SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15514

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In the Matter of

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

RESPONDENT WILLIAM F. LEX'S POST-HEARING BRIEF

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TABLE OF CONTENTS

TABLE OF CITATIONS

CASES **PAGE**

STATUTES AND OTHER AUTHORITIES

Respondent William F. Lex respectfully submits this post-hearing brief and requests that this proceeding be dismissed in its entirety with no relief awarded to the Division whatsoever.

I. INTRODUCTION AND SUMMARY

The Division's case against Respondent Bill Lex is a classic prosecution based on the kind of 20/20 hindsight that comes only with the luxury of extensive law-enforcement investigative power and resources that make Monday-morning quarterbacking a breeze for those who are fortunate to possess them, and an unjustified nightmare for those who are their object. The Division seeks to destroy the career and reputation of an honorable man, and to extract draconian financial penalties and forfeitures from him, because he allegedly failed to conduct a "searching" due diligence inquiry that the Division says would have uncovered secretive misconduct occurring 300 miles away at the distant headquarters of McGinn Smith, the storied brokerage firm with which Mr. Lex, a lifelong insurance salesman, was remotely associated (but never employed) for the limited purpose of occasionally selling fixed-income securities products to his clients.

Like many of the non-securities insurance products Mr. Lex also sold, most of the fixed-income securities he occasionally sold through McGinn Smith were "senior" notes that provided a modest rate of return and, at least as intended according to the detailed private placement memoranda ("PPMs") prepared and vetted by the firm's experts, the safety of knowing that unless the particular investment vehicle lost in most cases 75%, and in some cases 50%, "senior" note investors would not lose any money and would receive exactly what was promised. Unaware of the secret misconduct of others that would ultimately lead to such improbable losses, Mr. Lex genuinely believed these notes were worthy of his clients' consideration, even though the commissions he earned on them were negligible compared to most of the annuities and other insurance products he also offered to those clients. He therefore had no motive whatsoever to steer his clients into these investments over his more lucrative insurance product options. His deeply-held confidence in these notes is conclusively demonstrated by the hundreds of thousands of dollars that he and his own family invested in the same notes, the vast majority of which has been lost (and, unlike for other investors, barred from recovery in the McGinn Smith receivership).

The Division concedes, as it must, that Mr. Lex had no knowledge of the wrongdoing that was secretly taking place 300 miles away at McGinn Smith, where as merely a remote "associated person" Mr. Lex lacked the access and privileges of even a low-level employee. He couldn't possibly have known about the secret wrongdoing. In the Division's hindsight view, however, if Mr. Lex had only undertaken his own "searching" due diligence inquiry into McGinn Smith, the principals would surely have confessed to Mr. Lex that they, at some point during the latter period of his association with the firm, had resorted to various forms of criminal misconduct that they had been scrupulously concealing for many years from Mr. Lex and others. Those others appear to have included the brokerage firm's legions of on-site lawyers, accountants, and auditors, all of whom were more proximate to the firm's offices than Mr. Lex and had vastly more expertise and access to relevant information than Mr. Lex could ever dream of having. To our knowledge, none of these expert professionals – who, unlike Mr. Lex, were paid specifically to monitor and ensure the firm's compliance with its legal obligations – have been charged.

In addition to all these paid professional gatekeepers, it is also clear that professional inspectors and examiners from FINRA and the SEC audited McGinn Smith at least several times during the relevant period, as they too were paid to do as a core function of their jobs. Perhaps more so than even the paid gatekeepers, the Division's colleagues at FINRA and the SEC had virtually unfettered access to all information necessary for exhaustive examinations of the bona fides of the McGinn Smith firm, including some of the very offerings and private placement memoranda ("PPMs") at issue in this case. Yet they too apparently noticed nothing amiss. And to our knowledge, the Division has not accused any of these SEC or FINRA colleagues with fraud – or even incompetence.

Unfortunately for Mr. Lex, the Division was not so forgiving with him. Unlike the paid minions of lawyers, auditors, and regulatory examiners who had vastly more expertise than Mr. Lex and far greater ability to conduct "searching" due diligence on McGinn Smith, Mr. Lex finds himself being prosecuted by a federal law enforcement agency for "willful" and "egregious" fraud, being required to expend vast sums first to cooperate with law enforcement and then to defend himself, and now being threatened with millions of dollars in penal fines and forfeitures for his alleged lack of diligence – all in a captive process deliberately chosen by the prosecutor to deprive him of any meaningful discovery or preparation time, any jury trial, and other basic protections of due process.

As explained below, this punitive prosecution is unconstitutional, unlawful, untimely, factually misguided, and legally meritless. It should be dismissed with no sanctions imposed.

II. FACTS

Mr. Lex respectfully incorporates by reference the Proposed Findings of Fact submitted simultaneously herewith.

III. ARGUMENT

A. The Constitution Forbids This Punitive Law Enforcement Prosecution or the Imposition of Any Penal Sanctions

The Securities and Exchange Commission proclaims: "First and foremost, the SEC is a *law enforcement* agency."[1] Its Division of Enforcement (the "Division"), the SEC continues, "assists the Commission in executing its *law enforcement* function" by, among other things, recommending law enforcement cases and "*prosecuting* these cases on behalf of the Commission."[2] As demonstrated by cases like this one – in which the Commission and its appointed prosecution team set out to exact draconian monetary fines against private American citizens, to deprive those citizens of their chosen livelihoods, to forfeit the hard-earned income of those citizens going back more than a decade, and to destroy the careers and reputations of those citizens with accusations of fraud and other wrongdoing – these self-characterizations of the SEC's prosecutorial DNA are undeniable.

Indeed, SEC leaders and the President himself have repeatedly described the agency's prosecutorial law enforcement approach in *overtly penal terms* (indeed sometimes even in martial terms[3]). For example, they routinely equate SEC officials with "cops on the beat,"[4] urge that SEC "punishment" be made to fit the "crime,"[5] and aspire to ensure "that individuals '*feel the pain* of our remedies.'"[6] Some of the most ominous of these statements were uttered within

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[1] SEC Website, "*What We Do*," available at www.sec.gov/about/whatwedo.shtml#org (emphasis added).

[2] *Id.* (emphasis added).

[3] *See, e.g.*, Remarks of SEC Chairman Before the Council of Institutional Investors, September 26, 2013 (referring to the SEC's aggressive use of all tools in its enforcement "arsenal" and extolling the influence of criminal justice procedures in the SEC's evolving approach to enforcement).

[4] *See, e.g.*, Remarks by President Barack Obama Announcing Appointment of SEC Chairman, January 24, 2013; Remarks of SEC Chairman Before the Council of Institutional Investors, September 6, 2013.

[5] Speech by SEC Chairman, "Perspectives on Strengthening Enforcement," March 24, 2014.

[6] Jean Eaglesham, "SEC Ramps Up Fine Amounts to Deter Misconduct; Enforcement Chief: Monetary Penalties Speak Loudly," Wall St. Journal, October 1, 2013 (emphasis added) (quoting Director of Enforcement). This particular comment is reminiscent of a former SEC Chairman's oft-quoted desire to render the agency's

days of the SEC's initiation of this law enforcement prosecution against Mr. Lex and the other respondents. Indeed, only a week after the OIP was filed, the most senior enforcement official in the New York Regional Office that launched this prosecution confirmed at a widely-attended conference that "the criminal model has been adopted" by the SEC.[7]

This case therefore presents front and center an urgent question that is the proverbial elephant in the room: When the SEC and its Division execute this "law enforcement function" by "prosecuting" citizens for allegedly fraudulent wrongdoing, and when they publicly indict those citizens with accusations of "egregious" and "willful" wrongdoing and set out to impose draconian sanctions that are undeniably penal in nature and magnitude (indeed, not materially different than the financial sanctions that the Department of Justice could seek in a criminal felony case alleging the same violations), are they not required – like all other American prosecutors since time immemorial – to prove their accusations in a court of law, before a jury of the accused citizen's peers, under the supervision of an Article III judge, with admissible evidence that proves their accusations beyond a reasonable doubt, and subject to other basic due process rights (including the Rule of Lenity) that have always protected American citizens when their government accuses them of serious wrongdoing?

Although these issues were prominently raised in various respondents' answers, the Division entirely ignores this elephant, and for obvious reasons. There is no plausible

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prosecutorial targets "naked, homeless, and without wheels." Meyer Eisenberg, *Enforcement Issues and Litigation*, 21 SEC. REG. L.J. 421, 421-22 (1994) (quoting former SEC Chairman Richard Breeden).

[7] Alison Frankel, "SEC Enforcement co-director: We're bringing 'swagger' back," Reuters Opinion, Oct. 1, 2013. Ironically, the enforcement official was specifically referring to the old-school tactic of not letting SEC investigative witnesses know whether they are targets or not, a tactic the enforcement staff misused in this case at Mr. Lex's great expense. After lulling him into a deposition under the pretense that he was wanted as a cooperating witness in the SEC's then-pending civil action against the actual wrongdoers in this case (and he later testified as a state's witness in the criminal case against them as well), the staff quickly turned the deposition into an inquisition designed to build a case against Mr. Lex himself. For obvious reasons, this form of trickery has long been harshly condemned by courts as an abuse of the "trust between government and the people." See, e.g., SEC v. ESM Govt. Secs., Inc., 645 F.2d 310, 316 (5th Cir. 1981).

constitutional basis to support what the government purports to do here. In essence, an Executive Branch law enforcement agency has unilaterally assigned to itself and its own personnel (including this tribunal) the all-encompassing role of investigator, prosecutor, judge, jury, sentencing authority, and appellate tribunal. All of these roles are performed under the unfettered control and direction of the prosecutor and its appointed personnel, without any of the checks and balances historically provided by a jury and independent Article III judge, without the protection of other basic due process rights, and – at least according to the prosecutors – under the lightest evidentiary burden of proof known to the law (the mere preponderance of the evidence standard). And the only outside check on this vast prosecutorial juggernaut is a limited, deferential, after-the-fact judicial appeal that typically occurs many years after most accused citizens have already been bankrupted by the legal expense of defending themselves in the prosecutor's entirely self-controlled chamber.

None of this is even remotely acceptable in our American constitutional system of checks, balances, separations of powers, and core due process protections, and any statutory scheme that purports to permit it is blatantly unconstitutional (as well as un-American). Quite simply, in America, a prosecutorial law enforcement agency and its appointed agents cannot unilaterally accuse an American citizen of "egregious" and "willful" wrongdoing, pronounce guilt, and administer draconian penal sanctions – all without having its accusations tested under the scrutiny of a jury trial, overseen by an independent Article III judge, with the full panoply of basic due process protections (including the Rule of Lenity), and with an evidentiary burden that requires proof of guilt beyond reasonable doubt. No constitutional exception allows any governmental law enforcement agency – particularly one so far removed from direct political accountability – to wield this kind of unchecked, soup-to-nuts prosecutorial and judicial power.

No federal law enforcement agent has the right to accuse a citizen of "egregious" and "willful" wrongdoing and then shunt the prosecution into a captive forum that denies basic due process protection and avoids having to substantiate those accusations in the crucible of an Article III court and jury. We are aware of no case that purports to exempt the SEC, when it acts in its prosecutorial capacity seeking penal sanctions for alleged wrongdoing, from this age-old axiom of American constitutional government.

The Division ignores these serious constitutional issues entirely. But we won't, and neither should this tribunal. We address them at some length below. Of course, because this tribunal had no control over the choice of venue for this prosecution – and oversees it entirely subject to rules and orders dictated by the prosecutor itself – there is only so much that can be done here to mitigate the numerous and fatal constitutional infirmities inherent in the proceeding. At a minimum, however, those infirmities can and should be partially mitigated by, among other things, holding the prosecution to the time-honored evidentiary burden of proof of beyond reasonable doubt; applying the Rule of Lenity in the numerous places where the Division is pressing highly dubious, petty, and retroactive interpretations of vague and ambiguous regulatory provisions; and refusing to impose *any* of the harshly punitive sanctions demanded by the prosecution. Although the Division's case against Mr. Lex would fail miserably even under the preponderance standard and without the Rule of Lenity, appropriate application of these well-settled protections in governmental prosecutions would readily expose the Division's case as largely frivolous.[8]

[8] Such an approach would also send an important message that complex, overtly punitive, multi-party prosecutions like this one, involving many millions of documents and dozens of witnesses, are categorically unsuited for contested administrative litigation under the current Rules of Practice. Apart from all the constitutional infirmities when the process is used for penal prosecutions like this one, the Commission that adopted the current Rules of Practice – which allow for negligible discovery and due process, and woefully inadequate time for any meaningful review of the relevant evidence less than 4 months with millions of documents, and 59 depositions where the Respondents did not participate – surely never dreamed that one day future Commissions would litigate complex

1. <u>This Punitive Law Enforcement Prosecution Exceeds the Executive Powers Conferred by Article II of the Constitution, Infringes Upon the Judicial Powers Conferred by Article III of the Constitution, and Violates the Constitutional Separation of Powers.</u>

In our American constitutional system, it is axiomatic that the power to decide "cases and controversies" is vested exclusively in the Judicial Branch of government created by Article III of the Constitution. <u>See</u> U.S. Const., Art. III. Lest there be any doubt that punitive federal government law enforcement prosecutions are <u>*exactly*</u> the type of "case or controversy" that must be decided in Article III courts, the Constitution mandates that the judicial power extends not just to some, but rather to "*all* Cases, in Law and Equity, arising under ... the Laws of the United States," as well as to "Controversies to which the United States shall be a Party." U.S. Const., Art. III, sec. 2. Under this constitutional system, the Executive Branch <u>*initiates*</u> and <u>*prosecutes*</u> certain cases and controversies, which of course necessarily "arise under" the laws of the United States <u>*and*</u> feature the United States as a party.[9] Executive Branch law enforcement agencies have <u>*no*</u> constitutional power to <u>*decide*</u> cases and controversies, and for obvious reasons they cannot decide the very same prosecutorial cases that they initiate and prosecute. Indeed, it is no exaggeration to say that Article III courts were created in large part precisely to protect against the prospect that the government would try to get away with simultaneously acting as both prosecutor and judge in the same case, thereby unilaterally deciding whom to prosecute, what charges to bring, whether the defendant is guilty or innocent, and what punishment to administer. "Article III, § 1, serves both to protect 'the role of the independent judiciary within the

penal prosecutions like this one administratively. Back then it was literally *unthinkable* that the Commission or the Division would someday seek to unilaterally impose draconian penal sanctions "in house" rather than putting their allegations to the test before an Article III judge and jury.

[9] Indeed, it is legitimately questionable whether "independent" Executive Branch regulatory agencies like the SEC can constitutionally even *initiate* and *prosecute* penal law enforcement proceedings that are designed to punish citizens, because these agencies are too insulated from the control of the president or even the attorney general. *See* Russell G. Ryan, "When Regulators Think They're Prosecutors," Wall St. Journal, Apr. 9, 2014, p.A15. In the interest of brevity (and presumed futility at this stage) we will not argue this point at length here, but we preserve it for future appeals if necessary.

constitutional scheme of tripartite government... and to safeguard litigants' 'right to have claims decided before judges who are free from potential domination by other branches of government.'" Commodity Futures Trading Comm'n v. Schor, 478 U.S. 833, 848 (1986) (internal citations omitted).

As Alexander Hamilton put is so poignantly in The Federalist No. 78:

> For I agree, that "there is no liberty, if the power of judging be not separated from the legislative and executive powers." And it proves, in the last place, that as liberty can have nothing to fear from the judiciary alone, but would have every thing to fear from its union with either of the other departments....[10]

James Madison was equally eloquent on this point in The Federalist No. 47:

> The accumulation of all powers, legislative, executive, and judiciary, in the same hands, whether of one, a few, or many, and whether hereditary, self-appointed, or elective, may justly be pronounced the very definition of tyranny.[11]

Like Hamilton, Madison went on to quote the "celebrated" "oracle" Montesquieu for the same truism that "[t]here can be no liberty...if the power of judging be not separated from the legislative and executive powers."

Moreover (and most respectfully), it is no cure to this fatal constitutional defect for the prosecutor to appoint and assign one of its own Article II employees – even one who works in the prosecutor's Office of Administrative Law Judges – to oversee the prosecution and supplant the traditional roles played by an independent Article III judge and jury. Whatever the tribunal's earnest efforts to provide a fair proceeding and to maintain the appearance of independence from its superiors in the prosecutor's office and its fellow employees in the prosecutor's enforcement division, the unavoidable constitutional fact is that no SEC employee could ever claim the true independence (not to mention the Presidential appointment, Senate Confirmation, and life tenure) that is required under Article III of the Constitution to ensure liberty against

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[10] The Federalist No. 78 (quoting "[T]he celebrated Montesquieu").
[11] The Federalist No. 47.

governmental prosecution, particularly an appointee who acts entirely subject to the rules and orders dictated by the very prosecutor that launched the prosecution (and ultimately determines both guilt or innocence and the harshness of any penalties and forfeitures). As was acknowledged before the hearing in explanation for why this tribunal was powerlessness to "second-guess" the Commission by considering the merits of our motion for summary disposition, agency personnel acting at the direction of the Commission are inherently and necessarily hamstrung in ways that preclude the type of independence required under the Constitution.[12]

Of course, the SEC is very familiar with the importance of pristine independence in other contexts. In each case of which we are aware, the Commission (and other regulators subject to SEC oversight) categorically reject as "independent" any person who is, among other things, employed by or otherwise under the control and direction of the person as to whom independence is required. *See, e.g.*, 17 C.F.R. § 210.2-01 (SEC's auditor independence requirements); 17 C.F.R. § 240.10A-3 (audit committee member independence); PCAOB Rule 3520 (auditor independence); NYSE Listed Company Manual Rule 303A.02 (independent board members); Nasdaq Marketplace Rules § 4200-1 (independent board members). We respectfully submit that if employment and control relationships impair the independence required for meaningful checks and balances in corporate board rooms and in auditor-client relationships, the impairment should be even more evident for purposes of protecting the rights of private citizens facing penal law enforcement prosecution.

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[12] *See* Pre-hearing transcript, Jan. 21, 2014, at 30 ("the agency does not want motions of summary disposition granted because you're second-guessing their decision that the case needs to get set down for hearing and that there is a legal basis for it"); *id.* at 33-34 ("I didn't start this proceeding. I don't have anything to do with it. If it's for naught, you have my apologies. I work for the Federal Government. I am an Administrative Law Judge. The case is in this office. It's been assigned to me for decision. So I have to hear it.").

But the constitutional problems go much deeper than the mere lack of independence. Simply put, when the federal government sets out to prosecute and punish a citizen for a serious offense and brand the citizen a wrongdoer, not only must the case and controversy be decided in the Judicial Branch of government, it must also be overseen by a presidentially-appointed, Senate-confirmed, and life-tenured Article III judge within the Judicial Branch. Even federal magistrate judges – who can at least claim proximity to the curtilage of Article III, although they too are not presidentially appointed and do not enjoy life tenure – cannot oversee trials of civil cases without the <u>*consent*</u> of the parties, and they cannot lawfully oversee trials of serious offenses *even if the defendant consents and even if a jury decides guilt or innocence*. <u>See generally</u> 18 U.S.C. § 3401; Fed. R. Crim. P. 58(b)(3)(b); 28 U.S.C. § 636; <u>cf. Stern v. Marshall</u>, 131 S.Ct. 2594, 2608 (2011) (similar concern with bankruptcy judges); <u>Northern Pipeline Constr. Co. v. Marathon Pipe Line Co</u>., 458 U.S. 50, 58 (1982) (earlier concerns with bankruptcy judges). The only exception to this bedrock safeguard is "petty offenses" where the maximum fine cannot exceed $5000 for an individual or $10,000 for an entity. Of course, in cases like this one against Mr. Lex, the alleged offense is anything but a petty one, given the parallel exposure to criminal felony prosecution and the Division's demand for outlandish penalties that are more than 100 times higher than the upper limit for petty offenses. The fact that even an Article III federal magistrate judge could not lawfully adjudicate a prosecution such as this one – even <u>*with*</u> a jury and even if the defendant <u>*consented*</u> – precludes any serious argument that the Commission or one of its own employees can lawfully do so without any jury, without any Article III judge, and over the defendant's strong objection.

Still another well-settled line of Supreme Court case law makes clear that when a government law enforcement prosecutor seeks to punish a citizen, all facts upon which the punishment is predicated must be decided *by a jury* and *beyond reasonable doubt*. The Court has recently made clear that this principle applies with equal vigor to findings of fact upon which the government seeks to predicate enhanced monetary fines. Under this line of cases, the Court has strictly held that even a truly independent, presidentially-appointed, Senate-confirmed, Article III judge may not adjudicate such facts – they must be decided by a jury beyond reasonable doubt. See generally Southern Union Co. v. United States, 132 S. Ct. 2344 (2012) (citing Apprendi v. New Jersey, 530 U. S. 466 (2000) and Blakely v. Washington, 542 U. S. 296 (2004)). If this is so, how can it possibly be that an Article II prosecutorial Executive Branch law enforcement agency – or one of its appointed administrative law judges – can adjudicate whether sufficient facts have been proved to warrant the draconian penal fines demanded by the Division in this law enforcement prosecution?

Article III contains still further proof that punitive law enforcement prosecutions cannot lawfully be decided by the Executive Branch prosecutor or its own personnel. It states that "The Trial of all Crimes, except in Cases of Impeachment, shall be by Jury; and such Trial shall be held in the State where the said Crimes shall have been committed." Article III, Sec. 2, ¶ 3. Again, the wisdom and purpose behind this bulwark of liberty seem obvious, and it is highly improbable that the founders intended to allow either Congress or law enforcement prosecutors to completely eviscerate it simply through the semantic contrivance of labeling an undeniably penal and punitive law enforcement proceeding as "civil." The Supreme Court has repeatedly held that constitutional protections cannot be circumvented simply by slapping the euphemistic label "civil" to a sanction or proceeding that is obviously punitive rather than remedial. See, e.g., Hudson v. United States, 522 U.S. 93, 99 (1997) ("Even in those cases where the legislature 'has indicated an intention to establish a civil penalty, we have inquired further whether the statutory scheme was so punitive either in purpose or effect' as to 'transform what was clearly intended as a civil remedy into a criminal penalty'" (internal citations omitted)).

As the Court explained just last year in Gabelli v. SEC, 133 S. Ct. 1216 (2013) (we'll say more about this case later, as the Division ignores it entirely), even when the penalties sought by governmental prosecutors are nominally "civil," the government is "a different kind of plaintiff" seeking "a different kind of relief," because even civil penalties "go beyond compensation, are intended to punish, and label defendants wrongdoers." Id. (citations omitted).

At oral argument in the Gabelli case, several justices were even more poignant on this point. Justice Breyer characterized SEC enforcement cases as "quasi-criminal" cases seeking something that "look[s] like criminal penalties." Justice Antonin Scalia echoed the same sentiment from the other end of the jurisprudential spectrum: "[W]e are talking here about prosecution, essentially, prosecution for a civil penalty rather than a criminal [penalty]." He reasonably observed: "I mean, a penalty is a penalty as far as I'm concerned if the Government's taking the money." Addressing the lawyer arguing on behalf of the SEC he noted that "You just call it a civil penalty and you don't have to prove it beyond a reasonable doubt…." Transcript of Argument in Gabelli case (available online or upon request).

Whether it is nominally labeled criminal, quasi-criminal, or anything else, the undeniable fact is that this law enforcement prosecution is overtly and purposefully penal in all material respects. It seeks to extract draconian penal sanctions including staggering million-dollar-plus penalties and million-dollar-plus forfeitures, and it threatens to destroy the career, reputation, and entire life savings of Mr. Lex and his co-respondents. It cannot be pursued in open defiance of basic constitutional requirements.

2. This Punitive Prosecution Violates Due Process

Because this is unquestionably a penal law enforcement prosecution seeking to brand Mr. Lex a wrongdoer (indeed a fraudster), deprive him of his livelihood, irreparably taint his personal reputation and future employment prospects, extract draconian financial penalties and forfeitures, Mr. Lex has a fundamental constitutional right to due process, including having the alleged charges against him decided by a jury of his peers under the supervision of an independent Article III judge. See U.S. Constitution, Art. III, § 2 ("The Trial of all Crimes…shall be by Jury"); id. at Amendment V ("nor shall any person…be deprived of life, liberty, or property, without due process of law"); id. at Amendment VII ("In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved"); Tull v. United States, 481 U.S. 412, 425 (1987) (right to jury trial in civil case where government seeks civil penalties). Thus, even assuming this proceeding does not violate Article II and Article III of the Constitution, as well as the separation of powers, it must respect basic constitutional due process principles.

For example, to prevail in its quest to severely punish Mr. Lex and brand him a lawbreaker – particularly based on its accusation of "egregious" fraud – the Division must be required to prove its case beyond a reasonable doubt – or at bare minimum by clear and convincing evidence. See, e.g., In re Winship, 397 U.S. 358 (1970) (proof beyond reasonable doubt is a core element of due process protection against governmental prosecution); Addington v. Texas, 441 U.S. 418, 424 (1979) (clear and convincing evidence is typically required "in civil cases involving allegations of fraud or some other quasi-criminal wrongdoing by the defendant"). The Division's facile attempt to get away proving its incendiary allegations of "willful" and "egregious" fraud and other wrongdoing by a mere preponderance of the evidence

– the lightest burden of proof known to the law, which would treat the stakes in this case as no more serious than a mundane contract dispute or a slip-and-fall accident case between two private litigants – simply won't cut it.

Finally, the Rule of Lenity – the age-old rule that requires all legal ambiguity to be resolved in the defendant's favor – should apply with full force and effect, with particular relevance to the Division's ill-conceived and largely inscrutable theories under Securities Act Section 5 and Exchange Act Section 10(b) and Rule 10b-5 thereunder. See, e.g., Leocal v. Ashcroft, 543 U.S. 1, 11 n.8 (2004) (Rule of lenity applies whenever the relevant statute "has both criminal and noncriminal applications"); County of Suffolk v. First Am. Real Estate Solutions, 261 F.3d 179, 195 (2d Cir. 2001) ("Due process requires that before a criminal sanction or significant civil or administrative penalty attaches, an individual must have fair warning of the conduct prohibited by the statute or the regulation that makes such a sanction possible"); United States v. One 1973 Rolls Royce by & Through Goodman, 43 F.3d 794, 819 (3d Cir. 1994) (Rule of Lenity applies to ambiguous statute where proceeding is punitive and quasi-criminal).

Applying these axiomatic constitutional safeguards to this penal law enforcement prosecution will readily expose the utter frivolity of the Division's charges.

B. A Controlling Federal Statute Explicitly and Unambiguously Forbids This Punitive Law Enforcement Prosecution From Being "Entertained"

In both his Answer and in a pre-hearing motion for summary disposition, Mr. Lex has consistently maintained that 28 U.S.C. § 2462 clearly and explicitly forbids this penal prosecution from being "entertained." The point is very straightforward, because the controlling statute is so exceptionally unambiguous and because the Supreme Court – in a *unanimous* opinion just last year – unequivocally said the statute must be interpreted and applied in accordance with its plain meaning. The statute provides in relevant part:

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

28 U.S.C. § 2462. The instant "proceeding" unquestionably seeks civil penalties and forfeitures.[13] Under the plain language of section 2462, therefore, it "*shall not be entertained*" unless it was commenced less than five years after the date when the asserted claims "*first accrued.*" Because the claims articulated in the OIP unquestionably first accrued more than five years before this proceeding was commenced on September 23, 2013, section 2462 flatly prohibits this "proceeding" from being "entertained" at all. For this reason, the proceeding must be summarily dismissed and not permitted to proceed to a determination of the merits.

The OIP asserts three claims: (1) the offer and sale of unregistered securities in violation of Sections 5(a) and 5(c) of the Securities Act; (2) fraud in violation of Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5; and, as to Respondent Guzzetti only, (3) failure to supervise. OIP ¶¶ 20 and 66-68. Under the facts and theories articulated by the Division, each of these three claims, to the extent viable at all, "*first* accrued" far more than five years before this proceeding was commenced – and likely about a decade before.

The OIP couldn't be clearer in this regard. Beyond a bare-bones listing of the so-called "Trust" offerings in paragraphs 16 and 31, literally every specific date assigned by the OIP to purported wrongdoing or "red flags" is well before September 2008. *See* OIP ¶¶ 15 and 22 ("Four Funds" offerings occurred between 2003 and 2005); ¶ 28 (Smith began "diverting"

[13] The penalties sought include statutory monetary penalties, industry sanctions, and purported "disgorgement." As discussed below, the kind of "disgorgement" sought here not only is punitive, but also would constitute a "forfeiture" within the plain meaning and intent of section 2462.

money in September 2003 to pay "pre-2003 investors"); ¶ 38 fn.3 (letter written in 2000(!) with reference to "pre-2003 offerings"); ¶ 40 (lack of available information from "September 2003 until January 2008"); ¶¶ 43-45 ("Redemption Policy" instituted "[b]y 2006" and known to respondents "at different times beginning in late 2006"); ¶ 46 (allegedly ominous meeting held "[o]n January 8, 2008"); ¶ 51 (trust offerings that occurred in May 2007 and October 2007 and a related bankruptcy filing in January 2008);[14] ¶ 63 (email sent in February 2006); and ¶ 64 (knowledge of the "Redemption Policy by December 2006" and receipt of an email "[i]n November 2007").

Given the Division's nearly exclusive citation to offerings, sales, events, and "red flags" that occurred well before September 2008, it is indisputable that the Division's three claims *first* accrued – and were fully chargeable as violations of the relevant securities law provisions – at least as far back as the various so-called "Four Funds" offerings during the period 2003 through 2005. For example, assuming the Division's legal theories are sound and its facts are correct, there was a viable and chargeable section 5 claim as soon the first of the Four Funds offerings was sold because that offering, no less than the ones that followed, was not registered with the SEC and no exemption was available. By its own articulated theory of the case, the Division likewise had a viable fraud charge at that point under Securities Act section 17(a) and Exchange Act section 10(b) because the respondents' alleged failure to conduct a "searching" due diligence investigation any of the Four Fund offerings, in the Division's hindsight view, constituted securities fraud. According to the Division's plainly articulated theory, therefore, all of the offerings were tainted in the exact same way, such that a viable claim *first* accrued and was fully

[14] Paragraph 51 does mention one date in late September 2009, but this date is irrelevant to any claim against Mr. Lex because, as the Staff presumably concedes, Mr. Lex had stopped selling any of the relevant securities at least two months before then. (See Exhibit 4K to Division Exhibit 2, summary of Lex sales.)

chargeable with the very first offering more than a decade ago. As such, this entire proceeding is barred by the plain language of section 2462.

To the extent there was any ambiguity about this before the hearing, all possible doubt was subsequently removed as the case went on and Division doubled and tripled down on its insistence that its claims *first* accrued more than a decade ago. In its post-hearing brief, for example, the Division insists that its claims *first* accrued "from the date each Selling Respondent *first* recommended and sold one of the Four Funds notes." Div. Br. at 37 (emphasis added). Indeed under the Division's theory of the case, its claims must have "first accrued" back in 2003 because the Division is demanding the forfeiture and disgorgement of commissions from 2003, which of course would not be the case if its claims had not first accrued by then.

In fact, under the Division's own theory, it is not just the dispositive *first* sale from the *first* of the Four Fund offerings that resulted in a first accrual of each of the claims asserted in the OIP, thus precluding entertainment of this proceeding. *Every sale* from *every one* of the Four Funds offerings occurred prior to September 23, 2008, rendering it absurd (and unlawful under section 2462) for the Division to seek penalties and forfeitures against Mr. Lex and the other respondents for anything having to do with those ancient Four Fund offerings. And this is especially important because nearly all of the purported "red flags" articulated by the Division in the OIP (itemized above) relate solely to those ancient Four Fund offerings, *not* to any of the subsequent Trust offerings. In fact, even a large portion of the subsequent Trust offerings took place before September 2008, so under the Division's own theory – even if the staleness of the Four Fund offerings were completely overlooked, and even if only the Trust offerings were considered – the Division's three asserted claims *still* "first accrued" before September 2008.

In its recent decision in Gabelli v. SEC, the Supreme Court unanimously held that a claim "accrues" within the meaning of section 2462 "when it comes into existence" – that is, "when the plaintiff has a complete and present cause of action." 133 S. Ct. 1216, 1220-21 (2013) (citations omitted). It obviously follows that where a claim allegedly accrues on multiple occasions, it *first* accrues for purposes of § 2462 "when it [*first*] comes into existence" or when a plaintiff [*first*] has a complete and present cause of action." In such circumstances, the claim cannot plausibly "*first* accrue" on more than one occasion. Under any plausible reading of the statute, even a claim that further develops after its initial accrual (which might increase the magnitude of potential penalties available against the violator) most certainly would not "*first* accrue" upon any of the subsequent developments. Here, there is no serious question that – at least according to the Division's theory and facts as articulated in the OIP – each of the Division's three purported claims "first accrued" long before September 2008. Tellingly, the Division's brief fails even to acknowledge Gabelli, much less address it.

To be sure, before Gabelli the SEC had loosely interpreted section 2462 in a number of respects, most notably by inferring the unwritten "discovery rule" that *Gabelli* unanimously rejected. A similarly loose SEC construction has occasionally defied the plain text of section 2462 by allowing "proceedings" for enforcement penalties to be "entertained" even when the asserted claims "first accrued" *more* than five years before commencement of the proceeding – and by allowing time-barred "conduct" to be "considered" but only for limited purposes in the proceeding – so long as the time-barred "conduct" wasn't "considered" when calculating the *amount* of any penalty ultimately imposed. See, e.g., Gregory O. Trautman, Exchange Act Release No. 61167, 97 SEC Docket 23492, 23525-26 (Dec. 15, 2009) (citing prior Commission opinions).

That loose reading of the statute is no longer plausible after Gabelli. The Supreme Court was crystal clear that section 2462 means what it says, and that neither the Commission nor the courts may even expand upon it to fill perceived gaps, much less engage in the kind of wholesale rewriting of the statute required to allow a proceeding seeking penalties to be "entertained" based on claims that first accrued a decade before the proceeding was commenced. As relevant here, section 2462 unambiguously says that a "*proceeding*" seeking a penalty "*shall not be entertained*" unless the asserted claims "*first accrued*" less than five years before the proceeding was commenced. The pre-Gabelli approach exemplified by Trautman essentially required the Commission to engage in three steps of logomachy: First, invert the phrase "shall *not* be entertained" and pretend that it reads "*may* be entertained;" second, rewrite the phrase "unless the claim" and pretend that it reads "so long as any conduct alleged in support of the claim;" and third, change the phrase "*first* accrued" and pretend that it reads "*last* accrued." We respectfully submit that this wholesale rewrite of the statute is far less plausible than the "discovery rule" the Commission urged in Gabelli, and it would suffer an equally grim fate before the Supreme Court. Indeed, we doubt the Commission would risk its credibility with the Court by even arguing the point after Gabelli.

Even without the force of the Supreme Court's unanimous Gabelli decision interpreting the very statute that applies here, section 2462 is no ordinary statute of limitations. It is uniquely worded in a way that does not merely allow a plaintiff to assert a claim within a prescribed period of time, with the defendant then obliged to raise and prove untimeliness as an affirmative defense. It is an explicit deprivation of the relevant tribunal's jurisdiction and lawful power to act – i.e., to "entertain" the "proceeding" at all – "unless" the conditions set forth in the statute for the exception are met. Because those conditions are not met here, the statute plainly forbids entertainment of the proceeding.

We have found only one other federal statute that contains the same "shall not be entertained" prohibition followed by a "savings clause" that provides an exception to the prohibition if, but only if, certain statutory conditions are met. That statute is 28 U.S.C. § 2255, which limits certain federal habeas corpus relief available under 28 U.S.C. § 2241, and federal courts have left no doubt that this type of statutory locution reflects an explicit legislative intention to deprive the tribunal of subject matter jurisdiction and the lawful power to act unless the "savings clause" applies. The Eleventh Circuit recently articulated this point at length in Williams v. Warden, 713 F.3d 1332, 1337-40 (11th Cir. 2013), explaining its reasons for joining with "the great weight of authority" in holding that "the savings clause is jurisdictional in nature."

> The savings clause [of § 2255] states that a § 2241 habeas petition "shall not be entertained...unless it...appears that the remedy by motion is inadequate or ineffective to test the legality of the detention." Based on the text alone, which speaks in imperative terms of what class of cases the district court has the power to hear, not what the petitioner himself must allege or prove in order to state a claim, we are compelled to conclude that the savings clause is a limitation on jurisdiction. It commands the district court not to "entertain[]" a § 2241 petition that raises a claim ordinarily cognizable...except in the exceptional circumstance where the petitioner's first motion was "inadequate" or "ineffective" to test his claim. The provision does everything but use the term "jurisdiction" itself, and there is no magic in that word that renders its use necessary for courts to find a statutory limitation jurisdictional in nature. As we have explained before, "[a] jurisdictional defect is one that strips the court of its power to act and makes its judgment void. *A plain reading of the phrase "shall not entertain" yields the conclusion that Congress stripped the court of subject-matter jurisdiction – in these circumstances unless the savings clause applies.*

Id. at 1338-39 (emphasis added; citations omitted; first two ellipses in original). Accord Abernathy v. Wandes, 713 F.3d 538, 557-558 (10th Cir. 1013); Rice v. Rivera, 617 F.3d 802, 807 (4th Cir. 2010); Harrison v. Ollison, 519 F.3d 952, 961 (9th Cir.), cert. denied, 555 U.S. 911 (2008).

Likewise here, Congress has plainly "stripped" the Commission of the jurisdiction and power to act upon "proceedings" that seek penalties or forfeitures, *unless* all conditions of the statutory savings clause are met. Here those conditions clearly are not met, because under any plausible reading of the Division's allegations, none of its three articulated claims "first accrued" less than five years before the proceeding was commenced.

It is patently unfair for a federal law enforcement agency to punish citizens based on claims this old, and that is precisely why statutes of limitations like section 2462 exist. Section 2462 gives the Division only two alternatives for having a proceeding like this lawfully "entertained." One is to seek no "civil fine, penalty, or forfeiture" in the proceeding, in which case the age of the underlying facts is largely irrelevant. The other is to articulate one or more claims that "first accrued" less than five years before the proceeding was commenced, and proceed only on such claims. Here the Division did neither. It commenced a proceeding that unquestionably seeks civil penalties and forfeitures (and little else), and it articulated two claims against Mr. Lex that each unquestionably *first* accrued more than five years earlier. Section 2462 thus unequivocally forbids the proceeding from being "entertained."

C. Even if Pieces of This Proceeding Could Lawfully Be "Entertained," the Vast Majority of the Relief Demanded by the Division is Time-Barred

Even if this "proceeding" could somehow be partially "entertained" in open defiance of the plain language of section 2462, the Division apparently concedes that civil penalties and industry sanctions cannot lawfully be based on facts or transactions that occurred before September 23, 2008 (i.e., five years before the OIP was issued). See generally Johnson v. SEC, 87 F.3d 484 (D.C. Cir. 1996) (censure and industry suspension) , Gabelli v. SEC, 133 U.S. 1216, 1219 (2013) (penalties). But it is equally clear that the Division's demand that Mr. Lex forfeit and disgorge a decade's worth of past brokerage commissions is also subject to section 2462. As quoted earlier, section 2462 applies to proceedings seeking "any civil fine, penalty, *or forfeiture*...."

As previously acknowledged (with some understatement) by the federal appeals court most likely to hear any appeals from this proceeding, "[i]t could be argued that disgorgement is a kind of forfeiture covered by § 2462, at least where the sanctioned party is disgorging profits not to make the wronged party whole, but to fill the Federal Government's coffers." Riordan v. SEC, 627 F.3d 1230, 1234 n.1 (D.C. Cir. 2010). That court did not squarely address the issue (which had not been raised by the appellant), noting only that the argument had been "implicitly" rejected by a prior panel decision that likewise had not actually addressed it.

In fact, courts and even the SEC routinely use the terms "forfeiture" and "disgorgement" in tandem and interchangeably. See, e.g., United States v. Usery, 518 U.S. 267, 284 (1996) (civil forfeitures "serve a variety of purposes, but are designed primarily to confiscate property used in violation of the law, and to require disgorgement of the fruits of illegal conduct"); United States v. Davis, 706 F.3d 1081, 1084 (9th Cir. 2013) (forfeiture sanction requires defendants to "disgorge their ill-gotten gains, even those already spent"); United States v. Contorinis, 692 F.3d 136, 146-47 (2d Cir. 2012) (forfeiture "focuses on the disgorgement by a defendant of his 'ill-gotten gains,'" rather than the victim's loss); United States v. Ben Zander, 2009 U.S. App. LEXIS 6809, at **7 (3d Cir. 2009) (distinguishing "disgorgement, which is the forfeiture of ill-gotten gains," from "restitution, which is 'a restorative remedy that compensates victims'"); United States v. Webber, 536 F.3d 584, 602-03 (7th Cir. 2007) (forfeiture, in contrast to restitution, is "punitive" because it seeks to disgorge any profits that the offender realized from his illegal activity"); United States v. Hoffer, 129 F.3d 1196, 1202 (11th Cir. 1997) ("disgorgement" order "was, in fact, a civil forfeiture," and "[t]he district court, at the government's request and with [defendant's] consent, specifically termed the disgorgement a forfeiture"); SEC Press Release No. 2002-126 (Aug. 21, 2002) (announcing Enron-related case in which defendant was ordered to "disgorge and forfeit" approximately $12 million in ill-gotten gains).

The SEC has also successfully argued in federal court that statutory language nearly identical in relevant part to section 2462 is broad enough to encompass disgorgement orders entered in SEC enforcement cases. In In re Telsey, 144 B.R. 563, 1992 Bankr. LEXIS 1411 (Bankr. S.D. Fla. 1992), the Commission sought to except a bankrupt debtor's disgorgement obligation from the general discharge of his pre-bankruptcy debts. In particular, the SEC argued that the disgorgement obligation fell within the statutory exception for a debt that "is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss...." Id. at 564-65. The court agreed, in large part because disgorgement orders generally serve a deterrent – and thus at least partially penal – purpose even when they also serve a predominantly compensatory purpose. Id. at 565. The court found "the deterrence purpose of the disgorgement order sufficiently penal to characterize the resulting debt as a 'fine, penalty, or forfeiture' within the meaning of [the statute]." Id. The court further refused, understandably, to draw fine distinctions between the concepts of "fines," "penalties," and "forfeitures" in the context of SEC disgorgement because those terms "are often used loosely and confusedly." Id. at 565 n.3 (quoting 36 Am. Jur. 2d Forfeitures and Penalties § 3 (1968)).[15]

[15] Our review of the docket sheet in Telsey suggests that the Commission may have later come to regret the persuasiveness of its own argument, as it apparently asked the court to vacate the decision. Unfortunately, due to the age of the case and the resulting unavailability of the relevant court records, we were not able to review or retrieve the pleadings and court orders filed after the published opinion cited herein.

And even if *some* kinds of disgorgement orders might arguably be distinguished from forfeitures (none come immediately to mind), orders like the one sought in this case – i.e., designed to claw back past compensation, rather than the typical demand for true "disgorgement" of illicit profits or avoided losses – are quintessential forms of forfeiture. Indeed, without specific statutory authority, this form of purported "disgorgement" is almost certainly impermissible –indeed even calling it "disgorgement" is a complete misnomer – especially when ordered by an Executive Branch law enforcement agency in a penal administrative proceeding rather than by a federal court exercising broad *judicial* powers in *equity* under Article III of the Constitution. Congress has given the SEC power to claw back compensation in only one specific statute, which is obviously inapplicable here but is nevertheless instructive in demonstrating that compensation clawbacks constitute forfeitures. We refer to the statutory clawback remedy at section 304 of the Sarbanes-Oxley Act of 2002, which applies only to certain bonuses and stock sale profits received by CEOs and CFOs of public companies that file accounting restatements. See 15 U.S.C. § 7243 (codification of Sarbanes-Oxley § 304). That provision leaves no doubt that compensation clawbacks are quintessential examples of forfeitures; indeed, the very title of the provision is "*Forfeiture* of Certain Bonuses and Profits." Id. (emphasis added). This is also consistent with the legislative history, during which one of the statute's principal co-authors, Senator Paul Sarbanes, explicitly called the remedy a "forfeiture":

> We have a provision that the CEO and the CFO who make large profits by selling company stock or receiving company bonuses while management is misleading the public about the financial health of the company would have to *forfeit* their profits and bonuses realized after publication of a misleading report.[16]

[16] 148 Cong. Rec. S6237, S6332 (daily ed. July 8, 2002) (emphasis added).

The Division inexplicably insists that its demand for forfeitures of commissions is immune from section 2462 because it is a demand for "equitable" relief. That's nonsense, because there is no such thing as "equitable" relief in an administrative proceeding. Of course, the Commission and the Division know full well how and where to obtain "equitable" relief – that is, an Article III court of equity – but for reasons we can all infer they made the deliberate tactical decision to hide from that venue, undoubtedly to ensure that Mr. Lex and the other respondents would be denied meaningful discovery, due process, a jury trial and all the other protections available in court. Having deliberately chosen its own captive Article II venue, the Division necessarily deprived itself of the opportunity to seek *any* equitable remedies, because neither the Commission nor its administrative law judges have any constitutional power to grant equitable remedies.

The power to grant equitable remedies is a core *judicial* power that the Constitution vests in Article III courts, not in Executive Branch law enforcement agencies like the SEC. See U.S. Const. Art. III, § 1 ("The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish"); id. § 2 ("The judicial Power shall extend to all Cases, in Law and Equity, arising under...the Laws of the United States").

Executive Branch law enforcement agencies are litigants that *prosecute* alleged lawbreakers; they do not sit as courts of equity, and they have no constitutional power to award themselves "equitable" remedies. Congress has authorized agencies to unilaterally impose certain punitive *statutory* sanctions – including *statutory* disgorgement, not "equitable" disgorgement – but none of those sanctions are "equitable" remedies because administrative agencies obviously are not courts of equity. Thus, for example, the Commission has no greater power to award "equitable" disgorgement than it does to issue an equitable injunction, or to impose a constructive trust, or to appoint an equity receiver. Those are all *judicial* powers of an Article III court sitting in equity, not those of an Executive Branch law enforcement agency.

Finally, a footnote in the Division's post-hearing brief baldly misstates well-settled law under section 2462, even pre-Gabelli law. It has been settled for decades that industry bars and suspensions constitute penalties under section 2462, beginning at least with the D.C. Circuit's seminal opinion in Johnson v. SEC, 87 F.3d 484 (D.C. Cir. 1996) (holding that even a six-month suspension is a penalty). We are aware of no recent case to the contrary, and indeed the only case cited by the Division was not an industry-sanction administrative proceeding at all but rather – tellingly enough (*see* prior discussion) – a federal court case that addressed the applicability of section 2462 to public-company director and officer bars).

D. The Division's Section 5 Claim Should Be Rejected and Dismissed

The Division's Section 5 claim against Mr. Lex is a woefully contrived house of cards that could easily be leveled with a baby's morning yawn. The Division's inexplicable desire to "stick it" to Mr. Lex under Section 5 by any means possible should be summarily rejected as baseless and vindictive. In any event, this tribunal should refuse to impose *any* sanction at all even if she finds the kind of blameless, good-faith, hyper-technical oversight that the Division is relentlessly pushing here.

The Division knows that every single sale of the Four Funds – including any and all sales to any unaccredited investors – occurred more than five years before the OIP was filed (and thus is absolutely immune from any punitive sanctions even under the Division's forgiving interpretation of 28 U.S.C. § 2462). (*See* OIP at ¶ 15.) The Division also admits that, without help of its contrived "conduit" theory, *none* of the Trust Fund offerings even arguably violated Section 5. (See OIP at 32; Div. Br. at 5.) Moreover, the Division knows that even assuming its contrived "conduit" theory had validity (which it does not), many of the sales of those Trust Funds to allegedly unaccredited investors (nearly every one of which must be proven even under the "conduit" theory to allow the Division to barely scrape together the necessary 35 in the aggregate) likewise occurred more than five years before the OIP was filed, and thus likewise are absolutely immune from punitive sanctions and should not be counted for purposes of aggregating "conduit" sales.

In any event, the "conduit" theory is entirely bogus. To start with the obvious and undisputed facts, there was never *any* "MFS Conduit" entity, and there was never *any* "TDM Conduit" entity. These are entirely fictitious concepts conjured up by the Division because without them the Division realized it had no plausible Section 5 theory and certainly none that was even close to within the statute of limitations. Apart from featuring these entirely fictitious entities created for the sole purpose of concocting a "strict liability" claim that otherwise would not exist at all, the "conduit" theory evaporates for many other reasons.

As just one example, the fictitious "MSF Conduit" theory purports to integrate four separate offerings into one (and even then the Division manages to cobble together a grand total of only 39 allegedly unaccredited investors out of the entire McGinn Smith operation – just four more than what the law indisputably allowed). (See OIP at ¶ 31; Div. Ex. 536.) Those four combined offerings were Firstline Trust 07, Firstline Senior Trust 07, TDM Verifier Trust 08, and TDM Verifier Trust 09. But the last of these offerings (TDM Verifier Trust 09) didn't begin until December 2008, a *full year after* the next most recent of the four combined offerings (i.e., TDM Verifier Trust 09 in December 2008), and *more than 18 months* after the earliest of the four (i.e., Firstline Trust 07 in May 2007). The SEC's own Rule unequivocally prohibits aggregating offerings that occurred that far apart. *See* 17 C.F.R. § 230.502(a) (providing safe harbor from aggregation for offerings occurring more than 6 months apart). Subtracting from the contrived "MSF Conduit" list, as the safe harbor says we must, those six investors counted by the Division solely because they bought notes in the December 2008 TDM Verifier 09 offering reduces even the Division's overall count of unaccredited investors to a number comfortably below the permitted 35, causing any plausible Section 5 claim based on this fictional conduit to evaporate entirely.

The Division's fictitious "TDM Conduit" fares even worse. It purports to lump together eight disperate offerings that were spread out over a period of more than 2-1/2 years. (See OIP at ¶ 31; Div. Ex. 535.) Again completely disregarding the SEC's promulgated 6-month safe harbor, the Division purports to aggregate, for example, the TDM Cable Trust offering from November 2006 with the TDM Verifier Trust 08R offering *nearly 32 months later* in July 2009. Moreover, it purports to mix together completely different types of investments – some to invest in alarm contract revenue streams, others to invest in cable TV revenue streams, still others to invest in so-called "triple-play" revenue streams, and still others to invest in luxury cruises.[17] By simply backing out the seven investors who are on the "TDM Conduit" list solely because they bought notes in the "luxury cruise" offering in July 2007 – a deal completely different from any of the other deals artificially lumped into this fictitious conduit and, not coincidentally, one that Mr. Lex did not sell to a single one of his customers – the list of allegedly unaccredited investors immediately shrinks to 37, a mere two above the indisputably legal limit. And backing out the additional eight who invested only in the very last of the eight fictitiously aggregated offerings for this "conduit" (i.e., the entirely different TDM Verifier Trust 08R deal a full two years later in July 2009, which involved alarm contract revenues rather than luxury cruise lines), this entire conduit – just like the fictitious "MSF Conduit" – immediately evaporates.

[17] If such disparate offerings can be lumped together despite the passage of more than two years between some of them, we suspect the Division has a lot of work to do in tracking down many, many other Regulation D offerings that could, with the same Herculean effort and 20/20 hindsight, be retroactively aggregated to penalize thousands of retail brokers (and, at least in the Division's view, with no applicable statute of limitations and no need to prove even simple negligence).

It is important to emphasize that all of the Division's strained efforts – all of the fabricated "conduit entities," all of the twisted facts, contorted law, disregarded safe harbors, and other legal machinations – are channeled into the singular aspiration of retroactively nailing an individual retail broker with a "gotcha"-style strict-liability violation for which he was totally blameless and took all reasonable precautions to *prevent*.

Yet even beyond the fabricated "conduits," the extraordinary *further* lengths (or depths, as it were) to which the Division must go just to cobble together the magic number of 35 unaccredited investors for these offerings speaks volumes about the absurdity of its Section 5 theory and the unreliability of its methodology and work product. Despite conducting a four-year investigation to come up with a headcount of purportedly unaccredited investors, the Division admits that the numbers alleged in the OIP were grossly inflated. Those numbers repeatedly shifted right up to and during the hearing (mostly going down with each new question raised about those who were included on the initial list), and upon cross-examination the Division's witness was forced to concede that many investors on the list had been double-counted or improperly counted as part of a household that should have been counted only once. Perhaps most troubling, the Division's witness further admitted that in order to cobble together the magic number of 35 purportedly unaccredited investors for some of the offerings and so-called "conduits," she had to rely on hearsay reports of Division prosecutors telling her that, in an apparent pre-hearing attempt to salvage its disintegrating claim, they reached out orally to some investors who had years earlier signed written subscription agreements attesting to being accredited, and supposedly those investors suddenly changed their minds to say, after all these years, that maybe they weren't accredited after all. And all just in time for the hearing, apparently. How the Division thinks Mr. Lex could have possibly predicted in real time that these investors (many of whom were not even his clients, but rather clients of other brokers) would many years later renounce their signed status from accredited to unaccredited on the eve of the hearing – much less why the Division thinks the government should prosecute and severely penalize him for not anticipating this bizarre turn of events – remains a complete mystery.

Remember too that the Division knows to a virtual certainty that Mr. Lex made reasonable, good-faith efforts to ensure that none of his sales would jeopardize any registration exemption applicable to these offerings, in particular the Rule 506 exemption for offerings to 35 or fewer accredited investors exception.[18] He consistently checked with the person at McGinn Smith who was responsible for keeping track of the number of unaccredited investors (Patty Sicluna), and he sold to unaccredited investors only after being assured that the sale would *not* jeopardize the exemption. (N.T. 1618:2-17.) The Division offers no evidence to the contrary, nor any hint of what else Mr. Lex reasonably could have done in the circumstances.

Instead, the Division offers the canard that a retail broker should be held strictly liable for selling any investment that later turns out not to have qualified for a registration exemption. (Div. Br. at 7.) The Division's simplistic reliance on this canard is misguided. To begin with, the notion that Section 5 violations can be based solely on strict liability – particularly in a penal law enforcement prosecution in which the government seeks to administer draconian punishment against the defendant – is dubious at best, and would strike many as utterly repugnant to basic American notions of fairness and due process (not to mention prosecutorial discretion). Moreover, although some lower courts have indeed parroted this dubious proposition (often in

[18] We understand that at least one of the other respondents will be briefing why these offerings did not involve any "public offering," and thus are also exempt under Securities Act Section 4(2). For sake of brevity, we will not separately brief that issue but support and join in that argument.

dictum without any meaningful analysis of whether it makes any legal or logical sense), the issue remains unsettled in the federal circuit most likely to decide any appeal from this proceeding. See, e.g., SEC v. E-Smart Technologies, 2014 U.S. Dist. LEXIS 31629, at *32 & n.1 (D.D.C. Mar. 12, 2014) (chastising SEC for suggesting that the issue is settled in the D.C. Circuit).[19]

In fact, the explicit text of the Securities Act, as well as SEC Rule 506 itself, negate any plausible argument that strict liability is appropriate in a case like this one against a remote individual retail broker engaged in a good faith effort to preserve the exemption he had every reason to believe was applicable. For starters, Securities Act Section 4(a)(1) explicitly says that "section 5 shall not apply to...transactions by any person other than an issuer, underwriter, or dealer." 15 U.S.C. § 77d(a)(1). Mr. Lex, of course, was none of the above, and thus his "transactions" appear clearly not to fall within the intended scope of Section 5 liability at all, much less to be subject to strict liability notwithstanding his reasonableness and good faith in relying on a wholly separate exemption. At a minimum – and we will come back to this point later in the remedies section of this brief – Section 4(a)(1) makes crystal clear that even if a Section 5 violation occurred at all, it was the underlying *offering* that triggered the singular violation, not each (or any) of the individual retail client sales made by the broker, all of which are explicitly exempted from any stand-alone Section 5 liability because of Section 4(a)(1).

[19] Indeed, even the other crutch relied upon by the Division – i.e., the notion that defendants (or here, respondents) bear the ultimate burden of proof in defending a Section 5 case based on a registration exemption – is likewise of questionable relevance (and equally repugnant) in a penal law enforcement prosecution seeking draconian punishment at the hands of the government. This burden-shifting convention dates back to SEC v. Ralston Purina Co., 346 U.S. 119 (1953), a Section 5 case against an *issuer* that purported to use an exemption (not a remote individual retail broker who merely sold the underlying security to retail clients). More significantly, in that case the SEC sought no punitive sanctions at all, but rather only an injunction to stop the offering from continuing, a purely prophylactic remedy carrying no penalty or stigma. In such a context, it is not surprising that the Supreme Court emphasized the "broadly remedial purposes of federal securities legislation" to justify shifting the burden of proof to the defendant, id. at 126, but that rational is entirely inapplicable in a harshly punitive law enforcement prosecution like this case, and we are confident that courts will very soon come to appreciate this glaring distinction.

Rule 506 makes equally clear that there is no strict liability even for *issuers* when the specific question is whether the number of unaccredited investors exceeded 35 for purposes of preserving the exemption. More specifically, the Rule explicitly states that the exemption applies if *either* there are no more than 35 unaccredited investors *or* the issuer "*reasonably believes*" this is the case. 17 C.F.R. § 230.506. Related SEC rules further emphasize that good faith attempts to comply with an exemption will prevent a forfeiture of the exemption or resulting liability under section 5. *See, e.g.*, 17 C.F.R. § 230.508. These provisions conclusively negate the concept of strict liability in the context of counting unaccredited investors (even assuming strict liability makes any sense in the context of establishing the SEC's prima facie case). Not surprisingly, the Division does not acknowledge these SEC rules at all, much less harmonize them with the notion of draconian penalties based solely on strict liability. Nor, of course, did the Division submit any evidence – or even argue – that Mr. Lex did not "reasonably believe" there were fewer than 35 total unaccredited investors in each of these offerings.

But the Division's wholesale reliance on strict liability begs a much more practical question: If, as the Division apparently concedes, there is no evidence of intent, fault, or even negligence against Mr. Lex in connection with purported Section 5 violations occurring completely unbeknownst to him, how could the Commission (or this tribunal) conceivably find that he committed a "willful" violation or conclude that draconian penalties for this no-fault violation are in the public interest – both of which are strict statutory prerequisites for imposing the penalties demanded in the OIP? The Division does not address this question at all, because the answer is obvious: It is the *antithesis* of the public interest for a governmental law enforcement prosecutor to harshly penalize citizens without proof of any fault or wrongdoing, and it is an utterly nonsensical oxymoron to say that someone "willfully" committed a no-fault offense predicated entirely on a theory of strict liability.

Finally, the Division essentially admits that even under its own generous view of the statute of limitations, punitive sanctions and forfeitures are completely barred for any violations involving the vast majority of transactions at issue in this case, including *anything* related to *any* of the Four Funds offerings. Moreover, even with the help of its contrived "conduit" theory to artificially concoct a Section 5 headcount for the Trust Fund offerings, the Division still cannot come close to cobbling together 35 unaccredited investors – for either of the two artificial Trust Fund "conduit" entities – without including investments that were made in many of those Trust Funds well more than five years before the OIP was issued, so Section 5 penalties should be completely barred for these Trust Funds as well.

E. The Division's "Fraud" Claim Should Be Rejected and Dismissed for Lack of Scienter

The Division's fraud claim alleges that Mr. Lex violated Exchange Act Section 10(b) and SEC Rule 10b-5 thereunder, as well as Securities Act Section 17(a). This claim is meritless.

The futility of the Division's Section 10(b) theory should be evident from the plain text of the statute. The statute prohibits only "manipulative or deceptive device[s] or contrivance[s]" in contravention of "such rules and regulations as the Commission may prescribe." The essence of the Division's Section 10(b) claim is Mr. Lex's alleged failure to conduct a "searching" due diligence inquiry into the McGinn Smith investments he sold. Apart from the fact that no such duty exists from any source (see below), it is indisputable that the SEC has *never* promulgated any rule or regulation imposing such an obligation on a retail broker. This is no mere oversight, since the SEC is fully familiar with how to promulgate rules on all manner of obligations, and indeed has not hesitated to promulgate due diligence obligations in other contexts. For example, it did so just recently in the context of conflict minerals. See 17 C.F.R. § 240.13p-1 (implementing Dodd-Frank section 1502, which is now codified at 15 U.S.C. § 13(p)(1)). By contrast, in the 80 years since Section 10(b) has been on the books, the SEC has never – ever – promulgated a single rule or regulation purporting to impose on retail brokers the duty to conduct due diligence on the products they sell. Notwithstanding the Division's razzle-dazzle of post-hoc FINRA rulemaking and 40-year-old cases that have been overruled by subsequent Supreme Court cases, this absence of *any* SEC rule or regulation on the subject conclusively negates any potential claim of fraud under Section 10(b) based on a failure to conduct due diligence.

To establish a violation of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), or Rule 10b-5 thereunder, the SEC must establish that Mr. Lex:

> (1) made a material misrepresentation or material omission as to which he had a duty to speak, or used a fraudulent device; (2) with scienter; (3) in connection with the purchase or sale of securities.

SEC v. Monarch Funding Corp., 192 F.3d 295, 308 (2nd Cir. 1999); SEC v. Amerindo Investment Advisors, Inc., 2013 WL 1385013 at *3 (S.D.N.Y. 2013); SEC v. Platinum Investment Corporation, 2006 WL 2707319 at *2 (S.D.N.Y. 2006).

The elements are the same for a violation of Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a), except that scienter is not required for the SEC to obtain an **injunction** under subsections (a)(2) or (a)(3) of the latter. SEC v. Monarch Funding Corp., 192 F.3d 295, 308 (2nd Cir. 1999); SEC v. First Jersey Securities, Inc., 101 F.3d 1450, 1467 (2nd Cir. 1996), cert. denied, 522 U.S. 812 (1997), citing Aaron v. SEC, 446 U.S. 680, 701-702 (1980); SEC v. Garber, 959 F.Supp.2d 374, 379 (S.D.N.Y. 2013); SEC v. Haligiannis, 470 F.Supp.2d 373, 381 (S.D.N.Y. 2007).[20]

[20] The Division maintains that scienter is not a requirement **at all** under subsections (a)(2) or (a)(3) of Section 17(a). (Division's Brief at 9.) This is not necessarily the case, because the Supreme Court's decision on that issue in

The scienter element for purposes of securities fraud is "a mental state embracing intent to deceive, manipulate, or defraud." Merck & Co., Reynolds, 559 U.S. 633, 648 (2010); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976). The broker must have "made a material misstatement *with an intent to deceive—not merely innocently or negligently.*" Merck, supra, at 649 (emphasis in original).

Scienter may be satisfied by evidence of "conscious misbehavior or recklessness." Gould v. Winstar Communications, Inc., 692 F.3d 148, 158 (2nd Cir. 2012). Conscious misbehavior in this context means "deliberate illegal behavior." Id.; Novak v. Kasaks, 216 F.3d 300, 308 (2nd Cir. 2000). And recklessness in this context means conduct that is:

> highly unreasonable, representing an **extreme departure** from the standards of ordinary care...to the extent that the danger was either **known** to the defendant or **so obvious that the defendant must have been aware of it.**

Gould, 692 F.3d at 158-159 (emphasis added); Rothman v. Gregor, 220 F.3d 81, 90 (2nd Cir. 2000); In re Computer Sciences Corporation Securities Litigation, 2012 WL 3779349 at *7 (E.D. Va. 2012).

The facts of this case dispel any notion that Lex acted with anything other than good faith when he sold the securities in question. First, if Lex were motivated by self-interest rather than a desire to help his clients, there is no reason he would have restricted his Four Funds sales to the highest two tranches--Senior and Senior Subordinated. In doing so, he knew he was limiting himself to the lowest possible commissions--just .8% for the one-year Senior Notes and 1.6% per

Aaron was necessarily premised on the fact that the SEC was not seeking any penal fines in that case (and indeed had no statutory power to seek penalties back then). The case is therefore plainly distinguishable from the penal law enforcement prosecution here, and it would be anomalous indeed to permit liability under Section 17(a) without scienter where the title of Section 17 is "**fraudulent** interstate transactions," 15 U.S.C. § 77q (emphasis added), and the title of Section 17(a) in particular is "use of interstate commerce **for purpose of fraud or deceit.**" 15 U.S.C. § 77q(a)(emphasis added). "Since Section 17(a), like Section 10(b), sounds in fraud, similar allegations are required to state a claim under that section." SEC v. First Jersey Securities, Inc., 101 F.3d at 1467; Savino v. E.F. Hutton & Co., 507 F.Supp. 1225, 1231 (S.D.N.Y. 1981).

year for the 3-year Senior Subordinated Notes. (N.T. 1578:24-1579:6; 1581:20-1582:13.) If he had sold Junior Notes he would have earned a 1.6% commission for each year of the 5-year term, with a single sale. (N.T. 4879:2-4.)[21]

The only logical explanation for restricting his Four Funds sales to the highest two tranches is that, as he explained, they offered the strongest protection to his clients in the event of default, and it was more important to him to protect his clients--not to earn the highest possible commissions for himself. (N.T. 4865:13-17.) Indeed, if he had been looking out for himself instead of his clients he would not have offered any of the Four Funds at all, but instead would have restricted his sales to variable and fixed annuities, which he did present as alternatives to virtually all of the clients who purchased the Notes (N.T. 4870:14-4871:6; 4844:7-8), because the commissions on the variable and fixed annuities were as high as 7% and 15% respectively. (N.T. 4877:19-4878:12.)

The Division presses the argument that Lex took advantage of clients who had longstanding relationships with him and who relied on his recommendations. But if Lex had such control over his clients' investment decisions and exploited that control to benefit himself, he certainly would not have sold the products and tranches that required the most work and yielded the lowest commissions. The fact is that he showed his clients all products producing income, and if they chose the Notes he would sell only the highest tranches that provided the most security. (N.T. 1578:20; 1597:11-12; 4865:13-17.) This conduct can hardly be characterized as "bad faith" or "greedy."

Second, if Lex had any inkling of the fraud, diversion, and misuse of funds that ultimately doomed the McGinn Smith private placements, it is inconceivable that he and his

[21] It should be noted that his commissions were gross commissions as opposed to .6% and 1.2% for the in-house brokers, whose rent, insurance, secretaries, pensions, equipment, computers, and all office expenses were covered by McGinn Smith. (N.T. 4867:9-22; 4868:3-5; 1583:11-14.)

immediate family would have invested more than $1.3 million in those same products. (N.T. 4880:2-4881:14; Lex Exhibit 55, printout from Receiver's website; Lex Exhibit 153, Summary of Lex Family investments per Receiver's website.)

When FIIN was first offered in the fall of 2003, the sixth sale that Mr. Lex made, on October 8, 2003, was to himself and his wife in the amount of $400,000.00. (N.T. 1594:17-20; Exhibit 4k to Division Exhibit 2, page 1, 6th row.) This hardly indicates a belief that the Notes were part of some fraudulent scheme, or a belief that Smith was not going to do the due diligence required in investing, or that Smith was undertaking a Ponzi scheme. It is indicative of his honest belief in Smith's abilities and experience, and in Smith's good faith.

In the same period of time, Mr. Lex's daughters and their families also made significant investments in the Notes, as follows:

Kathleen M. Lex (daughter)	FIIN	10/3/03	$55,000
Kimellen Remar (daughter) & William Lex	FIIN	10/7/03	$25,000
Loraine McEvoy (daughter's life partner who is a financial advisor)	FIIN	10/22/03	$65,000
William & Kathleen C. Lex (wife)	FIIN	12/29/03	$10,000

(Exhibit 4k to Division Exhibit 2.) Lex and his family members still hold these amounts in the Four Funds today. (Lex Exhibits 55 & 153.)

After the fact it is easy to scour the database of thousands of e-mails and other documents to make it appear that Lex and the other brokers must have known that there was a problem. But using that theory it is just as likely that the regulatory agencies who were auditing McGinn Smith, and who had with the resources, expertise, and legal obligations to oversee McGinn Smith and the McGinn Smith private placements--the NASD, FINRA, and the SEC itself--also knew or should have known of the wrongdoing. In fact, these agencies reviewed the PPMs and had the ability to make document and record demands and conduct audits, something Bill Lex did not have the authority to do.

In viewing the evidence on the issue of Lex's scienter, the most salient evidence is Lex's conduct at the time: (1) restricting his sales to the products and tranches with the most protection for his clients and the lowest commissions for himself, and (2) heavily investing for himself, his immediate family and numerous friends, in the same products that are at issue in this case.
In April 2010, Lex and his wife took out a home equity loan to invest $125,000 in the Firstline "rescue mission." (N.T. 4919:13-16.) This was more than four months after he had severed his relationship with McGinn Smith. (N.T. 4919:10-12.) His purpose was to see to it that the aggrieved investors had a chance to recover their money. (N.T. 4919:23-25.) At that point Les was gone from McGinn Smith and McGinn Smith was shut down. He had no reason to do this other than to help "rescue" his investors. This is not the act of a selfish man, much less a fraudster.

F. As a matter of law, no alleged omissions or misrepresentations were material because it is undisputed that all pertinent risks of the investments were set forth <u>in writing in the PPMs and Subscription Agreements.</u>

The Division's claims of omissions and misrepresentations by Lex are centered on his alleged failure to inform his clients that the McGinn private placements were risky, and his alleged statements that they were safe. (Division's Brief at 27.) Lex denies that he characterized the investments as safe, but because the clients all received written materials that were replete with prominent and warnings about the high risk of the investments, and because the investors all signed Subscription Agreements acknowledging their understanding of the high-risk nature of the investments, any alleged oral statements or omissions to the contrary are immaterial as a matter of law.

Under the materiality requirement for securities fraud, the allegedly false statement or omission statement or omission must be one "that a reasonable investor would have considered significant in making investment decisions." Ganino v. Citizens Utilities Company, 228 F.3d 154, 161 (2nd Cir. 2000), citing Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988). Accord, Marini v. Adamo, 2014 WL 465036 at *23 (E.D. N.Y. 2014); In re Longtop Financial Technologies Limited Securities Litigation, 939 F.Supp.2d 360, 376 (S.D.N.Y. 2013). Where all pertinent disclosures are set forth in a written PPM made available to the investor, the investor is bound with knowledge of those disclosures. Brown v. The E.F. Hutton Group, Inc., 991 F.2d 1020 (2nd Cir. 1993)(defendants allegedly orally characterized investments as "conservative" and "low risk"; affirming summary judgment for defendants because "the alleged oral statement are contradicted by the offering materials"); Mercury Air Group, Inc. v. Jet USA Airlines, Inc., 1998 WL 542291 at *7 (S.D.N.Y. 1998), aff'd, 189 F.3d 461 (2nd Cir. 1999)(dismissing securities claim because the private offering memorandum "clearly contradicts the alleged oral representations"). Therefore, as long as the investor has all pertinent truthful information in the written offering materials, any alleged oral omissions or representations to the contrary are legally insignificant and immaterial. Acme Propane, Inc. v. Tenexco, Inc., 844 F.2d 1317, 1322 (7th Cir. 1988).

"Where the facts and circumstances allegedly omitted or misrepresented have actually been disclosed in the relevant transaction document, there is no liability under the securities laws because the materiality element is absent." Taylor v. Prudential Insurance Company of America, 2003 WL 21314254 at *7 (S.D. Ind. 2003).

In Wamser v. J.E. Liss, Inc., 838 F.Supp. 393 (E.D.Wisc. 1993), the plaintiff sued for securities fraud on the ground that defendants allegedly failed to disclose pertinent risks of a private offering and instead characterized the product as a "no risk investment." Id. at 397. The court dismissed all claims on summary judgment because "where the alleged misrepresentations and omissions were directly contradicted or cured by written statements contained in the placement circular," materiality is lacking as a matter of law. Id. at 398. "[O]ral misrepresentations or omissions were not material, as a matter of law, when they were directly contradicted by written statements and warnings provided to the buyer prior to investing." Id. at 399. The court held:

> [W]here written, accurate and truthful information is provided to the buyer, information that contradicts oral misstatements and cures alleged omissions, Congress' objective has been met. To hold otherwise would extend the accountability of sellers far beyond that which is fair and which the language of the statue intends.

Id. at 399.

In In the Matter of VMS Limited Partnership Securities Litigation, 1992 WL 249594 (N.D. Ill. 1992), plaintiffs alleged that the defendants violated the securities laws by orally characterizing certain investments as "secure," "conservative," and "reasonably expected to be profitable," when they were in fact highly risky. Id. at *11. In dismissing all claims, the court held that the materiality element was lacking as a matter of law because (as in this case) the alleged oral misrepresentations were contradicted by the numerous written warnings in the private placement memoranda and subscription agreements.

The PPM in VMS (as in this case) explained that "[i]nvestment in the units involves a high degree of risk" and is suitable only for persons who "could withstand a loss of their entire investment in the Units." VMS at *11. As in this case, the investors in VMS "warranted that they had reviewed the offering materials when they signed their subscription agreements." Id. at *14. The VMS court continued:

> Moreover, by signing the subscription agreement, plaintiffs expressly acknowledged that "the Units are speculative investments which involve a high degree of risk of loss by the undersigned of his entire investment." Hence, disclosures about the risky nature of the investments could hardly have been more plain.

VMS at *11.

The courts recognize as follows:

> [T]he securities laws are designed to encourage the complete and careful written presentation of material information. A seller who fully discloses all material information in writing should be secure in the knowledge that it has done what the law requires. Just as in the law of contracts a written declaration informing one party of an important fact dominates a contrary oral declaration, so in the law of securities a written disclosure trumps an inconsistent oral statement. Otherwise even the most careful seller is at risk, for it is easy to claim: "Despite what the written documents say, one of your agents told me something else."

Acme Propane, Inc. v. Tenexo, Inc., 844 F.2d 1317, 1322 (7th Cir. 1988).

This principle protects against frivolous claims, as follows:

> This principle is necessary to provide sellers of goods and services, including investments, with a safe harbor against groundless, or at least indeterminate, claims of fraud by their customers. Without such a principle, sellers would have no protection against plausible liars and gullible jurors....Risky investments by definition often fizzle, and an investor who loses money is a prime candidate for a suit to recover it. If the documents he was given, warning him in capitals and bold fact that it was a **RISKY** investment, do not preclude the suit, it will simply be his word against the seller's concerning the content of an unrecorded conversation.

Carr v. CIGNA Securities, Inc., 95 F.3d 544, 547 (7th Cir. 1996)(defendant allegedly told plaintiff "that the limited partnerships were safe, conservative investments"; securities fraud claim dismissed because defendant gave plaintiff "documents that disclosed the riskiness of the investment"). See also Kennedy v. Josephthal & Co., 814 F.2d 798, 805 (1st Cir. 1987)(affirming summary judgment for broker because alleged oral misrepresentations about safety of investment were "completely at odds with the offering memorandum"); Zobrist v. Coal-X, Inc., 708 F.2d 1511, (10th Cir. 1983)(defendant allegedly represented that investment "couldn't miss" and was a "sure thing" with "no risks"; judgment for investor was reversed because the PPM "clearly and specifically stated the risks involved in the investment"; investor "must be charged with constructive knowledge of the risks and warnings contained in the Private Placement Memorandum.").

Here, this tribunal need not try to reconstruct, as much as ten years after the fact, whether Mr. Lex orally disclosed the risks of the investments to his clients because it is undisputed that all of the pertinent risks were disclosed in writing in the PPMs and the Subscription Agreements. The investor witnesses that the Division called to testify against Mr. Lex were not deprived of this information; they simply failed to heed it. For example, Alice Forsyth, M.D., who testified on behalf of the Division, acknowledged that Mr. Lex always presented her with the PPMs relating to the proposed investments and gave her a full opportunity to review the written materials. (Forsyth testimony at 1514:2-10.) She testified as follows on this subject:

> Q. ...Mr. Lex always provided you with whatever written material was necessary or related to the various notes; isn't that right?
>
> A. Oh, yes.
>
> Q. And gave you an opportunity to read the material?
>
> A. Oh, yes.

(Forsyth testimony at 1514:3-10.) She further testified that Mr. Lex was always available to answer any questions she might have had about the written materials. (Forsyth testimony at 1518:11-14.) Dr. Forsyth further testified that Mr. Lex always presented the McGinn Smith private placements as just one possible investment along with other alternatives, including annuities. (Forsyth testimony at 1495:16-1496:25.) And he left it completely up to Dr. Forsyth to decide which investments to make, if any:

> Q. [H]e left it up to you, did he not, for you to study these things and to make your own determination; isn't that right?
>
> A. Yes. We were free to choose.

(Forsyth testimony at 1497:2-6.)

The problem was not that Mr. Lex failed to provide her with all pertinent information regarding the investments, but rather that Dr. Forsyth, by her own admission, never paid attention to the information. She testified that early on she didn't review the materials because she was distracted, and later on she didn't review them because she knew her earlier McGinn Smith investments had been performing well. Her testimony was as follows:

> Q. Did he give you any written materials to review relating to the investment?
>
> A. Yes, he usually gave us written materials to review, and at that time--in 2003, I was still, you know...I was trying to get some other things done.
> **So I didn't pay much attention to them.** I figured that most of the things, these investments, came with papers attached, and **I didn't review them**, though.
>
> * * *
>
> Q. And I assume that before you signed the subscription agreements, you at least read the language that you were signing, right?
>
> A. I **probably** did. **But mostly I didn't examine it closely** because I knew that the early McGinn investments had performed okay....
>
> **So I saw no reason to examine them closely.**

(Forsyth testimony at 1479:13-24; 1514:11-22; emphasis added.)

Similarly, Dr. Marvin Weinar, who testified on behalf of the Division, acknowledged that before he made investments Mr. Lex would meet with him, discuss the products, and give him the PPMs for him to review. (Weinar testimony at 747:15-24.) Mr. Lex explained the features of the investments, explained the three tranches, and offered only the two most secure tranches. (Weinar testimony at 758:8-759:5; 759:6-9, 19-25; 760:2-4; 762:15-763:17; 768:20-769:6.) Mr. Lex was always available and responsive to Dr. Weinar's questions. (Weinar testimony at 768:17-19; 777:17-20.)

As with Dr. Forsyth, Dr. Weinar candidly admitted that the problem was not a failure to receive the written disclosures of all of the pertinent risks, but rather his own failure to pay attention. Dr. Weinar testified that he only "skimmed [the PPM] and, sad to say, did not read it with the attention I should have." (Weinar testimony at 770:2-4.) Although he signed the Subscription Agreements and knew he was bound by what he signed, he only read the Subscription Agreements "to some extent." (Weinar testimony at 763:18-764:10.) He only "looked...over" the Subscription Agreements before signing them, even though he knew he would be bound by their terms. (Weinar testimony at 766:20-767:3.)

As set forth above, the court in Carr, supra, warned about the prospect of frivolous claims and faulty memories if investors were permitted to testify about alleged oral representations or omissions contrary to written disclosures in the offering materials. That observation is particularly apt in this case. For example, the Division relies on Dr. Forsyth's recollection that, in December 2004, Mr. Lex allegedly told her that the risk of the TAIN investment was negligible. (Division's FOF 386.) But Dr. Forsyth candidly acknowledged that she had virtually no recollection of her discussion with Mr. Lex regarding that 2004 investment **or any of her other McGinn Smith investments.**

Regarding this December 2004 TAIN investment, Dr. Forsyth testified as follows:

> Q. Do you remember the circumstances of that transaction?
>
> A. **No....I don't remember specifics about it,** other than I was told that these were contracts that were--had a predictable attrition rate and they would--the chances were very strong that they would mature at their face value. But the risk was negligible.

(Forsyth testimony at 1478:18-1479:5, emphasis added.) [22]

Indeed, Dr. Forsyth soon contradicted this very allegation when she was asked specifically about representations regarding risk:

> **Q. During these years, these investments from '04 to '07, do you remember Mr. Lex ever saying anything to you about the notes in terms of their risk?**
>
> **A. No.**

(Forsyth testimony at 1483:15-19, emphasis added.) As Dr. Forsyth was asked about each transaction with Mr. Lex, she made clear she had no recollection of the discussions surrounding any of them.

Mr. Stoelting asked his witness, Dr. Forsyth, whether she remembered Mr. Lex making certain statements about risk in connection with her second TAIN investment and she responded that she did not remember. (Forsyth testimony at 1480:20-1481:2.) Mr. Stoelting continued as follows:

> Q. Then if you flip over to the next page, there's a $65,000 investment in First Albany Income Notes, FAIN, in January 2006.
>
> Do you see that?
>
> A. Yes.
>
> Q. Do you have a specific recollection of that....?

[22] Dr. Forsyth was obviously thinking of the alarm contracts, which she had both before 2003 and after 2006. (See Exhibit 4k to Division Exhibit 2.)

A. ...**I don't remember specifics.**

Q. And then in March 2006, $55,000 investment in FAIN, again in your IRA account.

Do you remember anything specific about this?

A. No.

Q. And then again, if we go to January 2007, another First Albany Income Note, FAIN, $15,000.

Do you remember this?

A. **No**, but I see it on the record.

Q. Do you remember receiving interest payments along the way, or did you just roll the interest back in to the investments?

A. ...**I don't know the specifics on each one.**

Q. During these years, these investments from '04 to '07, do you remember Mr. Lex ever saying anything to you about the notes in terms of their risk?

A. No.

* * *

Q. Just to go through the rest of your investments, in February 2007, First Independent Income Notes, $50,000....Do you have any separate recollection of that other than the general recollection?

A. **No. Nothing specific.**

* * *

Q. If you turn to the next page, do you see there's a First Line 9.25 in July 2007 of $55,000?...Do you remember any discussion with Mr. Lex about the First Line?

A. **No.**

Q. And then there's an investment with Alice Forsythe and Susan Forsythe, FEIN, August 2007 of $35,000.

Do you remember that?

A. **I don't have a specific recollection....**

*　　*　　*

Q. And then next is another Alice and Susan, $65,000 in August 2007.

Do you remember Mr. Lex talking to you about First Line...?

A. No.

*　　*　　*

Q. Then the next page is in December 2007, there's a $20,000 investment in TAIN.

Do you recall that one?

A. **No, I don't recall it,** but I see it here.

(Forsyth testimony at 1482:10-1487:18, emphasis added.)

It would be an egregious injustice to subject Mr. Lex to substantial monetary fines, penalties and forfeitures based on an alleged statement about "negligible risk" nearly 10 years ago, where the investor's recollection of the events from that time is admittedly hazy at best, but more precisely, non-existent. And this is not criticism of Dr. Forsyth. This is one of the salutary rationales for holding the terms of written disclosures to be binding and conclusive, regardless of whether the investors admit that they read them, and barring investors from claiming that the broker made statements or omissions contrary to those written disclosures. Even if the witnesses are earnestly trying to recollect distant discussions to the best of their ability, it is understandable that their memories would be imperfect.[23]

[23] This is also the rationale for respecting the statute of limitations.

For example, what investors now claim to remember as statements about the "safety" of the Four Funds in general could easily in fact have been explanations about the **relative** safety of the Senior and Senior Subordinated tranches in comparison to the Junior tranche. And it is particularly hazardous to rely on human memory of what was allegedly **not** said many years ago, as the Division does when it relies on Lex's alleged **failure** to disclose the high risks of the investments.

For the foregoing reasons, materiality is lacking as a matter of law.

G. Even if Mr. Lex had characterized the Private Placements as "safe," that is not the sort of measureable, objective assertion of fact that can form the basis of liability for alleged misrepresentations of fact.

According to the Division, Lex's affirmative misrepresentation was that he told his clients the private placements at issue were "safe." (Division's Brief at 27.) Lex denies he so characterized the investments (N.T. 4882:2-8), and this Court should not base the kind of penalties requested by the Division on 7-9 year-old "statements" by witnesses who are just as likely to be testifying about their impressions as opposed to actual statements. This dispute of credibility need not be resolved because, as a matter of law, the characterization of a security as "safe" is not the sort of objective, verifiable factual assertion that can give rise to an action for securities fraud.

"To be actionable [as securities fraud], a misrepresentation must be 'one of existing **fact**, and not merely an expression of opinion, expectation, or declaration of intention.'" In re Moody's Corporation Securities Litigation, 599 F.Supp.2d 493, 507 (S.D.N.Y. 2009)(emphasis added)(quoting Greenberg v. Chrust, 282 F.Supp.2d 112, 121 (S.D.N.Y. 2003); Smith v. Meyers, 130 B.R. 416, 423 (Bankr. S.D.N.Y. 1991); In re Duane Reade Inc. Securities Litigation, 2003 WL 22801416 at *4 (S.D.N.Y. 2003)).

"To allege a misrepresentation or omission of material fact [under the securities laws], a plaintiff 'must point to a **factual** statement or omission--that is, one that is demonstrable as being true or false." Carlucci v. Han, 886 F.Supp.2d 497, 517 (E.D. Va. 2012)(emphasis in original)(quoting Ottmann v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 342-43 (4^{th} Cir. 2003); Longman v. Food Lion, Inc., 197 F.3d 675, 682 (4^{th} Cir. 1999)).

"Statements of 'hope, opinion, or belief about...future performance' are not actionable." In re Moody's, supra, 599 F.Supp.2d at 507 (quoting San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., 75 F.3d 801, 811 (2^{nd} Cir. 1996); Lapin v. Goldman Sachs Group, Inc., 506 F.Supp.2d 221, 239 (S.D.N.Y. 2006)). Similarly, "generalized statements of optimism that are not capable of objective verification are not actionable" under the securities laws. In re XM Satellite Radio Holdings Securities Litigation, 479 F.Supp.2d 165, 176 (D.D.C. 2007). Accord, Grossman v. Novell, Inc., 120 F.3d 1112, 1119 (10^{th} Cr. 1997); In re Harman International Industries, Inc., 2014 WL 197919 at *16 (D.D.C. 2014).

It follows that statements as to the general "riskiness" or "safety" of particular securities are too general to be actionable. Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Company, 753 F.Supp.2d 166, 182 (S.D.N.Y. 2010). "[S]tatements that the stock of defendant Monterey was a red hot stock and plaintiff could not lose on an investment in Monterey, that plaintiff would make a bundle of money on the stock of defendant Automated, and that it was impossible to lose money in an investment in Automated...are not actionable under either the federal or state securities laws." Rotstein v. Reynolds & Co., 359 F.Supp. 109, 113 (N.D. Ill. 1973). Statements that Philip Morris was "'optimistic' about its earnings and 'expected' Marlboro to perform well ...cannot constitute actionable statements under the securities laws." San Leandro, supra, 75 F.3d at 811.

Statements about Harman's "strong" balance sheet and "very strong" sales were too subjective to be actionable. In re Harman, supra, 2014 WL 197919 at *17. "Defendants' alleged assurance that the Hotel was a 'great' investment for Dafofin which would make 'quick' money" is not actionable. Dafofin Holdings S.A. v. Hotelworks.com, Inc., 2001 WL 940632 at *4 n. 6 (S.D. N.Y. 2001). The "statement that NPCT 'enjoys a very strong financial position' was merely a statement of opinion" and therefore non-actionable under the securities laws. Nanopierce Technologies, Inc. v. Southridge Capital Management LLC, 2003 WL 21507294 at *8 (S.D.N.Y. 2003). Statement that corporate acquisition was a "unique opportunity" with "very compelling valuations" was not actionable because expressions of "corporate optimism do not give rise to securities violations." In re Bank of America Corp. Securities, 2012 WL 1353523 at 8*9 -10 (S.D.N.Y. 2012).

Statements that corporation's financial position was "solid," "robust," "strong," "improved" and "well positioned" were not actionable. In re Splash Technology Holdings Inc. Securities Litigation, 160 F.Supp.2d 1059, 1077 (N.D. Cal. 2001). The statement that particular bonds would be a "marvelous" investment was not actionable. Zerman v. Ball, 735 F.2d 15, 20-21 (2nd Cir. 1984). Statements that Monsanto expected "solid growth" are not actionable because they "do not contain any specific, concrete factual representations as to present facts." Rochester Laborers Pension Fund, 883 F.Supp.2d 835, 854 (E.D. Mo. 2012). "Nelson's statement that the stock was just as good as EAC and that it was hot on the market are classic opinions which do not rise to the level of a misrepresentation." Marchese v. Nelson, 809 F.Supp. 880, 888 (D. Utah 1993). Here, "safe" is a relative and subjective matter of opinion, not subject to verifiable proof as either true or false. For this reason, the allegation that an investment was characterized as "safe" cannot give rise to liability for securities fraud.

H. Even if Mr. Lex had failed to orally disclose the risks of the private placements, those omissions cannot give rise to liability because it is undisputed that those disclosures were repeatedly made in writing in the PPMs and Subscription Agreements.

The Division's case of fraud by Mr. Lex rests largely on alleged omissions rather than affirmative misrepresentations. According to the Division, Lex "never mentioned the high risk nature of the notes…." (Division's Brief at 27.) This basis for liability fails as a matter of law because it is undisputed that all investors were repeatedly and specifically warned of the serious risks in the investments through the numerous disclosures in the PPMs and Subscription Agreements.

The concept of a false affirmative representation is fairly straightforward. But an **omission** is "false" only if "the omitted fact renders a public statement misleading." Carlucci v. Han, 886 F.Supp.2d 497, 517-518 (E.D. Va. 2012); Ottmann v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 343 (4th Cir. 2003). Accord, Nagel v. First of Michigan Corp., 784 F.Supp. 429, 435 (W.D. Mich. 1991). There is no duty under the securities anti-fraud laws to disclose all material information. United States v. Yeaman, 987 F.Supp. 373, 378 (E.D. Pa. 1997); United States v. Crop Growers Corp., 954 F.Supp. 335, 349 (D.D.C. 1997).[24] The anti-fraud provisions do not require a dealer or broker "to state every fact about stock offered that a prospective

[24] The duty to disclose is addressed separately in Section 5 of the Securities Act, which requires the filing of a registration statement in connection with the sale of certain securities. 15 U.S.C. § 77e. For the reasons stated in Section D of this Brief, the securities in this case were exempt from the registration requirement.

purchaser might like to know or that might, if known, tend to influence his decision." Trussell v. United Underwriters, Ltd., 228 F.Supp. 757, 762 (D.Colo. 1964). "Liability may exist under Rule 10b-5 for misleading or untrue statement, but not for statements that are simply incomplete." Winer Family Trust, 503 F.3d 319, 330 (3rd Cir. 2007); In re Harman International Industries, Inc. Securities Litigation, 2014 WL 197919 at *19 (D.D.C. 2014). Accord, Brody v. Transitional Hospitals Corp., 280 F.3d 997, 1006 (9th Cir. 2002); Backman v. Polaroid Corp., 910 F.2d 10, 16 (1st Cir. 1990).

This is clear from the wording of the anti-fraud provisions themselves. The misrepresentation provision of Section 17(a) of the Securities Act makes it unlawful:

> to obtain money or property by means of any untrue statement of a material fact or any **omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.**

15 U.S.C. § 77q(a)(2)(emphasis added).

In substantively identical language, the misrepresentation provision of Rule 10b-5 makes it unlawful:

> To make any untrue statement of a material fact **or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.**

17 C.F.R. § 240.10b-5(b)(emphasis added).

Here, Mr. Lex was not required to orally advise his clients of the risks of the investments because those risks were thoroughly and repeatedly spelled out in writing in the PPMs and the Subscription Agreements. In connection with the purchase of the Notes in question, all of Mr. Lex's customers signed a Subscription Agreement informing them, among other things, of the following:

INVESTORS SHOULD BE AWARE THAT THEY MAY BE REQUIRED TO BEAR THE FINANCIAL RISKS OF THIS INVESTMENT FOR AN INDEFINITE PERIOD OF TIME.

* * *

1. The undersigned represents, warrants, and agrees as follows:

* * *

(b) The undersigned has carefully read the Offering Materials, all of which the undersigned acknowledges have been provided to the undersigned....

(c) The undersigned is aware that the purchase of Notes is a **speculative investment involving a high degree of risk** and that there is no guarantee that the undersigned will realize any gain from this investment, and that **the undersigned could lose the total amount of the undersigned investment.**

* * *

(f) The undersigned represents that the undersigned, if an individual, has adequate means of providing for his or her current needs and personal family contingencies and **has no need for liquidity** in this investment in the Notes....

(g) The undersigned is financially able to bear the economic risk of this investment, including the ability to hold the Notes indefinitely or to **afford a complete loss of his, her or its investment in the Notes.**

(Division Exhibit 5 at 36-38; emphasis added.)

The accompanying PPMs are also replete with similar warnings, as follows:

The notes are not...guaranteed or insured....Investing in the notes involves a high degree of risk.

* * *

There is no existing or public market for the notes. We cannot provide you with any assurance as to:

- the liquidity of any market that may develop for the notes;

- your ability to sell or pledge your notes; or
- the prices at which you will be able to sell your notes.

*   *   *

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

*   *   *

The Notes Will Not Be Registered Under The Securities Act And You May Not Be Able To Sell The Notes Quickly, Or At All.

*   *   *

The Secured Assets May Be Inadequate to Repay The Notes.

*   *   *

The Notes Will Have No Insurance Or Guarantee.

*   *   *

We May Be Unable To Finance Our Operations.

*   *   *

Our cash flow is wholly dependent on our ability to find and acquire suitable Investments.

(Division Exhibit 5 at 1, 9, 11-13, emphasis added.)

Mr. Lex's clients were already informed that there was no guarantee of liquidity and that they could lose their entire investment. To the extent liquidity problems eventually occurred with the onset of the world-wide financial crisis, no additional oral disclosures were required to "correct" the prior written representations because the original written disclosures already fully advised the investors of that very risk, as well as all other pertinent risks.

I. The duty to investigate lies with the member firm, not the individual broker.

Without evidence of material misstatements or omissions, the Division ultimately rests its case on an alleged duty on the part of the individual brokers to investigate and/or conduct due diligence into the securities in question or the issuing companies before offering the securities for sale. According to the OIP, the Respondents "had an obligation to conduct a reasonable investigation of the issuers" (OIP ¶34) and "a searching inquiry into the offerings." (OIP ¶39.) The Division's Brief reiterates that "when recommending the Four Funds, the Trust Offerings and MSTF, Selling Respondents had a duty to conduct an independent investigation…." (Division's Brief at 11.) The Division's expert also opined that the Respondents had "due diligence obligations" (Division Exhibit 1, Lowry Report at 11) and a duty to investigate. (Id. at 5.)

The Division's theory bears no support in the applicable law. Brokers cannot be held liable for **fraud** for failing to conduct some appropriate level of investigation or due diligence. Indeed, throughout the period at issue in this case, 2003-2009, it was clear that the obligation of investigation and due diligence into the issuer and the product rested exclusively on the broker-dealer member firm rather than on the individual broker.

The Division has acknowledged that no Respondent in this case is a "member" within the meaning of the NASD/FINRA regulatory scheme. (See testimony of Division's expert witness, Robert Lowry at 865:10-19.) NASD Notice to Members 03-71, issued November 2003, distinguished between what it called "due diligence" or "reasonable-basis" suitability on one hand, which it imposed exclusively on "members," that is, the institutional broker-dealer, and "customer-specific" suitability on the other hand, which it imposed on both members and "associated persons" or individual brokers.

With respect to "due diligence," Notice 03-71 states:

> [P]erforming due diligence is crucial to a **member's** obligation to undertake the required reasonable-basis suitability analysis....[T]he reasonable-basis suitability analysis can only be undertaken when a **member** understands the investment products **it** sells. Accordingly, a **member must perform appropriate due diligence** to ensure that **it** understands the nature of the product, as well as the potential risks and rewards associated with the product. Moreover, the fact that a member intends to offer an NCI [non-conventional investment] only to institutional investors does not relieve **the member of its responsibility to conduct due diligence** and a reasonable-basis suitability analysis.
>
> ...[T]here are some common features that **members** must understand about products before registered representatives can perform the appropriate suitability analysis....**Members should examine these and other appropriate factors when conducting due diligence.** A member may in good faith rely on representations concerning an NCI contained in a prospectus or disclosure document....

(Notice 03-71, p. 767-768, emphasis added.) Thus, the obligation for what the Notice calls "due diligence/reasonable-basis suitability" is placed exclusively on the member firm rather than on the individual broker.

The obligation of "associated persons" or "registered persons," that is, the individual broker, is discussed separately in the section of Notice 03-71 on "customer-specific" suitability. As implied by the term "customer-specific" suitability, the focus here is on the financial condition and investment goals of the individual customer. In this section, the Notice states as follows:

> **Members and their associated persons** must reasonably believe that the product is a suitable investment prior to making a recommendation to a particular customer. To ensure that a particular investment is suitable for a specific customer, **members and their registered persons** must examine: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives, and (4) such other information used or

> considered to be reasonable by such member or registered representative in making recommendations to the customer.

(Id., p. 768, emphasis added.) In this case, under the OIP, there is no claim that Lex violated customer-specific suitability.

By exclusive use of the term "member" in the section on due diligence/reasonable-basis suitability, it is clear that the NASD intended that obligation to be borne exclusively by the broker-dealer firm rather than, as the Division now claims, on the individual broker. If there were any doubt about that intent, it is dispelled in FINRA Regulatory Notice 12-25, issued May 2012, where FINRA quotes from Notice 03-71 and replaces the word "member" with the synonym "broker-dealer" and "firm" in brackets, as follows:

> [T]he reasonable-basis suitability analysis can only be undertaken when a **[broker-dealer]** understands the investment products it sells. Accordingly, a **[firm]** must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product.

(Lex Exhibit 150, FINRA Regulatory Notice 12-25 fn. 62, emphasis added.)

Despite the clear language of Rule 2310 and Notice 03-71, and despite the Division's acknowledgment that no Respondent in this case satisfies the definition of "member" under the NASD/FINRA regulatory scheme (see testimony of Division's expert witness, Robert Lowry, at 865:10-19), the Division's expert nevertheless interprets the term "member" in Rule 2310 and Notice 03-71 to include individual brokers such as the Respondents in this case. (Lowry testimony at 860:19-861:5; 864:10-20.)

The Division's anomalous interpretation of the term "member" to include individual brokers is based on impermissible, retroactive application of Rules that were not in effect during 2003-2009, the period of the conduct in this case. In particular, the Division cites FINRA Rule 2111, which, as Mr. Lowry acknowledged, did not take effect until 2012, and was not in effect during the relevant period in this case. (Lowry testimony at 1008:25-1009:7.) In any case, while Rule 2111 uses the term "reasonable diligence" in connection with both members and associated persons, it does so only with respect to the customer-specific inquiry. Thus, Rule 2111(a) states in pertinent part:

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

FINRA Rule 2111(a)(emphasis added).

The Division also cites footnote 1 to FINRA Regulatory Notice 10-22. Because Notice 10-22 was not issued until 2010 (Lowry testimony at 651:19-23), it is not applicable to this case.

The McGinn Smith Compliance Manual provides that when McGinn Smith acts as underwriter for private placement offerings, **it** would conduct due diligence, as follows:

> Due Diligence Procedures
>
> When McGinn, Smith acts as underwriter in connection with...private placement offerings, **it** will make a reasonable investigation of the project to include inspection of completed projects, conversations with in-house counsel where applicable, a complete examination of financial documents and any other documents deemed necessary to deal fairly with the investing public. Paperwork recording the due diligence will be kept in the legal files.

(Exhibit FC-9, p. 44, emphasis added; N.T. p. 1019:17-1020:9, Lowry testimony.) The brokers, including Mr. Lex, were entitled to rely on that provision.

Mr. Lex's expert witness, Charles Bennett, testified that the applicable Rules, Notices and Compliance Manuals mean what they say. The broker-dealer's obligation is to investigate and conduct due diligence on the product and the issuer, to determine whether the product is appropriate for at least some investors. The broker's role is to understand the product, know his clients, and determine for which of his particular clients, if any, the product may be appropriate. (N.T. 4126:21-4127:7; 4131:20-4133:15; 4133:22-4134:7; 4134:20-25.) In this regard, Mr. Bennett explained as follows:

> The primary obligation for investigation lies with the broker dealer who has the experience and the expertise to evaluate whatever information is in the prospectus and hire lawyers or accountants if they need that kind of help in order to complete the diligence investigation to their satisfaction.
>
> After that, the broker has an obligation to read the prospectus or offering memorandum. As they read through it, they probably develop a list of questions.
>
> * * *
>
> If all goes according to plan, they get back answers which are consistent with what they know from what they've read, and they are satisfied and they can sell the product. That is how the process works in the business.
>
> * * *
>
> [T]he member has the duty of diligent investigation or diligent inquiry. They take the lead on making sure that they understand from a diligence perspective of whether or not they are going to approve the product for sale to at least some customers.
>
> Thereafter, the registered representative also has a reasonable basis obligation, and that is to take reasonable steps to understand the product that is being offered, ask any questions that...he or she might have.
>
> * * *
>
> ...Investigat[ion] falls on the member firm.
>
> The duty to reasonably understand the product is the broker's responsibility. That is why I keep saying, to the extent that the duty is investigation, **the industry believes that that duty lies with the due diligence personnel that have been put on the**

> **diligence committee to determine whether or not that product could be suitable for at least some customers in the firm.**
>
> * * *
>
> **...The member is the only person that has the obligation to do a diligent investigation.**

(N.T. 4131:20-4134:25, emphasis added.) The testimony of David Tilkin, the expert witness for Respondents Chiappone, Mayer, Rabinovich and Rogers, was to the same effect. (N.T. 3987:11-3993:21.)

Mr. Bennett explained that there is no authority or logic behind requiring individual brokers to duplicate the due diligence work of the member firm:

> There is no reason in the world to think that when you properly segregate the division of responsibilities within a written supervisory procedure, that a registered representative has any obligation to conduct due diligence if due diligence has been reserved to the member firm, and that is what this [N]otice [03-71] says.

(N.T. 4126:6-13.)

Mr. Bennett pointed out that, with teams of both in-house and outside lawyers, accountants and investment bankers at their disposal, broker-dealer firms such as McGinn Smith are far more equipped than the individual brokers to conduct due diligence, particularly if the aim is to uncover fraud, which the perpetrators always do their utmost to conceal. On this issue Mr. Bennett testified as follows:

> ...The registered representatives, I know of no case law that says registered representatives are under an obligation to uncover fraud. Their duty is to take reasonable steps to understand the product that they intend to offer to their clients.
>
> They are not to uncover fraud.
>
> * * *

> If there is a problem, it has to be uncovered in diligent investigation by the member firm who has the personnel and the resources and the staff sophistication in order to conduct an adequate inquiry.
>
> Most [brokers] as salesmen do not have MBAs, as Ms. Palen. They are not certified fraud examiners.
>
> They have entered into an association where they rely on their broker dealer to put a product on the approved list, and then they go and they understand the product, they ask whatever questions they have to ask.
>
> * * *
>
> It is unfortunate sometimes that there are frauds and Ponzi schemes, but the [broker] doesn't uncover that. The broker dealer – if somebody could, the broker dealer uncovers it. The reps can't. They don't have the tools, the training and sophistication to do so.

(N.T. 4137:12-4138:21.)

Indeed, the Division's own expert, Mr. Lowry, had to concur that the member firm is far better equipped than the individual brokers to conduct due diligence investigations. Mr. Lowry testified as follows on this issue:

> Q. Would you agree with me that the investment bankers and accountants and business people are far more qualified, by virtue of their education, training, experience and skill set, to do the due diligence than the individual brokers themselves?
>
> A. **Well, yes. I would agree.**

(N.T. 1022:14-20, emphasis added.) Thus, Mr. Lowry was compelled to concede the main point **--that the individual brokers were entitled to rely on the due diligence conducted by McGinn Smith, the broker-dealer firm.** On this issue, Mr. Lowry testified as follows on cross-examination:

> A. **I agree with what you just said, as far as the registered reps can rely on due diligence of the firm** to fulfill

> their responsibility to investigate and make the determination that the product is suitable for some investors, that that is one way it can be done.

(N.T. 984:14-20, emphasis added.)

Mr. Lowry opined that each individual broker was required to review the firm's due diligence file. (N.T. 690:5-11; Division Exhibit 1, Lowry report at 10.) But Mr. Bennett explained that such a practice is foreign to actual practice in the industry because the file is replete with confidential and privileged information. Mr. Bennett testified as follows on this issue:

> In my experience running both a syndicate desk and acting as in-house counsel for capital markets groups that did offerings, we never gave a registered representative access to the due diligence file.
>
> * * *
>
> For example, I remember quite clearly a transaction in which the private investigative firm that we hired found out that the CEO of the company was a philanderer. We would not want the registered representative to know that. That wasn't material. It wasn't in the registration statement.
>
> If you give somebody access to a file, and they read extraneous information that is not disclosed in the registration statement, you are putting them in jeopardy of saying something to the client that could create a liability.
>
> You never show people a due diligence file.
>
> * * *
>
> Well, I sat on a securities industry association syndicate committee for seven, eight years, so my clients in the industry, whether they were at a regional firm like [Janney Montgomery Scott] or they worked for Goldman Sachs, none of the syndicate participants would ever give a registered representative open access to a due diligence file.
>
> * * *

> That file in many cases is covered by attorney client privilege. Diligence is often conducted by an outside law firm so they can claim privilege on that file.
>
> I don't understand why [Mr. Lowry] said it. It doesn't happen in the industry, and I disagree with his opinion.

(N.T. 4200:14-4202:15.)

In analyzing the credence to be given to Mr. Bennett versus Mr. Lowry, the following should be noted.

After 14 years with NASD/FINRA in which Mr. Bennett had active supervisory roles dealing with investigations of sales practices, reviewed several thousand offerings, and headed up a program involved in regulatory surveillance and anti-fraud programs, he went to work for Hornor, Townsend & Kent where he was Vice President in charge of compliance, which involved, *inter alia*:

- Establishing the firm's due diligence committee and developing the written supervisory procedures utilized to assure compliance with best practices in product due diligence;
- Developing sales and marketing systems, as well as supervisory, compliance, and oversight systems for the broker-dealer and investment advisors with a nationwide distribution system of over 1,300 brokers;
- Supervising a staff of 10 professionals that provided legal and compliance advice to New Business Development, retail sales and marketing, trading and operations, contracts and licensing;
- Managing and coordinating responses to customer complaints related to potential broker misconduct and alleged fraudulent sales practices;
- Supervising the investigation and preparation of responses to regulatory inquiries made by federal and state regulators and self-regulating organizations regarding allegations of fraudulent sales and trade practices and allegations of broker misconduct.

(Lex Exhibit 147, Bennett Curriculum Vitae at 3.)

In addition, he served as Compliance Counsel for BB&T Capital Markets where he:

- Was primary legal and regulatory contact for issues affecting approximately 250 employees engaged in equity trading, institutional sales, research, taxable and non-taxable fixed income and municipal trading and origination;
- Was primary compliance officer responsible for sales practices and branch office examinations of the firm's South Carolina retail branch offices;
- Participated as a member of the due diligence committee evaluating public and private offerings for potential underwriting or distribution by the registered sales force;
- Prepared and updated supervisory procedures for equity and fixed income trading desks.

(Lex Exhibit 147, Bennett Curriculum Vitae at 4-5.)

In those capacities, both as a regulator and working in the industry, Mr. Bennett had first-hand familiarity with the relevant obligations and responsibilities of registered representatives on the one hand, and the broker-dealers on the other.

Mr. Bennett is an attorney with a Master of Laws in Securities from Georgetown University, and holds the following securities licenses:

- Series 7, general securities exam
- Series 9, options supervisory sales exam
- Series 10, general securities supervisory exam
- Series 24, general securities principal exam
- Series 55, securities traders exam
- Series 66, uniform state law exam

(Lex Exhibit 147, Bennett Curriculum Vitae at 8.)

Mr. Lowry, on the other hand, is not a lawyer, has neither a Series 7 nor Series 24 license, never worked as a registered representative, never had clients as a securities broker, never worked as a manager of registered representatives, and, in fact, <u>never worked for a broker-dealer firm</u>. (N.T. 633:7-634:8; 635:2-5.)

Mr. Bennett not only demonstrated his technical knowledge, but also his practical knowledge of the industry. Moreover, his testimony made practical sense. For example, when the Division's attorney was questioning Bennett about the alleged "redemption policy," Bennett explained how, as the head of a syndicate desk, it was critical for him to know what redemptions were about to occur and what replacements, if any, were in the offing. (N.T. 4166:17-4167:22.)

The Division's case, on the other hand, disregards both the law and the realities of the brokerage industry. Ms. Palen testified that to ferret out the fraud, and the fact that purchases from related companies did not comply with the PPM requirements as to price, she was required to examine the tax returns, bank records of over 250 bank accounts, and the financial statements attached to the tax returns. (N.T. 280:25-281:6; 231:16-20.) Not only are brokers not underwriters or forensic accountants, they certainly would not have access to confidential bank records or tax returns.

Finally, if the SEC wanted to put a special obligation on registered representatives to investigate when the issuer and placement agent are related, they easily could have issued such a regulation. The Division can point to no regulation which prevents the placement agent and issuer from being related, nor is there a regulation that enhances the broker's duty in such a scenario. The Division is making up Rules that the SEC and FINRA have not felt obliged to codify, and liability should not be imposed on brokers who have no reason to be aware of such a made-up duty.

Despite the clear direction from the industry Rules and Notices that were in effect during the relevant time period, 2003-2009, the Division purports to find support in case law that individual brokers are liable for **fraud** if they fail to independently investigate and perform due diligence on the securities they present to their clients. (See Division's Brief at 10-11.)

If the cases indeed held as the Division claims, it would present a serious due process problem for brokers to be liable for substantial monetary fines and penalties for failing to perform functions that the applicable NASD and FINRA Rules clearly advised them were not their responsibility. Not surprisingly, the cases hold no such thing. Rather, as more specifically set forth below, what the cases hold is that a broker may not blindly pass along specific representations of fact that are obviously false, outlandish or dubious, such as predictions of unusually high rates of return, without some reasonable basis supporting the truth of the representation.

For example, in Hanly v. SEC, 415 F.2d 589 (2nd Cir. 1969), cited in the Division's Brief at 10-11, the various respondents made all of the following glowing, specific, affirmative misrepresentations about the stock in question, all with no reasonable basis whatsoever: that Sonics stock "would probably double in price within six months to a year," that it "would go from 6 to 12 in two weeks and to 15 in the near future," that it "should double after three or four weeks," that it "would rise 10 to 15 points," that it "should reach 15 in a year," that it "would double in six months," and that it "would rise from 8 to 12 or 15 in a short time." Id. at 593-595. In fact, throughout the period in question, the issuing company "operated at a deficit" and "was insolvent." Id. at 592.

The respondents in Hanly "argued that their violations of the federal securities laws were not willful but involved at most good faith optimistic predictions...." Id. at 592. The respondents thus claimed that they lacked scienter as to their specific, affirmative, misrepresentations of fact. In response to that defense, the court held that if the brokers make specific, false, affirmative representations of fact, they cannot claim lack of scienter when they made the representations with no investigation whatsoever. It was under the facts of that case that the Hanly court held as follows:

> 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 has a duty to know and **recklessly state facts about matters of which he is ignorant.**

Id. at 595-596 (emphasis added).

Three of the five respondents in Hanly were office managers of the dealer-broker, and the court made clear that all five respondents were in fact well aware of the truth regarding Sonics' dire financial straits, as follows:

> **[K]nowing** that Sonics had never shown a year end profit since its inception [and] that it was still sustaining losses,...Gladstone [nevertheless made the specified misrepresentations]....Stutzmann learned of Sonics, **including its weak financial condition**, through information given him by Gladstone and Paras....It was Fehr, together with Gladstone, who conveyed to Hanly, Stutzmann and Paras information concerning Sonics, **including its poor financial condition and its record of losses**....Although **fully aware of Sonics' financial condition,** Hanly [made the misrepresentations set forth above].

Id. at 593-595 (emphasis added).

In this case the Division does not even allege that Mr. Lex made any such outlandish, utterly unfounded claims to his clients or represented "facts about matters of which he was ignorant." To the contrary, Mr. Lex gave all of his clients the PPMs, which repeatedly warned the investors that the investments involve a high degree of risk, that the investors could lose the total amount of their investment, that investments are not guaranteed or insured, that the secured assets may be inadequate to repay the Notes, and that the issuer may be unable to finance its operations.

In any event, the Division's heavy reliance on Hanly – and on a handful of more recent decisions that have followed Hanly without any meaningful analysis of whether it remains good law – is woefully misguided, because that case was in all material respects plainly *overruled* by the Supreme Court in the landmark case of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1975).

Hochfelder, of course, is the seminal Supreme Court case that squarely held that liability under Section 10(b) and Rule 10b-5 requires proof of scienter – that is, intentional deception or possibly extremely reckless deception – and cannot be premised on merely negligent or unreasonable failures (for example, failure to have a "reasonable basis" for an investment recommendation). Before Hochfelder (particularly during the 1960s and early 1970s), the federal circuit courts of appeal were split on that issue, with the Second Circuit being the leading proponent of the *erroneous* view that scienter was *not* required, having repeatedly held that "unreasonable" conduct or "negligence" was sufficient for liability. Hanly was just one example of several such cases decided by the Second Circuit during this pre-Hochfelder period. In Hanly, the court explicitly *assumed* the now-rejected premise that "negligence" or "unreasonable" conduct *could* violate Section 10(b) and Rule 10b-5. Indeed, the court quoted as foundational predicate for this assumption its opinion a year earlier in SEC v. Texas Gulf Sulphur, the relevant portion of which had emphatically staked out – contrary to the eventually more influential concurring opinion by Judge Friendly in that case – the position that scienter was *not* required for liability under Section 10(b) or Rule 10b-5:

> In an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent insider conduct has become unlawful . . .. Absent any clear indication of a legislative intention to require a showing of specific fraudulent intent . . . the securities laws should be interpreted as an expansion of the common law both to effectuate the broad remedial design of Congress . . . and to insure uniformity of enforcement . . ..

Hanly, 415 F.2d at 596 (quoting verbatim from SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-55 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969)). In fact, the sentences in Texas Gulf Sulphur that immediately follow the above-quoted passage *conclusively* expose the fatal flaw in the Division's reliance upon these cases. In the fuller passage from Texas Gulf Sulphur, the Second Circuit eerily presaged the Division's very theory here that Section 10(b) and Rule 10b-5 liability can be based on "negligence as well as active fraud," thus outlawing "lack of diligence, constructive fraud, or unreasonable or negligent conduct." Texas Gulf Sulphur, 401 F.2d at 855.

Hochfelder completely swept aside – root and branch – each and every assumption baked into the Second Circuit's flawed pre-Hochfelder approach to securities fraud, especially those assumptions baked into the fabric of that court's hoary decision in Hanly. Indeed, the Hochfelder opinion itself explicitly cites to Texas Gulf Sulphur several times – not to the now-overruled majority opinion in that case quoted and relied upon by Hanly, but rather to Judge Friendly's prescient *concurring* opinion in which he vehemently disagreed with the majority's misguided view that "negligence" or failure to act "reasonably" can constitute securities fraud under Section 10(b) or Rule 10b-5. After Hochfelder, there is no plausible argument that "lack of diligence," or failure to act "reasonably," can support a claim under Section 10(b) or Rule 10b-5.

In Matter of Pinkerton, No. 3-8805, S.E.C. Release No. 98 (Oct. 18, 1996), cited in the Division's Brief at 10-11, the broker made the following **specific, affirmative** misrepresentations for which he had absolutely no basis whatsoever: that BFL shares would trade publicly any day; that the shares would initially trade at a premium; that three broker-dealers would make a market in the stock; that these market makers would take the price of BFL share up to $8.00 or $10.000 a share; and that BFL shares would double from the $3.00 unit offering price. Id. at 18-19. He also "falsely represented to customers that BFL had filed registration documents which would permit public trading in BFL private placement shares on the NASDAQ **when he knew this was not true."** Id. at 15 (emphasis added). Finally, the broker passed along the false representation that:

> BFL was a health-care company that was developing nutritional supplements, anti-smoking products, and prototype vitamins. In fact, BFL had **no** operations, **no** manufacturing capability, and **no** revenue.

Id. at 7 (emphasis added). As an employee of RR&S, the broker had to know the falsity of those representations about BFL because "BFL was located in RR&R's offices…and Mr. Steele was its single employee." Id. at 7.

Similarly, in Matter of Giesige, No. 3-12747, S.E.C. Release No. 359 (Oct. 7, 2008), cited in the Division's Brief at 11-12, the broker represented to investors that Carolina Development would file an IPO by December 2005 when she **knew** that as late as October of that year the company, whose headquarters consisted of a boiler room operation, id. at 3, did not even have audited financial statements. Id. at 24. She also told investors that after the IPO the price per share would more than double, when she had "no credible evidence to support her prediction…." Id. And when the promised IPO didn't occur, she told investors to be "patient, it isn't every day we have the opportunity to make **1000% gain in less than a year."** Id. at 26 (emphasis added).

In Matter of Stires & Co., Inc., No. 3-9120, S.E.C. Release No. 130 (Aug. 11, 1998), cited in the Division's Brief at 11 & 13, the SEC indeed sanctioned the respondents for failing to conduct a "due diligence inquiry" into certain securities they were offering. Id. at 7. But the respondents in that case were not individual registered representatives. Rather, the respondents who were charged with the due diligence obligation in Stires were: (1) Stires & Co., Inc., which was an investment banking firm as well as a securities dealer and member of NASD, id. at 2, and (2) Sidney Stires, who was the company's owner, President and Chairman of the Board. Id. The Opinion notes that "[a]s an individual able to direct the actions of the firm, Mr. Stires was a control person and his actions are attributable to the firm." Id.

Unlike Mr. Stires, Mr. Lex of course was not a principal or control person of McGinn Smith. Indeed, he was not even a McGinn Smith employee, but rather an independent contractor. (N.T. 4838:2-9.) Moreover, the respondents in Stires circulated a "Program Summary" for an investment that, unlike in this case, they **knew** was replete with false, **affirmative representations of fact**. The Opinion explains:

> Stires & Co. acted with scienter when Mr. Stires reviewed, approved, and circulated the Program Summary for Euro-GICs. The Program Summary falsely represented that Stires, O'Donnell & Co. ("Stires, O'Donnell"), which was Stires & Co.'s institutional brokerage affiliate, specialized in Euro-GICs and "synthetic" GICs. (Div. Ex. 1 at 1; Div. Ex. 91 at 80.) **Mr. Stires knew when he made this material misrepresentation that neither Stires & Co. nor Stires, O'Donnell had ever engaged in transactions involving Euro-GICs or "synthetic" GICs.**

Id. at 7 (emphasis added). Indeed, "[a]lmost all the representations in the Program Summary were false. The entire offering was bogus." Id. at 8.

In SEC v. Platinum Investment Corp., 2006 WL 2707319 (S.D. N.Y. 2006), cited in the Division's Brief at 11, again the defendant broker made **specific representations of fact** to his clients regarding securities of PIHC with no basis whatsoever:

> (a) that PIHC would be conducting within a matter of months an initial public offering ("IOP"); (b) that he estimated the opening price of the stock would be $3.50 per share; (c) that the price could eventually be as high as $8 or $9 per share if PIHC performed akin to other companies in the same field; and (d) that, as plans changed

> in May and June 2002, the IPO would be conducted in the form of a reverse merger.

Id. at *1. Moreover, in stark contrast to Mr. Lex, the broker in Platinum "did nothing to familiarize himself with private placements and what private placement memoranda should look like,...he failed to familiarize himself with the materials being sent to his clients regarding the PIHC offering or to examine the private placement memoranda and the representations made therein." Id. at *3. In fact, the broker in Platinum distributed PPMs with representations whose falsity was obvious on their face: that a Citicorp Vice President had become the President, chief Executive officer and Treasurer and Chairman of the Board of the issuing company, and that the issuing company had an equity-trading program that would produce returns in excess of 5% per month. Id. at *1.

In SEC v. Milan Capital Group, Inc., 2000 WL 1682761 (S.D.N.Y. 2000), cited in Division's Brief at 10, the issuing company (Milan) was a sham, id. at *2, and the defendants were principals of Milan. Milan, through AC Financial, solicited funds from dozens of investors based on representations that it would use the funds to purchase IPO shares for the investors. Defendants claimed they had access to the IPO through such financial giants as Morgan Stanley and Goldman Sachs, when in fact they had none of the access required to participate in the IPO. Id. at *2. Instead, Milan diverted the funds for its own use.

Citing Hanly, the Milan court reiterated that a "broker is under a duty to investigate **the truth of his representations to clients**, because by his position he implicitly represents he has an adequate basis for the opinions he renders." Id. at *5 (emphasis added). The duty to investigate is particularly high "where promotional materials are in some way questionable, for example, by promising unusually high returns." Id.

In this case, Lex is not alleged to have made any specific representations of fact to which a duty of investigation would attach. The only affirmative representation to which the Division points, is that Lex allegedly characterized the private placements to two people as "safe." (Division's Brief at 26.) As set forth above, even if he so characterized the investments, which he denies, such a statement cannot give rise to liability for securities fraud because it is not an objective, verifiable statement of fact, and it is immaterial as a matter of law because it is contrary to repeated warnings in the PPMs and Subscription Agreements setting forth in detail all of the serious risks of the investments.

Nor did Lex pass along promotional materials, or any other written materials, with questionable claims for the investments, such as "promising unusually high returns." Milan at *5. To the contrary, what he properly distributed to his clients were the PPMs and Subscription Agreements which, far from making dubious, extravagant claims for the investments, repeatedly warned the investors that the products were not insured, not guaranteed, and that investors stood the risk of losing all of their money. No amount of investigation would have revealed that those representations were false.

The Supreme Court has repeatedly emphasized that the *sine qua non* of a securities fraud violation is deception--not the mere failure to perform due diligence, even in breach of a fiduciary duty. See United States v. O'Hagan, 521 U.S. 642, 655 (1997)("§10(b) is not an all-purpose breach of fiduciary duty ban; rather, it trains on conduct involving manipulation or deception."); Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 473 (1977)("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception."). If inadequate investigation could give rise to liability for fraud, every case would pose the issue of how much investigation is sufficient. No clear standard is possible, and every broker, no matter how thorough his investigation, could face liability for fraud, monetary penalties, and exclusion from the securities industry for failing to foresee some future financial downturn. Failure to investigate, where the failure is not tied to a particular representation of fact, is nothing more than negligence, and cannot give rise to liability for securities fraud.

It is tragic that many innocent investors were hit with a one-two punch of a once-in-a-lifetime meltdown of the world financial markets, combined with outright theft and fraud committed by David Smith and Timothy McGinn. But the securities laws do not require individual brokers to foresee and prevent such events. "There is no securities fraud by hindsight." City of Livonia Employees' Retirement System and Local 295, 711 F.3d 754, 758 (7th Cir. 2013)(citations omitted). Accord, Bay Harbour Management LLC v. Carothers, 282 Fed.Appx. 71, 75, 2008 WL 2566557 at *2 (2nd Cir. 2008). Defendants in securities cases "need not be clairvoyant," Novak v. Kasaks, 216 F.3d 300, 309 (2nd Cir. 2000), cert. denied, 531 U.S. 1012 (2000), and "liability cannot be imposed on the basis of subsequent events." In re NAHC, Inc. Securities Litigation, 306 F.3d 1314, 1330 (3rd Cir. 2002).

"Securities fraud cases often involve some more or less catastrophic event occurring between the time the complained-of statement was made and the time a more sobering truth is revealed (precipitating a drop in stock price)." City of Philadelphia v. Fleming Companies, Inc., 264 F.3d 1245, 1260 (10th Cir. 2001)(quotations omitted). It cannot be assumed on the basis of the unexpected later event that the defendant's statement was false when made, much less that the defendant made it with the requisite scienter. Id.

J. <u>The Division's Allegations about "Red Flags" Are Without Merit.</u>

The Division's Brief lists 10 "red flags" that, according to the Division, Respondents should have "investigated and resolved" before recommending the McGinn Smith private placements. (Division's Brief at 18.) This will address each of those alleged red flags.

<u>Four Funds had a new mandate</u>

First, the Division cites the fact that the investment mandate of the Four Funds was "completely different" from that of the pre-2003 Trust Offerings. (Division's Brief at 18.) The Division is unable to explain why this feature of the Four Funds is a red flag.

The Four Funds had the benefit of being underwritten and managed by the McGinn Smith operation, including its affiliates and all of their resources--the same operation that had some two decades of experience in managing private placements. Although the investment mandate of the Four Funds was different from that of the pre-2003 Trusts, it was reasonable for Lex, knowing what he knew then (rather than improperly looking back in hindsight from what was eventually revealed after years of government investigation and a criminal trial), to look on McGinn Smith's management of the pre-2003 Trusts as a positive indication of McGinn Smith's financial acumen and integrity, boding well for the Four Funds.

<u>Smith's lack of experience as a manager of offerings similar to the Four Funds</u>

It is true that the principal manager of the pre-2003 Trusts was Timothy McGinn rather than David Smith. But as of 2003, Lex had known Smith well for two decades, was familiar with Smith's record of success, and had every reason to place full confidence in him as a skilled and trustworthy manager of investment funds. Lex viewed Smith as a pillar of the community. (N.T. 4876:22-4877:3.) Both Smith and McGinn were generally viewed as pillars of the community for their educational and professional backgrounds, achievements, and involvement in public and charitable causes. (See Lex testimony at 4876:22-4877:3.) Lex knew that Smith was well connected with leading Wall Street brokerage firms, knew about the bonds and other products Smith had underwritten, and knew that Smith was the leading investment advisor for a local college. (Lex testimony at 4885:17-4886:20.)[25]

Lex's confidence in both Smith and McGinn was confirmed by the successful performance of the pre-2003 alarm Notes. (Lex testimony at 4886:21-4887:6.) That achievement was particularly noteworthy because it occurred notwithstanding the general market crash in the early 2000's. (N.T. 4227:15-4228:10.)

With each passing year, from 2003 to 2004, 2005, 2006 and 2007, as all of his Four Funds investors received all of their interest and redemptions on time and in full, Lex's confidence in the Four Funds grew, and his initial judgment was confirmed.

Smith's control of the issuer, placement agent, owner and trustee for the Four Funds

The Division cites Smith's control of the issuer, placement agent, owner and trustee as a red flag. But the only authority the Division cites is In Matter of Pinkerton, No. 3-8805, S.E.C. Release No. 98 (Oct. 18, 1996), cited in the Division's Brief at 18-19. The problem in Pinkerton was that, unlike in this case, the potential conflict was not disclosed to investors. The Pinkerton opinion explains that "Mr. Campbell knew, ignored, **and did not disclose to customers** that the issuer and the broker-dealer were controlled by the same individual...." Pinkerton at 15 (emphasis added).

[25] Lex's confidence in Smith was well founded and widely shared. Other brokers noted that even before the founding of McGinn Smith in 1980, Timothy McGinn and David Smith were partners in predecessor firms and had established stellar reputations for their achievements in the financial investment industry. (Rogers testimony at 5665:10-19; Rabinovich testimony at 4228:15-17.) Rogers, Rabinovich and Mayer all shared Lex's high opinion of Smith's ability and integrity. (Rogers testimony at 5662:13-5665:19; Rabinovich testimony at 4229:16-25; Mayer testimony at 4967:10-4969:19.) Smith served on the Saratoga Economic Development Commission and sat on the boards of various hospitals and nursing care facilities. (Rabinovich testimony at 4229:18-22.)

In this case, Mr. Lex did inform all of his clients of the conflict of interest through the PPM, which explained as follows:

> **The Trustee May Experience A Conflict Of Interest.** *The trustee under the indenture governing the notes is an affiliate of our managing member, acts as our servicing agent and represents all three tranches of notes.*
>
> The trustee is McGinn, Smith Capital Holdings Corp., which is an affiliate of our managing member, McGinn, Smith Advisors, LLC and of our placement agent, McGinn, Smith & Co., Inc. In addition, we have retained McGinn, Smith Capital Holdings Corp. to act as our servicing agent....
>
> * * *
>
> We are solely managed by our managing member, McGinn, Smith Advisors, LLC, a New York limited liability company....McGinn, Smith Advisor, LLC is a wholly-owned subsidiary of McGinn, Smith Holdings, LLC, a New York limited liability company and an affiliate of this offering's placement agent, McGinn, Smith & Co., Inc.
>
> * * *
>
> Our servicing agent, McGinn, Smith Capital Holdings Corp., an affiliate of our managing member McGinn, Smith Advisors, LLC and or our placement agent, McGinn, Smith & Co., Inc., is also the trustee under the indenture governing the notes. As a result, McGinn, Smith Capital Holdings Corp. may experience a conflict of interest between its role as our servicing agent and as the trustee for the note holders.

(Division Exhibit 5, PPM for FIIN at 12, 15, 17.)

Mr. Lex's expert witness, Charles Bennett, explained that such affiliations among issuers, broker-dealers and others in the process of marketing private placements "happens all the time," including with such major firms as Morgan Stanley and Goldman Sachs. (Bennett testimony at 4039:21-4040:8.) David Tilkin, the expert witness for Respondents Rabinovich, Mayer and Rogers, also testified that such affiliations are very common, "almost a daily event," and that as long the conflict is fully disclosed in the PPM, that is no red flag. (Tilkin testimony at 3941:6-13; 4002:4-17.)

<u>Transactions with affiliates</u>

The Division characterizes the possibility of transactions with affiliated entities as a red flag, but again, this feature of the Four Funds was fully disclosed in the PPMs. The PPM for FIIN states as follows:

> We may acquire such Investments directly, or from our managing member or an affiliate of us or our managing member that has purchased the Investment. If the Investment is purchased from our managing member or any affiliate, we will not pay above the price paid by our managing member or such affiliate for the Investment, other than to reimburse our managing member or such affiliate for its costs and any discounts that it may have received by virtue of a special arrangement or relationship. In other words, if we purchase an Investment from our managing member or any affiliate, we will pay the same price for the Investment that we would have paid if we had directly purchased the Investment. We may also purchase securities from issuers in offerings for which McGinn Smith & Co., Inc. is acting as underwriter or placement agent and for which McGinn, Smith & Co., Inc. will receive a commission.

(Division Exhibit 5, PPM for FIIN at 7.)

Because this feature of the investments is common and was fully disclosed in writing, it was not a red flag or cause for heightened investigation. Nevertheless, the Division maintains that "Selling Respondents should have asked for information on all affiliated transactions and demanded to know whether the price restrictions were observed." (Division's Brief at 19.) To demand verification of whether the price restrictions on transactions with affiliates were observed, would impose an impossible burden on each of the more than 40 individual brokers, that no Rule, Notice, case or other legal authority requires. As a practical matter it would require access to, and analysis of, untold reams of banking and financial records, and would unnecessarily duplicate the work that investment bankers, accounting departments, and outside accountants are charged with performing. For purposes of efficiency, the detective work that the Division now wants to impose on individual brokers is allocated to those with the expertise and resources to perform it, such as investment bankers, accountants and compliance personnel inside the broker-dealer.

Kerri Palen was able to unearth such information only with training as a CPA and certified fraud examiner, subpoena power, access to 400 separate bank accounts, accountants' work papers, all of the confidential tax records and financial statements of McGinn Smith and its affiliates and principals at her disposal, three years of work, and all of the resources of the SEC behind her. (Division Exhibit 1, Palen Declaration ¶¶2, 6-9; Palen testimony at 231:17-20; 404:16-17; 509:16-25.)

While Palen conducted her investigation once, after McGinn Smith had been shut down by the SEC, under the Division's theory the brokers would have had to be conducting their investigation continuously throughout 2003-2009 as the Four Funds and the Trusts continued to make their investments. The law does not require brokers to duplicate the job of the broker-dealer and its team of professionals.

The Division's principal argument is that transactions between McGinn Smith entities were allowed by the PPM, but only if the Fund acquired the assets at no greater than the cost to the affiliated entity. To enforce compliance with that provision would require the brokers to continuously monitor all of the Four Funds' transactions, essentially act as an auditor of all transactions, first, to determine if they are with affiliated entitities, and then to evaluate the cost to the affiliated entity versus the purchase price paid by the Fund. Assuming the brokers could gain access to all of the necessary financial information, they would then have to evaluate it and formulate their conclusions: under GAAP? With adjustments for inflation or other extrinsic conditions? With consideration for the time-value of money? The brokers are not qualified to do this, nor should they be required to do so. The FinOp, accounting, and compliance departments of the broker-dealer firm are expected to perform these functions, and the brokers have the right to expect they will carry out these functions diligently and honestly.

Next, the Division will be asking the brokers to conduct investigations of the broker-dealer to make sure the CFO and accounting departments are making book entries correctly and honestly. There are divisions of responsibility, and it is absurd to require brokers to double check what other qualified and responsible professionals are doing.

Limit to accredited investors

According to the Division, the Respondents violated the provision in the PPMs restricting sales to accredited investors only. And the fact that officials at McGinn Smith "may have told them to ignore the language in the PPMs...made an already red flag more glaring." (Division's Brief at 20.) The Division mischaracterizes both the language in the PPMs and the testimony regarding that provision.

The PPMs state as follows:

> The notes are being offered only to "accredited investors", **as that term is defined by Regulation D under the Securities Act, and the rules and regulations thereunder....**
>
> * * *
>
> Subscriptions will be accepted only from "accredited investors," **as that term is defined in Regulation D promulgated under the Securities Act.**

(Division Exhibit 5 at 3, 10; emphasis added.) Thus, the PPM expressly incorporates the provisions of Regulation D, which "relates to transactions exempted from the registration requirements of section 5 of the Securities Act of 1933." 17 C.F.R. § 230.500(a). Regulation D in turn states that Section 5 of the Securities Act is satisfied if "[t]here are no more than **or the issuer reasonably believes that there are no more than** 35 purchasers of securities from the issuer in any offering under this section." 17 C.F.R. §§ 230.505(b)(2)(ii) & 230.506(b)(2)(i).

Lex was **not** told to "ignore" the language in the PPM. He was told that, in light of Regulation D, allowing up to 35 unaccredited investors did not violate the restriction. Mr. Lex testified as follows on cross-examination:

> Q. ....You knew that at the time, right, what the PPM said?
>
> A. My understanding was that it was under Regulation D, which has the exemption of 35 people.
>
> * * *
>
> It was explained to me by the compliance people at McGinn Smith that that was all part and parcel of Regulation D.
>
> Q. What was the name--who explained that to you?
>
> A. Multiple times, both David Smith and later on his compliance officer, Steven Smith--no relation--confirmed that.
>
> * * *
>
> They pointed out to me what Regulation D said.
>
> Q. And that seemed right to you?
>
> A. They were the authority.

(N.T. 1545:5-1546:10.)

Before selling any private placement investment to an unaccredited client, Mr. Lex always checked first with Patricia Sicluna, the vice president of registration, to make sure that that offering had not exceeded the limit of 35 unaccredited investors. (N.T. 1618:2-17.) Patricia Sicluna kept running track of whether the number of non-accredited investors for any particular offering exceeded the limit of 35 allowed under Regulation D. For example, by e-mail dated February 21, 2006, Ms. Sicluna informed Richard Feldmann as follows: "We have room for non-accredit[ed] investors" in FAIN. (Lex Exhibit 137.)

The Division likens this case to Matter of Pinkerton, No. 3-8805, S.E.C. Release No. 98 (Oct. 18, 1996). (See Division's Brief at 20.) But in Pinkerton, the broker accepted advice "that he could **ignore** language in the private placement memorandum" restricting the securities to accredited investors. Pinkerton at 15 (emphasis added). That is not what happened in this case. What happened here is that Mr. Lex heeded advice from the manager of the Funds and the compliance officer--the very official charged with interpreting these Rules and regulations and advising the brokers about their professional obligations--that Regulation D and the provision in the PPM on accredited investors were both satisfied if the unaccredited investors did not exceed 35. Given the wording of 17 C.F.R. §§ 230.505(b)(2)(ii) & 230.506(b)(2)(i), it was eminently reasonable for Mr. Lex to follow that advice.

While it is suspicious to tell a broker to "ignore" a provision in the PPM, it is quite another matter for the compliance officer to provide a facially reasonable **interpretation** of such a provision.

Confidentiality

According to the Division, Smith was "secretive" about how the Four Funds proceeds were invested, as if he mysteriously and arbitrarily refused to divulge any information about the investments. (Division's Brief at 20.) The fact is that there was constant communication between Lex and Smith, as well as CFO David Rees, about the investments in question. In 2003, Lex spoke with Smith about prospective investments that FIIN would be making. (N.T. 4859:4-11.) Mr. Lex took notes of those discussions with Smith and Lex received and reviewed PPMs from the companies that Smith was considering as possible investments for FIIN, including

InCapS Finding I, Ltd.; Maracay Homes Arizona I, LLC; CMET Finance Holdings Inc.; and Dekania CDO I, Ltd. (N.T. 4855:15-4861:18; Lex Exhibits 141-146.)

The Commission complains that Lex did not produce those 2003 PPMs or his notes from those early discussions with Smith in response to the Commission's 2010 subpoena in connection with the Commission's civil suit against McGinn Smith and its affiliates in the Northern District of New York. (Division's FOF 381-383.) But if the Division is intimating that the documents are inauthentic, such a theory simply does not square with the objective evidence.

First, the Division claims that the documents in question were encompassed within the scope of the 2010 subpoena's request for "all documents concerning [FAIN, FEIN, FIIN and TAIN]." (Division's FOF 383, quoting Division Exhibit 693 at 6.) Lex made a good-faith effort to comply with that broad request in full, providing approximately 25,000 pages of documents at a cost of approximately $12,000. (N.T. 4958:17-23.) The production included, among many other things, his entire client files for all of the clients who purchased any of the Four Funds, all of his e-mails regarding the Four Funds, and all of the PPMs for the Four Funds. He could not foresee that the request might be interpreted to include notes or PPMs for **other** entities in which Smith was considering investments. He had no way of knowing that the SEC was targeting him, let alone on a theory that he didn't diligently investigate the Four Funds.

Second, to conserve paper, Lex's notes regarding his 2003 discussions with Smith were taken on the reverse side of faxed pages that have burn marks with dates of December 16, 1998, June 4, 2002, and September 29, 2003. (Lex Exhibits 145 & 146.) Lex's attorney showed the originals of those exhibits to the Division's attorney at trial so that he could examine for himself the condition of the originals. (N.T. 4856:5.) The Division presented no testimony or evidence challenging the age or authenticity of the documents. Does the Division really contend that Lex saved those fax pages for more than 15 years to manufacture evidence on them?

Third, the fact that Lex discussed FIIN's possible investments with Smith in 2003 and reviewed PPMs relating to those possible investments conforms with the undisputed, objective fact that Lex and his wife invested $400,000 in FIIN as early as October 8, 2003. (N.T. 1594:8-13; page 1 of Exhibit 4k to Division Exhibit 2.) Is it really likely that Lex invested such a large sum **without** first obtaining available information about the **possible** investments?

During that same time period, Lex and his immediate family also made the following additional investments in FIIN:

Kathleen M. Lex (daughter)	10/3/03	$55,000
Kimellen Remar (daughter) & William Lex	10/7/03	$25,000
Loraine McEvoy (daughter's life partner and financial advisor)	10/22/03	$65,000
William & Kathleen C. Lex (wife)	12/29/03	$10,000

(Exhibit 4k to Division Exhibit 2.)

To assume that the documents are false, and that Lex and his immediate family would make such major financial commitments without any idea of Smith's possible investments, is to jump to the least likely of scenarios and to impermissibly draw all inferences in favor of fault. The suggestion that these documents are fabricated is outrageous and without foundation.
Lex thereafter kept up with the status of the Four Funds in regular, constant conversations and communications with Smith about their performance. (N.T. 4881:17-23.) In response to Lex's requests, Smith informed Lex what industry sectors the Four Funds were invested in, but initially explained that confidentiality agreements prevented him from disclosing the names of individual companies in which the Four Funds were invested. (N.T. 4884:21-4885:12; 4887:7-24; Lex

Exhibit 25, letter dated March 22, 2006 from McGinn Smith to Mr. Lex listing the investment portfolio of FIIN, FEIN and TAIN by industry and percentage allocation.)

Smith's explanation about confidentiality agreements seemed reasonable to Lex because, based on their relationship of more than two decades at that time, Lex had every reason to trust Smith. (N.T. 4885:13-19.) As Charles Bennett explained, there is nothing suspicious or unusual about small companies requesting confidentiality for their loan or investment agreements. (Bennett testimony at 4153:11-4154:13.)

Mr. Bennett's expertise in this regard should carry significant weight because he has served as a senior capital markets executive and corporate securities lawyer with over 30 years' experience in all aspects of public, private and municipal underwritings and distributions in both governmental and private sectors. (Lex Exhibit 147, Bennett CV at 1; Bennett testimony at 4029:15-4031:8.) He was chief compliance officer and in-house counsel responsible for developing, implementing, and overseeing sales practices and compliance systems for broker-dealers and investment advisors, and he consulted with broker-dealers and investment advisors to assure compliance with applicable legal and regulatory mandates. (Lex Exhibit 147 at 1.)
Mr. Lex continued to ask Smith and McGinn Smith CFO David Rees for updates on the Four Funds' investments. (N.T. 4887:25-4889:25; Lex Exhibits 39, 40 & 78, e-mails of 8/1/07 & 8/8/07.) In response to Lex's requests, on August 9, 2007 he received written portfolio analyses of the Four Funds' investments, showing the identity of the companies, a description of the investment, the amount of principal invested, and the yields. (N.T. 4890:2-5; Lex Exhibits 63 & 125.)

After Mr. Lex received the portfolio analyses he had a follow-up discussion with McGinn Smith CFO David Rees in which Mr. Reese informed Lex and that all of the investments were performing and that there were no defaults or problems with the investments. (4890:6-16.) By e-mail of August 15, 2007, Mr. Lex (through his assistant, Deb Adkins) wrote to David Rees as follows:

> Thank you for your listing of the assets in each of the Note Offerings. **I am confirming our recent conversations that all of the assets in the notes are performing and there are no pending or suspected defaults.** Thanks again for your help. **I would hope to be advised if any problems develop.**

(N.T. 4890:17-23; Lex Exhibit 41, emphasis added.)

There was no unusual or suspicious "secrecy" about the Four Funds investments.

"<u>Redemption policy</u>"

The Division contends that Lex (and the other Selling Respondents) are liable because they sold the securities despite their knowledge that Smith had instituted a "redemption policy" requiring Respondents to find replacement investors before existing investors could redeem. (Division's Post-Hearing Brief at 21.) This argument fails because Mr. Lex was never aware of any such policy.

According to the Division's Proposed Findings of Fact, "Smith instituted a redemption policy" (Division's FOF p. 38), and "Lex knew about and followed the redemption policy." (Division's FOF p. 79.) To support these contentions, the Division refers to 29 e-mails from November 14, 2006 through March 17, 2009. (See Division's FOF 148-159 & 355-361, referring to Division Exhibits 16-18, 20, 118-120, 125, 155, 160, 279, 281, 500.) With the exception of a string of four e-mails at the tail end of that period, March 16 and 17, 2009 (Division Exhibit 20), **Mr. Lex was not a party to any of those e-mails.**

The e-mails to which Mr. Lex **was** a party reveal that he was fighting as hard as he could for his clients. Thus, on March 16, 2009 he e-mailed David Smith regarding $125,000 worth of redemptions in TDM Verifier as follows:

> I believe if we don't get my clients redeemed immediately if not sooner, we could be facing regulatory complaints. I think making the redemptions happen is cheaper than dealing with complaints. Please advise that my clients will be redeemed today so I can communicate that fact to my clients.
>
> (Division Exhibit 20.) Smith responded to Lex the next day as follows:
>
> **It would be helpful** if you could sell the $125,000 worth of redemptions. We have not moved any of this produce for weeks, which is causing the bottleneck. Do you have anything pending?

(Division Exhibit 20, emphasis added.) Thus, even as late as March 2009--well after the financial markets had collapsed world-wide, and just four months before Lex stopped all sales of the private placements--Smith was still not requiring Lex to find a replacement investor as a pre-condition to redeeming existing investors. Rather, Smith simply said "it would be helpful" if Lex could make additional sales. Nevertheless, Lex responded in the strongest possible terms, as follows: "I NEED TO HEAR BEFORE NOON TODAY THAT THESE CLIENTS ARE GOING TO BE REDEEMED THIS WEEK." (Division Exhibit 20.) And Mr. Lex testified that, as a result of his objection, his clients in fact were redeemed. (Lex testimony at 1640:23-1641-4.) Mr. Lex testified as follows:

> And my people were redeemed with no replacements.
>
> That's the only time in my history with McGinn Smith. And it wasn't a policy. It was just a comment. And I squelched that immediately.

(Lex testimony at 1640:23-1641:4.)

The e-mails in which Lex was **not** a party, and on which the Division nevertheless relies in support of its contention that he followed an alleged redemption policy, consist largely of Patricia Sicluna's tracking of the brokers' redemptions and new sales of the Four Funds. (See, e.g., Division Exhibits 125, 279 and 500, cited in Division's FOF 361.) Regardless of whether Ms. Sicluna was aware of such a policy, there is no evidence that Mr. Lex was aware of such a policy. Apart from the fact that Lex was not a party to these e-mails and cannot be charged with knowledge of them, they simply do not reflect the existence of a redemption policy, that is, a policy of **prohibiting** redemptions **until** the redeeming investor's broker finds a replacement investor. As Lex's expert witness, Charles Bennett testified, there is nothing nefarious in tracking the redemptions and replacements to ensure that the amount in equity remains at the required level of $20 million (or, in the case of TAIN, $30 million). (Bennett testimony at 4207:6-4208:20; 4166:17-4167:22.) Indeed, the PPMs for the Four Funds made clear that upon maturity of the Senior and Senior Subordinated Notes, new Notes of the same respective tranche may be issued to replace them, as long as the aggregate principal amount of the outstanding Notes does not exceed $20 million (or, in the case of TAIN, $30 million). (See, e.g., Division Exhibit 6 at 1 and Division Exhibit 9B at 1.)

The PPMs did not prohibit using money from new investments as one source for **paying redemptions**. When McGinn Smith went further and appeared to be attempting to require replacement investments as a pre-condition to redeeming existing investors, Lex vehemently objected and McGinn Smith backed down. (See, e.g., Division Exhibits 20 & 166; Lex testimony at 1640:23-1641:4.)

<u>The August 2007 Porfolio Analysis</u>

As set forth above, in August 2007, Lex received, in response to his requests, a portfolio analysis of the Four Funds' investments, showing the identity of the companies, a description of the investments, the amount of principal invested, and the yields. (N.T. 4890:2-5; Lex Exhibit 63 & 125.) According to the Division, this document was a red flag (see heading XI(C)(4) in Division's FOF page 76, stating: "The August 2007 Portfolio Analysis Received by Lex Was a Red Flag"), which required Lex to perform "due diligence on the Trust Offerings in 2008 and 2009." (Division's FOF 348.)

The Division's theory is that the August 2007 portfolio analysis reflects overlapping investments among the Four Funds, and David Smith had initially told Lex that the Four Funds would not have overlapping investments. (Division's FOF 347.) The Division concludes that Smith's pre-2007 statement about the investment strategy was a "lie" (Division's FOF 348), so that presumably Lex should not have believed anything that Smith **or McGinn** ever said to him again.

The first and most critical problem with this argument is that **the OIP does not characterize the August 2007 portfolio analysis as a red flag.** Indeed, the OIP does not even mention the 2007 portfolio analysis at all. In response to the concern raised in Respondents' pre-trial Motions for a More Definite Statement, the Division assured the Respondents and this tribunal that the recitation of red flags in the OIP was intended to be exclusive. The Division stated:

> [Respondents] complain that they are uncertain whether there are red flags other than the ones identified in the OIP. The OIP, however, should not be read to suggest that there is some category of unnamed and undisclosed red flags. **The red flags discussed in the OIP are the red flags that will be presented at trial....**

(Division's Memorandum of Law in Opposition to Motions for More Definite Statement, filed Nov. 25, 2013, at 7; emphasis added.)

At trial, when the Division sought to present testimony of an alleged red flag that was not listed in the OIP, Russell Ryan, on behalf of Mr. Lex, reminded the Judge about the Division's pre-trial representation that the list of red flags in the OIP was exclusive, and the Judge properly agreed, as follows:

> MR. RYAN: In the opposition [to] the motions for more definite statement, the Division specifically and explicitly represented to you and all of us that the only red flags in this case were the ones in the OIP.
>
> * * *
>
> JUDGE MURRAY: ...I think Mr. Ryan has a point. You said the only red flags were the red flags specified in the OIP.
>
> * * *
>
> This testimony is not one of the red flags.

(N.T. 271:5-272:15.) As the Judge recognized, the parties specifically asked the Division before trial whether the list of red flags in the OIP was exclusive so that Respondents could properly prepare their strategy for trial. In response to the Respondents' specific inquiry, the Division assured Respondents and the Judge, in writing, that the list of red flags in the OPI was exclusive and that the Division would not later claim the existence of other red flags. Respondents relied on that representation in preparing for trial. If Lex's attorneys had known the Division would claim the August 2007 portfolio analysis to be a red flag, they may well have altered or supplemented their questioning about the document, done additional analysis of its contents, called other witnesses, or made additional arguments. The Judge has properly recognized the unfairness and impermissibility of allowing the Division to raise new red flags not listed in the OIP after having assured all parties that the list in the OIP is exclusive.

On the merits, contrary to the Division's assumption, there is no basis for concluding from the August 2007 portfolio analysis that Smith's pre-2007 statement was a "lie." It is equally plausible that the common investments reflected a change in strategy.

Lex testified that he was disappointed when he learned in August 2007 of the overlapping investments, not because Smith had "lied" to him earlier, but rather because Smith had failed to keep Lex up to date and notify Lex that his strategy had changed after Smith first indicated that he planned different investments for each of the Four Funds. (Lex testimony at 4954:6-4958:6.)

Lex did specifically inquire and follow up with Smith about the change in strategy. In response, Smith "assured [Lex] that as the manager, he was doing those assets in multiple LLCs because they were performing, and he thought if it benefits FIIN, it will benefit another one." (Lex testimony at 4958:2-6.) The explanation that the Four Funds were performing, and that Smith's strategy was working, conformed with Lex's experience in seeing his clients at that time continuing to receive all of their interest payments and redemptions on time and in full. (N.T. 4890:24-4891:13.)

Because the PPMs did not prohibit common investments among the Four Funds, and because all investors affirmed in writing that they were not relying on representations outside the PPM, any oral statement about a plan to avoid common investments was immaterial as a matter of law. Acme Propane, Inc. v. Tenexco, Inc., 844 F.2d 1317, 1322 (7th Cir. 1988); Taylor v. Prudential Insurance Company of America, 2003 WL 21314254 at *7 (S.D. Ind. 2003); Wamser v. J.E. Liss, Inc., 838 F.Supp. 393, 397 (E.D. Wisc. 1993); In the Matter of VMS Limited Parnership Securities Litigation, 1992 WL 249594 at *11 (N.D. Ill. 1992).

January 2008 default of the Four Funds Junior Notes

According to the Division, the announcement in January 2008 of the default of the Four Funds Junior Notes should have been a red flag to the Respondents about all tranches of the Four Funds and, indeed, all McGinn Smith private placements. (Division's Brief at 23.) The Division refers to a meeting on January 8, 2008 in Albany at which McGinn allegedly told the attendees that they needed to "pump out the swamp" and drive up revenues to generate fees for McGinn Smith. (Division's FOF 162.)

It is undisputed that Mr. Lex was not invited to, and did not attend, the January 8, 2008 meeting. (N.T. 4895:9-15.) He was not aware of the meeting, and no one told him what occurred at the meeting. (N.T. 4896:18-4897:2.)

On January 14, 2008, a draft letter intended for Junior noteholders in the Four Funds was distributed by e-mail to certain McGinn Smith brokers for their review. (Division Exhibit 151.) The letter stated that, because of the financial crisis, McGinn Smith Advisors was taking proactive measures to protect the LLCs by reducing the interest payments to Junior noteholders only to 5%. (Division Exhibit 151.)

Mr. Lex was not listed as a recipient of the January 14, 2008 e-mail distributing the draft letter referred to above, and he did not receive the draft letter referred to above. (N.T. 4896:11-17; Division Exhibit 151.)

The Division then refers to a letter dated January 15, 2008 "sent to certain investors in Four Funds **junior** tranche (10.25%) notes," in which Smith advised the **junior** Noteholders that their interest payments would be reduced to 5%. (Division's FOF 163; Division Exhibit 132, January 15, 2008 letter from David Smith to Junior Noteholders.) Again, Mr. Lex did not see this letter because he had not sold any Junior Notes. (N.T. 1578:19-20; 1597:11-12; 4865:13-

17.) Although he eventually learned about the reduction in interest payments on the Junior Notes, that did not affect any of his clients precisely because he had no clients with Junior Notes. If anything, the restructuring affirmed Lex's foresight in restricting his sales to the most secure tranches, Senior and Senior Subordinated.

The Division next refers to more restructuring in April 2008. (Division's Brief at 24.) But because all of Mr. Lex's clients were in the Senior-most Notes, all of Mr. Lex's Four Funds clients continued to receive their interest payments for an additional two years, through April 2010, when the SEC shut down McGinn Smith. (N.T. 4917:23-4918:6.) In October 2008, all tranches were affected by a payment restructuring, except for interest to the Senior-most Notes. (See Division Exhibit 192.)

Mr. Lex's expert witness, Charles Bennett, explained that the restructuring of the Four Funds was not a red flag as to the Trust Offerings because the Trusts "were totally separate and segregated offerings." (N.T. 4074:6-7.) The Division's own expert acknowledged that the Trust Offerings "were not at all similar to the income notes…." (Division Exhibit 1, Lowry expert report at 25.) Indeed, the OIP itself states that the Four Funds were "far different" from the Alarm Trusts. (OIP ¶38b.)

Furthermore, as of the time Bill Lex started selling Trusts again (March 2006, see page 13 of Exhibit 4k of Division Exhibit 2), the only experience he had had with the Trusts was their exceptional performance. These offerings stood on their own as historically successful investments which the then economy would unlikely affect. Indeed, the "triple play" offerings, including cable and phone, were likely to have nowhere near the attrition rate of alarm contracts.

Even with the pre-2003 alarm contracts, any attrition rate never prevented full performance by McGinn's "alarm Notes."[26]

The Trust Offerings

The Division states that with the Trust Offerings, "McGinn and Smith's fraudulent uses of offering proceeds became even more flagrant," and that they engaged in "outright theft and other improper uses of offering proceeds." (Division's Brief at 24, 25.) But there is no evidence that Mr. Lex knew or should have known of the carefully concealed fraud and theft, any more than NASD, FINRA, or the SEC itself, with all the resources at their disposal and their examinations and audits, were able to uncover such fraud and theft until after the fact and after all the damage had been done. (See, e.g., Livingston Exhibit 102, OCIE examination report dated January 30, 2004; Livingston Exhibit 103, OCIE examination report dated February 26, 2004; Division Exhibit 341, NASD examination report dated April 5, 2006; RMR Exhibit 120, NASD examination report dated September 5, 2006; RMR Exhibit 135, NASD examination report dated May 14, 2007.)

The Division also claims that two "red flags" are found on the face of the Trust PPMs: fees that the Division now characterizes as "exorbitant" and provision for use of Trust proceeds to redeem earlier Trust investors. (Division's Brief at 25.)

If these features are truly impermissible on their face, the regulatory agencies charged with reviewing the PPMs, such as NASD, FINRA and OCIE, should have caught these alleged improprieties at the outset.

[26] Of course in hindsight, the Division says there were problems with the alarm notes that were "covered up" by the 2003 IASG public offering. But there is no evidence that Lex was aware of any of that when he was selling the post-2006 Trusts.

The only Trust with unusually high fees on its face was Benchmark, and the Division's own evidence reflects that **Mr. Lex never sold any Benchmark.** (See Exhibit 4k to Division Exhibit 2, summary of Lex sales.)[27]

September 2009 revelation of the Firstline bankruptcy

The Division points out that Smith and McGinn concealed the January 2008 bankruptcy of the Firstline Trust for some 18 months, until September 2009. (Division's Brief at 25.) Mr. Lex was indeed angry when he learned of the concealment. (N.T. 1707:17-20.) But by that time Mr. Lex had already ceased **all** sales of all McGinn Smith private placements, with his last sale occurring, according to the Division's own evidence, on July 17, 2009. (See page 19 of Exhibit 4k to Division Exhibit 2, summary of Lex sales.)

K. The Division is Entitled to None of the Remedies It Has Demanded

We previously explained at length why all of the Division's requested sanctions are precluded by 28 U.S.C. § 2462. And even if not precluded in their entirety, those that are penalties, fines, or forfeitures are clearly prohibited by section 2462 as well as numerous constitutional axioms that prohibit Article II agencies from deciding case or controversies and even Article III judges from deciding factual predicates for penal sanctions rather than a jury. And even if section 2462 could be twisted and pulled to allow slivers of these remedies to survive because individual acts or transactions happened within the relevant 5-year period, no penalty or forfeiture remedy is permissible for any act or transaction after Septermber 23, 2008. Finally, as discussed earlier, all of the financial sanctions demanded by the Division – including

[27] The Division's case arises from the sale of 26 offerings. (See Division Exhibit 2, Palen Declaration¶4 and Exhibit 3 thereto.) The Division's own evidence reveals that Lex never sold any investments in three of the offerings on that list: TDM Luxury Cruise Trust, Cruise Charter Ventures Trust, and TDMM Benchmark Trust. (See Exhibit 4k to Division Exhibit 2, summary of Lex sales.)

the compensation clawback and forfeiture euphemistically referred to as "disgorgement" – constitute either penalties, fines, or forfeitures within the meaning of section 2462.

The Division contends that "a significant penalty award" against each of the Respondents "would be consistent with precedent." (See argument sub-heading in Division's Brief at 44.) The disingenuousness of this representation is best illustrated by the fate of Brian Shea. Shea, who was the CFO at McGinn Smith and a leading financial officer at its affiliates during the period underlying this case, **pleaded guilty** to obstructing and impeding the administration of the Internal Revenue laws. (Shea testimony at 2363:7-22; Division Exhibit 451, criminal Information against Shea; Division Exhibit 456, Shea's guilty plea and criminal judgment.)[28] In fact, Shea assisted in the fraud and the cover-up by concealing unlawful diversions of investor funds, creating false accounting entries, and creating back-dated promissory notes to disguise improper payments as loans. (Shea testimony at 2416:15-2417:14; 2424:6-2425:12.) Despite this, **the fine imposed on Shea amounted to a grand total of $5,000.** (Division Exhibit 456 at 4.)

It would be arbitrary and unjust for the Commission to punish brokers such as Lex for failing to uncover fraud, while Shea himself, an actual participant in the fraud and the cover-up, emerges financially and professionally unscathed. Indeed, Shea has been given a salary of $150,000 a year by the Receiver. (Brown testimony at 2541:8-15.) It is unseemly that the Division defends Shea, yet wants to destroy the lives of the brokers. Shea, as a CPA, had responsibilities to the public as well. Yet he is portrayed with sympathy and tolerance.

[28] Shea became the controller at McGinn Smith in 1992 and the CFO several years later. (Shea testimony at 2360:12-18.) When the pre-2003 McGinn Smith alarm trusts went public in 2003 under IASG, Shea became executive vice president and corporate secretary of IASG. (Shea testimony at 2361:7-11.) In 2007 he began work at McGinn Smith Alarm Trading, Inc., and in 2009 he returned to McGinn Smith as the CFO. (Shea testimony at 2361:13-23.)

Section 21B(b) of the Exchange Act sets forth three tiers of monetary penalties depending on the severity of the violation. A violation rises from the first to the second tier only if the Commission proves that the violation "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." 15 U.S.C. § 78u-2(b)(2). To justify a third-tier penalty, the Commission must prove that the violation involved the foregoing level of scienter **and** that "such act of omission 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(b)(3).

The applicable **maximum** penalties per violation,[29] which are periodically adjusted, are as follows:

For violations occurring between February 15, 2005 and March 3, 2009:

First tier: $6,500

Second tier: $65,000

Third tier: $130,000

For violations occurring after March 3, 2009:

First tier $7,500

Second tier: $75,000

Third tier: $150,000

17 C.F.R. §§ 201.1003 & 1004.

[29] The Division's post-hearing attempt to belatedly multiply the two claims asserted against Mr. Lex in the OIP into hundreds of individual "violations" in order to attain an outlandishly inflated penalty should be rejected. Assuming any multiplication of the two claims is even permissible, that multiplication should mirror the Division's own concocted theory that there were only two "conduit" offerings within the 5-year statute of limitations. The Division cannot claim there were only two offerings for purposes of contriving its claim, and then disavow the same logic when determining the number of violations as a penalty multiplier.

But before the Commission may impose **any** penalty, it must first find that such a penalty: (1) is in the public interest, **and** (2) that the Respondent **willfully** violated a provision of the securities laws. 15 U.S.C. § 78u-2(a)(1). Thus, the mere fact that there was no **willful** violation is sufficient in itself to preclude a penalty. This is especially obvious with respect to the Division's Section 5 claim, which it concedes is baseless without the generous help of a strict liability requiring no evidence of any fault whatsoever. If this tribunal nevertheless proceeds to consider the public interest, the following factors must be weighed in determining whether a penalty is in the public interest:

1. whether the Respondent's conduct involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

2. the harm to other persons resulting from the Respondent's misconduct;

3. the extent to which the Respondent was unjustly enriched;

4. prior administrative findings of securities violations or certain criminal convictions;

5. the need for deterrence; and

6. such other matters as justice may require.

15 U.S.C. § 78u-2(c); In the Matter of Lorenzo, No. 3-15211, S.E.C. Release No. 544 at 11 (Dec. 31, 2013); In the Matter of Gerasimowicz, No. 3-15024, S.E.C. Release No. 496 at 6 (July 12, 2013). "Not all factors may be relevant in a given case, and the factors need not all carry equal weight." Matter of Sandru, No. 3-15268, S.E.C. Release No. 452 at 9 (Aug. 12, 2013).

The following is an analysis of the relevant factors, starting with the six statutory factors listed in 15 U.S.C. § 78u-2(c):

Fraud or deceit

As fully set forth above, Mr. Lex did not commit any fraud or deceit. At most he: (1) failed to orally repeat warnings about risks that were already repeatedly and prominently spelled out in the written offering materials that each of his clients received and affirmed in writing that they read and understood; and (2) failed to undertake due diligence investigation into the McGinn Smith private placements. For the reasons set forth above, Lex maintains that he was under no legal obligation to orally repeat warnings that were already spelled out in writing, nor to duplicate the due diligence function that was the responsibility of the broker-dealer firm under the terms of the governing regulatory Rules and Notices.

In any case, even if this tribunal concludes that these duties may be imposed on Mr. Lex, his failure to fulfill them still does not rise to the level of fraud or deceit. With respect to the alleged Section 5 violation, the Division does not allege any fraud or deceit, but rather proceeds on a theory of strict liability. Mr. Lex maintains that the Division's theory under Section 5 is unfounded. In any case, because the Division has not presented evidence of fraud or deceit, this factor weighs against the imposition of any significant penalty.

Harm from Respondent's misconduct

First, it must be remembered that many of Mr. Lex's clients who invested in the McGinn Smith private placements were fully redeemed, and the redemptions continued through as late as December 2009. (Lex Exhibit 152, list of redemptions.) Other investors will see substantial recoveries, in large part through the efforts and cooperation of Mr. Lex, from NFS, SIPC, and/or the Receiver.

While many McGinn Smith investors, including Mr. Lex himself and his immediate family, undoubtedly lost money on their investments, Mr. Lex is not a guarantor of those investments, and to punish Mr. Lex for the misconduct of others, such as McGinn, Smith, Shea and Matthew Rogers, would constitute an egregious violation of due process. Mr. Lex can only be responsible for harm caused by **his misconduct**--not his conduct, and not the misconduct of other people.

The Division's own witness, Kerri Palen, detailed the misuse and diversion of investment proceeds that was perpetrated by McGinn, Smith, and Matthew Rogers, as well as the fraudulent accounting methods that were used by both inside and outside accountants to conceal the underlying fraud. (Division Exhibit 2, Palen Declaration.) Investors, including Mr. Lex himself, were victimized by a combination of that fraud and the world-wide financial crisis beginning in 2007. The losses were not caused by Mr. Lex, and Mr. Lex should not be further penalized because of them.

Unjust enrichment

Mr. Lex indeed was compensated for the sales that he made. That compensation was in the form of a portion of the gross commissions received by McGinn Smith, in accordance with his contract with McGinn Smith. There was nothing "unjust" about the compensation because it was in return for the services that Mr. Lex provided.

Prior violations

The fourth statutory factor under 15 U.S.C. § 78u-2(c) is:

> whether such person previously has been found by the Commission, another appropriate regulatory agency, or a self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted by a court of competent jurisdiction from violations of such laws or of any felony or misdemeanor described in section 78o(b)(4)(B) of this title.

15 U.S.C. § 78u-2(c)(4).

Here, Mr. Lex has never been convicted of any felony or misdemeanor, nor enjoined from violating any securities laws. There were indeed arbitration awards issued in favor of the Changs and Dr. Weinar, but neither award found fraud by Mr. Lex nor any violation of any securities law or statute by Mr. Lex. (See Division Exhibit 514, Chang award; Division Exhibit 520, Weinar award.) The claims in both cases were triggered by the fraud committed by McGinn and Smith, the same circumstances that brought the SEC proceeding in this case. Neither award is final, and Mr. Lex is still in the process of challenging both awards in the courts. For these reasons, this factor as well weighs against the imposition of any significant penalty.

Deterrence

Because Mr. Lex is no longer in the securities business, there is no need to deter him from any future securities violation, and punishment would serve no deterrent purpose as to him. As to other brokers, deterrence would serve no purpose because the underlying conduct is not something within the brokers' control. Under the Division's theory, even if a broker limits his sales of a private placement to 35 unaccredited investors, he is nevertheless liable if, **after** those sales, **unbeknownst to him, other** brokers sell the same offering to additional unaccredited investors. Because a broker has no control over the sales of other brokers, punishing Mr. Lex in this case will not deter the conduct in question. Brokers who would be tempted, on their own, to **knowingly** sell private placements to more than 35 unaccredited investors are already adequately deterred by the penalties rightly meted out to any brokers who would knowingly engage in such conduct.

With respect to the alleged fraud, the analysis is the same. There simply was no evidence of a specific fraudulent representation that would be the proper subject of deterrence. What the Division presented instead was a failure to uncover fraud that others perpetrated and concealed, and a failure to orally repeat warnings of risks that were already fully disclosed in writing. Fraud detection is simply not the proper function of individual brokers. If Mr. Lex is punished to prod other brokers to engage in forensic investigations of the products they sell and the issuing entities, it will simply be ineffectual because brokers are not trained or equipped to carry out that function, and fraudsters are skilled in covering their tracks.

Such other matters as justice may require

Other factors that are relevant in this case include the following:

- Mr. Lex has already suffered substantially as a result of the events underlying this proceedings. He has been barred from associating with a broker-dealer, thus effectively ending his four-decade long work in the securities business. (Lex testimony at 1534:19-23; Division Exhibit 482, BrokerCheck Report at 10-13.) This has substantially reduced his income, relegating him to sales of insurance when, for more than 30 years, he had a thriving variable annuities practice;

- He has been named as a Respondent in several claims by individual investors, as well as in this enforcement action. (See Division Exhibit 514, Chang award; Division Exhibit 520, Weinar award.) The litigation has consumed enormous time and attention, cost substantial money in attorneys' fees and costs, and resulted in several arbitration awards that Mr. Lex is still challenging in the courts;

- He and his immediate family have lost over $1 million in the same investments that underlie these proceedings because he, just like some of his clients, was duped by the fraud of McGinn, Smith and others. (N.T. 4916:25-4917:8);

- He has fully cooperated with the authorities, testified in the criminal trial against McGinn and Smith, spent four days in Utica waiting to be called, produced 25,000 pages of documents at a cost of approximately $12,000, and put up $125,000 for the Firstline rescue mission. (N.T. 4914:8-23; 4958:17-23; 4919:10-25.)

- He has expended considerable time and effort to assist his clients in receiving as much recovery as possible from the Receiver, the NFS, and SIPC, going so far as to lobby Senators and Congressional representatives to push SIPC to undertake this cause. (N.T. 4912:12-4913:11; Bove testimony at 5552:9-5553:16.)

In addition to the six factors enumerated in 15 U.S.C. § 78u-2(c) and analyze above, the Commission also may consider the following so-called "Lybrand" factors from SEC v. Lybrand, 281 F.Supp.2d 726, 730 (S.D.N.Y. 2003), aff'd on other grounds, 425 F.3d 143 (2nd Cir. 2005):

> (1) The egregiousness of the violations at issue; (2) defendants' scienter, (3) the repeated nature of the violations; (4) defendants' failure to admit to their wrongdoing; (5) whether defendants' conduct created substantial losses or the risk of substantial losses to other persons; (6) defendants' lack of cooperation and honesty with authorities, if any; and (7) whether the penalty that would otherwise be appropriate should be reduced due to defendants' demonstrated current and future condition.

In the Matter of Bandimere, No. 3-15124, S.E.C. Release No. 507 at 87 (Oct. 8, 2013); In the Matter of Sandru, No. 3-15268, S.E.C. Release No. 452 at 9 (Aug. 12, 2013). These factors, many of which are duplicative of the six statutory factors from 15 U.S.C. § 78u-2(c) discussed above, are relevant in considering disgorgement as well as monetary penalties. SEC v. Bear, Stearns, & Co., 626 F.Supp.2d 402, 407 (S.D.N.Y. 2009).

The Division's demand for disgorgement is equally misguided. The primary purpose of disgorgement is to deter violations of the securities laws by depriving violators of their ill-gotten gains. SEC v. Fischbach Corp., 133 F.3d 170, 175 (2nd Cir. 1997); SEC v. Verdiramo, 890 F.Supp.2d 257, 277 (S.D.N.Y. 2011); SEC v. Svoboda, 409 F.Supp.2d 331, 344 (S.D.N.Y. 2006). It follows that the Division must prove not simply that Lex earned money on sales, but that the earnings were "ill-gotten," that is, the result of securities violations. For example, if Mr. Lex is found liable because e-mails from March 2009 are deemed to be a red flag and it is found that his response to that red flag was inadequate, only sales made **after March 2009** may be found to constitute violations. And the deterrent purpose of disgorgement works only if the violations are committed with scienter.

If any disgorgement is ordered, it must be remembered that the Division's figures for Lex's commissions are gross figures, from which he paid approximately 25% for expenses in office supplies and equipment, utilities, rent, telephones computers, clerical help, and so on. (N.T. 4867:9-22; 4868:3-5; 4868:22-4869:4; 1583:11-14.) In addition, in an attempt to help his clients after the fact, he effectively disgorged $125,000 in an ultimately unsuccessful attempt to create a fund to compensate investors. (N.T. 4919:10-25.) Finally, he has likewise already disgorged much of what the Division is demanding in legal fees to cooperate and testify in the SEC's pursuit of McGinn and Smith and the related criminal prosecution – for all of which he should be given credit and an offset from any disgorgement, given that the sole legitimate purpose of disgorgement is to remove the profits from alleged wrongdoing.

The seven "Lybrand" factors listed above, which are considered for both monetary penalties and disgorgement, are analyzed below:

Egregiousness of the violations

For the reasons discussed in this Brief on the merits, we believe that there were no violations by Mr. Lex at all. If this tribunal concludes otherwise on the merits, we submit that any violations found cannot be deemed egregious. There is no evidence of any actual fraud by Mr. Lex. Any finding of liability would necessarily be based one or more of the following conclusions: that he had a duty to investigate the securities, that he improperly characterized the securities as safe to two investors, that he failed to orally warn his clients about the risks of the securities, despite the written warnings provided to all of his investors, and/or that he violated Section 5 of the Securities Act.

None of those violations can be characterized as egregious because the regulatory Rules and Notices applicable during 2003-2009 specified that the duty to investigate securities was the function of broker-dealer firms rather than individual brokers; the risks of the securities were repeatedly and prominently set forth in the PPMs and the Subscription Agreement that Mr. Lex's clients signed before purchasing any of the securities in question; and the Division is proceeding on a theory of strict liability on the Section 5 claim because the evidence establishes that Mr. Lex reasonably relied on the advice of David Smith and compliance officer Stephen Smith that the securities were exempt from the registration requirement under Section 5 as long as they were sold to no more than 35 unaccredited investors, and that he necessarily relied on Patricia Sicluna, McGinn Smith's vice president of registration, who kept track of the number of unaccredited investors purchasing each offering. (N.T. 1618:2-17.)

In addition, if Lex's sales of the McGinn Smith private placements are somehow deemed to constitute a securities violation, the fact that he and his immediately family invested so heavily in the same securities belies any notion that he sold the securities in bad faith or that the violations were egregious.

Scienter

This factor is similar to the first statutory factor discussed above. If this tribunal finds any violations at all, the evidence refutes any notion that Mr. Lex acted in bad faith or with fraudulent intent. To the contrary, he restricted his sales to the products and tranches that yielded the lowest commissions to himself because he knew that they provided the highest protection for his clients. (N.T. 1578:20-1579:6; 1581:20-1582:13; 1597:11-12; 4865:13-17; 4877:19-4878:12; 4879:2-4.) The Section 5 claim is proceeding on a theory of strict liability because Mr. Lex reasonably relied on David Smith and the compliance officer for the interpretation of the Regulation D exemption, and reasonably relied on Patricia Sicluna to keep track of the total number of unaccredited investors (for all McGinn Smith brokers) per offering. This factor therefore weighs against imposition of monetary penalties or disgorgement. It is unjust to penalize a broker who was acting without scienter, and the deterrent rationale of disgorgement is inapplicable if the broker didn't know he was acting unlawfully.

Repeated nature of the violations

As fully set forth above, we maintain that there were no violations at all.

Failure to admit wrongdoing

Mr. Lex is devastated by the losses that his clients incurred, but he was always trying to act in his clients' best interests. Of course he wishes he could have discovered the fraud before it was too late, but that does not constitute wrongdoing on his part any more than the SEC itself engaged in wrongdoing by failing to discover the fraud.

Whether Respondent's conduct caused substantial losses to others

This is addressed in the second statutory factor discussed above.

Cooperation with authorities

As discussed above, Mr. Lex has fully cooperated with the authorities, testified in the criminal trial against McGinn and Smith, spent four days in Utica waiting to be called, and produced 25,000 pages of documents at a cost of approximately $12,000. (N.T. 4914:8-23; 4958:17-23.)

Consideration of Respondent's current condition

A finding of fraud will surely result in Mr. Lex's loss of his insurance license. He will have no way to earn a living after over 40 years in the business with an unblemished record.

Consideration of Mr. Lex's current condition weighs against any substantial penalty or disgorgement. He has been suffering financially and emotionally for more than four years as a result of the events underlying these proceedings.

Most of his clients were like family to him, and he was devastated by the losses they suffered from McGinn Smith's fraud. (N.T. 4909:19-4911:18.) Investors, unable to proceed against McGinn Smith or its principals because of the stay and receivership, have targeted him for the losses caused by the theft and fraud of McGinn and Smith. (See Division Exhibit 514, Chang award; Division Exhibit 520, Weinar award.) He has incurred monumental legal fees and expenses in challenging the investors' claims as well as litigating this protracted proceeding, four weeks away from home and away from his ailing wife. The publicity from the litigation has been humiliating to his personal prestige and reputation. (N.T. 4910:15-4911:3.) Even his insurance practice has been eviscerated.

Because he was unable to pay the Chang award of more than $800,000 he has been barred from any future association with a broker-dealer firm, thus effectively ending his four-decade long career in the securities industry. (Lex testimony at 1534:19-23; Division Exhibit 482, BrokerCheck Report at 10-13.) Because he is suspended from further involvement in the securities industry, there is no need to deter him from future violations. He has been devastated in every way imaginable. His credit has been destroyed due to the Chang judgment. Further punishment, for conduct that at worst was simply an excess of trust or naiveté, would serve no legitimate purpose and would amount to gratuitous cruelty.

For these reasons, even a cease-and-desist order is inappropriate here. While there need not be the same likelihood of repetition that is required for a court injunction, it is well-settled that there needs to be at least some likelihood of repetition. WHX Corp. v. SEC, 363 F.3d 854 (D.C. Cir. 2004) (citing cases). Here, as the Division concedes, Mr. Lex stopped selling securities approximately five years ago and disassociated himself from McGinn Smith shortly thereafter, and he is completely barred by FINRA from re-entering the securities industry. Coupled with his devastation over what has happened and his lack of any interest in selling securities ever again, any future violations by Mr. Lex of the laws at issue here are not only highly unlikely but virtually inconceivable.

IV. CONCLUSION

For the foregoing reasons, Respondent William F. Lex respectfully request that this proceeding be dismissed in its entirety with no sanctions being imposed.

Respectfully submitted,

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