 2008 and 2009. FoF ¶¶ 503.

Livingston also had first-hand knowledge of the Four Funds' disastrous investment of $8.8 million in alseT, which enriched him because he received large salaries from both MS & Co. and alseT. FoF ¶ 476. Despite knowing that 10% of the Four Funds proceeds had gone to a totally non-performing asset, and knowing of other "HUGE conflicts" in the portfolio, FoF ¶ 461, Livingston did nothing to either warn other brokers of the crisis or find out the risk to the investors. FoF ¶ 480. On the contrary, even in late 2008, Livingston encouraged the MS & Co. sales staff to "reach out to our clients and convey confidence and direction!" FoF ¶ 481.

Rabinovich had no knowledge regarding the cash flow generated by the Four Funds investments. FoF ¶ 610. He knew that Livingston had an ownership interest in alseT and that it was a venture capital investment "different than the mandate called for" in the Four Funds PPMs, but never asked questions because he did not "understand fully what the investment was at the time or what the structure of the investment was." FoF ¶ 610-611. Rabinovich also claimed not to be aware that a customer to whom he sold a $100,000 Pacific Trust note in 2002 was redeemed in 2008 with funds from FEIN, TAIN and FIIN. FoF ¶¶ 615-624. Rabinovich testified that he knew that the Four Funds purchased security alarm contracts from the Pre-2003 Trust Offerings, and knew that these assets were purchased from affiliates due to a non-compete

agreement between MS & Co. and IASG, but never asked how much the Four Funds paid for these assets. FoF ¶ 610. He also did not know that the Four Funds had invested nearly $3 million in Exchange Boulevard, a risky Pink Sheet company. FoF ¶ 613. Rabinovich stated that Smith selected the interest rates for the Four Funds, but acknowledged that he did not know, or ask, how Smith selected the interest rates for the various Four Funds tranches. FoF ¶ 614.

Mayer did not know the "specific investments" in the Four Funds, he "never did an independent investigation" to find out the portfolio, and never investigated whether Smith's claims of diversification were true. FoF ¶¶ 537, 545, 548. Smith told Mayer that the Four Funds purchased security alarm contracts as part of their investment portfolios, but Mayer did not recall the source of the Four Funds' security alarm contracts, did not know that the Funds purchased contracts from the SPT trusts, and did not ask Smith what the Four Funds paid for the security alarm contracts. FoF ¶ 538. Mayer never asked questions about the structure of MS & Co.-related entities' investments in alseT, and therefore claimed not to know that the Four Funds had invested heavily in alseT even though the alseT team was housed in the very branch office he was in charge of managing. FoF ¶ 539. Mayer was also not aware of the Four Funds' significant investment in Exchange Boulevard.com, Inc., a risky investment in a Pink Sheet company. FoF ¶¶ 542, 613. Mayer knew that Smith selected the interest rates payable on the Four Funds, but admitted he never did an independent investigation to determine if these interest rates were achievable and just relied on the MS & Co. investment banking department (which was controlled by Smith). FoF ¶¶ 544-45. Finally, Mayer knew that the Four Funds PPMs limited sales to accredited investors only, but nevertheless sold to unaccredited investors. FoF ¶ 549.

Similarly, Rogers did not know the specific investments in the Four Funds before January 2008 and he never asked anyone for this information. FoF ¶ 695. He relied on Smith to perform

due diligence for the Four Funds' investments, even though he knew that Smith had never created or managed a fund like the Four Funds before. FoF ¶ 696. Although Smith told him that the Four Funds could achieve a 12% yield on investments in security alarm contracts, Rogers never asked Smith how much the Four Funds paid for security alarm contracts when the only available pool of such assets were from the Pre-2003 Trust Offerings (as the result of a non-compete agreement between MS & Co. and IASG). FoF ¶¶ 696-97; *see also id.* at 612. Despite his lack of investigation, or perhaps as a result of it, Rogers believed that a Four Funds senior note was a "very conservative investment vehicle" and that it was "extremely low risk," despite statements in the Four Funds' PPMs to the contrary. FoF ¶ 700.

Most of Selling Respondents sought to minimize or even recant their deposition testimony regarding their due diligence, asking the Court to credit their 2014 testimony over statements made under oath closer to the events in question. *See, e.g.*, FoF ¶¶ 208 (Chiappone); 285 (Gamello); 537 (Mayer); 625 (Rabinovich); 695 (Rogers). But even accepting their trial testimony at face value, Selling Respondents' conduct falls far short. The fact remains that a multitude of illegal actions were occurring with money received from Selling Respondents' customers. All the while, Selling Respondents asked few or no questions about how their customers' money was invested and ignored bright red flags that called out for investigation. Selling Respondents looked the other way for six years during more than two dozen offerings. So even crediting their new version of the facts presented at the hearing – against the weight of the evidence in this case –Selling Respondents acted knowingly or recklessly.

2. Respondents Knowingly and Recklessly Failed to Investigate and Resolve Red Flags

Failing to investigate and resolve red flags constitutes a knowing or recklessness violation. *See, e.g., Stires*, 1998 WL 462230, at *8. Over a six year period, Selling Respondents

knew about and yet ignored ten categories of red flags that they should have investigated and resolved prior to recommending the MS & Co. offerings to their customers.

*a. The Four Funds Had a Totally Different Investment Mandate Than the Pre-2003 Trust Offerings*

The broad investment mandate of the Four Funds was completely different from the Pre-2003 Trust Offerings. FoF ¶¶ 120-122. Selling Respondents knew this, *e.g.*, FoF ¶¶ 601, and should have exercised greater diligence as a result. Instead, they relied on the purported success of the Pre-2003 Trust Offerings – a "success" which itself was a fallacy, FoF ¶¶ 33-39 – as a substitute for due diligence on the much different Four Funds.

*b. Smith Had Never Served as a Fund Manager for Offerings Similar to the Four Funds*

Although Smith had been running MS & Co. for more than twenty years, he never had responsibility for investing anything like the Four Funds. FoF ¶¶ 123-125. Moreover, the due diligence team that had handled the Pre-2003 Trust Offerings—a team that did not include Smith—had left MS & Co. to work for McGinn at IASG. FoF ¶ 125. They also knew that Smith had no experience managing investment vehicles like the Four Funds. FoF ¶ 124.

*c. Smith Controlled the Issuer, Placement Agent, Owner and Sole Managing Member, Issuer, Trustee and Servicing Agent for the Four Funds Offerings*

Smith's ownership and control of the issuer, the placement agent, the trustee, and the servicing agent was a red flag. FoF ¶¶ 126-132. None of the Respondents, however, saw this as anything that merited their attention. Livingston, for example, had no concerns because the Pre-2003 Trust Offerings "had gone off without any . . . problem whatsoever." FoF ¶¶ 441-442. Selling Respondents were wrong to ignore Smith's multiple conflicting roles. *See Pinkerton*, 1996 WL 602648 at *6 ("[Respondent] chose to ignore facts which required him to perform a

more thorough investigation . . . For example, [Respondent] knew, ignored, and did not disclose to customers that the issuer and the broker-dealer were controlled by the same individual.").

#### d. *The Four Funds PPMs Disclosed that the LLCs Could Acquire Investments from MS & Co. Affiliates*

The "Affiliated Transactions" disclosure in the Four Funds PPMs was a red flag, FoF ¶¶ 133-134, and it should have caused the Respondents to ask for information regarding affiliated transactions. As experienced securities professionals, Respondents should have known the inherent suspicion which surrounds affiliated transactions. "[T]ransactions between a company and its officers or directors...are viewed with extreme skepticism in all areas of finance." *McCurdy v. SEC,* 396 F.3d 1258, 1261-62 (D.C. Cir. 2005). "While related party transactions are not inherently bad, they have proven to be an easy and effective way for perpetrators of fraud and money laundering schemes to misstate the economic substance and reality of financial transactions." *In re Am. Preferred Prescription, Inc.,* 1997 WL 158401, at *3 n.11 (Bankr. E.D.N.Y. Mar. 21, 1997). *See also In re Bear Stearns Companies, Inc. Sec., Derivative, & ERISA Litig.*, 763 F. Supp.2d 423, 472 (S.D.N.Y. 2011) (related party transactions should be "evaluated with a high degree of professional skepticism").

Related party transactions were at the heart of the fraud. FoF ¶¶ 40-59. Selling Respondents should have asked for information on all affiliated transactions and demanded to know whether the price restrictions were observed. *See, e.g.,* FoF ¶¶ 326, 443. Indeed, one of Smith's fraudulent transfers with an affiliate in October 2003—to redeem investors in an earlier MS & Co. offering—was conduct even Respondents recognized was wrong. *See* FoF ¶ 323.

Respondents, however, never investigated the Funds' transactions with related parties. Lex, for example, never asked Smith about affiliated transactions and never asked what kinds of affiliated transactions Smith might be doing. FoF ¶ 326. Livingston knew about the affiliated

transactions disclosure, but never asked Smith about it, or whether he complied with the sales prohibition. Livingston testified he would have been concerned had he known more than half of Four Funds proceeds were invested with affiliates. FoF ¶ 446.

*e. The Four Funds' PPMs Limited Sales to Accredited Investors Only*

Selling Respondents knew that the Four Funds' PPMs restricted sales to accredited investors only. This was a red flag because each of them, other than Gamello, sold the offerings to unaccredited investors, and therefore knew that a term of the PPMs was disregarded in practice. FoF ¶¶ 135-138. That Smith or others at MS & Co. may have told them to ignore the language in the PPMs did not resolve this flag – if anything, receiving word from a boss to disregard language in the PPM should have made an already red flag more glaring. *See Pinkerton*, 1996 WL 602648, at *6 (Respondent "was wrong to accept, without any support, [issuer/broker-dealer's] advice that he could ignore language in private placement memorandum that [the issuer's] securities were only being offered to accredited investors as defined in Rule 506 of the Regulation D exemption.").

*f. Smith Was Secretive Regarding How He Invested Four Funds Proceeds*

Smith kept information about the Four Funds' investments and performance tightly controlled. FoF ¶¶ 139-147. As he told Chiappone in December 2008, in response to a request for a list of investments in TAIN: "Frank, I have repeatedly told all of those who have previously requested this information that it is confidential." FoF ¶ 144. Smith's refusal to tell his brokers critical information about the very investments they were selling to investors should have triggered additional investigation. *SEC v. McNulty,* 137 F.3d 732, 741 (2d Cir. 1998) ("obviously evasive and suspicious statements" by principal should be investigated). Selling Respondents,

however, accepted Smith's refusal to disclose complete financial information for the Four Funds. Rabinovich testified that "Smith didn't want to compromise the sales process": as a result, he had no problem with Smith's reluctance to provide full disclosure. FoF ¶ 607.

g. *Smith Instituted a Redemption Policy*

The Redemption Policy was a red flag. FoF ¶¶ 148-159. As experienced securities professionals, Selling Respondents should have known – as Lex's expert Charles Bennett testified – that "one of the hallmarks of a Ponzi scheme is using fresh money to pay off earlier investors." FoF ¶ 150. *See also* Lex Ex. 147-A at 2 ("a Redemption Policy, that is, a policy requiring brokers to provide a replacement customer, as a condition to redeeming one of their existing customers, would be a red flag"); *In re M&L Bus. Mach. Co.*, 84 F.3d 1330, 1332 n.1 (10th Cir. 1996), *cert. denied,* 519 U.S. 1040 (1996) (defining a Ponzi scheme as "an investment scheme in which returns to investors are not financed through the success of the underlying business venture, but as taken from principal sums of newly attracted investments. [The victims] are promised large returns for their investments. Initial investors are actually paid the promised returns, which attract additional investors.").

The Redemption Policy put Selling Respondents on notice of potential wrongdoing that they were obligated to investigate. The fact that new investor funds were needed to redeem existing investors should have caused Selling Respondents to investigate the offerings because the duty to investigate is greater whenever the legitimacy of an investment is in some way questionable. *SEC v. Milan Capital Group, Inc.* Indeed, even if the Court were to credit Respondents' contention that they found liquidity problems to be understandable in light of global economic conditions—essentially, an argument that assumes MS & Co. would have trouble selling Four Funds assets without incurring a substantial loss, FoF ¶ 292—such a belief

would warrant *more* questions about MS & Co.'s ability to manage investors' money, not less. Selling Respondents, however, did nothing despite their knowledge of the Redemption Policy.

There is extensive evidence of the Redemption Policy. In November 2007, Smith emailed Guzzetti, who Smith tasked with enforcing the Policy, that "[a]ny redemptions have to have replacement sales before hand." FoF ¶ 156. Chiappone understood that he needed to have "replacement tickets" whenever a client wanted to redeem. FoF ¶¶ 224-225. Gamello testified that the first "heard of the redemption policy" toward the end of 2007 when he learned from Guzzetti that Smith wanted brokers to find investors to replace money going to redeeming clients. FoF ¶ 288. In November 2007, Gamello emailed Guzzetti regarding a redemption request and asked "Andy, I'm required to have replacement tickets??? That's news to me." FoF ¶ 289. The next day, Gamello emailed Guzzetti to say that "I don't really have a replacement at this time" but said that "[f]or the future I'll look to have replacement set up." FoF ¶ 290. Gamello made good on his promise to find replacement tickets and, in a December 21, 2007 email, Guzzetti asked Smith to "okay this redemption" because Gamello had "replaced the money." FoF ¶¶ 292-293.

Lex also knew about and followed the Redemption Policy. FoF ¶¶ 355-361. Indeed, as the largest seller (FoF ¶ 308), Lex had extensive experience with the need to find "replacement tickets," as shown in numerous emails. FoF ¶ 361. Mayer also knew about and complied with the Redemption Policy. FoF ¶¶ 550-552.

Rabinovich testified in 2011 that he knew about the Redemption Policy, was concerned about it, and understood that by December 2007 "[n]o new redemptions were taking place without it." FoF ¶ 625. Rabinovich also experienced the Redemption Policy firsthand when his father's investments of $600,000 in Firstline, and $250,000 in TDMM Cable 09, were both

repaid directly with money raised from other investors. FoF ¶¶ 630-642. Rabinovich also bought a TDM Verifier 11 certificate in August 2009 solely in order to redeem one of Rogers' customers in order avoid "possible legal action." FoF ¶¶ 643-645. Rogers, too, knew about and complied with the Redemption Policy. FoF ¶ 705.

h. *The January 2008 Default of the Four Funds Junior Notes*

The announcement of the January 2008 default was a red flag that, combined with the prior accumulated red flags, should have, at a minimum, led to a further investigation into whether Smith had misrepresented facts about the Funds and whether MS & Co. should continue to launch unregistered offerings. FoF ¶¶ 160-168. Instead, Respondents uniformly accepted Smith's "market meltdown" explanation without doing any independent investigation.

Mayer testified that he was "upset" about what he learned at the meeting announcing the default, but did nothing because he believed that the issues were "just like any of the other investments that weren't working at the time." FoF ¶ 555. Rabinovich also was "shocked" and "very upset" by the revelations at the January 8 meeting. FoF ¶ 649. Like the other Respondents, however, Rabinovich did no independent investigation into anything at MS & Co., continued to recommend the Trust Offerings to his customers, and reassured customers who inquired that McGinn and Smith would right the ship. FoF ¶¶ 651-658. Rabinovich even accepted McGinn's exhortation to "pump out the swamp," referring to the need to bring in new revenue because so much money was tied up in the Four Funds. FoF ¶ 650.

Rogers was "stunned, upset, [and] angry" after the January 8 meeting. FoF ¶ 708. However, he did not tell his customers of their rights under the PPM in the event of default. FoF ¶ 709.

Even Chiappone, who realized in 2008 that Smith's "market meltdown explanation," was "just a screen," did nothing. FoF ¶¶ 238-241. As Chiappone explained, other brokers realized in 2008 that "they, along with their clients, had been misle[d]." FoF ¶ 235.

One reason brokers may have begun to realize Smith was lying to them was the disclosure of investments in the Four Funds revealed that they were not the "silos" invested in different underlying assets, but rather four differently named funds with significantly overlapping investments. When Chiappone learned that the Four Funds held many of the same investments, he found this "incomprehensible," FoF ¶ 243; Lex, too, was "upset" by this news. FoF ¶ 247. Nevertheless, they did nothing to investigate anything and continued to sell the Trust Offerings.

Selling Respondents learned of more defaults in April 2008 and October 2008, when Smith sent letters to Four Funds investors to disclose additional "restructurings," FoF ¶¶ 167, but Selling Respondents took no actions to investigate the cause of the restructurings.

In addition, at a September 2008 meeting in Clifton Park, Smith and McGinn disclosed to Rabinovich, Mayer, Rogers, Lex and Gamello the need for more "restructuring" of the Four Funds. FoF ¶ 819. This did not prompt any further investigation.

Mayer even continued to sell, without further investigation, MS & Co. offerings after learning about problems regarding MS & Co.'s dwindling net capital that were discussed at March 17, 2009 meeting he attended. FoF ¶¶ 559-564. *See also* FoF ¶¶ 116-119 (series of letters from NFS noting MS & Co.'s net capital violations).

*i.* *The Trust Offerings Had Features that Constituted Red Flags*

When the Trust Offerings began in November 2006, McGinn's and Smith's fraudulent uses of offering proceeds became even more flagrant. FoF ¶¶ 64-115. No doubt, Smith and

McGinn knew that Selling Respondents would continue to sell the Trust Offerings and never ask them to explain how the investors' money was being used. Indeed, in addition to the outright theft and other improper uses of offering proceeds, FoF ¶¶ 64-77, the Trust Offerings suffered from egregious due diligence failures. FoF ¶¶ 170 (Receiver's testimony that due diligence was "very poor" and "not well run"); 88 (failed to discover prior equity owner of TDM Cable 06 asset); 92 (ignored risk of Firstline bankruptcy during due diligence and failed to make proper UCC filing to perfect interest); 99 (purchased Integrated Excellence assets that failed to generate sufficient income to pay investors); 110 (overpaid for Benchmark asset). Four of these offerings were created for the specific purpose of redeeming earlier Trust investors, *see* FoF ¶ 175, and others charged exorbitant fees. *See* FoF ¶¶ 171-74.

*j. The Revelation that McGinn and Smith Concealed the Firstline <u>Services, Inc. Bankruptcy Was a Red Flag</u>*

After the Firstline bankruptcy filing in January 2008, which Selling Respondents learned of on September 3, 2009, Smith and McGinn concealed the bankruptcy from them and paid Firstline investors from other improper sources. This was obviously a red flag. FoF ¶¶ 176-178. Nevertheless, even this most blatant and egregious of lies did not cause any change in some Respondents' conduct. Chiappone, for example, sold a Benchmark note on November 3, 2009, with knowledge of the Firstline deception and without sharing with the Benchmark note purchaser any concerns he had about McGinn's or Smith's trustworthiness. FoF ¶¶ 261-263. Rabinovich accepted customer funds for a Benchmark purchase on September 15 and 21, 2009, even though he knew Smith and McGinn concealed the bankruptcy. FoF ¶ 666. Mayer, too, did not look out for his customers after learning McGinn and Smith had concealed from him the Firstline bankruptcy. FoF ¶ 576.

## B. Selling Respondents Misrepresented and Omitted Material Facts

"It is clear that a salesman must not merely avoid affirmative misstatements when he recommends the stock to a customer; he must also disclose material adverse facts of which he is or should be aware." *Hanly,* 415 F.2d at 592 (citing *Richard J. Buck & Co*, 1968 WL 86080, at *6 (Dec. 31, 1968)). Because Selling Respondents recommended the MS & Co. private placements to their customers, they were obligated to disclose all known or reasonably ascertainable material adverse information about the recommended securities. *Hanly,* 415 F.2d at 597; *see also Kwiatkowski v. Bear Stearns & Co.,* 306 F.3d 1293, 1302 (2d Cir. 2002) (broker "is obliged to give honest and complete information when recommending a purchase or sale").

In addition, a broker who lacks essential information about an issuer or its securities when he makes a recommendation, including recommendation of securities in Regulation D offerings, must disclose this fact as well as the risks that arise from its lack of information. *See SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1 (D.D.C. 1998) (if essential information is not known to a securities dealer, the dealer must inform investors that this information is unknown and must disclose the risks of such uncertainty).

Selling Respondents made numerous misrepresentations and omitted material information in connection with the offer, sale and purchase of the Funds, the Trust Offerings and MSTF. They failed to disclose the risk factors associated with these investments, and they repeatedly told prospective customers that Smith and McGinn had a reliable track record and that their principal would be safe. Selling Respondents failed to disclose to investors adverse information that they knew of or that was reasonably ascertainable.

Examples abound. Chiappone told his customer, Gary Ardizzone, that the Four Funds were conservative investments, and Chiappone led Ardizzone to believe that the Four Funds were

alarm deals. FoF ¶¶ 264-266. Chiappone's representations left Leanne Sweet, an investor Chiappone called to testify, similarly confused. FoF ¶ 272.

Chiappone also failed to disclose to his customers his highly material concerns about McGinn's and Smith's trustworthiness. For example, he sold Ardizzone a note in October 2008 without disclosing his concerns regarding Smith and McGinn's trustworthiness. Had Ardizzone known that, he would have "run like a scared rabbit." FoF ¶¶ 267. Likewise, Bruce Becker would have wanted to know of Chiappone's concerns about Smith and McGinn, but Chiappone never shared his concerns with Becker, who testified that he expected Chiappone to have conducted due diligence on the notes. FoF ¶¶ 268-271.

Gamello told potential FAIN investors that the previous Four Funds offerings "by all accounts . . .are performing." FoF ¶ 301. He also sold an MS & Co. note in August 2009 without disclosing that some of his customers had not been paid on a prior offering. FoF ¶ 302. And Gamello sold more than $1 million in MS & Co. to two sisters without telling them he had done no independent investigation of the offerings. FoF ¶ 303.

Three customers of Lex – Alice Forsythe, Barbara Monahan and Marvin Weinar – testified as to Lex's repeated misrepresentations and omissions. Lex told them the Four Funds and Trust offerings he recommended were safe for their retirement accounts, he never mentioned the high risk nature of the notes, and he never disclosed his own inadequate due diligence. FoF ¶¶ 384-425. Monahan, who put away small amounts every month for her retirement from her work as a labor and delivery nurse, told Lex that she did not want any high risk investments. FoF ¶ 398. Lex nevertheless recommended that Monahan invest a total of $262,000 in FAIN, Firstline and Integrated Excellence. FoF ¶¶ 395-404. And Lex told Weinar, who invested his $410,000 retirement account in FEIN, TAIN, FAIN and Integrated Excellence, that the PPMs contain "stuff

that the lawyers want in there just to protect themselves" and that reading a PPM "would induce sleep." FoF ¶ 419.

Daniel Ferris and David LaFleche testified about Livingston's material misrepresentations and omissions to them. FoF ¶¶ 501-518. For example, Livingston never mentioned any risks concerning the notes he recommended to LaFleche, FoF ¶ 510, and Livingston never told Ferris about any of the problems at MS & Co. about which Livingston was aware. FoF ¶ 504.

Mayer made material misrepresentations and omissions and failed to provide material information to his Four Funds and Trust Offerings customers. FoF ¶¶ 565-592. For example, Vincent O'Brien—who indicated a "moderate" risk tolerance and a "limited" knowledge of investments on account opening documents—was of the view that his private placements were "safe" based on discussions with Mayer. FoF ¶¶ 570, 572-73. Mayer also failed to disclose the Four Funds default to O'Brien, although he had touted MS & Co.'s success with respect to private placements in his sales pitches. FoF ¶ 571. Mayer never disclosed to O'Brien the high fees and expenses associated with certain Trust Offerings and never warned O'Brien not to purchase TDMM Benchmark after Mayer learned about the concealment of the Firstline bankruptcy. FoF ¶¶ 574-76. Notably, all of this conduct occurred *after* September 23, 2008, the beginning of the applicable limitations period. Other examples of Mayer's misrepresentations and omissions can be found at FoF paragraphs 579 to 592.

Rabinovich described FEIN in an email as an asset with "substantial cash flow, a history of performance and limited liquidity in the market place," even though this language was from the letter that Smith drafted to describe another fund (which was never created) and Rabinovich had done no investigation into FEIN's cash flow and performance. FoF ¶¶ 669-72. Patricia Chapman

and Ketan Patel testified about Rabinovich's material misrepresentations and omissions to them. FoF ¶¶ 673-683.

Rogers made material misrepresentations and omission to his customers, including Peggy and Jim LoScalzo and Stephen Fowler (whose video deposition is in evidence). FoF ¶¶ 715-732. Fowler, who had purchased more than $3 million of MS & Co. private placements through Rogers, had a high risk tolerance but nevertheless understood from Rogers that the investments he purchased were safe, "substantially lower risk" than venture-capital investments like Biodel, and "paid a coupon on a regular basis." FoF ¶¶ 726-727. Fowler testified that he would not have invested in Benchmark if he had known 30% of the funds raised were fees. FoF ¶ 731. And in late April 2010—after the NDNY SEC Action had been filed and Fowler read online that MS & Co. had been closed down due to net capital violations—he emailed Rogers to say that the article was "not quite how you explained the move to Dinosaur. And why was I not informed that MS had 'shut its doors because capital levels had fallen too low.' I had no idea they had not been conducting business since December!" FoF ¶ 732. Rogers' misrepresentations and omissions to the LoScalzos are detailed at FoF paragraphs 717 to 724.

### C. Selling Respondents also Violated Rule 10b-5(a) and (c) and Securities Act Section 17(a)(1) and 17(a)(3)

Selling Respondents were the keystone of a scheme to defraud investors. Scheme liability may arise from misstatements alone. *See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148, 158 (2008); *see also Matter of Cady, Roberts & Co.,* 40 S.E.C. 907, 913 (1961) ("The three main subdivisions of Section 17 and Rule 10b-5 have been considered to be mutually supporting rather than mutually exclusive."). Here, however, the fraud that victimized Respondents' customers was broader than their misstatements and omissions alone.

Each of the Selling Respondents undertook a course of deceptive conduct that involved adhering to the Redemption Policy and selling McGinn Smith private placements after numerous red flags made it clear that something was amiss at the broker-dealer with respect to the private placement offerings that MS & Co. had underwritten and sold previously. Selling Respondents' robust sales efforts in the face of serious red flags permitted the fraud to continue for years.

### D. Selling Respondents Acted Negligently

To show that Selling Respondents violated sections 17(a)(2) and 17(a)(3) of the Securities Act, the Commission need only show (i) material misrepresentations or materially misleading omissions, (ii) in the offer or sale of securities, (iii) made with negligence. *SEC v. U.S. Pension Trust Corp.*, No. 07-22570-CIV, 2010 WL 3894082, at *19 (S.D. Fla. Sept. 30, 2010) (citing *SEC v. Merchant Capital, LLC,* 483 F.3d 747, 766 (11th Cir. 2007)). At a minimum, Selling Respondents acted negligently.[4]

To establish negligence, the Commission must show that Selling Respondents failed to conform to the standards of care applicable to its industry or profession. *See SEC v. Fitzgerald*, 135 F. Supp. 2d 992, 1028 (N.D. Cal. 2001). As explained by expert witness Robert Lowry, Selling Respondents failed to conform to the standards of care applicable to registered representatives confronted with the flags that existed here. *See, e.g.*, FoF ¶¶ 134, 170, 174.

The standard of care by which to measure conduct, however, is not defined solely by industry practice, "but must be judged by a more expansive standard of reasonable prudence, for which the industry standard is but one factor." *SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 856

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[4] Section 17(a)(2)'s requirement that one obtain money or property through misstatements or omissions about material facts, *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 861 (S.D.N.Y. 1997), *aff'd*, 159 F.3d 1348 (2d Cir. 1998), is easily satisfied here, where Selling Respondents each made thousands of dollars from their sales. FoF ¶¶ 1, 2, 4-8.

(9th Cir. 2001). A securities professional has a fundamental obligation to investigate a security to ensure that the key statements about the security that are provided to investors are truthful and complete. Whether this basic obligation has been satisfied is highly relevant to whether his conduct was reasonably prudent. *See, e.g.*, *Dain Rauscher*, 254 F.3d at 859 (finding existence of material fact as to whether securities professional complied with controlling standard of reasonable prudence as to both his investigative and disclosure responsibilities). As discussed above, Selling Respondents failed in these obligations and, consequently, their conduct was not reasonable or prudent.

## III. GUZZETTI FAILED TO DISCHARGE HIS SUPERVISORY RESPONSIBILITIES

### A. Guzzetti Supervised Selling Respondents

"[D]etermining if a particular person is a 'supervisor' depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue." "In each situation a person's actual responsibilities and authority . . . will determine whether he . . . is a 'supervisor' for purposes of [Exchange Act] Sections 15(b)(4)(E) and (6)," rather than his "line" or "non-line" status or job title.'" *Bloomfield,* 2014 WL 768828, at *11 (Feb. 27. 2014) (quoting *Matter of Kolar*, No. 3-9570, 2002 WL 1393652, at *4 (S.E.C. June 26, 2002) and *Matter of Gutfreund*, No. 3-7930, 1992 WL 262753, at *15 (Dec. 3, 1992)).

There is substantial evidence that Guzzetti was a supervisor of the brokers during the five years he was an employee of MS & Co. and that he was a supervisor with regard to the private placements. Guzzetti performed many supervisory functions, and in mid-size firms like MS & Co., "senior managers often wear many hats." *Bloomfield*, 2014 WL 7698828, at *11. Among

other things, Guzzetti recruited brokers, he assigned customers to brokers, and he consulted with branch managers regarding broker evaluations. FoF ¶¶ 745-747.

Guzzetti held weekly telephonic sales calls with all the brokers where he would lead the discussion. FoF ¶ 766. During these weekly calls, Guzzetti testified that he instructed the brokers on selling private placements with "my three big ones": "make sure accredited," "[n]o cold calling and make sure you sell off the PPM." FoF ¶ 780.

Guzzetti also participated in meetings with Smith and McGinn regarding broker compensation, and developed a grid that was used in determining broker compensation. FoF ¶¶ 748. In addition, he used the "Guzzetti ranking system" to establish the "Directors' Council," a recognition awarded to the top producers at the firm. FoF ¶ 749.

Guzzetti acted on behalf of the firm. He and Mayer spent nearly a year interviewing many potential clearing firms in 2005, and participated in the final selection of MS & Co.'s clearing firm. FoF ¶¶ 116, 753. Guzzetti also attended, at Smith's request, Exit Conferences with FINRA examiners. FoF ¶ 751. He also claimed to be "head of MS Advisors." FoF ¶ 750.

The 2007 and 2008 Compliance Manuals list Guzzetti as one of the few "Supervisory Personnel" who "are responsible for the supervisory activities of the firm," and they also state that "Andy Guzzetti, as Managing Director – Private Client Group, is directly responsible for all outside RRs," which includes Lex. FoF ¶¶ 756, 758. The 2008 Compliance Manual states that "[a]ll brokers in the Clifton Park office are under Andy Guzzetti's direct supervision," which included Anthony, Feldmann and Chiappone. FoF ¶ 759-760. MS & Co.'s written Branch Office Procedures gives broad responsibility to branch managers, including the duty to ensure that "no unusual sales practice activities are occurring in connection with the review of daily trading." FoF ¶ 761.

Other Respondents testified as to Guzzetti's supervisory role. Mayer, who was the branch manager in MS & Co.'s NYC office, testified that he was always under Smith "but then Andy Guzzetti arrived in approximately 2004 and I was under Andy Guzzetti. . . . [After 2004], [i]t was more reporting to Andy . . .the day-to-day operational things were under Andy." FoF ¶ 764. Gamello testified that Guzzetti was a supervisor and that he would consult Guzzetti "for any questions on anything." FoF ¶ 765. Lex testified that Guzzetti was a sales supervisor, Chiappone testified that Guzzetti could tell him what to do and not do, and Rogers testified that "at some point [Guzzetti] was a report." FoF ¶¶ 766-769.

Guzzetti had the training and background for a supervisory position. He was a branch manager at two different Shearson offices from 1992 through 2002, and he also trained financial consultants at Shearson's National Training Department. FoF ¶¶ 738-741. Guzzetti now works as a supervisor in an office of supervisory jurisdiction for DLG Wealth Management. FoF ¶ 742.

### B. Guzzetti's Claim that His Areas of Supervision Excluded the Private Placements is Not Credible

Guzzetti testified at the hearing that he "did not supervise when it came to the [Four Funds, Trust Offerings and MSTF]," FoF ¶ 777, and his Answer (at ¶ 62) states that "Guzzetti admits that after October 2006, he was a supervisor for some of the MS & Co. brokers for their general securities activities but denies that he had any supervisory responsibility for the Four Funds and the Trusts." FoF ¶ 763. This position is not credible for several reasons.

*First*, in prior testimony in 2011, Guzzetti never claimed that he had no supervisory authority over the Four Funds, Trust Offerings and MSTF, and he also never drew a distinction between supervision of the private placements and supervision of other areas. In 2011, for example, Guzzetti testified that "everything came through me to go to the brokers as far as . . . products . . . Yes, I was a supervisor, retail." FoF ¶ 755. Similarly, Guzzetti testified before the

grand jury that "I had all the retail sales force reported to me when it came to products and prospecting for new business and things like that." FoF ¶ 754.

*Second*, the other Respondents who identified Guzzetti as a supervisor never said that his supervision excluded the private placements. FoF ¶¶ 764-769.

*Third*, the distinction between supervision of the private placements and supervision of other areas is not set forth in the Compliance Manual or the Branch Office Procedures. FoF ¶¶ 756-761.

*Fourth*, Guzzetti admitted that nobody ever told him that his area of supervision excluded the Four Funds, Trust Offerings and MSTF, and he could not identify a single document that supported his position on this point. FoF ¶¶ 777-778.

*Finally*, and as discussed below, Guzzetti's claim is contradicted by his own conduct and by the many emails he sent and received over four years. This evidence shows that Guzzetti exercised significant supervisory authority with regard to the Four Funds, Trust Offerings and MSTF: among other things, he implemented and enforced the Redemption Policy; he urged the brokers to move their customers' money out of money market funds and into the MS & Co. private placements even though he knew nothing about how the Four Funds were invested, FoF ¶¶ 770-776; he vigorously encouraged the brokers to sell MS & Co. offerings although he knew of the liquidity crisis at least by 2006, and he was involved in decisions about which customers get redeemed. FoF ¶¶ 780-844.

### C. <u>Guzzetti Failed Reasonably to Supervise Selling Respondents</u>

Under Exchange Act Section 15(b)(6), incorporating by reference Exchange Act Section 15(b)(4)(E), a person associated with a broker-dealer may be sanctioned if that person "has failed reasonably to supervise, with a view to preventing violations of [the federal securities laws by],

another person who commits such a violation, if such other person is subject to his supervision." 15 U.S.C. § 78o(b)(4)(E).

The duty of supervisors like Guzzetti to respond to any indications of wrongdoing is firmly established: "We have made it abundantly clear that supervisors must act decisively when an indication of irregularity is brought to their attention. That irregularity need not be a violation of the securities laws. Decisive action is necessary whenever supervisors are made aware of suspicious circumstances, particularly those that have an obvious potential for violations." *Kolar*, 2002 WL 1393652, at *4; *See also Bloomfield*, 2014 WL 768828, at *11 ("'The supervisory obligations imposed by the federal securities laws require a vigorous response even to indications of wrongdoing.' 'Red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of the securities laws.'") (*quoting Gutfreund*, 1992 WL 362753, at *15, and *Matter of Murphy*, No. 3-14609, 2013 WL 3327752, at *18 (July 2, 2013).

Guzzetti received numerous emails that, at a minimum, required further inquiry. Instead, Guzzetti – who testified that in his career he has never heard the term "red flags" (FoF ¶ 846) – did nothing. The record does not contain a single instance of Guzzetti making any inquiry into any of the numerous irregularities he encountered.

On December 21, 2006, Guzzetti received an email from Smith stating that "Rabinovich needs to replace the $100,000 before doing the trade. I am running on fumes with these redemptions and cannot afford any more." FoF ¶ 788. Guzzetti knew that Smith's instruction was contrary to the PPM, but did nothing. FoF ¶ 788. On November 10, 2007, Guzzetti received another email from Smith stating that redeeming without a replacement was "not

permissible. With the interest payment coming due and commissions payable in December I do not have the liquidity. Any redemptions have to have replacement sales beforehand. . . . Please handle this with TLC. We need some team play and cooperation." FoF ¶ 156. Rather than demand an answer as to why Smith would institute such a policy, Guzzetti complied with Smith's request and told the brokers, including Selling Respondents, about it at the next conference call. FoF ¶ 157. Guzzetti, with Patricia Sicluna's assistance, kept track of redemptions to make sure brokers complied with the policy, and he emailed Selling Respondents to remind them of the obligation to have "replacement tickets." FoF ¶ 786-789, 792-810.

Guzzetti was involved in decisions about which customers get redeemed. In January 2008, he emailed Smith that "we may want to redeem" a customer because "I don't want to get a letter from their lawyers." FoF ¶ 810. And in April 2009, Smith, who was deciding which of two customers should be redeemed, asked Guzzetti "[w]hich squeaky wheel should we take care of?" Guzzetti responded by naming his preference and also giving his reason: "only because he can do other deals." FoF ¶ 832.

Guzzetti received numerous other emails that should have prompted some kind of inquiry from him; many of these emails concerned Lex, who was an "outside RR" (FoF ¶¶ 756-757) and therefore directly supervised by Guzzetti. *See* FoF ¶¶ 799 (Lex concerned about clients not being paid upon redemption); 809 (redemption problems); 811 (Lex: "the fiduciary duty to the clients has been breached"); 829 (Lex's clients ask if "they've bought into a Ponzi scheme).

Guzzetti not only failed to take any measures to respond in any way to the red flags at MS & Co., he appears to believe that nothing he saw was any indication of wrongdoing. In perhaps the clearest evidence of Guzzetti's egregious supervisory failures, when he was asked whether he ever saw anything suspicious at MS & Co., he replied "absolutely not." FoF ¶ 845.

*See also* FoF ¶ 848 (Division Expert Robert Lowry opinion that "Guzzetti did not reasonably discharge his supervisory duties and obligations").

## IV. The Court Should Impose Meaningful Sanctions Against Respondents

The Division seeks relief to ensure that Respondents do not profit from their misconduct, are prevented from future violations victimizing the investing public, and are punished for violating the securities laws. To accomplish these goals, the Division seeks an order (i) compelling Selling Respondents to disgorge all ill-gotten gains plus prejudgment interest; (ii) imposing significant civil monetary penalties on all Respondents; (iii) imposing a full associational and penny stock bars on all Respondents; and (iv) compelling all Respondents to cease and desist from committing or causing any violations or future violations of the securities laws that each Respondent violated.

### A. The Division's Request for Relief for Respondents' Violations of the Securities Laws Occurring Between September 2003 and November 2009 Is Not Barred by Any Statute of Limitations

Respondents' violations of the securities laws occurred from the date each Selling Respondent first recommended and sold one of the Four Funds notes until that Respondent's final sale of the Trust Offering certificates or, in the case of Guzzetti, for the period that he supervised Selling Respondents.[5] The Division's requests for non-punitive equitable relief, including disgorgement of Selling Respondents' commissions from their sales, plus prejudgment

[5] On January 10, 2014, Lex filed a Motion for Summary Disposition, which several Respondents joined, arguing that this proceeding could not even be "entertained" under Section 2462. The Court denied this motion on January 21, 2014. Tr. of Telephonic Prehearing Conf. at 30-31 (Jan. 21, 2014). On January 15, 2014, Lex filed a Motion for Reconsideration of Order Dated January 15, 2014. The Court denied this motion on January 27, 2014. Tr. 4:11 – 6:7. Notably, Lex did not cite a single case holding that 28 U.S.C. Section 2462 bars entirely this proceeding. To the contrary, this Court has recently held that the statute of limitations "*does not* apply to this entire proceeding, but only to particular sanctions." *See Matter of Raymond J. Lucia Companies, Inc. et al.*, No. 3-15006, 2013 WL 6384274, at *53 (Dec. 6, 2013) (emphasis added).

interest thereon, and for a cease-and-desist order, are not subject to the five-year statute of limitations set forth in 28 U.S.C. § 2462.[6] *See Matter of Trautman*, No. 3-12559, 2009 WL 6761741, at *20 (Dec. 15, 2009) (entirety of respondent's conduct may be considered because cease-and-desist and disgorgement orders apply prospectively); *SEC v. Power*, 525 F. Supp. 2d 415, 426 (S.D.N.Y. 2007) ("Disgorgement is an equitable remedy to which Section 2642 does not apply."). Thus, disgorgement and cease-and-desist orders are appropriate regardless of when Respondents' violative conduct occurred.

With respect to the Division's request for civil monetary penalties and prophylactic associational bars, violative conduct that occurred before the limitations period may be considered to establish "motive, intent, or knowledge in committing the violations that are within the limitations period." *See Trautman*, 2009 WL 6761741, at *20. "Further, such acts may be considered in determining the appropriate sanction if violations are proven." *Matter of Warwick Capital Mgmt.*, Inc., No. 3-12357, 2007 WL 505772, at *2 (Feb. 15, 2007) (citation omitted).

The Division has proven that Selling Respondents committed egregious violations of the securities laws <u>after</u> September 23, 2008 by recommending and selling unregistered, fraudulent private placements without fulfilling their duty of inquiry, by making misrepresentations and omissions to customers and, in the case of Guzzetti, failing to prevent these serious violations. The Division has also set forth a wealth of evidence concerning events and actions that occurred <u>before</u> September 2008. That evidence is relevant to the Court's analysis of what sanctions are appropriate both because (i) they make clear Respondents' motives, intent and knowledge at the

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[6] Indeed, some courts haves concluded that prophylactic bars are not punitive where there is a risk of recurrence and a risk to the investing public. *SEC v. Quinlan*, No. 08-2619, 373 Fed. Appx. 581, 587 (6th Cir. Apr. 21, 2010) (officer and director bar was not a "penalty" under 28 U.S.C. § 2462 given the risk of recurrence and that the risk to the investing public outweighed the potential collateral consequences of the equitable relief).

time of their post-September 2008 violations, such as post-September 2008 sales of MS & Co. products made after learning earlier of the Four Funds' defaults, and (ii) because proven prior transgressions are relevant to the Court's analysis of what sanctions are appropriate to protect the public interest and promote deterrence.

### B. Selling Respondents Should Be Required to Disgorge All Ill-Gotten Gains and Pay Prejudgment Interest

"Securities Act Section 8A(e) and Exchange Act Sections 21B(e) and 21C(e) authorize disgorgement, including reasonable prejudgment interest, in a cease-and-desist proceeding and a proceeding in which a civil money penalty may be imposed." *Matter of Bloomfield,* No. 3-13871, 2014 WL 768828, at *20 (S.E.C. Feb. 27, 2014). Disgorgement is "designed to deprive wrongdoers of their unjust enrichment and deter others from similar misconduct." *Id.*; *see also SEC v. Teo*, --- F.3d ---, 2014 WL 503455, at *11 (3d Cir. Feb. 10, 2014) (affirming disgorgement award, explaining "the SEC's use of the disgorgement remedy has been constructed around two objectives: to deprive a wrongdoer of his unjust enrichment and to deter others from violating securities laws.") (citations omitted)); *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1474 (2d Cir. 1996) ("effective enforcement of the federal securities laws requires that the SEC be able to make violations unprofitable") (citation omitted).

Because disgorgement seeks to deprive wrongdoers of ill-gotten gains, such relief is appropriate whether those gains were obtained due to fraud or sales that were unlawful for some other reason, such as Respondents' violations of Section 5 of the Securities Act. *Bloomfield*, 2014 WL 768828, at *20-21 (awarding disgorgement of commissions earned on sales in violation of Section 5 of the Securities Act); *see also SEC v. CMKM Diamonds, Inc.*, 729 F.3d 1248, 1261 (9th Cir. 2013) (affirming award of disgorgement of ill-gotten gains obtained through sales made in violation of Section 5).

A proper measure of Selling Respondents' unjust enrichment is the commissions paid to each Respondent for his respective unlawful sales. *See VanCook v. SEC*, 653 F.3d 130, 142 (2d Cir. 2011) (affirming Commission disgorgement award of all commissions earned on unlawful sales); *Matter of Ward*, No. 3-9237, 2003 WL 1447865, at *14 (S.E.C. Mar. 19, 2003) (ordering disgorgement of commissions).

Selling Respondents received the following commissions on their sales: Chiappone: $531,844; Gamello: $108,250; Lex: $1,775,544; Livingston: $143,879; Mayer: $122,455; Rabinovich: $586,741; Rogers: $251,443. FoF ¶¶ 1, 2, 4-8.

"Prejudgment interest shall be due on any sum required to be paid pursuant to an order of disgorgement." Rule of Practice 600(a). Prejudgment interest deprives a defendant of an interest-free loan in the amount of his ill-gotten gains, thereby preventing unjust enrichment. *SEC v. Grossman*, No. 87 Civ. 1031, 1997 WL 231167, at *11 (S.D.N.Y. May 6, 1997), *aff'd in part and vacated in part on other grounds*, 173 F.3d 846 (2d Cir. 1999); *see also Bloomfield*, 2014 WL 768828, at *21 (awarding prejudgment interest "to make violations unprofitable.").[7] Accordingly, Selling Respondents should pay prejudgment interest on all disgorged gains.

### C. Respondents Should Be Required to Pay Substantial Penalties

The Division seeks civil monetary penalties for each of Respondents' violations of the securities laws since September 23, 2008, or five years prior to the filing of the OIP. Each of the Selling Respondents made numerous sales of different offerings in the five years preceding the

[7] Interest "shall be due from the first day of the month following each such violation through the last day of the month preceding the month in which payment of disgorgement is made." Rule of Practice 600(a). The Commission ordinarily calculates prejudgment interest quarterly based on Section 6621(a)(2) of the Internal Revenue Code. *See, e.g., Bloomfield*, 2014 WL 768828, at *21.

filing of the OIP. The Commission may impose civil monetary penalties against any respondent found to have willfully violated any provision of the Securities Act or Exchange Act if such penalties are in the public interest. Securities Act Section 8A(g) [15 U.S.C. § 77h-1(g)]; Exchange Act Section 21B(a) [15 U.S.C. § 78u-2(a)].

- Chiappone made 36 sales of 7 different offerings raising $1,035,000 from 21 investors.
- Gamello made 12 sales of 7 different offerings raising $1,010,000 from 2 investors.
- Guzzetti made 3 sales of 2 different offerings raising $85,000 from 2 investors.
- Lex made 49 sales of 7 different offerings raising $1,605,000 from 39 investors.
- Livingston made 5 sales of 3 different offerings raising $255,000 from 3 investors.
- Mayer made 31 sales of 7 different offerings raising $995,000 from 7 investors.
- Rabinovich made 38 sales of 8 different offerings raising $1,975,000 from 19 investors.
- Rogers made 13 sales of 5 different offerings raising $645,000 from 7 investors.

FoF ¶¶ 194-201.

These unlawful sales warrant significant penalties.

Respondents' Misconduct Warrants Third-Tier Penalties.

Section 21B(b) of the Exchange Act specifies a three-tier system identifying the maximum amount of civil penalties, depending on the severity of the respondent's conduct. Second tier penalties are awarded in cases involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. Third-tier penalties are awarded in cases where Respondents' conduct reflects such a state of mind and the conduct in question directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons, or resulted in substantial pecuniary gain to the person who committed the act or omission. 15 U.S.C. § 78u-2(c).

The third tier numbers relevant here are a $150,000 maximum penalty for wrongful acts post-dating March 3, 2009 and $130,000 for acts on or before that date.[8] 17 C.F.R. §§ 201.1003, 1004. As discussed below, those figures are for "each such act or omission" warranting a third-tier penalty, not a maximum penalty for a Respondent's total conduct. 15 U.S.C. § 78u-2(b)(3).

By statute, courts should look at six factors to determine whether civil monetary penalties are in the public interest: (1) deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to others; (3) unjust enrichment; (4) prior violations; (5) deterrence; and (6) such other matters as justice may require. 15 U.S.C. § 78u-2(c); *see also Matter of Gualario & Co., LLC*, No. 3-14340, 2012 WL 627198, at *17 (Feb. 14, 2012).

Here, each factor militates in favor of awarding significant penalties.

<u>Respondents' Conduct Was Deceptive</u>

Because this case involves violations of the antifraud provisions of the securities laws, a finding of liability under those statutes essentially answers the question of whether Respondents engaged in an act involving deceit or deliberate or reckless disregard of a regulatory requirement. Indeed, violations of the antifraud provisions of the securities laws are presumed to be the kind of misconduct that satisfies the "deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" prong of the public interest test. *See Matter of Gerasimowicz*, No. 3-15024, 2013 WL 3487073, at *6 (July 12, 2013) (respondents "violated the antifraud provisions, so their violative actions 'involved fraud [and] reckless disregard of a regulatory requirement' within the meaning of Sections 21B(b)(3) of the Exchange Act, 203(i)(2) of the Advisers Act, and 9(d)(2) of the Investment Company Act.").

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[8] Pursuant to the Debt Collection Act of 1996, the maximum penalties under each tier are adjusted every four years. The second tier maximum awards per wrongful act are $75,000 for violations occurring on March 3, 2009 or later and $65,000 for earlier violations.

Respondents Reaped Significant Financial Rewards on the Backs of Defrauded Investors

Respondents' conduct caused great harm to investors. These brokers bridged the gap between McGinn and Smith and the investors whose money was necessary to perpetrate the long lasting fraud. Investors lost millions of dollars and in many cases had their lives, and plans, drastically altered. FoF ¶¶ 28-29.

Meanwhile, Respondents made many thousands of dollars from the sale of the Offerings. As set forth above, Respondents' commissions received for their role in selling the Offerings to investors ranged from $108,250 to $1,775,544. FoF ¶¶ 1, 2, 4-8.

Prior Unlawful Activity

As set forth above, Respondents' misconduct after September 23, 2008 followed several years of similar failures to investigate investments they recommended to their customers and misrepresentations of material facts about those investments. While the penalties the Division seeks are to address only post-September 23, 2008 securities law violations, Respondents' conduct prior to September 2008 is relevant to the Court's determination of what penalty is appropriate here. Courts may "consider conduct that occurred outside the statute of limitations to establish Respondents' motive, intent, or knowledge in committing violations that occurred within the statute of limitations." *See Matter of Brown*, No. 3-13532, 2012 WL 625874, at *14 (Feb. 27, 2012) (citation omitted). Past misconduct may also be considered in determining the appropriate sanction for Respondents' more recent violations. *Warwick Capital Mgmt.*, 2007 WL 505772, at *2 (citation omitted). Thus, Selling Respondents' track record of profiting by selling MS & Co. investments without first determining whether such investments were suitable provides helpful context when evaluating Respondents' intent when, after September 2008, they

continued to blindly accept what McGinn and Smith told them and misled their customers about new MS & Co. offerings.

Similarly, the disciplinary history for Respondents Mayer and Rogers supports the imposition of a significant sanction for those Respondents. FoF ¶ 522, 689.

Third-Tier Penalties Serve Goal of Deterrence

Finally, only significant penalties can have a proper deterrence effect here. *See Bloomfield,* 2014 WL 768828, at *23 (finding penalties in excess of disgorgement award to be necessary to "serve the public interest and the need for deterrence"), citing Securities Law Enforcement Remedies Act of 1990, H.R. Rep. No. 101-616 (1990), reprinted in 1990 U.S.C.C.A.N. 1379, 1384 (stating that civil penalties "provide a financial disincentive to violations that reflect an unwillingness to incur the cost of full compliance with the securities laws, as opposed to engaging in affirmative conduct to defraud investors"); *Gualario & Co., LLC,* 2012 WL 627198, at *18 ("Deterrence requires substantial penalties against Respondents because of the abuse of the fiduciary duty owed to advisory clients.").

A Significant Penalty Award Would Be Consistent with Precedent

Three cases substantially similar to the matter here before the Court are particularly instructive. In *Matter of Giesige*, No. 3-12747, 2008 WL 4489677 (Oct. 7, 2008), *aff'd,* 2009 WL 1507584 (S.E.C. May 29, 2009), this Court imposed a third-tier penalty of $500,000 where a broker failed to conduct adequate due diligence into fraudulent investments before recommending then to multiple investors. In *Giesige*, respondent failed to verify information provided to her about the investments she recommended, including information in this issuer's income statement and balance sheet, because she trusted the source and "just couldn't believe that someone would just make all this stuff up like they did." *Id.* at *19. Like Respondents here,

Giesage "knowingly, or utterly recklessly, advocated the most speculative type of investment to people of moderate means, many of whom used their retirement funds to make the investment." *Id.* at *31.

In *Matter of Stires & Co., Inc.*, No. 3-9120, 1998 WL 462230 (Aug. 11, 1998), this Court found that a third tier penalty was warranted "because the activities which violated the securities statutes involved fraud and recklessness, and resulted in substantial loss to five individual investors." *Id.* at *14. In *Stires*, the primary misconduct at issue was a broker's failure to "perform a due diligence inquiry [and] to investigate and resolve … red flags" before recommending private placement investments to his customers. *Id.* at *8. That is precisely what Selling Respondents did here, selling multiple offerings to many investors without asking any of the questions brokers are required to ask when confronted with the red flags apparent here and by misrepresenting and omitting material facts in connection with the sale of the Offerings here at issue. *See supra* at § II.A, B.

Similarly, in *Matter of Pinkerton*, No. 3-8805, 1996 WL 602648 (Oct. 18, 1996), this Court imposed a civil penalty of $550,000 on a broker who recommended securities to his customers without making "inquiries appropriate … to verify the accuracy of information provided to him by others" and without disclosing various risks relating to the investment to his customers. *Id.* at *6. Because the respondent in *Pinkerton* had ill-gotten gains of less than $30,000 and had no significant history of unlawful conduct, the Court imposed only a second tier penalty of $50,000 (the maximum tier two penalty at that time for each unlawful act), but the Court reached a total penalty figure of $550,000 by imposing a $50,000 penalty for each defrauded customer. *Id.* at n.26; *see also Matter of Bresner*, No. 3-15015, 2013 WL 5960690, at

*125 (Nov. 8, 2013) (imposing third tier penalties against three respondents despite mitigating factors).[9]

Penalties Should Be Imposed for Each Violative Act

Once the Court determines the tier of penalty that is appropriate for Respondents' misconduct, the next inquiry is how many bad acts should be penalized. The statutes' use of the phrase "each act or omission" has led court's to impose penalties per sale, per victim, and per investment product, among other multipliers. For example, in *Bloomfield*, the Commission held that a broker whose conduct warranted a second-tier penalty should pay the maximum $65,000 penalty "for each of the nine securities underlying [Respondents'] primary violations," which, along with an additional penalty for aiding and abetting other unlawful conduct, resulted in a total penalty of $650,000 for each of the two brokers. 2014 WL 768828, at *23; *see also Gerasimowicz,* 2013 WL 3487073, at *7 (imposing a maximum third tier penalty of $150,000 for each of 13 harmed investors for a total penalty of $1,950,000); *Matter of Bandimere*, No. 3-15124, 2013 WL 5553898 (Oct. 8, 2013), *petition for review granted*, 2014 WL 198175 (finding violations of Section 5 and antifraud statutes and imposing third tier penalty three times for total of $390,000); *Pinkerton,* 1996 WL 602648 at *6-7 (penalizing fraudulent acts to each customer).[10] Courts have also opted to impose a penalty equal to the amount of disgorgement

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9 Respondents' disregard for the Securities Act's registration requirements calls for significant penalties as well. Whereas Respondents' state of mind is not relevant for determining whether they are liable for violating Section 5, their recklessness in violating that statute for sales made after September 23, 2008 is relevant to the question of what relief is appropriate. *See Bloomfield*, 2014 WL 768828, at *22 (imposing second tier penalties where violations of Section 5 were deliberate or reckless).

10 *See also SEC v. Colonial Inv. Mgmt. LLC*, 381 Fed Appx. 27, 32 (2d Cir. 2010) (holding district court acted within its discretion by awarding a penalty of $25,000 for each of defendant's eighteen violative transactions); *SEC v. Lazare Indus., Inc.*, 294 Fed Appx. 711, 715 (3d Cir. 2008) (noting that the statute would permit a penalty equal to the maximum amount multiplied by the 54 illegal sales of stock); *SEC v. Glantz*, No. 94 Civ. 5737 (LAP), 2009 WL 3335340, at

awarded against particular respondents. *See, e.g., Matter of Sandru*, No. 3-15268, 2013 WL 4049928, at *10 (Aug. 12. 2013).

### D. Selling Respondents Should Be Barred from Working in the Securities Industry

Section 15(b) of the Exchange Act, 15 U.S.C. § 78o(b), authorizes the Commission, if it finds that it is in the public interest, to bar any person from being associated with any broker or dealer. The Securities Act and Investment Company Act of 1940 contain similar provisions. *See* Securities Act Section 8A; Investment Company Act 9(b). "The public interest requires a severe sanction when a respondent's past misconduct involves fraud because opportunities for dishonesty recur constantly in the securities business." *Matter of Warwick Capital Mgmt., Inc.*, 2007 WL 505772, at *14 (citation omitted). Just as the Commission deemed it appropriate to bar Respondent Feldmann from working in the securities industry and to issues a penny stock bar for his fraudulent offers and sales of MS & Co. securities, *Matter of Anthony, et al.*, No. 3-15514, 2014 WL 1320384, at *7 (Apr. 3, 2014), Selling Respondents should face the same sanction.[11]

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*6 (S.D.N.Y. Oct. 13, 2009) (imposing maximum third tier penalty for each investor defrauded); *SEC v. Milan Capital Group, Inc.*, No. 00 Civ. 0108 (DLC), 2001 WL 921169, at *3 (S.D.N.Y. Aug. 14, 2001) (while holding that third tier penalties were justified, court imposes second tier penalty of $50,000 for each of 200 defrauded investors); *Kenton Capital, Ltd.*, 69 F. Supp. 2d 1, 17 and n. 15 (D.D.C. 1998) (imposing maximum third tier penalties for each investor solicited).

[11] Feldmann, per the Commission's order, was:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization;
>
> prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter; and
>
> barred from participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with

Whether a bar is in the public interest depends on "the egregiousness of the respondents' conduct; the isolated or recurrent nature of the infraction; the degree of scienter involved; the respondents' recognition of the wrongful nature of their conduct; the sincerity of any assurances against future violations; and the likelihood that the respondents' occupations will present opportunities for future violations." *See Bloomfield*, 2014 WL 768828, at *18 (citations omitted); *Matter of Weeks*, No. 3-9952, 2002 WL 169185, at *53 (Feb. 4, 2002) (same). These criteria are often referred to as the "*Steadman* factors" owing to the Fifth Circuit's recitation of them in *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979).

The egregiousness of Respondents' deceptive conduct is well-established. As discussed above, Selling Respondents each willfully defrauded many investors in connection with the sale of numerous products over several years. At best, Respondents were extremely reckless for many years while handling millions of investors' dollars. At their worst, Respondents affirmatively misled their customers fully knowing that they could not stand behind their own recommendations. *Supra* at § II.

Despite the egregious nature of Respondents' violations, no Respondent has taken responsibility for the wrongful nature of his conduct or made any credible assurances that he will refrain from continuing to conduct his business in the same way. To the contrary, Respondents place all of the blame for the losses their customers suffered on others. And Respondents' other deceptive actions, along with their consistently changing – and, at times, incredible – testimony about the facts in this case, offer further reason to bar them from roles where customers would

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> a broker, dealer or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

*Anthony,* 2014 WL 1320384, at *7 (Feldmann Order).

rely on them for handling their personal assets. *See, e.g.*, FoF ¶¶ 511-512 (Livingston instructed a customer to lie on his subscription agreement because Livingston was not permitted to sell to unaccredited investors)[12]; *see Giesige*, 2009 WL 1507584, at *5, 18 (barring respondent whose testimony seemed to be not credible, particularly where defenses "contradict basic industry standards").

Furthermore, each Respondent except Lex remains in the securities industry and all, unless barred, are threats to repeat their violations. FoF ¶¶ 203, 276, 306, 307, 436, 522, 523, 597, 689, 690, and 742; *Matter of Lorenzo*, No. 3-15211, 2013 WL 6858820, at *9 (Dec. 31, 2013) (barring respondent where his "business provides him with the opportunity to commit violations of the securities laws in the future); *Ward*, 2003 WL 1447865, at *13 (barring broker where he had not worked in the securities industry for eight years but "he has indicated a desire to return if given the opportunity.").

Barring Respondents from practicing in the securities industry would be consistent with this and other courts' prior decisions. Case law provides ample precedent for barring each of the Selling Respondents from associating with any broker or dealer or investment adviser. For example, in *Giesige*, 2008 WL 4489677, described above, this Court barred from the industry a broker who, like Respondents here, simply passed along information she received from others without performing adequate due diligence. *E.g., id.* at *18; *c.f. Epstein v. SEC*, 416 Fed. Appx.

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[12] *See also, e.g.*, FoF ¶¶ 244 (Chiappone denying that he shared his accusatory email to Smith with Guzzetti or Gamello after testifying at the Hearing to the contrary); 285 (Gamello stating prior testimony about failing to read Four Funds PPMs should be discounted because he appeared at his deposition testimony hoping to help the SEC); 846 (Guzzetti claiming he never even heard of phrase "red flags" despite decades of experience in securities industry); 498-500 (Livingston claiming "no involvement … whatsoever" with investments of two customers where facts plainly demonstrate otherwise); 537 (Mayer attributing harmful deposition testimony to nerves caused by Smith attending the deposition); 625 (Rabinovich changing testimony at hearing); 695 (Rogers recanting deposition testimony).

142 (3rd Cir. 2010) (affirming bar from securities industry for failure to satisfy FIRNA suitability rules).

In fact, Respondents' conduct far exceeds that which has been found to support industry bars for other wrongdoers. For example, in the recent case *Lorenzo,* 2013 WL 6858820, the Court barred Respondent Frank Lorenzo from the securities industry on the basis of a misleading statement he sent by email to only two people. *Id.* at *9. The Court found that Lorenzo was reckless in sending the false statements contained in the email and could not escape liability by blaming others for instructing him to send the email. Unlike Respondents here, Lorenzo who obtained virtually no ill-gotten gain from his conduct and acknowledged that he was at least negligent in transmitting the false email, but the Court nevertheless barred him from the securities industry because his "violations involved scienter [and his] business provides him with the opportunity to commit violations of the securities laws in the future." *Id.* Like Respondents here, Lorenzo "attempt[ed] to blame others" for his misconduct, but the Court found that those efforts were "aggravating factors." *Id.*

### E. Cease and Desist Orders Are Warranted Against Selling Respondents

The Commission is authorized to issue cease and desist orders where a person has, among other things, been found to have violated any provision of the Securities Act or Exchange Act, or the rules and regulations thereunder. Section 21C of the Exchange Act, 15 U.S.C. § 78u-3; Section 8A of the Securities Act, 15 U.S.C. § 77h-1. "In determining whether a cease-and-desist order is appropriate, the Commission considers the *Steadman* factors ..., as well as the frequency of the violation, the degree of harm to investors or the marketplace, and the combination of sanctions against the respondent." *Matter of Bresner*, No. 3-15015, 2013 WL 5960690, at *122 (Nov. 8, 2013). But the showing of a likelihood of future violations is

'significantly less than that required for an injunction." *Id.* (quotations omitted); *Matter of Weeks*, 2002 WL 169185, at *54 (same).

As described above, Selling Respondents each willfully violated Securities Act Sections 5(a), (5c) and 17(a), and Exchange Act Section 10(b) and Rule 10b-5 of the Exchange Act. Their actions demonstrate a conscious disregard of the federal securities laws. Accordingly, cease-and-desist orders against Selling Respondents are appropriate to prevent violations and future violations of the statutes and rules set forth above.

### F. Guzzetti Should Pay a Third Tier Penalty, Be Barred from the Securities Industry, and Be Ordered to Cease-and-Desist His Misconduct

"Sections 15(b)(4)(E) and 15(b)(6)(A)(i) of the Exchange Act authorize the Commission to bar or suspend a person from association with a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization if it finds that such person failed reasonably to supervise, with a view to preventing violations of the federal securities laws, another person who commits such violations, if the other person is subject to the person's supervision, and if it is in the public interest." *Matter of Angelica Aguilera*, No. 3-14999, 2013 WL 3936214, at *25 (July 31, 2013) (citations omitted). Whether such a sanction is in the public interest turns on the same *Steadman* factors discussed above. *Id.* Similarly, cease-and-desist orders may be issued against individuals found to have failed to supervise under the same standard as those who violated other provisions of the federal securities laws. *See Bloomfield*, 2014 WL 768828, at *19 (applying same standard to respondents found to have violated different statutes).

Under Section 21B(a)(1)(D) of the Exchange Act, the Commission may impose a civil penalty if it is in the public interest and if respondent "has failed reasonably to supervise, within the meaning of section 15(b)(4)(E), with a view to preventing violations of the provisions of such

statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision." *Id.* at *28.

In *Aguilera*, Respondent, like Guzzetti, "completely failed to recognize the wrongful nature of her conduct" and "consistently attempted to shift responsibility for [her] supervisory failings [to others]." *Id.* at *25. This led the Court to impose a third tier penalty of $150,000 and a bar "from association with a broker or dealer in a supervisory capacity and from association with a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization" to be in the public interest. *Id.* at *26, 29. As Judge Elliot there explained: "The securities industry relies on supervisors to help police itself, and Aguilera clearly cannot be relied upon for that purpose." *Id.* at *26.

The Commission recently echoed that view in *Bloomfield*, reiterating that "[s]upervisors are the first line of defense against wrongdoing by their subordinates." 2014 WL 768828, at *19. As such, "failures to supervise are serious violations." *Id.* The *Bloomfield* court barred a respondent from association with any broker or dealer (with a right to reapply, after two years, only in a non-supervisory capacity), where that respondent, like Guzzetti, "failed to respond to red flags of possible misconduct," among other misconduct. *Id.* at 18; see also Kolar.

As discussed above, Guzzetti ignored red flags right in front him for several years and, rather than supervise properly the registered representatives under his charge, he urged them to keep selling more MS & Co. products even as the signs of fraud became more glaring. FoF ¶¶ 789-841. In addition to earning commissions on his sales, FoF ¶ 3, Guzzetti was paid a salary to supervise the Selling Respondents. FoF ¶ 744. Most significantly, Guzzetti supervised the Selling Respondents during all of their post-September 23, 2008 sales. *See supra*, at § III.A.

Still, Guzzetti has taken no responsibility for his actions, and seeks to remain in the securities industry unless barred from doing so. FoF ¶ 742, 845-847.

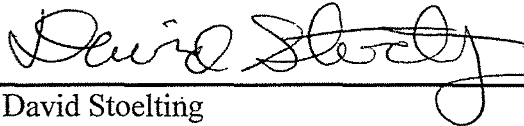
## CONCLUSION

Based on the foregoing, the Division respectfully requests that this Court enter the Division's proposed findings of fact and conclusions of law and impose the requested sanctions on the Respondents.

Dated: New York, NY
April 9, 2014

Respectfully submitted,

DIVISION OF ENFORCEMENT



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