SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15514

In the Matter of

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

Respondents.

RESPONDENT FRANK H. CHIAPPONE'S POST HEARING BRIEF

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I. PRELIMINARY STATEMENT

Respondent Frank Chiappone ("Chiappone" or "Mr. Chiappone"), by his counsel, Tuczinski, Cavalier & Gilchrist, P.C., submits this post-hearing brief in accordance with the directions of Chief Administrative Law Judge Brenda A. Murray.

In this matter, the Enforcement Division has cast its nets too widely, bringing charges against ten subordinate individuals with unblemished prior records whose only sins were to place trust and confidence in their firm, its senior management, compliance officers, back office personnel, its in-house and outside counsel, and in its two principals – individuals with whom they had worked for over a decade. As it turned out, that trust and confidence was betrayed by deliberate lies and intentional withholding of material information, none of which were reasonably foreseeable. The two principals of MS & Co., David Smith ("Smith") and Timothy McGinn ("McGinn"), were permanently barred by FINRA in September 2011, and were convicted in February 2013 on multiple counts of mail and wire fraud, securities fraud, and filing false tax returns. Both received lengthy prison terms. The FINRA bar and criminal convictions occurred following several years of intense investigation of McGinn, Smith and MS & Co. by regulators and the Justice Department.

Having dealt with the wrongdoers, the Division of Enforcement of the Securities and Exchange Commission (the "SEC" or "Division") then turned its attention to certain of the individual registered representatives in what amounts to guilt by association and fraud by hindsight. Although the lies and deceptions practiced by Messrs. McGinn and Smith continued undiscovered for more than a decade – principally because senior management were participants in the fraud – the Division argues that Chiappone and the other brokers should have uncovered the fraud and put a stop to it. Accordingly, the Division commenced this civil proceeding on September 23, 2013,

seeking relief, "including, but not limited to, disgorgement and civil penalties" against ten registered representatives who had previously been registered with the now defunct brokerage firm, McGinn, Smith & Co., Inc. ("MS & Co."). As concerns Chiappone, the Order Instituting Proceeding ("OIP") alleges the Respondents "willfully violated Sections 5(a) and (c) of the Securities Act by offering and selling notes for which no registration statements were in effect;" and Respondents "willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, by knowingly or recklessly, or negligently, failing to perform reasonable due diligence to form a reasonable basis for their recommendations to customers, and made misrepresentations and omissions in recommending the Four Funds and Trust Offerings".[1]

II. STATEMENT OF FACTS

A. Chiappone Background; Overview of McGinn Smith Organization.

Chiappone has been in the securities industry for 33 years. He holds licenses in series 7, 24, 63 & 66, as well as being a certified retirement counselor and insurance licenses for life, accident and health.[2] Prior to the filing of the OIP, Mr. Chiappone's record was spotless. He had never been the subject of any disciplinary proceeding by the SEC, FINRA or NASD, never was made a party to any lawsuit or arbitration proceeding brought by an unhappy customer, and had never had so much as a written complaint filed against him.[3]

[1] The "Four Funds" were four separate limited liability companies each of which was formed to "identify and acquire various public and/or private investments" and which issued three tranches of notes with differing interest rates (ranging from 5% to 10.25%) and terms (ranging from 1 year to five years).
The "Trust Offerings" consisted of 21 special purpose entities offering two tranches of debt investments with interest rates ranging between 7.75% and 13%. The entities were each established to invest in burglar alarm service contracts, "triple play" (broadband, cable, and telephone) service contracts, or luxury cruise ship charters.

[2] Chiappone testimony, Transcript (hereinafter abbreviated to "Tr.") pp. 5399 – 5400.

[3] See, Chiappone Broker Check Report, Ex. FC-16, and Chiappone Testimony, Tr., pp. 5400 - 02.

Mr. Chiappone joined MS & Co. in August of 1988, ending that affiliation in December of 2009. His previous employment was with First Albany, an old line Albany brokerage firm.[4] Mr. Chiappone never sold a private placement until he arrived at MS & Co.[5] While he functioned as a sales manager for a period of time, Mr. Chiappone never held a supervisory or compliance role at MS & Co. He was not an owner, nor did he ever hold a position as a director or officer of MS & Co. or any of its affiliated companies.[6] Mr. Chiappone was supervised by David Smith, the firm's chief compliance officer, and for some period of time, by Steven Smith, who assisted with compliance.[7] While at MS & Co., Chiappone sold stocks, mutual funds and other traditional investment securities, insurance products, as well as MS & Co. sponsored private placement investments.[8] Those private placements consisted mostly of debt instruments (notes) that were used to acquire receivables and future payments on security alarm contracts (the "pre-2003 alarm deals"). Mr. Chiappone was never involved in structuring any of the private placements, nor did he receive any remuneration from them beyond his ordinary sales commissions.

The pre-2003 alarm deals provided above-average income for his clients, and were not correlated with the stock markets. To Chiappone, such a track record spoke volumes for the ability of MS & Co. to appropriately scrutinize companies and to strike profitable deals, particularly in the recurring monthly revenues market.[9] Chiappone only sold private placements to those investors for whom he determined the investment would be suitable. He also sold mutual funds and listed securities to some clients who also opted to buy privately placed securities. In some cases, he sold only private placements to a client, but was aware that the client had a balanced portfolio that

[4] Chiappone testimony, Tr. pp. 5402 – 5403.
[5] Chiappone testimony, Tr. p.5412 – 5413.
[6] Chiappone testimony, Tr., pp. 5405 – 5412 (as to sales manager duties; pp.5411 (not a director or officer).
[7] Chiappone testimony, Tr., pp. 5416 . Steven Smith is not related to David Smith.
[8] Chiappone testimony, Tr. p. 5413.
[9] Chiappone testimony, Tr., pp.5412 – 13 as to products sold; pp. 5466 – 67 as to success of early alarm deals.

included marketable securities in other accounts, serviced by other brokers.[10] Mr. Chiappone evaluated the offerings himself, and did not sell every single offering promoted by MS & Co.[11]

B. Organizational Structure & Background of MS & Co.

(1) General Organizational Structure. MS & Co. was formed in 1980, and operated as a successful investment banking and investment brokerage firm for many years, selling stocks, bonds, mutual funds and other traditional investments. MS & Co. was a mid-sized, full service firm, conducting a retail brokerage practice, an investment banking practice, and participating in syndications with major investment houses in public offerings. In addition to a well-qualified due diligence team, MS & Co. had two compliance officers, a chief financial officer, [12] in-house counsel, outside counsel, an accounting staff supervised by its' chief financial officer, and competent back office personnel. Until March of 2010, MS & Co. enjoyed a solid reputation in the Capital District business community and beyond. MS & Co. engaged the services of certified public accountants, who were likewise mid-sized and well-reputed firms.[13] The firm used outside legal counsel at times in connection with engaging in private placements made pursuant to SEC's Regulation D (rule 506).[14] Each office, including the one that Chiappone worked in, had a branch manager, responsible for supervising the registered representatives and who served as a critical communication liaison between MS & Co. management and the registered representatives.

Prior to the offerings referenced in the Order Instituting Proceeding ("OIP"), MS & Co. had developed a niche in structuring private placement investments based on recurring monthly revenue, with a particular specialty in the burglar alarm monitoring industry. The firm also

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[10] Testimony of Jerry Mirochnik, Tr., pp. 3117.

[11] Chiappone testimony, Tr. p. 5454.

[12] At various times, the CFO slot was held by Elizabeth Drew, Brian Shea and David Rees. Chiappone testimony, Tr. pp. 5416 – 5417.

[13] The CPA firms were Bollam, Sheedy, Torani & Co. (Albany, NY) and Piaker & Lyons (Binghamton, NY). Chiappone testimony, pp. 5417 – 5418.

[14] Chiappone testimony, Tr. pp. 5418 – 5419.

developed a regional reputation for providing financing for local businesses. Tim McGinn, the company's CEO, ran the investment banking side, locating and structuring deals, sometimes with Smith's assistance. Smith, the company's president, supervised operations, ran the retail brokerage side, and was responsible for compliance. Over time, Chiappone came to admire and trust McGinn and Smith, and became personal friends with both of them, and their families.[15]

In brief, MS & Co. would raise capital through debt offerings and would fund an entity (typically controlled by MS & Co.), that would purchase at a discount the rights to the recurring monthly revenues generated by a basket of home alarm monitoring contracts. Those revenues would then fund interest and principal payments due to the investors.[16] As time passed, private placements became a larger part of MS & Co.'s business. For many of those years, MS & Co. and its principals successfully portrayed to investors, employees, and regulators that MS & Co. was a substantial, successful investment banking and brokerage house, with a history of successful offerings of private placement securities. Mr. Chiappone's experience with most of the pre-2003 alarm offerings, was that they performed well, paying interest on schedule, and returning principal upon maturity. The two principals, McGinn and Smith, along with their senior accounting and investment banking staff, had convinced the financial world that they were capable of locating, investigating and analyzing the receivables and contract revenues of home security alarm monitoring companies, purchasing those accounts receivable at an appropriate discount relative to their real value, and using the payment stream from those accounts receivables to yield substantial returns to their investors. The company also developed a reputation for financing local business

[15] Chiappone testimony, Tr. pp. 5413 – 5414).

[16] In some instances, the transactions were structured as loans to the alarm companies secured by the monthly payments of customers on alarm monitoring contracts, rather than the outright purchase of the contract receivables. Mary Ann Cody testimony, Tr. p. 4544 - 4545.

enterprises and municipal entities, including the Saratoga City Center and several medical facilities.[17]

(2) ***The MS & Co. Due Diligence Team.*** Unlike many regional brokerage houses, MS & Co. featured a substantial due diligence team. This team was assembled when MS & Co. was conducting the pre-2003 alarm offerings. That team was headed by Mary Ann Cody, Esq., who served first as outside counsel, and then went in-house. She testified in great detail and with obvious pride on the work done by the due diligence team. The key personnel were Ms. Cody, Brian Shea and Doug Keenholtz, as well as Tim McGinn himself. At some point, Key Corp., a substantial super-regional bank, discontinued its leasing operations, and MS & Co. hired 11 or 12 of the leasing team that had performed due diligence operations for Key Corp.'s leasing division. They were familiar with due diligence procedures, and with the concept of recurring monthly revenues, a hallmark of the early MS & Co. offerings.[18]

After McGinn had identified a candidate, the due diligence team would visit the alarm company, review operations, obtain and read all alarm contracts to be purchased (or loaned against), and then call each of the individual alarm customers to verify the existence and terms of the alarm contracts.[19] The results of each due diligence investigation were reduced to writing, and the records were kept at MS & Co. headquarters, in a fire-proofed location.[20] Ms. Cody noted that MS & Co. not only conducted the due diligence to protect MS & Co. and its investors, but that they touted the thoroughness of the process as a selling point in marketing the offerings. In short, MS & Co. ran a first-class operation in terms of vetting its' investment products.

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[17] Chiappone testimony, Tr. pp. 5403 – 5404 & 5463 – 5465.
[18] Chiappone testimony, Tr. pp. 5419 – 5422; Cody testimony, Tr. pp. 4547 – 4548.
[19] Cody testimony, Tr. p. 4546.
[20] Cody testimony, Tr. pp. 4548.

Moreover, the MS & Co. Supervisory Compliance Manual specifically addressed how due diligence would be performed in connection with private placement investments:

> "Due Diligence Procedures. When McGinn, Smith acts as underwriter in connection with limited partnership and/or private placement offerings, it will make a reasonable investigation of the project to include inspection of completed projects, conversations with in-house counsel where applicable, a complete examination of financial documents and any other documents deemed necessary to deal fairly with the investing public. Paperwork recording the due diligence will be kept in the legal files."[21]

The years of apparently successfully structured private placement investments underwritten by MS & Co. was a reasonable basis on which the registered representatives could rely in trusting that appropriate due diligence was being done.

(3) ***Communicating Due Diligence Findings to Brokers.*** The brokers were not involved in the due diligence process itself, but were aware that due diligence was being handled by a team of specialists.[22] Once due diligence was completed and the offering documents prepared, the results of the due diligence investigation were passed on to the brokers via a presentation by the key due diligence team members to the sales staff. At the meetings, McGinn and/or Smith, Shea and Cody (and sometimes others) would discuss the features, merits and risks of the offering with the sales force.[23] Those discussions included the business model (typically alarm receivables), the specific assets being purchased, discounts on RMR assets purchased, structure of the tranches of notes being offered, interest rates, risk factors (such as attrition), and the credit quality of the customers whose contracts were being purchased.[24] Brokers could and did ask questions, including Mr. Chiappone, who testified that, when he did ask questions, he received satisfactory answers.[25] Mr. Chiappone also sold private placements sponsored by organizations not controlled by McGinn

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[21] McGinn Smith Compliance Manual for 2008, Exhibit Div-329, p. 44.
[22] Cody testimony, Tr. pp. 4553.
[23] Chiappone testimony, Tr. pp. 5422 – 5423; Cody testimony, Tr. pp. 4553 – 4555.
[24] Chiappone testimony, Tr. pp. 5423 – 5426; Cody testimony, Tr. pp. 4553 – 4555.
[25] Chiappone testimony, Tr. pp. 5426 – 5427; Cody testimony, Tr. pp. 4555.

or Smith, and found that the due diligence presentations from the MS & Co. team were comparable to those done by outside sponsors.[26]

When Tim McGinn left MS & Co. in 2003 to form and operate Integrated Alarm Service Group ("IASG"), most of the due diligence team went with him, where they continued to work on the purchase of alarm company recurring monthly revenues.[27] IASG raised $200 million in an IPO, and used some of the proceeds to purchase notes issued in pre-2003 alarm deals. It also purchased new alarm receivables with IPO proceeds. All of the investors in deals that were rolled up into IASG were paid in full. While some of the investors in earlier alarm deals were not rolled up into IASG and were not paid at that time, Mr. Chiappone did not learn of that until Ms. Palen testified at the hearings. Mr. Chiappone testified that when McGinn returned to MS & Co. in April or May of 2006, the due diligence team came back with him.[28] This included key team members Brian Shea and Doug Keenholtz.[29] That team conducted the work on the alarm and triple play offerings ("Trust Offerings") that took place in late 2006 and thereafter, and the quality of that due diligence was similar to that done on the pre-2003 alarm deals.[30]

(4) ***Chiappone's Practices; Suitability.*** Mr. Chiappone was fully aware of the rules that governed suitability during the period covered by the OIP. They were NYSE Rule 405, the "know your customer" rule (now known as customer-specific suitability), and NASD Rule 2310 on suitability (now known as reasonable basis suitability).[31] The factors he took into account in assessing whether a particular offering was suitable for a given client included age, education,

[26] Chiappone testimony, Tr. pp. 5429 – 5430.
[27] Cody Testimony, Tr. p. 4557.
[28] Chiappone testimony, Tr. pp. 5430 – 5431, 5447 – 5448 and 5568.
[29] Chiappone testimony, Tr. pp. 5447 – 5448. Ms. Cody did not return to MS & Co. in 2006, as she had since divorced Tim McGinn for reasons not related to the actions that resulted in his criminal conviction (Tr. p. 4558).
[30] Chiappone testimony, Tr. pp. 5431 – 5432.
[31] Chiappone testimony, Tr. pp. 5432 – 5433. The bifurcation of the suitability concept into "reasonable basis" and "customer-specific" appears to have been codified in FINRA Rule 2111, which was not in effect during the time period represented in the OIP.

income, net worth, time horizon, risk tolerance, investment objectives, assets held outside of MS & Co. and need for liquidity.[32]

While nothing in his licensing exams or continuing education indicated a broker was personally responsible to perform due diligence on an investment product, Mr. Chiappone did understand his obligation to *understand* the features, merits and risks of each private placement offering. But, Mr. Chiappone did not believe he needed to duplicate due diligence team's work. He respected the division of labor within the MS & Co. structure, and reasonably relied on the work of the due diligence team.[33] His testimony on that subject follows:

> "Q. What is your understanding of your obligation with respect to an investment product that you are recommending?
> A. To research to the best of my ability due diligence on the individual product. And that meant talking to the sponsors of the product, getting my arms around it, feeling comfort after having those discussions to be able to recommend it to my client.
> Q. Do you feel you have to understand a product to recommend it?
> A. I feel that is important to do so because if a client asks me about that particular product, you want to be able to share the important points of it"[34]

In addition to attending the due diligence meetings, Mr. Chiappone performed debt service coverage calculations on each of the offerings, the mechanics of which he explained to the court.[35]

Mr. Chiappone did not offer private placements to all of his clients. He sold primarily to clients that were looking for alternatives to the equity markets.[36] In fact, less than one out of five (about 19%) of his customers was ever sold a private placement.[37] Chiappone's private placement customers had other, marketable, securities either in their MS & Co. account or accounts with other

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[32] Chiappone testimony, Tr. pp. 5433 – 5435.
[33] Chiappone testimony, Tr. pp. 5435 – 5436.
[34] Chiappone testimony, Tr. p. 5436.
[35] Chiappone testimony, Tr. pp. 5479 – 5481, and 5485.
[36] Chiappone testimony, Tr. pp. 5436 – 5437 and 5453 – 5454. .
[37] Chiappone testimony, Tr. pp. 5441 – 5443.

firms.[38] He never recommended that any customer purchase only private placements.[39] He never used discretionary authority to purchase a private offering for a customer's account.[40] MS & Co. had specific rules concerning marketing private placements, and he followed them.[41] While he did sell some private placements to unaccredited investors, he was careful not to overly concentrate privates in customer accounts. Frank did his own review of every offering that MS & Co. promoted; and some he did not sell after determining they were not suitable.[42]

Mr. Chiappone ensured that each customer to whom he sold a private placement, was issued a private placement memorandum ("PPM"), and completed, signed and returned an investor questionnaire and subscription agreement, which contained information sufficient to establish that the notes offered were suitable for that particular investor.[43]

From the perspective of investors, employees (including the brokers), and regulators, MS & Co. time and again succeeded in structuring alarm offerings. Of 64 private placement investments sold by Chiappone prior to the Four Funds and Trust Offerings, 61 such investments had paid all interest and principal to investors.[44] Based on this track record, Chiappone came to believe that the bankers and due diligence staff who located, structured and performed due diligence on these deals, knew what they were doing, and were capable of continuing to generate investments that provided above-average income and were not correlated to the stock markets. He reasonably relied on that track record in recommending new private placements to his clients.

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[38] Jerry Mirochnik, who testified for Mr. Chiappone, testified that he only bought private placements from Chiappone, but that he had marketable securities in other accounts with different brokers. Mirochnik testimony, Tr. pp. 3117.

[39] Chiappone testimony, Tr. p. 5438.

[40] Chiappone testimony, Tr. p. 5454.

[41] Chiappone testimony, Tr. pp. 5444 – 5445.

[42] Chiappone testimony, Tr. p. 5454.

[43] Chiappone testimony, Tr., pp. 5452.

[44] Chiappone testimony, Tr. pp. 5466 – 5467 (testimony that only 3 or 4 of the 64 pre-2003 offerings did not pay investors in full).

Not until after the SEC's investigation was completed, was it disclosed to Chiappone that most of the pre-2003 alarm offerings had been rescued when MS & Co. formed IASG, conducted a successful IPO and purchased most of the pre-2003 alarm notes. It was also not disclosed to Chiappone until recently that investors in notes not rolled into IASG were paid with proceeds of the Four Funds offerings.[45] The record is devoid of any evidence that Mr. Chiappone was ever aware of any infirmity in the finances of the pre-2003 alarm deals, until Ms. Palen testified to use of Four Funds proceeds to pay out pre-2003 investors.[46] All that Chiappone knew before Ms. Palen testified was that his clients had been paid back their invested funds, with interest, on time. No client ever called Mr. Chiappone to complain about late interest, lack of redemption or any other issue with the pre-2003 alarm deals.[47] He had no knowledge, nor any means to discover, that Four Funds proceeds was used to pay deficiencies owed to holders of some of the pre-2003 alarm deals.[48]

At some point in time, unbeknownst to investors, employees, and regulators, Smith, McGinn, and a small, tightly closed circle of their cohorts, began to misuse funds raised from investors in the Four Funds offerings and some of the Trust Offerings. Information that subsequently came to light establishes that McGinn and Smith had secretly used investor funds to pay (among other things) maturing notes of earlier investors with funds raised from later investors. This was never disclosed to Chiappone, but was established in a long, handwritten letter written by Smith (and apparently intended to be given to McGinn) sometime in late 1999 or early 2000.[49] Thus, while Chiappone had believed that the pre-2003 alarm deal offerings had consistently yielded

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[45] Exhibit Div-002 (¶¶ 24-50, pages -8-16).
[46] Testimony of Chiappone, Tr. pp.5466 – 5468.
[47] Chiappone testimony, Tr. pp. 5466 – 5467.
[48] Chiappone testimony, Tr. pp. 5467 – 5470.
[49] This document is colloquially known as the "Dave Smith Confession," Division Exhibit Livingston-31 (originally referenced in testimony as Livingston ex. 30). For testimony establishing the time frame of the undated document, see Chiappone testimony, Tr., pp. 5613 – 5615.

sufficient revenue to pay investors interest and principal, it now appears by 20-20 hindsight that such investors were secretly paid off by use of over $12 million of the funds invested in the Four Funds—something which was deliberately concealed from Chiappone, the other registered representatives and investors.

The fraud that was perpetrated without the knowledge or participation of Chiappone was shocking to all at the time of its discovery. MS & Co. had a compliance program that included a Supervisory Compliance Manual that addressed regulatory compliance matters,[50] and day-to-day supervision of registered representatives. MS & Co. had two compliance officers, including David Smith as the firm's Chief Compliance Officer.[51] It employed in-house counsel, utilized outside counsel as needed, had a Chief Financial Officer and an accounting staff. Smith and McGinn were able to perpetrate and conceal their criminal fraud for years from their own employees, as well as regulatory agencies charged with oversight of broker-dealers. This is primarily due to the fact that the most senior officers of the company (McGinn, Smith and Brian Shea-all of whom were convicted of serious crimes) conspired to hide the misuse of funds from stockbrokers and other employees. In these circumstances, it is submitted that there is no basis in the record for a finding that Chiappone should have known, or even that he could have discovered, any of the fraudulent acts committed by his superiors.

Distilled to its essence, the Division now alleges that Chiappone committed securities fraud because he failed to ferret out the various improper and criminal acts of his superiors. There has been absolutely no allegation, and certainly no proof, that Chiappone participated in the fraudulent misuse of customer monies, tax fraud and other illegal acts, benefited from such acts, or was even aware of such acts during the time he worked at MS & Co. Yet, in spite of the fact that the SEC

[50] See Division Exhibits DIV 329 (2008 Compliance Manual), and Guzzetti Ex. 2 (2007 Compliance Manual, received at Tr. 2996)

[51] Steven Smith (no relation to David Smith) also worked in compliance. Chiappone testimony, Tr., p. 5416.

failed to uncover any of the material aspects of the fraud in its' 2004 examination, and NASD failed to do so in its' 2006 and 2007 examinations, the Division argues that Mr. Chiappone should be severely punished for his inability to uncover a fraud that was actively and deliberately concealed by its perpetrators, for a period in excess of ten years.[52] Note that Ms. Palen, a CPA and certified fraud examiner, working with full access to MS & Co. financial records and accounting personnel, took over 2½ years to uncover and document the fraud that was perpetrated and concealed by McGinn, and Smith.[53] The Division's theory that the brokers should have uncovered the fraud while also servicing their clients, would place upon them an impossible burden.

C. Expert Opinions on Suitability:

The reports of Respondents' experts on suitability are similar in describing the nature and extent of an individual broker's obligations with respect to suitability of his recommendations. David Tilkin, who wrote reports for Mr. Chiappone as well as Rogers, Mayer and Rabinovich, noted that suitability is the foundation for building and maintaining an ethical investment relationship. It is at the heart of the relationship among firm, broker and client.[54] The central thesis of his report and his testimony was that the obligations of a broker regarding suitability, as they are taught, trained, tested and applied in actual practice, are different from the "duty to investigate" set forth in the *Hanly* case and subsequent decision relying on *Hanley*.[55] The following are excerpts from his report on that subject:

> "I believe there is a significant distinction between client/investment suitability and the concept of "duty to investigate" as it relates to the underlying investment recommendation. It must be noted that the principle of "duty to investigate" is not included as subject matter in the Series 7 Registered Representative Exam or Series 63 Uniform State Securities Exam. I have been unable to identify any industry resource that discusses or presents instruction or argument detailing a registered representative's "duty to investigate". There

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[52] As to the SEC and NASD examinations, see Exhibits Div-370, Div-341 & Div-501.

[53] Palen testimony, Tr. pp. 392 – 393. She testified that approximately 50% of her time was spend on this case during the 2½ - year period.

[54] Tilkin Report for Chiappone, at p.6, Exhibit FC-90 and RMR-350 (admitted at Tr. p. 4015).

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

is no doubt that if the SEC or FINRA believed that this was a core responsibility of a registered representative it would be the subject of a qualification exam, regulatory notice or firm compliance manual. The question that must be asked is how does any regulator expect a registered representative to be familiar with this concept if it is not taught, tested or trained?

There is no doubt that a registered representative *must be knowledgeable of the investment recommended* but the principle of "duty to investigate" is simply not part of the securities industry curriculum. It is subject matter that in my experience has not been discussed at an annual compliance meeting, licensing exam or continuing education curriculum. If this concept is so central to the responsibility of the registered representative why is the topic not advanced in the day-to-day operation of a broker-dealer similar to that of suitability? *The reality is that registered representatives are not hired to execute detailed due diligence on structured product such as was the subject of the McGinn Smith private placements. That is the function of the investment banking, legal and compliance staff. . . . Brokers . . . are not trained or tested on how to conduct a due diligence investigation.* The Securities and Exchange Commission has apparently attempted to alter what is in fact the working day-to-day reality of the brokerage environment and the defined expectations and requirements of the registered representative. It is my opinion that Frank Chiappone conducted reasonable suitability determinations measured even in the face of two principals that were secretly executing a precise and determined fraud." Exhibit FC-90, pp. 7-8 (emphasis supplied).[56]

For clarity, Mr. Chiappone acknowledges that the "duty to investigate" is a legal concept that governs brokers' conduct in certain circumstances. The point being made is that the broker has a duty to *understand* the features and risks of product he recommends; not that he personally must perform each step of the due diligence process on every security offered. Rather, the broker has a right to respect the division of labor inherent in all significant broker-dealer firms, unless special circumstances ("red flags") exist which call into question the adequacy of the information provided by the broker-dealer, either as to its veracity or completeness. Just what circumstances constitute a red flag that triggers the duty to investigate further are discussed in Legal Argument, Point III, below.

Similar opinions can be found in the report of Charles L. Bennett, who opines that the obligation of a broker is "to reasonably understand the securities being offered." He states he has never encountered a broker's duty of "searching inquiry" articulated by the Division in the OIP.[57]

[56] Similar language is found in Tilkin's report for RMR Respondents, Ex. RMR 350, pp. 5-7.
[57] Bennett Report for Respondent Lex, Exhibit LEX-147 & LEX-147A, pp.4-5, received in evidence at Tr. p. 4212.

D. The Four Funds Offerings:

Smith continued operating MS & Co. following McGinn's forming IASG. In September 2003, he structured the first of the Four Funds, First Independent Income Notes, LLC ("FIIN"). FIIN offered three tranches of debt investments: a senior note offering 5% interest and maturing in one year; a senior subordinated note offering 7.5% interest and maturing in five years; and a junior note offering 10.25% interest and maturing in five years.[58] The PPM was prepared by an outside law firm located in New York City that specialized in securities work. The PPM stated that the purpose of FIIN was "to identify and acquire various public and/or private investments, which may include, without limitation, debt securities, collateralized debt obligations, bonds, equity securities, trust preferreds, collateralized stock, convertible stock, bridge loans, leases, mortgages, equipment leases, securitized cash flow instruments, and any other investments that may add value to our portfolio." The same disclosure was in the other Four Funds PPM's. In addition to the written disclosure, Mr. Chiappone told his clients about the blind pool nature of the offerings.[59]

The FIIN PPM explained that "[t]he 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 FIIN PPM also listed a number of risk factors, including that "we will not be required to maintain any ratios of assets to debt in order to increase the likelihood of timely payments to you under the notes," that FIIN was a newly formed company with no historical financial information, and that if FIIN encountered insufficient cash flow, it may become necessary to pursue alternative strategies, *such as restructuring the notes*. Also disclosed were

[58] FIIN PPM, Division Exhibit No. Div-005.
[59] Chiappone testimony, Tr. pp. 5484 – 5485.

potential conflicts of interest, including the fact that FIIN would be managed by McGinn, Smith Advisors, LLC, a subsidiary of an affiliate of MS & Co., the placement agent.

After FIIN was offered and sales began, Smith structured three more similar investments, First Excelsior Income Notes, LLC ("FEIN"); First Advisory Income Notes, LLC ("FAIN"); and Third Albany Income Notes, LLC ("TAIN"). Each of FEIN, FAIN, and TAIN had similar offering terms and private placement memoranda to that of FIIN.[60]

Chiappone read the relevant provisions of the Four Funds' PPM's[61] and recommended them to clients for whom he determined such investments would be suitable. Surprisingly, he did not note that the Four Funds' PPM's, as contrasted to the pre-2003 offerings, were to be limited to accredited investors. He viewed the reference to Rule 506, the section of Reg. D that was used for most prior private placements he had sold, as allowing 35 unaccredited investors, which was the way that prior alarm offerings had been structured.[62] In general, his practice was to contact an existing client and inform the client of the availability of the investment, the nature of its terms, and the risks of the investment. Both Mr. Mirochnick and Ms. Sweet testified that Mr. Chiappone did advise them of the risks of these blind pool investments.[63] If a client expressed interest in a particular offering, Mr. Chiappone would arrange for a PPM to be sent to the client, along with the Investor Questionnaire and Subscription Agreement. If the client decided to purchase the investment, he or she would complete the Investor Questionnaire, execute the Subscription Agreement, and return both documents to the MS & Co. Albany office.

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[60] See, PPMs of FEIN, TAIN and FAIN, respectively Division Exhibits, Div-005, Div-006 & Div-009 and Div-012.
[61] Mr. Chiappone testified that he read the provisions of the PPMs that related to the nature of the offering, the risk factors and conflicts, but that he sometimes did not read other "boilerplate" aspects of the PPM's, as they were substantially identical to many prior PPMs that he had previously read. Chiappone testimony, Tr. pp. 5559 – 5560.
[62] Chiappone testimony, Tr., pp. 2704 – 2705.
[63] Mirochnik testimony, Tr. pp. 3116 – 3118, and Sweet testimony, Tr. pp. 5380 – 5381.

Upon receipt, Patricia Sicluna, operations manager in the Albany office, would provide the executed documents to Smith, the President and Chief Compliance Officer of MS & Co. Smith would review the documents and if he deemed it appropriate based on the information contained therein, he would execute the Subscription Agreement. The responsibility of tracking the number of unaccredited investors in any particular Fund was centralized in Patricia Sicluna and Smith. Chiappone was never advised by either Ms. Sicluna or Mr. Smith that the limit of 35 unaccredited investors was reached in any of the Four Funds offerings, although it was established at hearing that all of those offerings were sold to more than the allotted 35 unaccredited investors. Mr. Chiappone had no way of knowing the cumulative number of unaccredited investors in any offering, as there were numerous brokers located in different offices selling the same securities. While document control was centralized with Smith and Ms. Sicluna, it is apparent that Smith either failed to notice the total number of unaccredited purchasers or, more likely, ignored the overages. There was no testimony or documentary evidence that Smith, Sicluna or anyone else ever sent the brokers updates on the number of unaccredited investors on any deal at any time. Ms. Sicluna was never called to testify, so there is no way of knowing whether the excess of unaccredited investors over the limit was an oversight or intentional on the part of Smith.

E. <u>The Trust Offerings:</u>

In 2006, McGinn returned to MS & Co., and picked up where he left off: structuring and managing investments involving recurring monthly receivables. However, he expanded the scope of these investments beyond the alarm monitoring market and into the market for "triple play contracts", involving broadband Internet, cable TV, and telephone service. And, rather than purchasing the accounts receivable of individual subscribers, McGinn was now purchasing the accounts receivable of entire homeowners' associations and apartment complexes. These customers

were less likely to suffer from attrition and had lower administrative costs due to receiving one check each month from the homeowners' association or apartment complex, rather than potentially thousands of smaller checks from individual subscribers.

From 2006 through 2009, McGinn structured and managed several Trust Offerings in alarm receivables and triple play receivables, and also a couple of investments in the luxury cruise charter market. By and large, those investments timely paid interest and principal. By far the largest majority Chiappone's sales in the Trust Offerings occurred before September 23, 2008, which is the date that is five years before filing of the OIP. In fact, of the $12,678,000[64] in private placements sold by Chiappone and listed on Division Exhibit DIV-2 (Schedule 4c), only a *maximum* of $1,035,000 could have been sold within the period of limitations allowed by 28 U.S.C. § 2462. That figure included all monies listed on or after Sept. 23, 2008 on Ex. DIV-2 (Ex.4c). However, Ms. Palen testified that the dates on this exhibit were taken from the dates that funds were received by MS & Co., not the date on which the sale was made.[65] Mr. Chiappone testified that funds were commonly received several days or even weeks after the sale took place.[66] Thus, for example, removing the $375,000 of funds received in the last 8 days of September, 2008 (which may have been sold <u>before</u> September 23, 2008), the total of privates sold by Mr. Chiappone within the period of limitations would be only $640,000.

Mr. Chiappone's clients liked the Trust Offerings, as they viewed them as similar to the pre-2003 alarm deals which everyone (except McGinn, Smith and Shea) still believed had been successful deals.[67] Chiappone himself felt that MS & Co. was getting back into a business that it

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[64] The total shown on Ex. DIV-002 (Schedule 4c) is $13,572,000. However, per Mr. Chiappone's testimony (Tr., pp. 5391 – 5394, and Exhibit FC-74, several of the sales listed under his name were in fact sold by other brokers and transferred after sale to his ledger, and some "sales" were in fact not sales but rather re-registrations.

[65] Palen testimony, Tr. pp. 239 – 240.

[66] Chiappone testimony, Tr., p. 5589.

[67] As to Chiappone's lack of knowledge of any problems in the pre-2003 alarm deals, see Tr. pp. 5455 – 5456 & 5467 – 5470.

knew well and in which it had substantial experience.[68] After the Four Funds restructuring in January, 2008, he sold only Trust Offerings, as he felt these were safe and suitable. While MS & Co. ventured into the cruise deals after 2006, he was not comfortable with the business model, and did not sell tow of the cruise ship deals that McGinn created.

Until the FBI raided the offices of MS & Co. in March of 2010, Mr. Chiappone had no direct or indirect knowledge of any of the misconduct that is described in the OIP, in the Palen Report (Ex. Div-2), and in Ms. Palen's testimony.[69] This includes the use of investor funds to pay amounts owed to earlier investors in prior offerings, the loans of monies from one issuer to other MS & Co. affiliated issuers, the loan of funds to McGinn and Smith personally, the payment of commissions and fees in excess of the amounts described in the PPMs, the mis-characterization of income items as "loans," backdating of documents, and tax fraud. Indeed, there is no allegation in the OIP that Mr. Chiappone ever played any role in such conduct, or was even aware that the conduct occurred while he was still employed by MS & Co. No testimony was produced that indicated he was aware of any of these transactions. Rather, the gravamen of the Division's case is that he failed to cease selling MS & Co. private placements after the occurrence of certain other events, commonly referred to as "red flags." The facts relating to each particular event characterized by the Division as a red flag are set forth in Part III (Legal Argument), Point III (Chiappone's Conduct Regarding So-Called Red Flags).

[68] Chiappone Testimony, Tr. pp. 5448 – 5450.
[69] Palen testimony, Tr. pp. 394 – 420.

III. LEGAL ARGUMENT

POINT I

ANY REQUESTS FOR CIVIL FINES, PENALTIES, AND FORFEITURES, PECUNIARY OR OTHERWISE, ARE BARRED BY THE APPLICABLE STATUTE OF LIMITATIONS TO THE EXTENT THEY ARE BASED ON ACTIONS OR OMISSIONS OCCURRING PRIOR TO SEPTEMBER 23, 2008.

This proceeding may not be entertained because it seeks punitive sanctions for claims that first accrued more than five years before this proceeding was commenced. Even if this proceeding may be entertained, the proof considered in arriving at a decision should be limited to facts or transactions occurring on or after September 23, 2008.

A. This "Proceeding" May Not Be "Entertained" Because it Seeks Punitive Relief for Claims that "First Accrued" Prior to September 23, 2008.

This proceeding was commenced on September 23, 2013. Because this proceeding seeks civil fines, penalties, and forfeitures, pecuniary and otherwise, based upon claims that "first accrued" before September 23, 2008, it may not be "entertained".

28 U.S.C. § 2462 provides:

> Except as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any **civil fine, penalty, or forfeiture,** pecuniary or otherwise, ***shall not be entertained*** unless commenced within five years from the date when the claim ***first accrued*** if, within the same period, the offender or the property is found within the United States in order that proper service may be made thereon. 28 U.S.C. § 2462 (emphases added).

As noted by the Supreme Court in interpreting the applicability of this provision in the context of SEC enforcement proceedings, "[s]tatutes of limitations are intended to 'promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared.'" *Gabelli v. Secs. & Exch. Comm'n*, 133 S. Ct. 1216, 1221 (2013) (*quoting Railroad Telegraphers v. Railway Express Agency, Inc.,* 321 U.S. 342, 348–349, 64 S. Ct. 582 (1944)).

In *Gabelli*, the Supreme Court ruled that, in the context of an SEC enforcement proceeding brought in a district court, the five-year period begins to run immediately upon the commission of the alleged fraud, not when the alleged fraud is discovered by the SEC. *Gabelli, supra*, 133 S. Ct. at 1220–24. Section 2462 has also been held to apply to SEC administrative enforcement proceedings. *3M Company v. Browner*, 17 F.3d 1453, 305 U.S. App. D.C. 100 (D.C. Cir. 1994).

Moreover, despite any subjective labels that the SEC seeks to attach to this proceeding, the test for determining whether the proceeding seeks punitive sanctions (and is therefore subject to five year statute of limitations under § 2462) is an objective one. If, viewed objectively, the proceeding is aimed at punishing and labeling the Respondent as a wrongdoer; or would stigmatize the Respondent and destroy his career; or would temporarily or permanently strip him of the license necessary to continue his profession; then the proceeding is one seeking punitive relief and is subject to § 2462's five-year statute of limitations. *Gabelli, supra,* 133 S. Ct. at 1223; *Securities & Exch. Comm'n v. Bartek*, 484 Fed. Appx. 949, 957 (5th Cir. 2012); *Johnson v. Securities & Exch. Comm'n*, 87 F.3d 484, 488–89 (D.C. Cir. 1996).

The OIP purports to characterize the relief it seeks as "remedial". See OIP, Section III, ¶¶ B, C, D. But the provisions under which it seeks those so-called "remedial" actions are sections that are designed to punish wrongdoers, not to compensate victims of wrongdoing or to return victims to the *status quo ante*. The OIP seeks action against Respondents pursuant to several provisions of the '33 Act and the '34 Exchange Act, as to respondent Chiappone. Those sections authorize:

- censures (15 U.S.C. § 78o(b)(4), (b)(6));
- limitations on activities, operations and functions (15 U.S.C. § 78o(b)(4), (b)(6));
- suspensions (15 U.S.C. § 78o(b)(4), (b)(6));
- revocations of registration (15 U.S.C. § 78o(b)(4));

- bars on association with brokers, dealers, and investment advisers, among others (15 U.S.C. § 78o(b)(6));
- civil monetary penalties (15 U.S.C. § 77h-1(g) and 15 U.S.C. § 78u-(d)3(A).
- bans on serving as an officer or director of public companies (15 U.S.C. § 77h-1(f); 15 U.S.C. § 78u-3(f)); and

Here, such sanctions are not designed to remedy violations; they are punitive sanctions designed to punish and label Chiappone. *See, Gabelli, supra*, 133 S. Ct. at 1223; *Johnson v. SEC,* 87 F.3d 484, 488–89 (D.C. Cir. 1996); *SEC v. Jones*, 476 F. Supp. 2d 374, 381 (S.D.N.Y. 2007). In the *Johnson* decision, the D.C. Circuit, after analyzing the difference between a remedial sanction and a penalty, stated: "In sum we conclude that a 'penalty' as the term is used in § 2462, if a form of punishment imposed by the government for unlawful or proscribed conduct, which goes beyond remedying the damage caused to the harmed parties by the defendant's action." *Johnson v. SEC,* 87 F3d at 488.

The OIP clearly goes much further than merely seeking "remedial action,"; it seeks to strip Chiappone of his livelihood and stigmatize him as having played a role in an expansive Ponzi scheme that even regulators conducting examinations or audits of MS & Co. were unable to uncover during the relevant period. Stripping Chiappone of his livelihood and forever casting him as a foot soldier in Smith's and McGinn's closely guarded criminal fraud bears no rational relationship to remedying the harm that the Division alleges has been done to investors, nor to preventing harm in the future. As such, this proceeding is one that seeks punitive sanctions.

(1) This Tribunal Lacks Jurisdiction Over Claims Occurring More Than Five Years Before the OIP Was Filed.

Similar statutory language (i.e., "shall not be entertained . . . unless . . .") has been held to deprive the tribunal of subject matter jurisdiction over the proceeding altogether. Although factually

dissimilar and involving a criminal habeas corpus petition under 28 U.S.C. § 2255(e), the Tenth Circuit found that "although the district court did not expressly state that it was dismissing Mr. Abernathy's petition for lack of jurisdiction," the statutory language noted above effectively makes the dismissal based on lack of jurisdiction. *Abernathy v. Wandes,* 713 F.3d 538, 557-58 (10th Cir. 2013). *See also*, *Williams v. Warden*, 713 F.3d 1332, 1339 (11th Cir. 2013) ("A plain reading of the phrase "shall not entertain" yields the conclusion that Congress intended to, and unambiguously did strip the district court of the power to act -- that is, Congress stripped the court of subject-matter jurisdiction -- in these circumstances unless the savings clause applies.").

(2) <u>The SEC's Claims "First Accrued" Many Years Prior to OIP</u>

As the Supreme Court has recently made clear, there is no discovery rule that might otherwise toll the statute of limitations in an enforcement proceeding such as the present one, and a claim first accrues "when the plaintiff has a complete and present cause of action" (*Gabelli v. SEC,* 133 S. Ct. 1216, 1220 (2013). Thus, the five-year limitations clock begins on the date the action first accrues, regardless of when the government actually discovers the alleged misconduct. *Gabelli,* 133 S. Ct. at 1221 (citing Black's Law Dictionary 23 (9th ed. 2009) (defining "accrue" as "[to] come into existence as an enforceable claim or right"). *See also, SEC v. Bartek,* 484 Fed. Appx. 949, 955 (5th Cir. 2012). In doing so, the Court discussed the importance of the limitation on the government's time in which to bring its claims as "vital to the welfare of society," because even wrongdoers are entitled to a time limit upon which "their sins may be forgotten." *Gabelli,* 133 S. Ct at 1221. It found that any broader interpretation of Section 2462 would "leave defendants exposed to government enforcement action not only for five years after their misdeeds, but for an additional uncertain period into the future," and "would hinge on speculation about what the government knew, when it knew it and when it should have known it." <u>Id.</u> at 1223. *See also*, *U.S. v. Core Labs.,*

Inc., 759 F.2d 480, 483 (5th Cir. 1985) (Congress enacted §2462 in large part to ensure a defendant's "right to be free of stale claims, which comes in time to prevail over the right to prosecute them."); *3M Co. v. Browner*, 17 F.3d 1453, 1460-61 (D.C. Cir. 1994) ("An agency's failure to detect violations, for whatever reasons, does not avoid the problems of faded memories, lost witnesses, and discarded documents in penalty actions" brought long after discovery).

As to Mr. Chiappone, this "proceeding" is largely premised upon claims that "first accrued" prior to September 23, 2008. In particular, each of the Division's claims "first accrued" when they were fully chargeable as alleged violations of the relevant securities laws provisions. For the Division's claims relating to the alleged sale of unregistered securities, such claims "first accrued" upon the first sale of a Four Funds investment, which according to the Division, occurred for Chiappone on October 3, 2003, almost ten years before this proceeding was commenced.

For the Division's claims relating to the alleged failure to undertake an investigation of the complained-of investments before selling them to investors, those claims "first accrued" when Chiappone first sold such an investment (October 3, 2003 for Four Funds investments, and in November 2006 for the Trust Offerings), which was almost ten years and seven years, respectively, before this proceeding was commenced.

With respect to the Division's claims that after Respondents learned about the alleged "Redemption Policy", Chiappone continued to sell MS & Co. investments without conducting an independent investigation, such claims "first accrued" on November 15, 2007, the sale of the first investment after Chiappone allegedly learned of the "Redemption Policy", almost six years before this proceeding was commenced. Even if the Division relies upon the date on which it claims that Respondents learned that the Four Funds had been mismanaged (January 8, 2008), such a claim

"first accrued" upon Mr. Chiappone's first sale of any private placement[70] thereafter, which according to the Division, occurred on January 10, 2008. Even at that late date, this proceeding was required to be commenced on or before January 10, 2013. But rather than timely commence this proceeding despite having investigated this matter and Respondents for several years, the Division waited until September 23, 2013 to commence this proceeding.

While a small number of sales (of the Trust Offerings only) occurred between October of 2008 and June 5, 2009, it is illogical to contend that these impact the accrual date of claims based on Chiappone's Trust Offering sales because the claims could not "come into existence" more than once and thus cannot be based on the subsequent sales. *See, e.g., SEC v. Jones,* 2006 U.S. Dist. LEXIS 22800 at *12 (S.D.N.Y. April 25, 2006) (rejecting the SEC's attempts to label each alleged violation -- collections of allegedly excessive fees -- as a new breach by the defendants).

(3) Statutory Civil Penalties are Barred by Section 2462.

The imposition of civil penalties sought by the SEC under 15 U.S.C. § 77h-1(g), 15 U.S.C. § 78u-2(a), 15 U.S.C. § 80a-9(d), and 15 U.S.C. § 80b-3(i)) are within the scope of Section 2462. *See, Zacharias v. SEC,* 569 F.3d 458, 471 (D.C. Cir. 2009) (citing *3M Co. v. Browner,* 17 F.3d 1453, 1456-58 (D.C. Cir. 1994). In *SEC v. Jones,* the Southern District of New York stated without equivocation that the SEC's claim "for civil monetary penalties" was "unquestionably a penalty" under section 2462. *SEC v. Jones,* 476 F. Supp 2d 374, 381 (S.D.N.Y. 2007). In *SEC v. Gabelli,*[71] the Supreme Court, addressing only the claim for civil penalties, held that the claim was barred by 28 U.S.C. § 2462, rejecting the SEC's argument that a discovery rule should toll or extend the 5-year statute. The Court noted that civil penalties go beyond compensation and are intended to

[70] As is noted in detail below, Mr. Chiappone vehemently contends that the restructuring of the Four Funds in no way constitutes a "red flag" (if at all) as to any private placements other than the Four Funds offerings.
[71] *Gabelli vs. SEC,* 133 S. Ct. 1216, 1220-23.

punish and label the defendants as wrongdoers,[72] thereby effectively confirming the theory under which *Jones* was decided.

(4) **A Permanent Injunction/Industry Bar Constitutes A Penalty or Forfeiture Under Section 2462.**

Numerous decisions, involving the SEC and other government agencies, have determined that the imposition of a permanent injunction or industry bar constitutes a "penalty" or "forfeiture" and thus subject to the 5-year time bar under section 2462. This is because it is well established that the limitations under Section 2462 apply to any claim that seeks to punish the offender, rather than merely to provide a private remedy to those injured by the wrong. *See, e.g., Johnson v. SEC,* *87* F.3d 484, 488 (D.C. Cir. 1996). As the D.C. Circuit explained in the landmark *Johnson* decision, "where a legal action is essentially private in nature, seeking only compensation for the damages suffered, it is not an action for a penalty." But where a sanction has "collateral consequences" beyond the immediate sanction, and is based mostly upon past conduct rather than a current "risk [that the defendant] poses to the public," the sanction is a "penalty" subject to section 2462. Id. at 488-90. Applying this rationale, a censure and six-month suspension were found to constitute a "penalty" under section 2462 because the suspension had "longer-lasting repercussions on [the manager's] ability to pursue her vocation," and because "the sanctions ... were not based on any general finding of [the defendant's] unfitness as a supervisor, nor any showing of risk she posed to the public, but rather on [her past acts]." Id. Numerous courts have followed the *Johnson* two-prong test, finding a sanction is a "penalty" within the meaning of Section 2462 if it: (1) has "collateral consequences" beyond merely remedying a wrong, and (2) is based mostly on the defendant's past misconduct rather than a risk of future violations.

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[72] *Gabelli,* 133 S.Ct. at 1223.

Cases involving the SEC in which a permanent injunction was found to be subject to the time limits of section 2462 include *SEC v. Bartek,* 484 Fed. Appx. 949 (5th Cir. 2012) (permanent injunction and officer & director bar constitute "penalties" under section 2462); *SEC v. Microtune,* 783 F. Supp 2d 867, 885-86 (N.D. Tex. 2011) (injunctive relief, officer and director bars were penalties under section 2462); *SEC v. DiBella,* 409 F. Supp. 2d 122, 128 n.3 (D. Conn. 2006) (officer and director bar is a "penalty"); *SEC v. Jones,* 476 F. Supp. 2d 374, 381 (S.D.N.Y. 2007) (permanent injunction prohibiting defendants from committing future violations of securities laws determined to be a penalty and subject to section 2462); and *SEC v. Power,* 525 F. Supp.2d 415, 427 (S.D.N.Y. 2007) (whether permanent injunction constitutes a "penalty" under section 2462 depends upon likelihood of recurrence).

Most instructive is *SEC v. Johnson,*[73] where the D.C. Circuit found that even a sanction as light as censure and a six-month bar was a "penalty" and therefore subject to the constraints of section 2462.

While acknowledging that the test for whether a sanction is sufficiently punitive to constitute a "penalty" within the meaning of § 2462 is an objective one, the court further noted that "the degree and extent of the consequences *to the subject of the sanction* must be considered as a relevant factor in determining whether the sanction is a penalty." (Id., 87 F.3d at 488). Applying that test, the court found the sanctions to be a penalty, in language that applies to the even more dire sanctions sought by the SEC in this proceeding:

> "The SEC not only restricted Johnson's ability to earn a living as a supervisor during her six-month suspension, but the suspension was also likely to have longer-lasting repercussions on her ability to pursue her vocation. Suspended brokers must forever after disclose the sanction, and it becomes part of their permanent public file.
>
> . . .
>
> Congress has also required securities associations such as the National Association of Securities Dealers to set up a toll-free number for investors and other members of the public

[73] *SEC v. Johnson,* 87 F.3d 484 (D.C. Cir. 1996).

to check whether brokers or other brokerage employees have been subject to disciplinary actions." (Id., 87 F.3d at 488-89).

The court further dismissed the SEC's argument that the history and common understanding of such professional sanctions have always been associated with continued regulation and remedial purposes, not punishment, noting "[t]o the contrary, there is substantial evidence that Congress and the courts have long considered the suspension or revocation of a professional license as a penalty." (Id., 87 F.3d at 489 n. 6). One significant factor that was present in the court's decision not to impose suspension upon Ms. Johnson was that, like Mr. Chiappone, she was not the primary actor, but rather had failed to detect a fraud perpetrated by a broker she was tasked to supervise.[74] Note the reversal of facts in *Johnson* vs the present matter. Johnson, a supervisor, was found not to have deserved suspension even though she had supervisory authority over the broker who actually perpetrated the fraud. In the present matter, Chiappone was the broker, who had no supervisory duties, and who merely failed to detect a fraud that the SEC, the NASD and all other MS & Co. personnel failed to detect for a period of at least 10 years. Accordingly, *Johnson* should apply all the more to a subordinate like Chiappone, as compared to a supervisor.

In the *Power* case, the district court, while noting the precedent in the Second Circuit for granting injunctive relief, stated:

> "Whether a permanent injunction constitutes a "penalty" under section 2462 depends on the likelihood of recurrence. In Jones II, the court stated that 'the Second Circuit demands that the Commission 'go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence.
>
> . . .
>
> In determining whether there is a reasonable likelihood of future violations, a district court may also consider: (1) the egregiousness of the violation; (2) the degree of scienter; (3) the isolated or repeated nature of the violations; and (4) the sincerity of defendant's assurances against future violations." (*SEC v. Power*, 525 F. Supp.2d at 427 (S.D.N.Y. 2007)[75]

[74] *Johnson v. SEC,* 87 F.3d at 489-490.

[75] After stating the nature of the test for determining whether injunctive relief is subject to §2462, the court did not make a merits determination on the facts, as the matter before the court was defendant's motion to dismiss, and the

Similarly, courts have applied § 2462 in matters involving other regulatory agencies. *See, e.g., Proffitt v. Federal Deposit Ins. Corp.,* 200 F.3d 855, 860-62 (D.C. Cir. 2000) (attempt to remove a bank director and bar him from the banking industry was punitive). *See also, Federal Election Comm. V. Nat'l Right to Work Comm.,* 916 F. Supp 10, 14-15 (D.C. Dist. Columbia 1996), wherein the court refused to issue an injunction requested by the Federal Election Commission, where § 2462 had been held to bar the imposition of a civil penalty. The court noted that "when legal and equitable relief are available concurrently, 'equity will withhold its relief ... where the applicable statute of limitations would bar the concurrent legal remedy'" (quoting from *Cope v. Anderson,* 331 U.S. 461, 464, 67 S. Ct. 1340 (1947)).

The Division has relied on *SEC v. Quinlan*[76] for its argument that its request for a permanent injunction against Mr. Chiappone is not considered a penalty under § 2642.[77] The *Quinlan* case does not so hold. Rather, the *Quinlan* court noted that *some* courts have so held, citing *SEC v. Kelly,* 663 F. Supp.2d 276, 286 (S.D.N.Y. 2009) and *Zacharias v. SEC,* 569 F.3d 458, 473 (D.C. Cir. 2009). However, the court also noted that other courts have engaged in a fact-intensive inquiry to determine whether the equitable remedies sought in a particular case are remedial or punitive, citing *Johnson v. SEC, supra,* and *SEC v. Alexander,* 248 F.R.D. 108, 115 (E.D.N.Y. 2007). The *Quinlan* court found that this was the better approach, and noted that the trial court had in fact applied this fact-specific test (as identified in *SEC v. Commonwealth Chem. Secs.), Inc.,*[78], and that

court found that the SEC had *alleged* facts sufficient to create a triable issue as to whether the relief requested was remedial or punitive.

[76] *SEC v. Quinlan,* 373 Fed. Appx. 581 (6th Cir. 2010).

[77] Division's response to Respondents' motion for more definite statement, p. 11, n.5.

[78] 574 F.2d 90,99 (2d. Cir. 1998). The court, in noting that injunctive relief should not be granted without positive proof of a reasonable likelihood that past wrong-doing will recur, cited several second circuit cases, including: *SEC v. Bausch & Lomb, Inc.,* 565 F.2d 8 (2d Cir. 1977); *SEC v. Parklane Hosiery,* 558 F.2d 1083 (2d Cir. 1977); and *SEC v. Universal Major Industries,* 546 F2d. 1044 (2d Cir. 1976).

its examination of the facts led it to believe that there was a strong likelihood of recurrence.[79] *See also*, *SEC v. Leslie,* 2008 U.S. Dist. LEXIS 69540 (*10-11), in which the N.D. of California opined that the case-specific inquiry into whether an industry bar is remedial or punitive in nature is the wiser approach.

The factors to be taken into account in determining whether to grant injunctive relief (degree of scienter involved, sincerity of defendant's assurances against future violations, likelihood of future violations), as set out by the Second Circuit in its decisions in *SEC v. Manor Nursing Centers* and the Southern District of New York in *SEC v. Drexel Burnham Lambert, Inc.,*[80] would logically be the same factors used to determine whether, in any particular case, the injunctive relief sought was punitive or remedial.

Thus, even if this tribunal applies the fact-specific examination suggested in *Quinlan* and applied in *Commonwealth Chem. Secs., Inc.,* the inevitable conclusion is that section 2462 applies as to Mr. Chiappone. The likelihood of recurrence is nil, since (i) Mr. Chiappone has been conducting his brokerage practice in excess of four years after he left MS & Co., without ever having sold a private placement (much less a proprietary private placement), and (ii) he has testified at the hearing that his current practice is geared towards investment advisory (vs. commission-driven) services, that he focuses on retirement and long term care planning, and that he focuses on products issued by well-known insurance companies. For a more detailed discussion of the requirement that the SEC establish facts supporting a reasonably likelihood of recurring violations, see Point IV, below.

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[79] *See, SEC v. Quinlan,* 373 Fed. Appx. at 587-88.

[80] *SEC v. Manor Nursing Centers, Inc.,* 458 F2d 1082, 1100 (2d Cir. 1972), and *SEC v. Drexel Burnham Lambert, Inc.,* 837 F. Supp 587 (S.D.N.Y. 1993).

(5) **Disgorgement Should Likewise be Subject to Section 2462.**

The Division claims that case law supports its' position that disgorgement is not subject to the 5-year limitation of 28 USC § 2462[81] citing *SEC v. Power*, 525 F. Supp.2d 415,426 (S.D.N.Y. 2007) and two non-reported decisions.[82] The *Power* case has little precedential value, as it merely refused to dismiss a complaint requesting civil monetary penalties. The facts are not similar, as *Power* involved a corporate officer falsifying accounting records in several instances. Aside from the factual difference, the court did not hold that civil penalties were exempt from the statute, it merely noted that some cases have so held, and stated that "The primary consideration when determining whether a claim seeks a 'penalty' to which Section 2462 applies is whether the remedy at issue is 'punitive' or 'remedial' in nature." *Power,* 525 F.Supp2d at 426. As noted below, in the present case, the disgorgement looks more like a penalty than a remedial measure.

In *Riordan v. SEC,* the District of Columbia Circuit held that, in the facts of that case, disgorgement of commissions earned by a stockbroker (who paid bribes to get government business) was not subject to 28 USC § 2462. However, it noted that an argument can be made 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). It noted that, in this case, the commissions would be returned to the governmental unit that was the subject of the bribe. The *Riordan* panel also cited to *Zacharias v. SEC,* another D.C. Circuit case that held that disgorgement of profits from fraudulent sales of stock was not punitive, as it was intended to primarily prevent

[81] Division Post-Hearing Brief, at p. 38 – 39.

[82] The other two decisions are *Matter of Trautman, No.3-12559, 2009 WL 6761741* and *Matter of Warwick Capital Mgt., Inc.,* No3-12357, 2007 WL 505772.

unjust enrichment.[83] It did note though, the "a disgorgement order might amount to a penalty if it was not 'causally related to the wrongdoing' at issue." *Riordan,* 569 F3d at 472. The *Zacharias* court also noted that, while the SEC need not calculate disgorgement precisely, it must "be a reasonable approximation of the profits causally connected to the violation." *Zacharias, 569 F3d at 473.*

In the present case, there exists a disconnect between the disgorgement sought (commissions ranging back to October, 2003), and the claimed "wrongdoing." That is, the Division contends that the respondents' duty to inquire arose from certain "red flags." The earliest "red flag" that could possibly give rise to concern on Chiappone's part was the November 15, 2007 email regarding a client's redemption of a note. Thus, to seek disgorgement of commissions earned on transactions before that date completely lacks any connection between the disgorgement and alleged wrongdoing.

In fact, the SEC has contended that a disgorgement obligation constitutes "a fine, penalty, or forfeiture" under another federal statute, which position was accepted by the court. *See, In re Telsey,* 144 B.R. 563, 1992 Bankr. LEXIS 1411 (Bankr. S.D. Fla 1992). In that case, *Tesly*, a broker violated a bar that prohibited him from affiliating with a broker or dealer, and the SEC sought to compel him to disgorge to the U.S. Treasury commissions earned during the period of his violation. He sought protection in bankruptcy. The SEC contended that disgorgement was sufficiently penal to characterize the debt as a "fine, penalty, or forfeiture" under 11 U.S. C. § 523(a)(7), and therefore exempt from bankruptcy discharge. It was acknowledged by both parties that the disgorgement was payable to a governmental unit and not as compensation for actual pecuniary loss. Finding that the primary purpose of the disgorgement was deterrence, the court

[83] *Zacharias v. SEC,* 569 F3d 458 (D.C. Cir. 2009). While *Zacharias* involved a stockbroker and two individuals who sold stock, the court's explanation of the remedial nature of disgorgement of ill-gotten profits was addressed to the two defendants who sold their stock, not to the broker.

held it penal in nature. *Tesley*, 144 B.R. at 565. Now, because it suits its interests to argue otherwise, the Division disregards *Tesley,* and seeks to have this tribunal take a position opposite to that which it advanced in *Tesley.* There has been no indication whatever that the disgorgement sought by the Division is intended to be distributed to the respondents' customers. The D. C. Circuit in *Johnson* noted that the SEC's position on disgorgement varies according to what seems to favor the agency, stating:

> "The SEC's own position on what constitutes a penalty appears to vary with the context. In *SEC v. Telsey* (citation omitted) the court agreed with the SEC that disgorgement orders are not dischargeable in bankruptcy because they have a deterrent purpose and thus are a 'fine, penalty or forfeiture.' The SEC never explains why the position it took in that case should not apply here as well." *Johnson v. SEC*, 87 F.3d at 491, fn. 10.

Some cases finding that disgorgement to the SEC is remedial in nature and not punitive, appear to be distinguishable. See, e.g., *SEC v. Bilzerian*, 29 F.3d 689 (D.C. Cir. 1994); and *SEC v. Lorin*, 869 F. Supp. 1117, 1122-23 (S.D.N.Y. 1994). In those cases, the amount disgorged was not commissions on brokered sales, but rather the actual illegal purchase of securities (manipulation in *Lorin* and failure to disclose purchases under §13(d)(1) of Exchange Act in *Bilzerian*). These cases are distinguishable from the present case, in which the disgorgement does not relate to the amount of customer losses, but rather seeks forfeiture of commissions earned from all sales made since October, 2003, which bears no relationship to the alleged wrongdoing that the Division claims Mr. Chiappone engaged in. The attempt to recover commissions relating back to October, 2003 could hardly be deemed remedial in nature.

In conclusion, because this "proceeding" seeks punitive sanctions based on claims that "first accrued" before September 23, 2008, it should not be "entertained" as to commissions on sales occurring prior to September 23, 2008. This includes commissions on all sales of the Four Funds, and the vast majority of commissions on the Trust Offerings. The total dollar value of the Trust

Offerings sold after 9/23/2008 is $985,000, on which commissions would be in the range of $ 25,905.[84]

B. Even if this Proceeding May be Entertained, the Court's Decisions on Liability and Sanctions Must be Limited to and Based Solely Upon Facts and Transactions Occurring on or after September 23, 2008.

Even if the Commission determines that this proceeding may be entertained, the proof on which the Division may rely in seeking punitive sanctions must be strictly limited to proof of facts and transactions occurring after September 23, 2008.

The Division now seeks extreme punitive sanctions, including a lifetime bar from the securities industry, against Chiappone, but it does so by poisoning the well with grossly inflated allegations of conduct and omissions that occurred long before September 23, 2008, which as a matter of law cannot be the premise for any such penalties. Because this statutorily-barred evidence has been admitted in the record and heard by the sole trier of both facts and law, the entire proceeding and any penalties or other sanctions arising from it are incurably tainted, and the proceeding should be dismissed with prejudice.

For example, the OIP includes accusations that "Respondents sold the Four Funds to unaccredited investors". OIP, ¶ 27. But according to the SEC's records, Chiappone did not sell a single Four Funds investment to *anyone* on or after September 23, 2008.[85]

Likewise, the Division's OIP alleges that Respondents "performed inadequate due diligence prior to recommending the Four Funds to their customers". OIP, ¶ 38. The Division alleges that "[f]rom the commencement of the FIIN offering in September 2003 until January 2008, Smith . . . steadfastly refused to give the brokers any meaningful information about how he had invested the Four Funds offering proceeds", a "refusal that should have prompted the brokers to further question

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[84] In general, commissions (net to the broker) on trust offerings averaged 2.63% of the amount of the sale.
[85] Exhibit Div-2 [Palen Ex. 4c].

the propriety of the Four Funds." OIP, ¶ 40. Even the Division's claimed "smoking gun"—what it has coined the "Redemption Policy"—had necessarily ended by January, 2008, when Smith explained to Respondents that he was going to be restructuring the Four Funds investments. But since Chiappone did not sell even a single Four Funds investment to anyone on or after September 23, 2008, a breach of a duty to perform due diligence prior to recommending the Four Funds investment simply could not have occurred on or after September 23, 2008. Despite these undisputed facts, the Division presented prejudicial evidence relating to the Four Funds investments.

Rather than presenting an accurate picture of Chiappone's actual sales during the relevant five-year period and tailoring its request for relief to allegations that are within the statute of limitations, the Division seeks the death penalty for Chiappone's career, and in furtherance thereof, indiscriminately lumps all sales together, regardless of their timing. According to the Division's own exhibit on Chiappone sales, almost 92% of Chiappone's sales from October, 2003 – November 2009 were made before September 23, 2008, beyond the statute of limitations under 28 U.S.C. § 2462. Stated another way, only 8.16% (by dollar value) of his sales occurred during a time period when the statute had not yet run. See, Exhibit Div-002. Pp. 57 – 67 [Palen Ex. 4c]).[86] ***Thus, the Division's OIP exaggerates its case against Chiappone, in terms of sales dollars, by over 1200%.***

The Division's attempt to justify its case for punitive sanctions against Mr. Chiappone by introducing evidence of pre-September 23, 2008 transactions greatly prejudices him. The Court is left with the impression that all of such sales were tainted by misconduct. Also, even under the Division's view of the facts, the earliest purported red flag claim against Mr. Chiappone occurred on November 15, 2007 (the email concerning the $45,000 redemption), so all sales prior to that date

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[86] The following is a calculation of the percentages noted in the text, above. Chiappone's total sales (as corrected for sales erroneously posted to his account per Ex. FC-74) = $12,678,000. Sales after September 23, 2008 = $1,035,000. Percent of sales made within period of limitations = $1,035,000 / $12,678,000 = .0816 or 8.16%.

could not have been the subject of any "duty to investigate." Thus, 83.8% of the sales put into evidence by the Division occurred before the earliest alleged red flag posited by the Division as to Mr. Chiappone! Alternatively, only 16.2% of his sales have any relevance to these proceedings if the November 15, 2007 emails are found to constitute a red flag.[87] Finally, it must be noted that the Division presented no evidence as to how many of Chiappone's customers were redeemed in whole or in part on their investments, leaving the impression that the sales figures represent total losses to each investor, again exaggerating the impact of failed investments. Accordingly, if the Commission determines that this proceeding is not barred in its entirety by the five-year statute of limitations, at a minimum, it must make its determinations based only on evidence of events occurring and losses suffered on or after September 23, 2008.

C. The Admission into Evidence of Acts and Transactions Occurring Beyond the Statute of Limitations Constitutes a Fundamental Denial of the Right to a Fair Trial and Due Process and Should be Dismissed in its Entirety With Prejudice.

The vast bulk of the Division's case consists of transactions and evidence that predate September 23, 2008, evidence that is beyond the five-year statute of limitations and therefore cannot be used as a basis either to establish liability or to fashion any sanctions. Because so much of the evidence that was presented at the hearing was beyond the limitations period, it is unusable and irrelevant for any purpose. Its very presentation to the Court has so tainted the proceeding as to amount to a denial of the right to a fair and impartial trial and of substantive due process. Mr. Chiappone has been severely prejudiced by the presentation of the legally improper and inadmissible evidence. The presentation of the improper evidence cannot be effectively reversed after the fact, nor can it by "unheard" by the ALJ entrusted with the decision-making as to both liability and sanctions. Federal Rules of Evidence, Rule 403 provides for the exclusion of evidence

[87] The math behind these percentages follows. All figures are taken from Exhibit Div-002 [Palen Ex. 4c]. Total adjusted sales from Oct. 2003 – Nov. 2007 = $12,678,000. Sales made <u>after</u> Nov. 15, 2007 = $2,060,000. Percentage of sales made after first alleged red flag = 2,060,000 / 12,678,000 = 0.1624 0r 16.2%.

"if its probative value is substantially outweighed by a danger of . . . unfair prejudice, confusing the issues [or] misleading the jury." Accordingly, Respondent Chiappone requests dismissal of the entire proceeding with prejudice.

POINT II

CHIAPPONE DID NOT VIOLATE SECTION 17(a) OF THE SECURITIES ACT, SECTION 10(b) OF THE EXCHANGE ACT, OR RULE 10b-5.

The OIP alleges that Respondents "willfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, by knowingly or recklessly, or negligently, failing to perform reasonable due diligence to form a reasonable basis for their recommendations to customers, and made misrepresentations and omissions in recommending the Four Funds and Trust Offerings." However, the Division's case in this regard is a classic case of "fraud by hindsight." *See, Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000)(there are limits to the scope of liability for failure to adequately monitor the allegedly fraudulent behavior of others).

A. Requirements of Brokers Under '33 Act §17(a) & 34 Act §10(b) and Rule 10b-5.

Section 17(a) of the '33 Act and '34 Exchange Act §10(b) and Rule 10b-5 provisions are based in concepts of fraud. Section 17(a) of the '33 Act prohibits the following conduct:

"(1) to employ any device, scheme or artifice to defraud, or
(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
(3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser." ('33 Act §17(a), 15 U.S.C. § 77q(a).

To establish a violation of §10(b) and Rule 10b-5[88], the SEC must show that the defendant:

[88] The elements of a cause of action and the requirement of scienter would likewise apply to a fraud-based claim brought under section 17(a) of the '33 Securities Act.

> "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 F3d 295, 308 (2d Cir. 1999); *SEC v. Platinum Inv. Corp.,* 2006 U.S. Dist. Lexis 67460 (SDNY 2006); *SEC v. Milan Capital Group, Inc.,* 2000 U.S. Dist. Lexis 16204 (SDNY 2000). '34 Act § 10(b), 15 U.S.C. § 78j(b).

The elements of a securities fraud claim under the above statutory provisions have not been established by the Division. In particular, there was no proof whatsoever (much less proof of acts within the five-year limitation period) that he "employed any device, scheme or artifice to defraud," or that he "made any untrue statement of a material fact" ('33 Act §17(a)(1) & (2)) nor that he "made a material misrepresentation ('34 Act, § 10(b)). Rather, all representations as to the private placement offerings were made by MS & Co., in writing via the PPM's. And, there was no proof that Mr. Chiappone acted with scienter, in that he knew of, or recklessly disregarded, material misrepresentations or omissions in those PPMs.

The Division's claims against Chiappone are not based not upon affirmative untruths or intentional non-disclosures. Instead, the fraud based claims are anchored in the broker's "duty to inquire." A number of cases do hold that when a broker makes a recommendation, it is an implied representation that there is an adequate basis for the recommendation (*Hanly v. SEC*, 415 F2d 589, 597 (2d Cir 1969); *SEC v. Milan Capital Group,* 2000 U.S. Dist. Lexis 16204 (SDNY 2000), *SEC v. Hasho*, 784 F Supp 1059 (SDNY 1992)). Hanly holds that brokers are under a duty to investigate and a broker cannot ignore that which he has a duty to know and recklessly state facts about matters on which he has no knowledge. He has to read available sales literature and cannot blindly accept recommendations made in sales literature *if he has reason to know otherwise*. In making a recommendation, a registered representative implies that a reasonable investigation has been made and his recommendation relies on that investigation. Registered representatives cannot avoid their

duty to investigate by relying solely on information provided by their employer or the issuer. See, *Walker v. SEC*, 383 F2d 344 (2d Cir 1967); *Berko v. SEC*, 316 F2d 137, 142 (2d Cir. 1964); *Hanley v. SEC, supra; SEC v. Milan Capital Group, supra; SEC v. Hasho, supra*. However, even a failure to inquire does not rise to the level of fraud under the securities laws, without a showing of knowledge or recklessness.

Mr. Chiappone fulfilled his duty to inquire by independently reviewing and analyzing the terms and risks of the various investments and by making his own individualized assessments of the suitability of the investments for each client. He read the relevant portions of the private placement memorandums, attended meetings at which the MS & Co. due diligence team explained each offering, asked questions when he wanted additional information, and personally conducted calculations on debt service coverage.[89] The due diligence on the viability of each product offering for the Trust Offerings (reasonable basis due diligence) was done by the due diligence team at MS & Co, as was testified to in great detail by Mary Ann Cody, in-house legal counsel.[90] As previously noted MS & Co. had a first-rate due diligence team that vetted the pre-2003 alarm deals. That team returned to MS & Co. in 2006, and conducted similar diligence on the alarm and triple play deals offered from late 2006 through 2009.

Mr. Chiappone did his own customer-specific due diligence in compliance with NYSE Rule 405,[91] the details of which are laid out in the Statement of Facts. Based on the collective efforts of the MS & Co. due diligence team and his own work, Mr. Chiappone had a reasonable basis on which to recommend the investments to a select group of his clients for which he determined the investment would be suitable.

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[89] Chiappone testimony, Tr. pp. 5559 – 5560 (as to reading PPM's); 5479 – 5481 (as to debt service calculations); and Tr. pp. 5426 – 5427 (as to attendance at due diligence presentations).
[90] Cody testimony, Tr. pp. 4545 – 4552.
[91] Chiappone testimony, Tr. pp. 5432 – 5435.

With respect to the Four Funds, due diligence on the investments to be made in the future could not be performed by any of the brokers, as the investments were not known in advance. This fact was disclosed in the PPM's of the Four Funds, and Mr. Chiappone explained this to his clients. Mr. Chiappone did make a determination that the interest rates promised to the Four Funds investors could be met if investments were wisely selected, as interest available on obligations from borrowers who were unrated were higher than the rates promised on the Four Funds notes. He also felt that Smith's experience with the Empire State College endowment fund, and his work in structuring private funding for medical facilities, the Saratoga City Center and a local hospital would qualify Smith to select and manage investments in the Four Funds.[92] Finally, Mr. Chiappone was aware that Smith had, for over 20 years, advised and selected marketable securities for his own "book of business" and that this experience would certainly apply to the selection of marketable securities for the Four Funds, which was one category of investments referenced in the PPM's.[93]

B. Cases on "Duty to Investigate" are Distinguishable.

(i) The Hanly Decision. The duty of a registered representative does not require the representative to duplicate due diligence that has already been performed by brokerage firm on the underlying investments of any offering, as the Division is alleging in this proceeding. Instead, the applicable standard as set forth in *Hanly v. Securities & Exchange Commission* is as follows:

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

[92] Chiappone testimony, Tr. p. 5463 (as to Empire State College investments) and Tr. pp. 5463 – 5465 as to non-marketable investments.
[93] Chiappone testimony, Tr. pp. 5465.

This holding requires that a reasonable investigation has been made; it does not state that individual brokers must perform every step in the due diligence process personally. In a typical broker-dealer firm, the due diligence on securities being offered is done by the securities analysts, not the brokers. In the case of the MS & Co. private placements, the due diligence was assigned to the firm, which employed a substantial due diligence team. This was set out in the 2007 and 2008 Compliance Manuals introduced into evidence:

> Due Diligence Procedures. When McGinn Smith acts as underwriter in connection with limited partnership and/or private placement offerings, *it will make a reasonable investigation of the project* to include inspection of completed projects, conversations with –n-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."[94]

The factual context of *Hanly* is critical in understanding the scope of a broker's duty. It is submitted that the facts in Hanly are markedly different from those in this proceeding. First, *Hanly* involved equity securities in an unseasoned high tech company. This matter involves a series of fixed income (debt) offerings made by issuers that were technically different entities, but were in fact run by the same management team, which was seasoned in such offerings, and had a track record that (at the time of the offerings) was thought to be exemplary.[95] In *Hanly*, the representatives made a number of affirmative statements guaranteeing the meteoric success of an over-the-counter stock they were selling, despite knowing that "[f]rom its inception the company operated at a deficit," potential merger negotiations with two major companies had failed, the US Navy had cancelled orders, and the company had been adjudicated a bankrupt.[96] Critically, despite knowing about those past failures, the representatives nonetheless made affirmative statements of

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

[95] Chiappone testimony, Tr. pp. 5466 (as to reliance on MS & Co. track record).

[96] Hanly, 415 F2d at 592-593.

sure success, such as claiming that the stock price "would go from 6 to 12 [dollars per share] in two weeks."[97] The guarantee of immediate success was premised exclusively on speculation that one particular product developed by the company would change the company's financial future. However, at the same time those reps were promoting the stock based on the allegedly revolutionary product, the company's negotiations in producing, distributing, and licensing the product were failing, as was the product itself in testing being performed by prospective customers. In that factual context, the *Hanly* court determined that the representatives—who had no knowledge of the company having ever had any success, had virtually no familiarity with the company's management, had no history of earnings (in fact, it had incurred known losses) on which to base any predictions of success, and had nothing other than pure speculation on which to base their promises of meteoric success—had acted recklessly by failing to investigate the merits of the investment before recommending it.

To the contrary, the issuers/managers of the Four Funds and Trust Offerings were not strangers to Chiappone. Chiappone had extensive personal familiarity with the prior success of the MS & Co. structured investments, had known and worked with MS & Co. management for years, and had personally sold scores of private placement investments structured or underwritten by MS & Co. that had yielded good returns for investors. He had a more than a reasonable basis on which to recommend MS & Co. private placements, particularly those which were based on recurring monthly revenue streams, such as alarm monitoring receivables and triple-play receivables. Mr. Chiappone, in selling the offerings referenced in the OIP, made no such promises of instant wealth. Rather, he sold fixed income obligations whose returns were set forth on the face of the PPM. In recommending these notes, he relied on what he and everyone else, including the SEC and NASD, believed to be (via its affiliated entities) a seasoned issuer of privately placed debt. That the

[97] Hanly, 415 F2d at 593.

principals of MS & Co. were in fact involved in systemic fraud was not known to anyone until early 2010. This was due to the fact that the fraud had been concealed by Messrs. McGinn and Smith, and was not reported by the company's chief financial officer, who surely knew of at least some of the wrongdoing. In fact, as admitted in a handwritten document authored by Mr. Smith, the fraudulent conduct dated back to at least late 1999 or early 2000.[98] As noted in detail further below, while *Hanly* may impose a duty on brokers, it does not alter the requirements of *scienter* imposed by relevant case law, and that case law requires more than simple negligence for fraud-based securities statutes. Hence, it is submitted that the holding in Hanley is based on facts that are distinguishable from the present case.

As noted above, *Hanly* requires only that *"a reasonable investigation has been made;"* it does not require that the broker *himself* make that investigation. That duty was imposed on the individual broker in *Hanly* because no one else made such an investigation, rendering Hanly's representations without any foundation. To the contrary, Mr. Chiappone was entitled to rely on the very real and substantial investigations made as to the Trust Offerings, as testified to by Ms. Cody and him.[99] *See also*, *SEC v. Platinum Inv. Corp.*, 2006 U.S. Dist. LEXIS 67460, 2006 WL 270319 (S.D.N.Y. 2006) (when recommending a security, a broker cannot rely *solely* on materials submitted by the issuer or given to him by his employer); *SEC v. Hasho,* 784 F. Supp. 1059, 1107 (S.D.N.Y. 1992) (broker may not rely solely on his employer or issuer (*citing Berko v. SEC,* 316 F.2d 137,142 (2d Cir. 1964)). It is submitted that Mr. Chiappone did not rely *solely* on the written materials submitted to him and the buyers. He relied on a perceived successful history as to the

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[98] See the so-called "Dave Smith Confession," Exhibit Livingston-31 (Tr. 5619, mistakenly marked as Ex. Livingston-30 at Tr. 5613. A typed version is also in evidence as Ex. Livingston-32 (Tr. p. 5619).

[99] Ms. Cody testified as to the due diligence procedures for the pre-2003 alarm deals (Tr. pp. 4545 – 4546) and Mr. Chiappone testified that the due diligence team returned to MS & Co. in 2006 and vetted all Trust offerings sold after their return (Tr. pp. 5430 & 5447).

pre-2003 offerings, and to a genuine (albeit mistaken) belief that Smith had the requisite skills to manage the Four Funds investments.

(ii) Hanly's Progeny. Cases subsequent to *Hanly* are likewise instructive on the "duty to investigate." In *Securities & Exchange Commission v. Hasho*, the SEC alleged that the salesmen had engaged in a "boiler room" operation, a temporary operation established only to sell a specific speculative security, exclusively by telephone solicitation to new customers, with the salesmen concealing the risks of the investment while also making favorable earnings projections and predictions of price rises without a factual basis. 784 F. Supp. 1059, 1062 (S.D.N.Y. 1992). In *Hasho,* the Court held that "[a] registered representative or salesman in a boiler room: (1) may not rely solely on his employer; (2) may not rely blindly upon the issuer for information concerning a company; and (3) cannot avoid his duty to investigate by blindly relying on the employers brochures." Id. at 1107 (citations omitted). The *Hasho* Court made clear that the scope of a registered representative's duty to investigate depends upon the environment in which the registered representative operates: "[A]n individual in boiler room activities is held to a higher standard". Id. at 1108. Reviewing the cases involving the duty to inquire, many of them involve so-called "boiler room" operations dealing with penny stocks and speculative securities. In addition to *Hasho, see*, *Walker v. SEC*, 383 F.2d 344, 345 (2d Cir. 1967); *Berko v. SEC*, 316 F.2d 137, 142–43 (2d Cir. 1963).

Unlike the high-pressure, boiler room sales operations such as those involved in *Hasho*, *Berko*, and *Walker*, MS & Co. was a longstanding brokerage firm offering a wide array of investments. Formed in 1980, MS & Co. was perceived by the Capital District business and finance communities to be a reputable full service retail brokerage firm, as well as an investment bank specializing in financing alarm receivables, with significant experience in financing local

businesses. There is no question that MS & Co. primarily funded companies what were not investment grade,[100] but they employed an extensive due diligence team, in-house counsel, outside counsel, internal accounting staff and outside CPA's, as well as investment bankers. Thus, these cases involve facts distinctly different from those present in this proceeding. To compare MS & Co. to the defendants in the *Hasho*, *Walker* and *Berko* cases (all boiler room operations) would not be appropriate, and the holdings of those cases are thus not germane to the determination of the present matter.

Other decisions can likewise be distinguished on the facts. In *SEC v. Milan Capital Group, Inc.*, the Court found that a broker should have independently investigated a fraudulent investment where (i) the promoter of the investment had directed the broker to conceal information regarding the investment from his compliance superiors; (ii) trade confirmations were "crude" and "handwritten", and therefore suspicious on their face; and (iii) the promoter of the investment, without disclosure to investors prior to their making the investment, placed the investors' funds in a self-induced pooled account and restricted the investors' control over the investments. 2000 U.S. Dist. LEXIS 16204, at *8, *17–*20 (S.D.N.Y. Nov. 9, 2000). In *Milan*, the court essentially found the defendants ignored obvious signs of fraud to amount to recklessness, sufficient to satisfy the *scienter* requirement inherent in a fraud-based violation. Under these circumstances, the imposition of a duty to investigate the *bona fides* of the investment is appropriate.

Again, the facts presented by the Division are markedly different from those in *Milan*. Here, the fraud was not obvious, and it was actively concealed from employees, the investors, the regulators (NASD, FINRA and the SEC) from early 2000 to early 2010. Moreover, for good reason, there are limits to the scope of liability for failure to adequately monitor the allegedly fraudulent conduct of others. *Novak, supra*, 216 F.3d at 309; *South Cherry Street, LLC v.*

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[100] Chiappone Testimony, Tr. pp. 5477.

Hennessee Group, LLC, 573 F.3d 98, 100 (2d Cir. 2009). By its very nature, fraud such as that perpetrated by Smith and McGinn is secretive. The suggestion that Chiappone's performance of additional due diligence would have revealed the secretive fraud ignores reality, particularly in light of regulatory failures to discover the fraud during the same time period. It is submitted that Mr. Chiappone's inability to discover criminal fraud not only fails to rise to the level of recklessness required for *scienter*, it does not even rise to the level of ordinary negligence. Hence, *Milan* does not govern the outcome of this case.

The key problem with the Division's application of *Hanly* and its progeny is that it turns the actual manner in which the brokerage industry is structured on its head. Almost all brokerage houses employ analysts whose duty it is to study the markets and individual securities and make recommendations. The registered representatives then sell what the analysts and investment committees recommend. In fact, to do otherwise is itself a prohibited practice, known as "selling away." Similarly, MS & Co. had its private placement Trust Offerings structured by the investment bankers and vetted by a due diligence team that was substantial.[101] The Four Funds investments were structured by the investment bankers at MS & Co. Application of the *Hanly* line of precedent to this situation would require Chiappone to ignore the work of the persons assigned to locate, structure and conduct due diligence on the investments, and perform the entire due diligence on his own, to make investment recommendations based upon his own analysis, a process in which he or virtually any registered representative utterly lacks the necessary education and training.[102] Yet, in this case, the government seems to claim that an individual broker, who has nowhere near the

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[101] Testimony of Mary Ann Cody, TR, pp. 4545 – 4552 .

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

resources of the SEC or any Self-Regulatory Organization, should have discovered what those same agencies failed to unearth during their routine audits.[103] Ms. Palen admitted that she was aware that the OCIE division of the SEC conducted an investigation of MS& CO. sometime around 2003, but she was not aware that they discovered any fraud.[104]

That position, we submit, is not the holding of the *Hanly* precedents. Rather, those cases that impose a duty of inquiry on a broker, do so only in very special circumstances, where it should be clear to a broker of average intelligence that the information being given to him should not be relied upon without further investigation. That duty certainly arises – and appears to most commonly arise – in the boiler room context, but is not limited to those situations.[105] However, the duty does not exist for each and every recommendation a broker makes. It arises only if facts come to the attention of a broker that trigger the duty. These types of factual situations are commonly known as "red flags." The types of situations that can trigger red flags include:

1. Promise of unusually high returns (*SEC v. Randy*, 38F. Supp.2d 657, 670 (N.D. Ill. 1999));
2. Issuer offering materials questionable on their face (*SEC v. Kenton Capital, Ltd.* (69 F. Supp.2d 1, 10 (D.D.C. 1998));
3. Memoranda regarding issuer financial difficulties, errors in financial statements, rapid turnover in management (*Benjamin v. Kim,* 1999 U.S. Dist. LEXIS 6089, 1999 WL 249706 (S.D.N.Y. 1999));
4. Awareness of prior allegations of misconduct (*Meadows v. SEC*, 119 F.3d 1219 (5thCir. 1997));
5. Broker knew of fraud or it was so obvious that failure to inquire was reckless (*SEC v. Milan Capital Group, Inc.*, 2000 U.S. Dist. LEXIS, 16204 [17] (S.D.N.Y. 2000)).

[103] See NASD investigation dated May 14, 2007 (Exhibit Div-501).
[104] Palen testimony on cross-examination, Tr. pp. 474 – 477.
[105] *Hanly v. SEC,* 415 F.2d at 597.

It is submitted that none of these factors was present in the MS & Co. offerings. While there is no question that the *Hanly* line of cases impose certain duties on brokers, it is submitted that the Division seeks to extend the holdings of those decisions to a factual situation not representative of prior decisions. In summary, the circumstances giving rise to a duty to investigate in *Hanly, Hasho, Milan, Berko,* and *Walker* (and other cases cited herein) simply were not present at the time Chiappone sold Four Funds investments or the Trust Offerings. Only after conducting a several year investigation and after deciphering millions of pages of internal MS & Co. records (to which Chiappone never had access), was the government able to secure criminal convictions against the wrongdoers. It is only with the benefit of 20/20 hindsight, that the Division claims that Chiappone, and the other registered representatives, could have done more.

C. Scienter Requirements Not Met as to Chiappone.

The Supreme Court has defined the term "scienter" as a mental state embracing intent to deceive, manipulate or defraud. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 fn. 12; 96 S. Ct. 1375, 1381 (1976).[106] In the context of a civil action for damages premised on '34 Act §10(b) and Rule 10b-5, the Court, rejecting the amicus arguments of the Commission, held that scienter is a requisite component of liability for '34 Act violations.[107] The Second Circuit formerly held that scienter, while required for a private action seeking redress for violations of the fraud-based securities statutes, was not required for an action by the SEC seeking injunctive relief. *SEC v. Coven,* 581 F.2d1020 (2d Cir. 1978); *Aaron v. SEC*, 605 F.2d 612 (2d Cir. 1979). However, in 1980, the U.S. Supreme Court settled the issue by finding that scienter was required for actions brought by the SEC under '33 Act §17(a)(1) (15 U.S.C. §77q(a)), '34 Act §10(b) (15 U.S.C.

[106] See also, *South Cherry St., LLC v. Hennessee Group, LLC,* 573 F3d 98, 108 (2d Cir. 2009) *(quoting Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308,318, 127 S. Ct. 2499 (2007)).

[107] Although plaintiffs did not make claims under the '33 Act, the decision clearly applies to the fraud-based sections of that act that do not specifically iterate a negligence standard.

§78j(b)) and Rule 10b-5. *Aaron v. SEC,* 446 U.S. 680, 100 S. Ct. 1945 (1980). The Court specifically determined that scienter was not an element for claims made under '33 Act §17(a)(2) & (3). In so deciding, the Court based its decision in large part on the rationale iterated in the *Hochfelder* decision, *supra,* dealing with private actions:

> "In our view, the rationale of *Hochfelder* ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and *Rule 10b-5*, regardless of the identity of the plaintiff or the nature of the relief sought. Two of the three factors in *Hochfelder* – the language of §10(b) and its legislative history – are applicable whenever a violation of § 10(b) or *Rule 10b-5* is alleged, whether in a private cause of action for damages or in a Commission injunctive action ...." *Aaron v. SEC,* 446 U.S. at 691.

The court then addressed whether any of the provisions authorizing injunctive relief bore upon the issue of whether scienter is required. Finding that they did not, the majority opinion then stated that when scienter is an element of the substantive violation sought to be enjoined, it [scienter] must be proved before any inunction may issue. *Aaron,* 446 U.S. at 700-01. Finally, the Court noted that, even as to §17(a)(2) & (3), although scienter is not a requisite element of a violation, which is not to say "that scienter has no bearing at all on whether a district court should enjoin a person violating or about to violate § 17(a)(2) or (a)(3):

> "In cases where the Commission is seeking to enjoin a person '*about* to engage in any acts or practices which ... *will* constitute ' a violation of those provisions, the Commission must establish a sufficient evidentiary predicate to show that such future violation may occur." (citations omitted) Moreover, as the Commission recognizes, a district court may consider scienter or lack of it as one of the aggravating or mitigating factors to be taken into account in exercising its equitable discretion in deciding whether or not to grant injunctive relief. And the proper exercise of equitable discretion is necessary to ensure a 'nice adjustment and reconciliation between the public interest and private needs.'" (emphasis in original) (citation omitted) *Aaron,* 446 U.S. at 701.

Chief Justice Burger, in his concurring opinion, also pointed out that, while scienter is required by some statutory sections but not others, the *degree of scienter* is an appropriate consideration when determining whether to issue injunctive relief. This is so because of the

requirement in injunctive proceedings of showing of a reasonable likelihood that the wrong will be repeated, and that therefore it will almost always be necessary for the Commission to demonstrate that the defendant's conduct are the result of more than negligence. *Aaron,* 446 U.S. at 703.[108]

Having resolved the issue of scienter, the Court specifically did not address the issue of whether recklessness constitutes scienter, as determination of that issue was not necessary to decide the matter before it: "We have no occasion here to address the question, reserved in *Hochfelder ibid.,* whether, under some circumstances, scienter may also include reckless behavior." *Aaron, supra*, 446 U.S. at 686, fn.5. The Court in *Hochfelder* acknowledged that recklessness is sometimes considered to be a form of intentional conduct,[109] and the Second Circuit has held in numerous cases involving private actions for damages that knowledge or recklessness will satisfy the scienter requirement. *See, e.g., South Cherry St., LLC v. Hennessee Group LLC,* 573 F.3d 98, 108-110 (2d Cir. 2009); *Novak v. Kaskas,* 216 F.3d 300 (2d. Cir. 2000); *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999); *IIT Int'l Inv. Trust v. Cornfeld,* 619 F.2d 909, 923 (2d Cir. 1980). The scienter determination is a factual one, and will depend upon the circumstances of the particular case. *Lanza v. Drexel & Co.*, 479 F.2d 1277, at 1306, fn. 98 (2d Cir. 1973). *Lanza*, another private action, also ruled that proof of a willful or reckless disregard for the truth is necessary to establish liability under Rule 10b-5. Id, at 1306.

While all these cases recognize that scienter may be found in recklessness (or a reckless disregard for the truth), they also acknowledge some limits on non-intentional conduct. In *South Cherry*, the Second Circuit elaborated on what constitutes recklessness in private actions: "By reckless disregard for the truth, we mean 'conscious recklessness – i.e., a state of mind *approximating actual intent,* and *not merely a heightened form of negligence*'" (citation omitted)

[108] A full quote of Justice Berger's opinion on the role of scienter in determining the sanction (vs the violation itself) is set out in this Brief at page 49.
[109] *Hochfelder*, 425 U.S. at 193, 96 S. Ct. at 1381, fn 12.

(emphasis in original). *South Cherry,* 573 F3d at 109 (quoting from *Novak v. Kasaks,* 213 F3d 300, 306 (2d Cir. 2000)). In *Press Chemical,* the Second Circuit held that "[t]he scienter needed in connection with securities fraud is intent 'to deceive, manipulate, or defraud,' or knowing misconduct" (citing *First Jersey Secs., Inc.*, 101 F.3d at 1467). *Press Chemical, supra,* 166 F.3d at 538.

In *Novak*, the court in noting that recklessness is harder to identify than intentional conduct, likewise put some definition as to exactly what conduct may be viewed as "reckless":

> "[W]e define reckless conduct as: at the least, conduct which is 'highly unreasonable' and which represents '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.'" *Novak*, 216 F.3d at 308.

Numerous other cases contain definitions of recklessness that closely parallel that enunciated by the *Novak* court.[110] What is clear from these cases is that the conduct at issue must rise beyond simple negligence or inattention to detail. "Reckless conduct includes 'not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it'" (*SEC v. Randy,* 38 F. Supp. 2d 657, 670 (ND Ill. 1999), citing *Meadows v. SEC*, 119 F.3d 1219, 1226 (5th Cir. 1997)).

In *Merkin v. Gabriel Capital, LP,* the Southern District of New York, citing to *South Cherry,* observed that an investment advisor who recommends investments in a fund that turns out to be a Ponzi scheme will not ordinarily be held liable for securities fraud unless there exist particular facts giving rise to a strong inference that the advisor either had fraudulent intent, or acted with "conscious recklessness' as to the truth or falsity of the advisor's statements to the investor.

[110] *See, e.g., Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital*, 531 F.2d 190,194 (2d Cir. 2008); *Chill v. General Elec. Co.*, 101 F.3d 263, 269 (2d Cir. 1996)(quoting *Rolf v. Blythe, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978). *See also, Kalnit v. Eichler,* 264 F3d 131, 142(2d Cir. 2001).

Merkin, 817 F. Supp. 2d 346, 357 (S.D.N.Y. 2011). While the above cases involve private claims, they do provide guidance as to what conduct constitutes scienter by "recklessness" and have been cited in civil enforcement actions by the SEC.

The scienter requirement has been similarly interpreted by various courts in cases brought by the Division. In *Hasho*, a civil action brought by the Division, the court found defendants' conduct to be flagrant, and that they acted knowingly and recklessly, thus supplying the required scienter. *Hasho*, 784 F. Supp. at 1108. *See also*, *SEC v. Sayegh,* 906 F. Supp 939, 946 (S.D.N.Y. 1995) ("Scienter may be established by proving conduct that was knowing, intentional, or reckless, as opposed to merely negligent"); *Abbondante v. SEC,* 209 Fed. Appx. 6, 7 (2d Cir. 2006) (broker may not recklessly make assertions about matters of which he is ignorant; scienter established by reckless disregard for the truth). Something more than mere negligence, amounting to an extreme departure from the standards of ordinary care is required to establish scienter in civil proceedings brought by the Commission. *See*, *SEC v. Carriba Air, Inc.,* 681 F.2d 1318, 1324 (11th Cir. 1982), in which the panel stated:

> "Scienter may be established by a showing of knowing misconduct or *severe recklessness.* The standard in this circuit has been set forth in *SEC v. Southwest Coal and Energy Co.*, 624 F.2d 1312 (5th Cir. 1980). Proof of recklessness would require a showing that the defendant's conduct was an extreme departure of the standards of ordinary care, ... which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Carriba Air,* 681 F.2d at 1324.

In the *Southwest Coal* case cited in *Carriba Air,* above (a Fifth Circuit decision) the court noted that:

> "[t]he degree of recklessness in one's disregard for the truth necessary to serve as scienter is extremely high. ... Reckless conduct may be defined as a highly unreasonable omission, ***involving not merely simple, or even in excusable negligence,*** but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it. (citations

> omitted). An important factor in this regard is the degree of intentional wrongdoing evident in a defendant's past conduct (citation omitted). (emphasis supplied) *Southwest Coal,* 624 F.2d at 1321, fn. 17.

In so stating, the panel in *Southwest Coal* noted that the original formulation of this standard of recklessness was articulated in *Franke v. Midwestern Okla. Devel. Auth.*, 428 F. Supp. 719 (W.D. Okla. 1976), but that it has been followed in the Third, Sixth and Seventh Circuits, as well as the Fifth and Eleventh Circuit.[111] The D.C. Circuit may require "extreme recklessness." *See*, *SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992) ("Although the [Supreme] Court has left the question open ... we have determined, along with a number of other circuits, that extreme recklessness may also satisfy this intent requirement"). In similar vein, see, *SEC v. Gane*,[112] suggesting that in the Eleventh Circuit, scienter may be established by a showing of severe recklessness. *Gane,* 2005 U.S. Dist. LEXIS at *41.

D. Law Applied to Facts Involving Chiappone's Activities.

First we address the statutes for which no scienter is required under *Aaron v. SEC, supra.* Section 17(a)(2) speaks to obtaining money or property "by means of any untrue statement of material fact or any omission to state a material fact ...." Mr. Chiappone was not charged (and no evidence was adduced) with making false statements or omissions to state a material fact. He testified, as did the two witnesses who appeared on his behalf, and the two witnesses called by the SEC against him, that in every case, the private placements he sold were sold under written PPM's, along with subscription agreements and investor questionnaires. He testified as to the procedure for sending out all three documents in a single packet, with the subscription agreements and investor

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[111] Cases cited by the court in *Southwest Coal* for this standard of recklessness are: *Accord, e.g. McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979) (quoting Franke standard); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979) (same); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.) *cert. denied*, 434 U.S. 875, 98 S. Ct. 225, 54 L. Ed. 2d 155 (1977) (same). *See also*, *Broad v. Rockwell Int'l Corp.,* 614 F.2d 418 (5th Cir. 1980).

[112] 2005 U.S. Dist. LEXIS 607; 18 FLW Fed D 401 (S.D. Florida 2005).

questionnaires being returned to MS & Co. upon signing. Mr. Chiappone testified that he disclosed the fact that private placements bear inherent risk of lack of liquidity, and the PPM's contained written disclosures of myriad risk factors, as well as certain conflicts of interest.[113] No one testified credibly that Mr. Chiappone ever misrepresented the relevant facts about the Trust Offerings, and he testified about how he went over the business aspects of the deals and the debt service coverage ratios with clients. Mr. Ardizzone, a Chiappone client called by the Division, originally testified that his belief that his TAIN and FEIN investments were alarm deals, similar to his prior purchases:

> Q. Did you understand that TAIN – was it your belief at the time that TAIN was another alarm-type product?
> A. That was my belief in any of these private placement things.
> Q. Did that belief stem from anything other than your conversations with Mr. Chiappone?
> A. No (Transcript p. 2771)

However, upon cross, he admitted (haltingly) that this was his *impression*, but that Mr. Chiappone never actually told him that:

[Mr. Cavalier, referencing FEIN note]:

> Q. Did Mr. Chiappone tell you that this was an alarm deal?
> A. My understanding was all of these private placement things were based on the alarm business in one form or another.
> Q. Well, my question to you is not what you understood. My question is, did he tell you that this was an alarm deal?
> A. Again, my understanding from conversations with him – we had many, many conversations.
> Q. Do you –
> A. Whenever he had something to sell he would call and we would talk.
> Q. Do you have a specific recollection of Mr. Chiappone telling you that this was an alarm deal?
> A. No. [Transcript pp. 2796:20 – 2797:13]

[113] Chiappone testimony, Tr. pp. 5701 (disclosure to clients of illiquid nature of Four Funds); Mirochnik testimony, Tr. pp. 3117 – 3118. See also Chiappone testimony, Tr. p. 5659 as to risks inherent in non-marketable private placements.

No witness testified that Mr. Chiappone made any misrepresentation or omission relative to the sale of private placement securities.[114] Hence, any case under § 17(a)(2) or §17(a)(3) is non-existent. Mr. Chiappone testified that he specifically discussed the blind pool nature of the Four Funds with Ardizzone.[115] Mr. Becker, called by the Division, did not purchase Four Funds because he was not comfortable when Mr. Chiappone disclosed the blind pool aspect of the Four Funds deals.[116]

As to the Four Funds, there could be no misstatement of material facts, as the only factual disclosures were set forth in the PPM's themselves, which Mr. Chiappone played no role in drafting. Due to their nature as blind pools, Mr. Chiappone necessarily made no disclosures as to the underlying investments. While there are certainly questions in hindsight as to David Smith's ability to manage the Four Funds investments, Mr. Chiappone testified as to his belief (and the reasons for such belief) at the time of inception of the Four Funds that Smith had the credentials to manage those funds.[117] Moreover, there was no testimony that Mr. Chiappone ever made any representations to any client as to Smith's qualifications to manage a portfolio of investments.

Section 17(a)(3) speaks to practices or a course of business that operates as a fraud or deceit upon the purchaser. Again, the disclosures in the PPM and those made by Mr. Chiappone would negate the presence of fraud or deceit. Further, Mr. Chiappone is not charged with engaging in any practice that operated as a fraud or deceit. Rather, he is accused of not recognizing certain alleged "red flags." Mr. Chiappone contends that missing a red flag, as a matter of law, is not sufficient to

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[114] The only other witness to testify for the SEC against Mr. Chiappone was Bruce Becker, who did not indicate that Mr. Chiappone ever mislead him. He also testified that he did not purchase any of the Four Funds investments (Tr. pp. 2936:22 – 2937:21), which indicates that he was aware of the difference between these blind pools and the alarm notes he had purchased from Chiappone. This casts more doubt on Ardizzone's claim that he thought the Four Funds were the same as the alarm notes. Finally, it should be noted that Becker actually purchased an investment from Chiappone after he testified for the Division! Chiappone testimony, Tr. pp. 5438 (as to Becker purchasing an investment from Chiappone during the course of the hearings in this proceeding).

[115] Chiappone testimony, Tr. pp. 5485 – 5486.

[116] Chiappone testimony, Tr. p. 5486.

[117] Chiappone testimony, Tr. pp. 5462-5466.

find a violation of § 17(a)(3). It is further submitted that as to the scienter requirement, the evidence concerning allegedly missed red flags to not rise to the level of knowing and intentional conduct, or conduct involving an "extreme departure" from standards of care.

POINT III

CHIAPPONE'S CONDUCT REGARDING SO-CALLED "RED FLAGS"

The Division's case is posited upon the theory that Chiappone, failed to consider certain incidents to be "red flags" and continued to remain employed by and sell securities for MS & Co. The division claims that in so doing, he violated sections of the securities laws requiring scienter, i.e., '33 Act § 17a and '34 Act §10(b) and Rule 10b-5, as well as the holdings of *Hanley* and its progeny. In order to establish violations of these sections, the Division's proof would have to show that Chiappone's failure to recognize the red flags was either knowing and intentional, or such an extreme departure from the standards of care that it presented a danger of misleading buyers or sellers that was either known to Chiappone was so obvious that he must have been aware of it. Simple, or even inexcusable, negligence will not suffice.

The OIP identified three major events that were characterized as red flags: (1) Smith's refusal to disclose to brokers how he invested Four Funds offering proceeds; (2) the so-called "Redemption Policy;" and (3) the restructuring of the Four Funds in January, 2008.[118] Although not specifically labelled a red flag in the OIP, at trial the Division also characterized the disclosure of the Firstline bankruptcy filing as a red flag. In addition, the OIP made allegations that all issuers were controlled by Smith or MS & Co. and had no operating history, that Smith had never before managed offerings of the size and scope of the Four Funds, and that the PPM's for the Four Funds

[118] See OIP, paragraphs 40-51.

could acquire investments from MS & Co. affiliates,[119] stating that these factors also gave rise to a duty to conduct an inquiry. The relevant facts, and Mr. Chiappone's response to the Division's arguments concerning red flags are set forth below.

A. <u>Smith's Failure to Disclose Investments of Four Funds.</u>

Chiappone was told that at the very beginning of the offering period that the Four Funds investment portfolio would include, among other investments, the recurring monthly revenue alarm receivables—which Chiappone had seen generate great returns to investors.[120] Smith also mentioned a water park project on Randall's Island, a clothing company, as well as financing local contractors. He further spoke of an intention to purchase mortgage REIT's, which are publicly traded securities yielding high dividends, and the financing of local businesses.[121] Blind pools are a recognized investment vehicle, and the fact that the Four Funds did not specify its investments in the PPM was not an obvious fraud that should have alerted Chiappone to second-guess the legitimacy of the Four Funds concept. The Four Funds private placement memoranda fully disclosed that the investments held by each of the Four Funds were not fixed, and would be determined in the discretion of the Fund manager. Other examples investments employing the blind pool methodology that are commonly utilized are hedge funds (of which there are hundreds), and actively managed mutual funds (of which there are thousands).[122]

In December of 2008, Mr. Chiappone emailed Smith asking for more detailed information on the assets of the Four Funds.[123] Smith responded that the information was confidential, as the borrowers did not want their private business made public.[124] At the time, Mr. Chiappone had no

[119] See, OIP, paragraphs 38-39.
[120] Chiappone testimony on direct, Tr. pp 5458 – 5459 .
[121] Chiappone testimony on direct, Tr. pp 5459 – 5460.
[122] Actively managed mutual funds disclose their investments only quarterly, not in advance of purchases or sales.
[123] Chiappone testimony, Tr. pp. 5607 – 5608, and exhibit Div-511.
[124] Chiappone testimony, Tr. pp. 5609 – 5610, and exhibit Div-425.

reason to believe that Smith was lying or attempting to conceal a fraud; and therefore, Smith's explanation of protecting the confidentiality of the private finances of the borrowers appeared on its face to be reasonable. However, whether Chiappone was justified in believing Smith's explanation is irrelevant, as Chiappone had already stopped selling the Four Funds in January of 2008, about eleven months prior to Smith's invoking confidentiality as to the Four Funds' investments.

B. Restructuring of Four Funds as a Red Flag.

(1) Red Flag as to Four Funds.

(i) The Restructuring was Not a Red Flag. Mr. Chiappone was at the meeting in January, 2008 when David Smith told the brokers about the restructuring of the Four Funds. He listened to Smith attribute the inability of the Four Funds investments to pay full interest due to investors on conditions in the credit and stock markets that caused the collapse of major financial institutions, and the accompanying liquidity crisis.[125] He read the form letters sent by Smith to customers, parroting what Smith had told the brokers, again citing market malaise/liquidity issues.[126] There is no question but that the failure of the Four Funds occurred in the midst of one of the most severe credit market meltdowns in financial history. Mr. Guzzetti, via his testimony and Guzzetti Ex. 17, illustrated the major financial failures of that time, including Bear Stearns suspending redemptions in its high-grade structured credit, money market funds breaking the buck, the failure of Lehman Brothers, the rescue of Merrill Lynch, as well as many other financial institutions failing.[127] Hence, the Four Funds restructuring was not perceived as a "red flag", but was instead viewed as quite consistent with investment professionals were seeing on a daily basis in the public media. At that time, Smith's explanation seemed to Mr. Chiappone to be reasonable, as it was widely known via public media that there was a liquidity crisis that had taken down major

[125] Chiappone testimony, Tr. pp. 5560 – 5567. See also, Tilkin Expert Report, Ex. FC-90, at page 10.
[126] Chiappone testimony, Tr. pp. 5564 – 65.
[127] Guzzetti testimony, Tr. pp. 4636 – 4643; Guzzetti Ex. 17.

financial houses.[128] In evaluating Mr. Chiappone's acceptance of Smith's explanation, it must also be remembered that the "Great Recession" that occurred during this time was the most severe financial crisis seen in this country since the Great Depression of the 1930's.

(ii) **If it was a Red Flag; Chiappone Acted Appropriately.** Even if the restructuring is viewed as a red flag, Chiappone's failure to recognize it as such was neither knowing, intentional, nor an extreme departure from standards of care. However, whether Mr. Chiappone was correct in initially believing Smith's explanation is an academic issue, for – notwithstanding his belief in Smith's explanation – Mr. Chiappone never sold another Four Fund investment after the January meeting. In fact, he has never sold another blind pool since that time.[129] Hence, even if the initial interest rate reduction was a red flag as to the Four Funds, Mr. Chiappone responded appropriately.

(2) **Restructuring as Red Flag For Trust Offerings.** Mr. Chiappone did not and does not believe that the Four Funds restructuring constituted a red flag as to future Trust Offerings. Clearly the Four Funds and the Trust offerings were entirely different types of investment. This was even admitted by the Division's expert witness, Mr. Lowry. In his report (Exhibit Div-001) he states "These offerings were not at all similar to the income notes [Four Funds notes] ...."[130] Moreover, the Division admits as much in its proposed Findings of Fact submitted to this tribunal, wherein it states "The Four Funds Had a Totally Different Mandate than the Pre-2003 Trust Offerings."[131] Aside from these admissions, the following differences are readily apparent:

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[128] Chiappone testimony, Tr. p. 5562 – 63.
[129] Chiappone testimony, Tr. p. 5566.
[130] Lowry Report, at p. 25 of 35 (Exhibit Div-001).
[131] Division Proposed Findings of Fact, at p.32 (paragraph heading "A" to Point VIII.

Four Funds:	Trust Notes (Alarm & Triple Play):
Managed by Smith	Managed by McGinn
Blind Pool	Investments disclosed in advance
Unlimited discretion in selecting investments	Limited to Alarm and Triple Play contracts (recurring monthly revenues)
New Concept for MS & Co	Long history of deals with alarm receivables
Included investments in equity	Invested only in debt or contract receivables
Investment in MS & Co. affiliates	All investments with unrelated parties

Mr. Chiappone testified that he considered the return to investments in recurring monthly revenues as getting back into a business that MS & Co. had conducted so successfully (to his knowledge) and in which they were steeped in experience.[132] He also noted that during the bursting of the tech bubble in 2000-2002, the pre-2003 alarm notes performed very well and did not suffer the losses that investors in the market suffered, and that he felt that the new Trust Offerings would likewise do well in the current credit crisis.[133] The fact that the Trust Offerings involved the familiar concept of recurring monthly revenues allowed Mr. Chiappone to perform his independent debt service coverage ratios, a key to an independent assessment of each proposed offering. There is no question that Mr. Chiappone relied, in part, on the past history of the pre-2003 alarm deals and, in 2006, he had no knowledge that the success of the pre-2003 alarm deals was (in part) illusory.[134] Also, at this point, it must be remembered that Mr. Chiappone had no knowledge of any intercompany loans, loans to Smith & McGinn, payments to preferred investors, payment of operating expenses with investor funds, the Firstline Bankruptcy or other misuse of funds by his superiors.[135] At this time, his belief in Smith's explanation about the Four Funds problems cannot be said to be unreasonable. In sum, it is submitted that the restructuring of the Four Funds notes

[132] Chiappone testimony, Tr. pp. 5448 – 5450.
[133] Chiappone testimony, Tr. pp. 5566 – 67. See also, Tr. p. 5568.
[134] Chiappone testimony, Tr. pp. 5455 – 5456, and 5466. Mr. Chiappone testified that he never received a call from a customer complaining about late interest, non-redemption of a matured note, or any other problem with respect to the pre-2003 alarm deals, and was not aware that money from Four Funds investors was used to pay off pre-2003 alarm investors. Tr. p. 5467 – 5479.
[135] Chiappone testimony, Tr. pp. 5568 – 5570.

would not have lead Mr. Chiappone to believe there was reason to pause in selling the Trust Offerings. One might just as easily argue that a broker who sold a high-flying tech stock that lost money should consider it a red flag against ever again selling a blue chip stock.

C. Redemption Policy as a Red Flag.

The Division's primary "red flag" is what it coins the "Redemption Policy." It claims that beginning in 2006, Smith had directed that redemptions of Four Funds maturing notes be replaced by new sales of maturing notes. Chiappone, though, had no knowledge of any such direction at any time in 2006 or at any time until mid-November 2007.[136] For the life of the Four Funds investments until November 2007, interest was timely paid, and Chiappone had no knowledge that redeeming note holders had experienced problems redeeming matured notes.

Mr. Chiappone received his first, and only, notice concerning issues with redemption of funds on November 15, 2007.[137] That email notice cannot fairly be construed as a warning that clients could not be redeemed unless the note was resold. First, the notice indicated that the client *had redeemed* (the past tense implying the redemption was completed). Secondly, the email did not state that failure to re-sell the note would quash the redemption.[138] Thirdly, Mr. Chiappone testified as to how he always expected that there would be re-sales of notes, particularly the shorter duration ones. The PPM's for the Four Funds all disclosed the ability to re-sell the notes at the top of the first page of the PPM.[139] A customer who read no further than the cover page would have learned this. Mr. Chiappone explained that the first tranche, due in 1 year, represented 25% of the entire offering and therefore, at the end of the first year, the issuer would need to replace 25% of the offering amount, plus interest on all 3 tranches, at a blended rate of about 8%. Thus, to redeem

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[136] Chiappone testimony, Tr. pp. 5595 – 5596 and Exhibit Div-302. See also Tr. 5598 – 5598.
[137] Exhibits Div-427 and Div 242.
[138] Chiappone testimony, Tr. 5599. See also, Chiappone testimony, Tr. p.2715.
[139] See PPM's for FIIN, FEIN, TAIN & FAIN, respectively exhibits Div-5, Div-6, Div-9 & Div-12.

notes from profits, Smith would have had to earn something like 33% to cover redemptions, interest, commissions and offering costs, an impossibly high hurdle. Thus, it was obvious that notes would need to be either (i) rolled over (extended), or (ii) re-sold, in order to avoid having to sell assets of the fund to finance a redemption.[140] However, this would not have alerted him to a red flag, in view of the past history of rollovers and the fact that there would be demand for re-sale of the notes. He explained that the last recourse for maturing notes would be the sale of assets.[141] Mr. Guzzetti likewise testified that it would be unwise to fund redemptions by selling assets into a falling market.[142] David Tilkin, expert witness for four of the respondents, testified that the re-sale provisions in the Four Funds PPM's could be viewed as an attempt to create a secondary market for the notes.[143] For these reasons, Mr. Chiappone never saw the need to re-sell notes as a "red flag." Mr. Chiappone testified that he was never told by Mr. Smith, Ms. Sicluna or anyone else that if he didn't resell a note, his client would not be redeemed.[144] The November 7th email chain was the only time he was requested to re-sell a redeeming note.[145]

By November 2007, financial markets worldwide, including credit markets, were in the process of suffering an unprecedented meltdown, a fact that was popular knowledge and certainly on the minds of investment professionals, like Chiappone.[146] So when Smith explained that the Four Funds were having difficulty paying redeeming note holders because the entities in which the Four Funds had invested had cash flow problems and what appeared to be a temporary inability to refinance their debt to the Four Funds, Chiappone had good reason to believe Smith.[147]

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[140] Chiappone testimony, Tr., pp. 5591 – 5594.
[141] Chiappone testimony, Tr. pp. 5594 – 5595.
[142] Guzzetti testimony, Tr. pp. 4640 – 4642.
[143] Tilkin testimony, Tr. p.3931; and Chiappone testimony, Tr. p. 5595.
[144] Chiappone testimony, Tr. p .5599.
[145] Chiappone testimony, Tr. pp.5600 – 5601.
[146] Chiappone testimony, Tr. pp. 2695; 5562 – 5566. See also, Tilkin Expert Report-Chiappone, Ex. FC-90 at pp. 9-10.
[147] Chiappone testimony, Tr. pp.5600. See also, Guzzetti testimony, 4640 – 4642.

It is apparent that Ms. Sicluna (likely at the direction of Smith) made tables of pending redemptions, re-sales and balances remaining to be re-sold, and Mr. Chiappone's name was on some of those tables. However, Mr. Chiappone was never sent those tables, and there was no testimony that he was ever aware of their contents. Ms. Sicluna prepared those charts, and then emailed them to Mr. Guzzetti, who in turn forwarded them to some of the brokers, but never to Mr. Chiappone. Curiously, the Division never called as a witness Ms. Sicluna (who was on the Division's witness list), who could have testified as to who had knowledge of a policy that redemptions were conditions on re-sales. The trier of fact may draw an inference that the missing witness (who had been deposed and was on the Division's pre-trial witness list) would not have implicated Mr. Chiappone.

Finally, when Mr. Chiappone did become aware of an unpaid redemption on a Trust Offering for one of his clients on October 6, 2009, he stopped selling all MS & Co. private placements shortly thereafter.[148]

In conclusion, the evidence – consisting of a single request that he re-sell a customer's redeemed note – is insufficient to establish that Mr. Chiappone was ever aware of a firm requirement that a maturing note must be re-sold before a client could be redeemed. Indeed, some evidence shows that the registered representatives believed that in the absence of a replacement ticket, the redeeming note holders would still be paid.[149]

Although the Division produced additional emails addressed to other brokers that it argues more clearly established that the redemption/resale policy was a mandatory requirement (Guzzetti testimony, Tr. pp. 3047 – 3049; Exhibits Div-278 & Div-119), the court must be mindful not to allow this evidence to taint the case against Chiappone. The record evidence is that Chiappone was

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[148] Chiappone testimony, Tr. pp. 5601 – 5606 and exhibit Div-290.
[149] Email from Joseph Carr to David Smith, dated September 8, 2009 (Exhibit Div – 431).

never sent the additional emails, was not aware of their content, and was never otherwise informed that redemptions would denied absent a resale. Hence, Mr. Chiappone must be judged on the proven facts as to his individual situation.

D. Nondisclosure of Firstline Bankruptcy as Red Flag.

The Firstline investments were offered to investors during 2007, and Firstline filed for bankruptcy in late January 2008. McGinn and Smith learned of the bankruptcy shortly after the bankruptcy filing. The revenue from Firstline's alarm contracts stopped being paid to the issuer entity, which in the normal course would have made payments from the trusts to investors impossible and would have alerted the registered representatives to problems in the investment. But McGinn and Smith took extraordinary steps to conceal the bankruptcy from investors and their brokers by secretly continuing to make interest payments using non-Firstline funds. Even worse, they encouraged the brokers to continue to sell unsold Firstline notes at a time they knew of the bankruptcy.[150] Mr. Chiappone first learned of the bankruptcy of Firstline on September 3, 2009, approximately 18 months after the bankruptcy occurred.[151] Upon learning the news, Mr. Chiappone took appropriate steps in fulfilling his responsibility to his clients – he immediately stopped selling Firstline.[152] In fact, after the September 3rd disclosure, Mr. Chiappone only sold one other MS & Co. investment.[153]

The bankruptcy took place in Utah, so it never made news in the areas in which MS & Co. had offices. Suggestions by the Division that the brokers should have or could have discovered the bankruptcy independently are unrealistic, and certainly do not rise to the level of an extreme departure from standards of care. The procedure suggested by Mr. Lowry would have required

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[150] Chiappone Testimony, Tr. pp. 5572 – 5573.
[151] Chiappone Testimony, Tr. pp. 5573 – 5575.
[152] Chiappone Testimony, Tr. p. 5578.
[153] Chiappone Testimony, Tr. pp.5588 – 5589.

each broker to "Google" every company that MS & Co. did business with every single day.[154] Upon examination, Mr. Lowry admitted that it would be impractical for the brokers to Google each of the investments made by the various issues every single day.[155] Also, there were no customer complaints (which would have triggered broker suspicions), as Smith and McGinn improperly caused interest to be paid to customers after the bankruptcy filing.[156] Again, even if Chiappone was negligent in not discovering the bankruptcy earlier, that does not rise to the level of scienter sufficient to trigger a violation of the fraud-based statutes under which the Division's case is brought.

Moreover, when Smith and McGinn did disclose the bankruptcy, they did not fully disclose all relevant facts. Rather, after giving a false explanation as to how interest had been paid, they told the brokers that they intended on buying the assets of Firstline in a bankruptcy auction, in order to assist the investors in recovery of at least some of their investment.[157] To bolster their continuing charade, they sent emails to the brokers, updating them on progress of the Firstline "rescue plan." This included copies of purchase agreements and assurances that they were likely to purchase the assets.[158] What was not disclosed was that, in order to make the purchase, MS & Co. needed to raise even more funds, as it did not have the ability to fund the purchase from company funds. That all-important detail was not disclosed until after the brokers had already left MS & Co., in late 2009.[159] By the time Mr. Chiappone finally learned the whole truth about Firstline, he was four months removed from his last sale of a MS & Co. private placement. In other words, he sold no private

[154] Testimony of Robert Lowry, Tr. pp. 1094 – 1095.
[155] Lowry testimony on cross-examination, Tr. pp. 1094 – 1095.
[156] It appears that Smith and McGinn used funds from other investments to pay interest on Firstline, although they lied to the brokers at the time of disclosure of the bankruptcy, telling them that a "white knight" had been making the payments. Chiappone testimony, Tr. pp. 2582 – 2583.
[157] Chiappone Testimony, Tr. pp. 5578 – 5579.
[158] Chiappone Testimony, Tr. pp. 5580 – 5584; Exhibits Div-197 & Div-199.
[159] Chiappone Testimony, Tr. pp. 5584 – 5585, Exhibit Div-200.

offerings at a time when he knew the entire truth about Firstline, and the fact that MS & Co. had no means to purchase the Firstline assets absent raising additional funds from investors.

In addition to the facts noted above, it must be emphasized that Mr. Chiappone and some of the other brokers were already in the planning stages to separate from the MS & CO. organization before Firstline became an issue. The brokers in the Clifton Park office, led by Mr. Guzzetti, were investigating a move to another brokerage firm. That departure took time to plan and execute, as it involved fining a new broker-dealer, and a clearing broker. Chiappone continued to work at MS & Co., but the chart of his sales (Ex. Div-002 [Palen ex. 4c]) will show that he essentially stopped selling just before the Firstline disclosure of Sept. 3, 2009. The chart shows two sales, dated as of September 2, and September 4, 2009, but the actual sales took place earlier, as the dates on this chart represent the date funds were deposited into the issuer's account.[160] Upon examination by Mr. Birnbaum, Mr. Chiappone testified as follows:

> Q. In September 2009 you learned that Mr. McGinn and Mr. Smith had hidden from you the Firstline bankruptcy for many months. Correct?
> A. Yes.
> Q. Did you look for another job?
> A. I think at that period of time discussions were taking place to have the retail sales force from DLG move to another advisor – another brokerage firm. So I knew those discussions were in place at that time.
> Q. In the meantime you continued to work for McGinn Smith?
> A. Yes, I think we all did until that transition took place.

Hence, the Firstline bankruptcy disclosure can't really be deemed a red flag, since Mr. Chiappone and other brokers were already essentially on their way to another firm.

E. Issuers New Entities With No Operating History.

The Division argues that the brokers were subject to a heightened duty of inquiry because each of the issuers of private placement notes was a new entity with no history of operations, therefor to be considered as an "unseasoned issuer." It is the case that recommending the securities

[160] Palen testimony, Tr. pp. 239 – 240.

of smaller companies of recent original can trigger a duty to investigate.[161] However, this is obviously an argument of form over substance. While it is true that a new entity was formed for each offering, the reality is that the same management team was in place for all of the offerings. With respect to the Trust Offerings, Mr. McGinn was primarily responsible for locating the assets to be purchased, negotiating the purchase terms, structuring the deals, and managing the assets purchased. The MS & Co. accounting staff performed the same functions for the new alarm and triple play offerings as they did for the pre-2003 alarm deals. The due diligence team was substantially the same as the team that had vetted the pre-2003 alarm deals.[162] In fact, Mr. Chiappone testified that he knew the MS & Co. management team was running all offerings, and did not consider any of the issuers to be unseasoned issuers.[163] He also testified that he relied on the expertise and experience of the MS & Co. organization in selling the Trust Offerings in 2006 and later years.[164] The cases on unseasoned issuers involve fact patterns that indicate that the issuer was truly a new entity, and there was no indication that management had past experience and track records that would translate into what the new company was doing. Those cases are therefore distinguishable from the present case.

F. Smith had Never Managed Offerings of Four Funds Size.

The Division claims that Smith had insufficient background to manage the $80+ million that was raised in the Four Funds offerings. Mr. Chiappone thought he was qualified. The Four Funds PPM's showed that the investments would consist of a mix of marketable securities and private investments. Mr. Chiappone knew and testified that Smith ran the equity side and dealt with

[161] See, e.g., *Hanley v. SEC,* 415 F.2d 589, 597 (2d Cir. 1996); *SEC v. Platinum Inv. Corp.,* 2006 WL 2707319, 2006 US Dist. LEXIS 67460 at *11 (S.D.N.Y. 2006)(citing *Hanley*).
[162] Chiappone testimony, Tr. p. 5430.
[163] Chiappone testimony, Tr. pp. 5439 – 5441.
[164] Chiappone testimony, Tr. p. 5466.

investments in marketable securities.[165] Mr. Chiappone believed Smith had a background in non-marketable investments, by reason of his work in connection with funding of various local businesses, his work on the Saratoga Springs City Center, funding for a local hospital, and a number of medical facilities in the Capital District and in the Binghamton area.[166] As to marketable securities, Chiappone felt that Smith's many years as a stockbroker, managing the accounts for his own book of business, involved the continuous review and recommendation over a total pool of millions of dollars. Hence, while Smith would now have four organizations whose investments he managed, it was (as to marketable securities) essentially no different than what he had been doing for his clients for most of his career.[167]

G. Four Funds May Acquire Investments From MS & Co. Affiliates.

Once again, the Division seeks to make a red flag from a factor that was actually disclosed to all purchasers of the Four Funds. All four of the PPM's specifically disclosed that the fund may purchase investments from MS & Co. or its affiliated companies, so long as the fund did not pay a sum in excess of what the MS & Co. or its affiliate paid. This was not only known to Chiappone, it was known to anyone who bothered to read the PPM that he or she was given. What was not known to Chiappone was that, in certain instances, the principals who controlled the companies actually sold assets to the Four Funds for more than the purchase price paid by the original purchaser. There was no testimony or other proof adduced that Mr. Chiappone knew about any of this misconduct. Likewise, there were occasions where McGinn and Smith charged fees in excess of what was disclosed in the PPM's, but again, it was never established that Mr. Chiappone had any inkling of this misconduct.

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[165] Chiappone testimony, Tr. p. 5414.
[166] Chiappone testimony, Tr. pp. 5462 – 5466.
[167] Chiappone testimony, Tr. pp. 5465.

Had the PPM's disclosed merely the fact that purchases could be made from affiliated companies, Mr. Chiappone may have had a need to inquire as to the pricing and circumstances of such purchases. However, having read the PPM's and knowing that the issuer's purchase price could not exceed the price paid by the affiliated entity, there was no "red flag" that was raised in his mind, as the PPM did not allow affiliates to make a profit on re-sales of existing assets.

Finally, it appears that Four Funds monies were used to rescue failing investments made by other MS & Co. offerings, including particularly AlseT. There was no testimony adduced to indicate that Mr. Chiappone had any knowledge of the use of funds for AlseT, nor for any of the other investments that were propped up with new investor funds. While this conduct is certainly egregious and unlawful, there was no evidence of any "red flag" with respect to the misuse of funds perpetrated by Messrs. Smith and McGinn. It is respectfully submitted that it is not "reckless" to fail to catch various fraudulent acts that began in the late 1990's and continued for a period of at least 10 years, undiscovered by NASD, FINRA, the SEC, in-house counsel and others.[168]

H. Sales to Unaccredited Investors.

The Division also asserts that the fact that sales of Four Funds investments were being made to unaccredited investors should have caused Respondents to investigate further. But Chiappone believed that the Four Funds investments were private placement offerings allowing up to 35 unaccredited investors. In fact, Patricia Sicluna, who was responsible for receiving, tracking, and organizing the subscription agreements, also believed that each of the MS & Co.'s private placement investments could be sold to 35 unaccredited investors. And given MS & Co.'s institutional organization, the registered representatives reasonably relied on management, the back

[168] As to the failures of regulatory agencies to unearth the fraud of Smith and McGinn, see, for example, Ex. Div-370, a letter from the SEC to MS & Co., listing numerous violations discovered during a routine examination of MS & Co. done in 2004, but having no mention of the various illegal acts that were the primary cause of the failure of company and the resulting losses to investors. Likewise, an NASD audit in 2006 failed to uncover any of wrongdoings (Exhibit Div-341), as did an NASD examination done in 2007 (Ex. Div-501).

office staff tasked with reviewing and recording customer subscriptions, as well as the compliance staff, to ensure compliance with Regulation D and the technical terms of the offering as stated in the private placement memoranda.

POINT IV

INDUSTRY BAR/INJUNCTIVE RELIEF IS NOT APPROPRIATE IN THIS MATTER UNDER EXISTING CASE LAW

The Division seeks to bar Mr. Chiappone from ever working in the securities industry as a registered representative, investment advisor, or in any other capacity. The Division seeks an industry bar, which is the functional equivalent of a permanent injunction, barring Mr. Chiappone from ever again selling a security. In that regard, the cases in which the SEC seeks an injunction barring future violations of securities laws are instructive. With respect to injunctive or equitable relief, there are a number of cases which hold that the critical criteria in determining whether to issue injunctive or prophylactic relief whether there is a reasonable likelihood that the conduct violative of the securities laws is likely to continue. See, for example, *Securities and Exchange Commission v. Patel*, 651 F3d 137 (2d Cir. 1995). The *Patel* case involved the issuance of a permanent injunction against an officer of a public company, as well as a lifetime bar from serving as an officer of director of a public company. In reversing a lifetime bar imposed by the district court, the Second Circuit iterated the need for a factual finding as to the likelihood of future misconduct, and further noted the impact that a lifetime bar would have upon the Defendant, stating:

> "We do find a problem in this case, however, with the district court's finding regarding the likelihood of future misconduct, which is always an important element in deciding whether the substantial unfitness found justifies the imposition of a lifetime ban. The only findings that the District Court made in this regard were that 'Patel was a founder of Par and used his position as an officer and director

to engage in misconduct.' This is merely a general statement of events and can in no way justify the prediction that future misconduct will occur.

Moreover, we think that it was error for the district court to say that the likelihood of future misconduct based on the foregoing statement 'is sufficient to warrant the imposition of injunctive relief requested.' Loss of livelihood and the stigma attached to a permanent exclusion from the corporate suite certainly requires more. In a case in which we approved lifetime banishment . . . we noted that the defendants 'had committed securities law violations with a 'high degree of scienter' and that their past securities law violations and lack of assurances against future violations demonstrated that such violations were likely to continue'" (*SEC v. Patel*, 61 F3d at 141-142).

There are numerous cases noting the requirement of the likelihood of future violations. See, for instance, *SEC v. Manor Nursing Centers*, 458 F2d 1082, 1101 (2d Cir. 1972) ("The critical question for a district court in deciding whether to issue a permanent injunction in view of past violations is whether there is a reasonable likelihood that the wrong will be repeated"). This aspect of the *Manor Nursing* decision was cited approvingly by Chief Justice Burger in his concurring opinion in *Aaron v. SEC,* 446 U.S. 680, at 703. In that opinion Justice Burger noted that, to obtain injunctive relief, the Commission must always show a likelihood of future violations, stating:

It bears mention that this dispute [about whether scienter is required for certain violations], though pressed vigorously by both sides, may be much ado about nothing. This is so because of the requirement in injunctive proceedings of a showing that "there is a reasonable likelihood that the wrong will be repeated." *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1100 (CA2 1975). Accord, *SEC v. Keller Corp.,* 323 F.2d 397, 402 (CA7 1963). To make such a showing, it will almost always be necessary for the Commission to demonstrate that the defendant's past sins have been the result of more than negligence. *Because the Commission must show some likelihood of a future violation, defendants whose past actions have been in good faith are not likely to be enjoined.* See opinion of the Court, ante, at 701. That is as it should be. An injunction is a drastic remedy, not a mild prophylactic, and should not be obtained against one acting in good faith." *Aaron,* 446 U.S. at 703 (emphasis supplied).

Other circuit court decisions similar to *Manor Nursing* include *SEC v. Culpepper*, 270 F2d 241, 249 (2d Cir. 1959) ("the critical question for the court in cases such as this is whether there is a

reasonable expectation that the defendants will thwart the policy of the Act by engaging in activities proscribed thereby"); *SEC v. Commonwealth Chemical Securities*, 574 F2d 90, 99-100 (2d Cir. 1978) ("the ultimate test is whether the defendant's past conduct indicates ... that there is a reasonable likelihood of further violation in the future").

The Second Circuit, in *SEC v. Commonwealth Chemical Securities*,[169] discussed the reasonable likelihood test and its development in some detail, stating:

> "It is fair to say that the current judicial attitude toward the issuance of injunctions on the basis of past violations at the SEC's request has become more circumspect than in earlier days. Experience has shown that an injunction, while not always a 'drastic remedy' as appellants content is often much more than the 'mild prophylactic' described by the dissenters in this court in *SEC v. Capital Gains Research Bureau, Inc.* (citation omitted). In some cases the collateral consequences of an injunction can be very grave (citations omitted). The Securities Act and the Securities Exchange Act speak, after all, of enjoining 'any person [who] is engaged or about to engage in any acts or practices 'which constitute or will constitute a violation' (citation omitted). Except for the case where the SEC steps in to prevent an ongoing violation, this language seems to require a finding of 'likelihood' or 'propensity' to engage in future violations (citations omitted). As said by Professor Loss, 'the ultimate test is whether Defendant's past conduct indicates . . . that there is a reasonable likelihood of further violation in the future' (citation omitted). Our recent decisions have emphasized, perhaps more than older ones, the need for the SEC to go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence"
> (citations omitted). 574 F.2d at 99-100.

Other cases containing essentially identical language to that in *Commonwealth Chemical* include *SEC v. Bausch & Lomb*, 565 F2d 8, 18 (2d Circ. 1977) where the Court went so far as to say "the Commission cannot obtain relief without positive proof of a reasonable likelihood that past wrong-doing will recur." *See also*, *SEC v. Universal Major Industries*, 446 F2d 1044, 1048 (2d Cir. 1976), and *SEC v. Parklane Hosiery*, 558 F2d 1083 (2d Cir. 1977) and *SEC v. Culpepper,* ("The case [for injunction] may be moot if the defendant can demonstrate that 'there is no reasonable

[169] *SEC v. Commonwealth Chemical Securities*, 574 F2d 90 (2d Cir. 1978).

expectation that the wrong will be repeated'")[170], and *SEC v. Milan Capital Group,* 2000 U.S. Dist. LEXIS 16204 (S.D.NY. 2000).

The Ninth Circuit has also held that another consideration in determining the appropriateness of injunctive relief is the remoteness of defendant's violations. *SEC v. Rind*, 991 F.2d 1486, 1492 (9th Cir. 1993). Applying the facts concerning Chiappone, it is now 4½ years since he sold a private placement, indicative of a lack of intent to do so in the future.[171]

It is clear that the burden of proof on establishing the need for an injunction on the basis of likelihood of further conduct is upon the government. *See, SEC v. Culpepper*, 270 F2d 241, 250, *SEC v. Bausch & Lomb*, 565 F2d 8, 18:

> "... [T]he moving party must satisfy the court that relief is needed. The necessary determination is that there exists some cognizable danger of recurrent violation, something more than the mere possibility which serves to keep the case alive."

To similar effect, *see*, *SEC v. Commonwealth Chemical Securities,* 574 F2d 90, at 100 ("our recent decisions have emphasized ... the need for the SEC to go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence"). In that regard, it must be noted that there was absolutely no evidence that suggested Mr. Chiappone was likely to resume selling any private placement securities.

It is the case that courts have held that fraudulence of past conduct gives rise to an inference of expectation of continued violations,[172] and that cessation of the complained-of conduct prior to the granting of an injunction will not necessarily render the request for an injunction moot.[173] However, facts established in this proceeding do not invoke the findings of any of the cases cited in footnotes 172 & 173. The inference of future violations from past misconduct is overcome in the

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[170] *SEC v. Culpepper,* 270 Fed at 249 (2d Cir. 1959).
[171] Tr., p. 5613. As to the 4½ year gap, see Div. Ex.2, Schedule 4c (Summary of Chiappone sales).
[172] *SEC v. Manor Nursing Centers*, 458 F2d 1082, 1100 (2d Cir. 1972); *SEC v. Keller Corp.,* 323 F2d 397, 402 (7th Cir. 1963); *SEC v. Culpepper*, 270 F2d at 250 (2d Cir. 1959).
[173] *SEC v. Manor Nursing Centers,* 458 F2d 1082, at 1101; *SEC v. Culpepper*, 270 F2d 241, at 249 (2d Cir. 1959).

present matter by Mr. Chiappone's having never sold or offered a private placement in the 4½ years since he left MS & Co. and his testimony that he has completely changed the nature of his practice, by eliminating private placements and focusing on insurance-based product and advisory services.[174] With respect to cessation of the conduct under review, the SEC cannot claim that Mr. Chiappone only ceased selling private placements in response to the filing of the instant litigation, or even the threat of such filing. In fact, Mr. Chiappone left his employ at McGinn Smith in late 2009, some four years before filing of the OIP in this case, and well before he was advised or became aware that he may be the target of a civil proceeding by the SEC. He stopped selling private placements because the collapse of McGinn Smith and the subsequent revelations of the illegal activities committed by its principals convinced him that he wanted nothing more to do with securities of this nature; not because he foresaw these proceedings. Hence, the language regarding cessation of conduct in the *Manor Nursing, Keller* and *Culpepper* decisions[175] have no bearing on this matter.

Courts have held that injunctive relief is particularly applicable where the Defendant's conduct involves a high degree of scienter. See, for example, *SEC v. Posner*, 16 F3d 520, 521-522 (2d Cir. 1994); *SEC v. Milan Capital*, 2000 U.S. District Lexis 16204 [*28] (SDNY 2000); and *SEC v. Drexler Burnham Lambert*, 837 F. Sup. 587, 611 (SDNY 1993). Here, the Division seeks to bar Chiappone and other brokers on a lifetime basis where there was a complete absence of showing of *any scienter*, much less a high degree of scienter. In fact, the Division has not proven nor even pleaded that Mr. Chiappone was a primary actor or even peripherally involved in the fraudulent activities that resulted in Messrs. McGinn and Smith being convicted and sentenced to federal prison. Nor has the SEC alleged that Mr. Chiappone was *aware* of the fraud being

[174] Tr., pp. 5612 – 5613.
[175] See decisions noted in footnotes 6 and 7, above.

committed by his superiors. Rather, the Division seeks to impose a lifetime bar because Mr. Chiappone (and the other brokers) failed to discover a fraud that was being actively concealed by his superiors. Hence, the conduct hardly rises to the level of scienter which is an important factor in deciding whether to issue injunctive relief, particularly where the relief sought is a lifetime bar.

Another factor to be considered in determining the appropriateness of injunctive relief is the lack of assurances on the part of the defendants that the conduct complained of will not be continued. In this regard, see, *SEC v. Posner*, 16 F3d 520, 521-522; *SEC v. Drexler Burnham Lambert*, 837 F. Supp. at 611; *SEC v. Patel*, 61 F3d 137, at 142 (2d Cir. 1995). It is important to note that Mr. Chiappone testified that in the four years since he left McGinn Smith and became affiliated with another broker, he has neither sold nor even offered a private placement to any customer at any time.[176] If conduct speaks louder than words, then Mr. Chiappone's conduct surely establishes that he has no intention to sell private placements, and that there is almost no likelihood that he will do so in the future.

A comprehensive discussion of many of the criteria to be applied in considering whether a lifetime industry bar is appropriate is *Seghers v. SEC,* 548 F.3d 129 (D.C. Cir. 2008). In *Segher,* the SEC obtained a permanent injunction against an investment advisor in a district court jury trial and then brought an administrative proceeding to bar defendant Seghers from ever associating with an investment advisor company. The court listed the factors bearing upon its decision to uphold the SEC's imposing a permanent bar:

> "The SEC considered 'the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendants assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations' in determining a sanction that protects the public interest." (*Seghers*, 548 F.3d at 135).

[176] Chiappone testimony, Tr. pp. 5611 – 5613.

In *Seghers,* the defendant was a direct participant in the wrongdoing, over-stating the value of customers' accounts (invested in private placements) to the company that produced customer statements, even after he became aware that the values he was sending were off the mark by almost $30 million. He also sent a letter to customers touting "positive developments," only days before he advised his attorney that the investments were in fact "in the toilet."

Contrast Segher's conduct with that of Mr. Chiappone. He was not an active participant in any wrongdoing, and in fact was not accused of such. Set forth below is a review of the criteria laid out by the D.C. Circuit, and their application to the facts in this case:

1. Egregiousness of Defendant's Actions. Mr. Chiappone can hardly be found to have acted in an egregious fashion, as the claim against him essentially asserts negligence in failing to detect the frauds committed by Messrs. McGinn and Smith. There is not one shred of evidence, nor any allegation, that he ever actually knew of the conduct of his superiors that was the driving factor in causing investor losses.

2. Recurrent Nature of the Infraction. Again, while Seghers repeatedly provided information that over-valued investments, Mr. Chiappone is accused of no misrepresentations, only of failing to know of underlying fraud at point in time that he sold certain private placement investments to clients. There is no allegation that he ever misled or misinformed clients after the time of the sale, as was the cases in *Seghers*.

3. Scienter. Similar to the "egregiousness" test, there is no allegation or any evidence that suggests that Mr. Chiappone ever engaged in conduct that was knowingly unlawful. In *Seghers,* the defendant was found to have knowingly or recklessly defrauded the investors (548 F.2d at 135).

4. Sincerity of Defendant's Assurances as to Future Violations. In the four years since he parted company with McGinn, Smith, he has neither sold nor offered a private placement

security. Actual conduct speaks louder than mere promises, no matter how sincere those promises may be.

5. Defendant's Recognition of Acts. While never believing his actions (in selling private placements) was wrongful at the time the sales took place, Mr. Chiappone clearly has become aware that the risks inherent in private placements – especially where the issuer and brokerage firm are commonly controlled. Once again, his refusal to offer any private placements in the ensuing four years after he left McGinn, Smith shows that he recognizes that proprietary product involves an additional layer of risk to the customer.

6. Likelihood that Defendant's Occupation will Result in Future Violations. While he is a fully licensed broker, Mr. Chiappone testified that his current practice is geared towards investment advisory, fee-based relationships (vs. commissions for transactions).[177] He is also much more involved with insurance company product, where the sponsors of the product are well-known, well-capitalized public companies.[178] This is a far cry from the proprietary offerings of MS & Co.

Hence, applying the criteria of *Seghers,* it is submitted that the sanction of a lifetime bar is not appropriate.

It is submitted that a lifetime bar would be punitive in nature and is not required for the protection of investors. While giving great deference to the decisions of the SEC in regard to choice of sanctions,[179] the courts have noted that the sanction chosen must be designed to protect investors, but not to punish a regulated person or firm. *Paz Secs., Inc. vs. SEC*, 566 F.3d 1172, 1175 (D.C. Cir 2009) (Paz II) (citing to its earlier decision in *Paz I,* 494 F.3d at 1065). *Paz* involved an appellate court review of the SEC's approval of a sanction initially imposed by the

[177] Chiappone testimony, Tr., pp. 5612 - 5613.
[178] Tr., pp. 5612.
[179] *See*, e.g., *Seghers v. SEC,* 548 F.3d 129, 135 (D.C.Cir. 2008); *WHX Corp. v. SEC,* 362 F.2d 854, 859 (D.C. Cir. 2004).

NASD. In *Paz I,* the court directed the SEC to explain why imposing the most severe, and therefore apparently punitive sanction is, in fact, remedial, stating:

> "When evaluation whether a sanction imposed … is excessive or oppressive, as we have stated before, 'the Commission must do more than say, in effect, petitioners are bad and must be punished' (citations omitted); at the least it must give [s]ome explanation addressing the nature of the violation and the mitigating factors presented in the record (citations omitted). … The Commission must be particularly careful to address the potentially mitigating factors before it affirms an order …barring an individual from associating with an NASD member firm – the securities industry equivalent of capital punishment (citation omitted)." *Paz I,* 494 F.3d at 1064-65.

Similarly, the Fifth Circuit, in *Steadman v. SEC,*[180] has held that a permanent bar should only be applied when justified by the facts. Aware of the limitations on the scope of review of an SEC administrative proceeding,[181] the court nonetheless noted the need for the SEC to justify the imposition of a permanent bar:

> "In our view, however, permanent exclusion from the industry is 'without justification in fact' unless the Commission specifically articulates compelling reasons for such a sanction. For example, the facts of a case might indicate a reasonable likelihood that a particular violator cannot ever operate in compliance with the law, (citation omitted), or might be so egregious that even if further violations of the law are unlikely, the nature of the conduct mandates permanent debarment as a deterrent to others in the industry …." (603 F.2d at 1140).
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> . . . .
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> "We heartily endorse the Commission's view that while scienter is not required to make out violations of several of the statutory sections involved here, *the respondent's state of mind is highly relevant in determining the remedy to impose. It would be a gross abuse of discretion to bar an investment adviser from the industry on the basis of isolated negligent violations.*" (emphasis supplied) (603 F.2d at 1140-41).

In a similar vein, the D.C. Circuit, in *Blinder, Robinson & Co. v. SEC,* 837 F.2d 1099, 1113, the court, in vacating certain SEC-imposed sanctions, stated: "In this setting [2-year ban on brokerage firm principal] the Commission is not simply rendering a policy judgment; nor is it simply regulating the securities markets; it is, rather, singling out and directly affecting the

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[180] *Steadman v. SEC,* 603 F.2d 1126 (5th Cir. 1979).

[181] *See, Steadman,* 603 F.2d at 1139-1140.

livelihood of one commercial enterprise and terminating (possibly forever) the professional career of the firm's founder. Faced with a task of such gravity, the Commission must craft with care." 837 F.2d at 1113.

Finally, there is authority for the proposition that a broker's conduct after the initiation of proceedings can be taken into account in reviewing the sanctions imposed. *See*, *McCarthy v. SEC,* 406 F.3d 179 (2d Cir. 2005). The *McCarthy* case involved a floor broker given a 2-year suspension.

The *McCarthy* court noted the purpose of sanctions being remedial and not punitive in nature, and went on to point out that the defendant had an exemplary record both before and after initiation of proceedings:

> "It is familiar law that the purpose of expulsion or suspension from trading is to protect investors, not to penalize brokers. In *Wright v. Securities & Exchange Commission,* we noted that the Securities Exchange Act 'authorizes an order of expulsion not as a penalty but as a means of protection investors .... The purpose of the order is remedial, not penal' (citations omitted). The Commission itself has recognized this. *See, e.g., In re Howard F. Rubin,* Exchange Act Release No. 35, 179, 58 S.E.C. Docket 1426, 1994 WL 730446 ('It is well-settled that such administrative proceedings are not punitive but remedial. When we suspend or bar a person, it is to protect the public from future harm at his or her hands.'). Our foremost consideration must therefore be whether McCarthy's sanction protects the trading public from further harm."
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> . . . .
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> "...Indeed, McCarthy has been trading on the floor of the Stock Exchange for the past 11 years (the two-year suspension was stayed pending appeal to the SEC and this Court), and the SEC does not dispute McCarthy's contention that, with the exception of his involvement with Oakford in 1995 and 1996, he has operated lawfully and within the rules. Thus, for nine years McCarthy has proven himself to be a rule-abiding trader. Even at the time the Board summarily imposed the two-year suspension, McCarthy had been trading without incident for six years." (406 F.3d at 188-189).

Once again, applying the facts to the principles noted in *Paz I & II, Steadman, Blinder, Robinson* and *McCarthy* decisions, it becomes apparent that a lifetime bar for Mr. Chiappone is both overkill and unnecessary for the public protection. Mr. Chiappone has served the investing

public since January of 2010, without a hint of misconduct. This actions and his stated intent to never again offer a proprietary private placement product, render the need for injunctive relief moot.

POINT V

IF INJUNCTIVE RELIEF IS GRANTED, IT SHOULD BE LIMITED IN SCOPE

All of the securities which are subject to the OIP were private placements, and the vast majority involved private placements of fixed income promissory notes. There was absolutely no allegation that Mr. Chiappone ever engaged in the typical types of broker misconduct, such as churning, front running, sales of penny stocks, selling away or misrepresentation as to the risks involved in particular offerings. Rather, the gist of the SEC's complaint is that the brokers should have stopped selling what they then understood to have been successful offerings of high-yield debt securities, due to purported "red flags." Coupled with the lack of any of the typical broker misconduct is the fact that Mr. Chiappone had a completely unblemished record prior to the institution of the present proceeding. He has never been the subject of any disciplinary proceedings by NASD or FINRA, and has never been named individually in a lawsuit or customer arbitration.[182] Hence, the request for a lifetime ban from selling all securities would be overkill, and completely unnecessary for the protection of the public interest. While it is clear that although the SEC (as opposed to a private plaintiff) does not have to show a likelihood of irreparable harm in order to obtain injunctive relief, this does not mean that the Courts can cast aside all notions of fairness in determining whether an injunction is necessary or appropriate. While acknowledging that the burden is higher on a private plaintiff seeking injunctive relief, the Court stated that "we scarcely need to imply that judges are free to set aside all notions of fairness because it is the SEC, rather

[182] Chiappone testimony, Tr., pp. 5400 – 5401.

than a private litigant, who has stepped into Court. The securities laws, like the price control legislation . . . hardly evidence a congressional intent to foreclose equitable considerations by the District Court . . . and, as we said in *SEC v. Manor Nursing Centers, Inc.*, (citation omitted) 'in deciding whether to grant injunctive relief, a District Court is called upon to assess all those considerations of fairness that have been the judicial concern of equity courts.'" *SEC v. Management Dynamics*, 515 F2d at 808. Here, balancing the equities it appears obvious that considerations of public protection do not require a lifetime bar against Mr. Chiappone's continuing to practice a profession that he has been engaged in for more than 30 years. His track record for the past 4½ years, clearly demonstrate that he has no intention to ever again market a proprietary private placement product.

Should this tribunal determine that some sanction is justified, it is submitted that the interests of protection of the public would be served by limiting an injunctive relief to a ban from selling private placement securities for a period of three years.

POINT VI

SALE OF UNREGISTERED SECURITIES
(SECTION 5 OF '33 ACT)

The Division also brought claims against Mr. Chiappone for alleged violations of § 5 of the 1933 Securities Act. It is clear is that the burden of proof to establish exemption from registration is on the broker. *Kane vs. SEC,* 842 F.2d 194 8thCir. 1988); *SEC v. Culpepper*, 270 F2d 241, 246 (2d Cir. 1959). What is less clear is the degree of culpability required to establish a § 5 violation. Some courts have determined that *scienter* is not an element of liability for § 5 claims. For instance, the Southern District of New York has ruled that *scienter* is not required for a § 5 violation. See, *SEC v. Universal Express, Inc.*, 475 F. Supp. 2d. 412, 422 (S.D.N.Y. 2007); *SEC v. Platinum Inv. Corp.,* 2006 U.S. Dist. LEXIS 67460, at [5]. These cases hold that to prove a §5

violation, the SEC must only show: (a) lack of a registration statement as to the securities sold, (b) the offer or sale of securities, and (c) use of interstate facilities, such as the phone or mails. *SEC v. Cavanagh*, 445 F.3d 105, 111, fn. 13; *SEC v. Platinum Inv. Corp.*, 2006 U.S. Dist. Lexis 67460 at [5] (SDNY 2006).

The decisions of the appellate courts on the requirements to establish a § 5 violation are less clear. In the *Universal Express* opinion, the district judge cited the Supreme Court case of *Aaron v. SEC* in support of its finding that scienter was not required.[183] However, review of the passage in *Aaron* (footnote 5) shows that the Supreme Court did not in fact decide that scienter was not a requisite to find a § 5 violation. In fact, Justices Blackmun, Brennan and Marshall, in that passage (part of their dissenting opinion) merely noted that § 5 "has been interpreted to require no showing of scienter," citing to the two Second Circuit cases cited above. They further noted that revocation of a broker-dealer registration would require a finding of scienter:

> "The 1934 Act incorporated the culpability requirements for Commission remedies that the 1933 Act had established, although it did set a scienter standard for SEC remedies of criminal prosecution and administrative revocation of broker-dealer registrations." 446 U.S. at 714, n. 5, 100 S. Ct. at 637, n. 5.

The issue of need for scienter is also less than clear in the D.C. Circuit. In *Zacharias v. SEC,*[184] the SEC administrative law judge had opined that that § 5 imposes strict liability, but also based the decision on a factual finding that the respondent knew or should have known of the lack of registration. The court then stated that "[u]ltimately, we need not resolve the question of whether strict liability applies because we affirm the SEC's finding that petitioner Zacharias knew or should have known [of the public distribution]."[185]

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[183] *SEC v. Universal Express, Inc.,* 475 F. Supp.2d at 422 (citing to *Aaron* at 446 U.S. 680, 714 n.5).
[184] *Zacharias v. SEC,* 569 F.3d 458 (D.C. Cir. 2009).
[185] *Zacharias,* 569 F.3d at 465-466.

However, even if scienter is not strictly applicable to a determination of liability, it can and should be taken into account in determining whether the § 5 violation was willful, which goes to the remedy that is appropriate to impose upon the broker. *Kane v. SEC, supra, at 198*. In *Kane,* the Eighth Circuit held that the reasonableness of the registered representative's belief that the shares were exempt from registration was relevant to the willfulness of the violation of section 5, not whether a violation occurred. *Kane,* 842 F.2d at 198.

There are a number of Second Circuit cases that hold that willfulness implies nothing more than intentionally committing the act that constitutes the violation. See, for example, *Arthur Lipper Corp. v. SEC, Jaffe v. SEC,* and *Tager v. SEC*. However, in *Tager,* the broker was barred for fraud-based violations, not lack of registration. *Jaffe* involved a violation of Rule 10b-6, again not a sale of unregistered securities. *Arthur Lipper* involved a Rule 10b-5 violation. Those violations themselves require scienter, so willfulness may, in that situation, require only intent to do the act.

The next question, is whether these Second Circuit cases, which state that scienter is not a requirement for a section 5 case, override the statutory requirement of 15 U.S.C. § 78(o). The decision in *SEC v. Spectrum, ltd.,* 489 F.2d 535, 541-542 (2d Cir. 1973) provides no guidance, as there was no registered representative disciplined. The issue of willfulness centered on the attorney who gave an opinion that registration was not required, and the court found that his liability as an aider and abettor was founded on a negligence standard.

Certain statutory provisions require a "willful" violation for the imposition of certain penalties. See, 15 U.S.C. § 78(o)(b)(4)(d), which provides:

> The Commission, by order shall … revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such … revocation is in the public interest and that such broker or dealer … or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated –
>
> (D) has willfully violated any provisions of the Securities Act of 1933 [15 USCS §§ 77a et. seq. …."

The Eighth Circuit, in the context of a sanction imposed via §78(o), for violation of the '33 Act §5(a) & 5(c) registration provisions, has held that willfulness implies something more than mere negligence:

> "The Commission sanctioned Wasson under § 15(b) of the Securities Act of 1934 for *willfully* violating § 5 of the Act and *willfully* aiding and abetting the violation of that provision. Wasson challenges the finding that he acted willfully, claiming that his behavior ... was merely negligent. Relying on Ernst & Ernst v. Hochfelder, supra, Wasson submits that willfulness as "a state of mind condition requires something more than negligence." *Id.* at n. 28. We agree that the concept of willfulness implies something more than mere negligence. However, neither the statute nor the relevant regulations defines the scope of that term. In negligence law, the words "'willful,' 'wanton,' and 'reckless' are employed either singly or in combination to characterize conduct * * * more heinous or culpable than ordinary negligence." 57 AM. JUR. 2nd, *Negligence*, § 101 at 451; Prosser, *Law of Torts*, 184 **[**20]** (4th Ed. 1971). In several securities' cases prosecuted under the willfulness standard of § 15, violations were found where the defendant proceeded in apparent disregard of or with reckless indifference to a known obligation or set of facts. In *Nees v. SEC*, 414 F.2d 211 (9th Cir. 1969), a salesman was sanctioned for selling unregistered securities; he defended on the ground that he had no obligation to investigate the validity of his employer's claim of exemption. The Court found a willful violation on the ground that the defendant was aware of facts which should have caused him to question the exemption claim. Similarly, in *Stead v. SEC*, 444 F.2d 713 (10th Cir. 1971), *cert. denied*, 404 U.S. 1059, 30 L. Ed. 2d 746, 92 S. Ct. 739 (1972), the Court upheld a willfulness finding where the defendant consciously closed his eyes to suspicious facts which should have suggested the need for registration."

Wasson v. SEC, 558 F.2d 879, 887 (8th Cir. 1977). In *Stead v. SEC* (cited by the court in *Wasson,* above), the Tenth Circuit applied a test of "willfulness" that involved wrongdoing on the part of the registered representative, finding that the SEC's determination that broker Stead "knew or should have known that there was no registration [was] well supported by the evidence." *Stead,* 444 F.2d at 716.

It is submitted that Mr. Chiappone's sale of any offerings that had more than 35 unaccredited investors does not meet the standards of *Wasson.*[186] Not only did he not know that total sales of all brokers exceeded the 35 investor limit, he had no way of knowing what sales had been made by other brokers at any given point in time. As noted above, the Eighth Circuit, via its' *Kane* decision also appears to require that the broker bear some element of fault in order for a revocation of registration to be imposed.

There likewise appear to be scienter requirements regarding the civil penalties. The Division seeks to impose civil penalties under 15 U.S.C. § 77h-1(g) and 15 U.S.C. § 78u-(d)3(A). In order to impose a Tier II penalty, both of those statutes require acts that "involved fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement. A Tier III penalty has the same requirements, plus substantial losses to other persons, or in the case of the '33 Act provisions, substantial gain to the offender. In *SEC v. Kern,* the Second Circuit, in assessing Tier II and Tier III penalties under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, assumed, without deciding, that scienter is necessary to an imposition of Tier III Penalties.[187]

In assessing civil penalties, the court may take into account the fact that the respondents were required to pay substantial sums in disgorgement. *SEC v. Whittemore,* 691 F. Supp.2d 198, 209 (D.D.C. 2010). In *Whittemore,* the court imposed a $25,000 civil penalty where the maximum Tier III penalty was $ 120,000, finding it ample for the purpose of deterrence, where the defendants were all required to disgorge all of their profits on a pump and dump scheme.[188] In assessing the amount of the penalty, the court may take into account the "essential and active roles the

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[186] It must be noted that the broker was found to have violated '33 Act § 5 in *Wasson,* as the court found he ignored an obvious need for further inquiry, and failed to disclose all relevant information to his superiors. Likewise, in the *Nees* case and the *Stead* case cited in *Wasson,* the courts found that, although willfulness implied wrongdoing, the respondent brokers had in fact knew or should have known of the lack of registration.

[187] *SEC v. Kern,* 425 F.3d 143, 153 (2d Cir. 2005). The court did not decide as to the scienter issue, as it found that the defendants conduct would have met a scienter requirement.

[188] *Whittemore,* 691 F.Supp.2d at 208-209.

individuals played in perpetrating the fraud ...." *SEC v. Lybrand,* 281 F.Supp.2d 726, 732 (S.D.N.Y. 2003). And of course, under Gabelli, the amount of the penalties must be determined only with reference to those sales occurring after September 23, 2008. Hence, it is submitted that civil penalties are not appropriate as applied to Mr. Chiappone but, if assessed, should be modest, considering that the central allegation in this case is not that Mr. Chiappone participated in or even actually was aware of any fraud, but that he failed to ferret out the fraud of others.

Finally, it is requested that the court take into account the fact that the § 5 violations were due to the fact that the Four Funds offerings did not qualify for the Reg. D, Rule 506 exemption, which in turn was due to sales of more than 35 unaccredited investors on each deal. But Mr. Chiappone was not privy to, and had no access to information as to total investors (accredited or unaccredited) on offerings, as sales were made by multiple brokers in multiple offices. Mr. Chiappone testified to a lack of knowledge of how many unaccredited investors were sold by other brokers, as neither Ms. Sicluna nor anyone else ever advised him of the count.[189] Mr. Guzzetti also testified that he was never advised that unaccredited investors had been sold Four Funds notes.[190] While this may not avoid a violation of the statute, it surely should be taken into account in determining what sanction, if any, is appropriate. Because it is likely that this condition (brokers not notified to stop selling at the 35 person limit) was the fault of David Smith, whose assistant had sole access to those figures, it is respectfully requested that no suspension or monetary penalties be levied with respect to the § 5 portion of the Division's case against Mr. Chiappone.

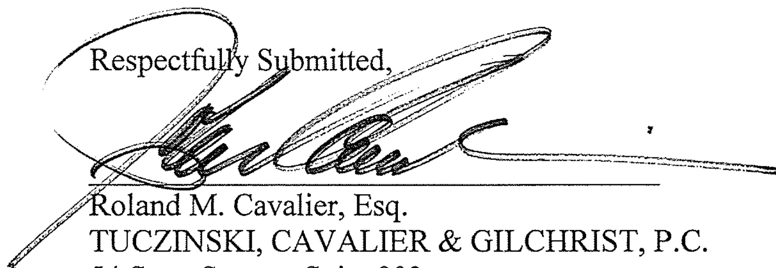
[189] Chiappone testimony, Tr. pp. 5493 – 5495.
[190] Guzzetti testimony, Tr. pp. 4646 – 4648.

CONCLUSION

Based on the foregoing, Respondent Chiappone respectfully requests that the Court enter his proposed findings of fact and conclusions of law, and dismiss the proceedings against him, with prejudice.

Dated: May 12, 2014
Albany, New York

Respectfully Submitted,



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