UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15514

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JUN 13 2014
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In the Matter of

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

Respondents.

CHIEF JUDGE BRENDA P. MURRAY

POST-HEARING REPLY BRIEF OF THE DIVISION OF ENFORCEMENT

David Stoelting
Haimavathi V. Marlier
Michael D. Birnbaum
DIVISION OF ENFORCEMENT
Securities and Exchange Commission
Brookfield Place
200 Vesey Street, Suite 400
New York, NY 10281-1022

June 12, 2014

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PRELIMINARY STATEMENT

Confronted with an extensive record that makes clear Selling Respondents failed to investigate the fraudulent MS & Co. private placements they recommended to their clients, Selling Respondents' primary defense is that as registered representatives—as opposed to broker-dealers—they had no duty of investigation. Their duty, however, has been firmly established at least since *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969), and has been reaffirmed by this and other Courts many times since then.

Selling Respondents utterly failed to discharge these duties, particularly in view of the red flags demanding further inquiry. Their failures, as well as their material misrepresentations and omissions, violate the antifraud provisions of the federal securities laws. Selling Respondents also violated Section 5 of the Securities Act by selling the unregistered MS & Co. private placements without an exemption from registration.

Respondent Guzzetti's defense, that he was a supervisor but was somehow walled off from the private placements, is contradicted by an extensive record. In fact, Guzzetti played a critical role in advancing the scheme; in particular by following Smith's command that "redemptions have to have replacement sales beforehand." Guzzetti failed reasonably to supervise, and his egregious failures allowed the fraud to continue.

Each of the Respondents' conduct warrants the remedies sought by the Division. Their profits should be disgorged with prejudgment interest thereon, their violations penalized with civil monetary penalties, and they should be ordered to cease and desist their misconduct. In addition, Respondents should be barred from the securities industry to protect investors and serve as a deterrent to brokers everywhere. Even with the benefit of time to reflect on their actions, Respondents uniformly take no responsibility, and show no remorse, for their misconduct, highlighting why industry bars are particularly appropriate in this case.

ARGUMENT

I. SELLING RESPONDENTS VIOLATED SECTION 5 OF THE SECURITIES ACT

A. The Four Funds had More than 35 Unaccredited Investors Each

Selling Respondents do not dispute that the Division proved a *prima facie* Section 5 violation. This shifts the burden to Selling Respondents to prove that some exemption or safe-harbor from registration was available (Division Initial Brief ("Div. Br.") at 3), but they fail to satisfy that burden. In particular, Selling Respondents did not present any evidence that the Four Funds had fewer than 35 unaccredited investors. By contrast, the Division's summary witness, Olumiseun Ogunye, testified that she analyzed and summarized voluminous records including purchaser questionnaires and the investor database and relied on the Division's investor interviews to conclude that each of the Four Funds had more than 35 unaccredited investors. Tr. 1348:13-1376:16; FoF ¶ 183.[1] Despite certain Selling Respondents' unsupported claims that her conclusions were unreliable, *see, e.g.,* RMR Br. at 34, Selling Respondents fail to offer any evidence suggesting any of the Four Funds had 35 or fewer unaccredited investors. Thus, the Four Funds did not qualify for the Rule 506 exemption from registration. Other exemptions from registration, including Section 4(2) of the Securities Act are not available. Div. Br. at 4-5.

B. Selling Respondents' Four Funds Sales Were Not in Good Faith

Whether Selling Respondents acted in good faith is irrelevant to the Court's consideration of their Section 5 liability. *See Matter of Doxey et al.,* No. 3-15619, 2014 WL 1943919, at *18 (May 15, 2014) (neither lack of intention to violate the Securities Act nor reliance on legal counsel are relevant to liability determination); *Matter of Bloomfield et al.*, No. 3-13871, 2011 WL 1591553, at *25 (Apr. 26, 2011) (scienter is not required for a violation of Section 5).

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[1] Except where otherwise specified, all references to "FoF" refer to the Division's April 9, 2014 Proposed Findings of Fact.

Selling Respondents cannot shield themselves from Section 5 liability with the excuse that others at MS & Co. were responsible for counting unaccredited investors: brokers cannot "abdicate [their] responsibility to ensure that an exemption from registration was available for the securities [that they] sold to investors."[2] *See Matter of Giesige*, No. 3-12747, 2008 WL 4489677, at *24 (Oct. 7, 2008), *aff'd* 2009 WL 1507584 (May 29, 2009) (rejecting broker's Section 5 defense that she relied on issuer to determine whether an investor was accredited and to limit the number of unaccredited investors).

To the extent the Court considers Selling Respondents' scienter in determining what relief is appropriate, Selling Respondents' Four Funds sales were not in good faith. *See* RMR Br. at 38; Lex Br. at 31; Chiappone Br. at 85-86; Livingston Br. at 31-32. First, the Four Funds PPMs state on numerous pages that the notes were to be offered to accredited investors *only.* FoF ¶ 135. Thus, the very terms of the PPMs, with which Selling Respondents were, or should have been, familiar, signaled that these were risky investments unsuitable for unaccredited investors. Selling Respondents either knowingly or recklessly ignored these explicit restrictions when they sold to unaccredited investors.[3]

Second, in order to purchase a Four Funds note, all subscribers (including unaccredited investors) had to sign a subscription agreement attesting that they were accredited investors and that they had "such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of an investment in the Notes." FoF ¶ 136; Div. Ex. 5 at 39

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[2] Nor can Respondents cherry pick sales to argue that they, on an individual basis, sold to fewer than 35 unaccredited investors and, therefore, should not be liable because the entire offering exceeded Rule 506's limit. Respondents cannot "isolate certain components of the distribution and argue that various exemptions to registration apply to those component transactions." *See Matter of Carley et al.,* No. 3-11626, 2008 WL 268598, at *7 (Jan. 31, 2008) (affirming Section 5 violations).

[3] Gamello sold Four Funds notes, but not to unaccredited investors. FoF ¶ 137.

(FIIN subscription agreement). Selling Respondents knowingly, or at a minimum recklessly, encouraged their unaccredited investor customers to make false representations regarding their net worth, income or their level of investment knowledge and experience. FoF ¶¶ 137, 138, 400, 430, 519, 549, 582, 594, 605-06, 684, 735. This cannot be characterized as an "act of good faith." *See Matter of Pinkerton*, No. 3-8805, 1996 WL 602648, at *6 (Oct. 18, 1996) (broker "was wrong to accept, without any support, [control person of broker-dealer's] advice that he could ignore language in the private placement memorandum that [issuer's] securities were being offered [only] to accredited investors").

More troubling, customers of Mayer, Livingston, and Lex testified that their brokers instructed them either to ignore the representation in the subscription agreement, or to falsely indicate a higher net worth. FoF ¶¶ 582 (Mayer told unaccredited investor Thomas Alberts not to worry about subscription agreement representation that he was accredited); ¶¶ 511-13 (Livingston told unaccredited investor David LaFleche to change his net worth from $250,000 to $1 million), ¶¶ 400-01 (Lex sent subscription agreements to unaccredited investor Barbara Monahan with "sign here" flags instructing her to represent that she was knowledgeable and experienced in financial matters, when he knew that she was an unaccredited investor lacking such knowledge and experience); *see also id.* ¶ 274 (Chiappone avoided "using up" unaccredited investor spots on smaller sales). These Respondents went one step beyond ignoring prohibitions in the PPMs or failing to read the subscription agreements before their customers signed: they knowingly induced their unaccredited and financially unsophisticated customers of moderate financial means to make false representations in order to invest in highly speculative investments. *See Giesige*, 2008 WL 4489677, at *31 (broker "knowingly, or utterly recklessly, advocated the most speculative type of investment to people of moderate means, many of whom used retirement funds to make the investment").

C. <u>The Evidence Supports Integration of the Conduit Entity Trust Offerings</u>

TDM Conduit Trusts and the MSF Conduit Trusts should be integrated under Rule 502(a) of Regulation D. The TDM Conduit Trusts and the MSF Conduit Trusts were part of single financing plans, and sales were made for the same general purpose. FoF ¶¶ 66-69, 186-189. RMR and Lex, ignoring the evidence of how MS & Co. and its principals used proceeds raised from these trusts, rely solely on PPM language promising to invest money in triple-play contracts, security alarm contracts, and luxury cruise bookings to conclude that the offerings were distinct plans of financing for different purposes.[4] RMR Br. at 35-36; Lex Br. at 28-29. But the Division has proven that funds were first advanced to a "conduit entity," then misappropriated to enrich McGinn, Smith or Matthew Rogers or to support MS & Co. and related entities as liquidity needs dictated. FoF ¶¶ 66-69. In all cases, only a fraction of the money raised from investors was actually invested in accordance with the PPM. FoF ¶ 69.

With respect to timing, Selling Respondents ignore evidence of when offers and sales actually occurred in favor of language in the Trust Conduit PPMs setting forth a specific offering period. Lex Br. at 28-29; RMR Br. at 34-35. The so-called six-month safe harbor set forth in Rule 502(a) is not dependent upon when a PPM says an offering will end: the appropriate inquiry is when offers and sales for the Regulation D offering at issue actually ended. *See* 17 C.F.R. § 230.502(a). The record, including the investor database documenting all private placement sales, proves that sales of MSF Conduit certificates were never more than six months apart, and sales

4 RMR's reliance on *Donohoe v. Consolidated Operating & Products Corp.*, 982 F.2d 1130 (7th Cir. 1992) is misplaced. That case did not involve the commingling of investor funds in a common entity in order to carry out a fraud.

of TDM Conduit certificates were never more than six months and three weeks apart. FoF ¶¶ 190-91. The mere fact that two offerings are more than six months apart does not necessarily defeat integration. *See, e.g., Argentinian Recovery Co. LLC v. Bd. of Direc. of Multicanal S.A.*, 331 B.R. 537, 548 (S.D.N.Y. 2005) (citing Louis Loss & Joel Seligman, Securities Regulation, § 3–C–1(ii) (2004) & *SEC v. Murphy,* 626 F.2d 633 (9th Cir.1980)). Courts must first determine whether other factors weigh heavily in favor of integration, as they do here. *See SEC v. Murphy*, 626 F.2d at 646. Accordingly, the Trust Offerings constituting the TDM and MSF Conduits, respectively, should be integrated. As with the Four Funds offerings, Respondents fail to offer any evidence indicating that the integrated Conduit Offerings had fewer than 35 unaccredited investors and, therefore, may not avail themselves of the Rule 506 exemption.

D. <u>Respondents' Violations of Section 5 Were Willful</u>

Several Selling Respondents argue that they did not "willfully" violate Section 5 of the Securities Act. *See* Livingston Br. at 31-32; Lex Br. at 33-34; Chiappone Br. at 83-86. This argument misconstrues the word "willful" to include some form of intent to violate the law, rather than intent to do the specific act—here, the sales of unregistered securities—that violates the law. "It is well settled that a finding of willfulness under the Exchange Act does not require an intent to violate, but merely an intent to do the act which constitutes a violation." *Matter of Steen et al.,* No. 3-8798, 1997 WL 104603, at *9 (Mar. 7, 1997) (citations omitted). Accordingly, this Court has held that brokers who intend to offer and sell unregistered securities, and do so, "willfully" violate Section 5. *See, e.g., id.* (broker willfully violated Section because he intended to offer and sell securities, and no registration statement was in effect). Selling Respondents intended to offer and sell the unregistered Four Funds and Conduit Entity Trust Offerings, for which no exemption was in effect, and therefore willfully violated Section 5.

II. SELLING RESPONDENTS VIOLATED SECURITIES ACT SECTION 17(a) AND EXCHANGE ACT SECTION 10(b) AND RULE 10B-5 THEREUNDER

In recommending nearly $100 million in fraudulent securities (i) without discharging their clear-cut duties to investigate those investments, and (ii) misrepresenting and omitting material facts about those investments to their clients, Selling Respondents knowingly, recklessly or negligently violated the antifraud provisions of the federal securities laws.

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

1. Selling Respondents Had a Well-Established Duty to Make Informed Suitability Decisions Before Recommending MS & Co. Notes

Even though the duty to investigate has been a bedrock responsibility of brokers for decades, at least since *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969), Selling Respondents do their best to distort and to deny the scope and nature of their duty. In their attempt to avoid the clear standard articulated in *Hanly* and its progeny, Selling Respondents offer varied self-serving formulations of a broker's duty, ranging from begrudging acknowledgement of *Hanly* to unsupported claims that *Hanly* is no longer good law. *Compare* Chiappone Br. 38-39 (in "making a recommendation, a registered representative implies that a reasonable investigation has been made") *with* RMR Br. at 9 (brokers need only to have "a basic understanding of the features, risks and rewards of the investments") *with* Livingston Br. at 19 (arguing that *Hanly* articulates a standard for broker-dealers but not registered representatives) *with* Gamello Br. at 3 (*Hanly* is a "classic outlier"). Lex takes the most extreme position by arguing "no such duty [to investigate the MS & Co. private placements] exists from any source." Lex Br. at 34.

Notwithstanding Respondents' differing formulations, the relevant caselaw is rather straightforward. *Hanly* and an extensive line of other cases, both federal court opinions and administrative decisions, make clear the existence of a registered representative's duty of inquiry. Div. Br. at 9-13 (discussing cases). These cases establish what this Court has called the "black letter law" that brokers have a duty to investigate securities before recommending them, especially in circumstances like the MS & Co. offerings, in which brokers recommended unregistered notes issued by newly created companies owned and controlled by the same persons who owned and controlled the broker-dealer. *E.g., Pinkerton*, 1996 WL 602648, at *5.

Several Respondents spend pages trying to distinguish various administrative decisions applying *Hanly* by arguing that facts described in those decisions do not resemble the record in this case. *See* Livingston Br. at 25-28; RMR Br. at 13-15; Lex at 70-74. Respondents' arguments, however, both misconstrue the facts as described in those cases and, critically, rely on the flawed premise that Selling Respondents did not know, and could not have known, that the products they recommended were unsuitable for sale. For example, Livingston seeks to limit the precedential value of *Hanly, Giesige, Pinkerton* and *Stires* by stating that in all but one of those cases, respondents had no information about the principal's background or the issuer's performance record. Livingston Br. at 25-26. This comparison hardly helps Livingston. While he did know Smith (and McGinn, who had no role with the Four Funds), for many years, his knowledge would not have placed him in a better position than the respondents in the post-*Hanly* cases. What Livingston knew of Smith's background put him on notice that Smith had never managed a Fund as large, or with as broad a mandate, as the Four Funds.

Livingston further claims that, unlike respondents in the post-*Hanly* cases, he "ceased selling any interests and disassociated himself with MS & Co. as soon as the 'red flags' became apparent," Livingston Br. at 27, but one can only reach such a conclusion by ignoring the timing of Livingston's—and the other Respondents'—sales. Livingston, for example, continued selling

MS & Co. products even after learning of the Four Funds "catastrophe" in 2007. FoF ¶ 450.[5] Finally, Livingston notes that the *Pinkerton* Court found that brokers receiving eleven percent commissions may have been a red flag. Livingston Br. at 27-28. But the facts in this case do not help Selling Respondents, as some Trust Offerings had similarly excessive fees and expenses, *see, e.g.*, FoF ¶ 75 (discussing Benchmark offering's use of more than *one-third* of its proceeds for items other than the acquisition of assets); *see also* Lex Br. at 96 (acknowledging Benchmark's "unusually high fees"), and others generating additional commissions and fees simply to redeem investors in older offerings. FoF ¶ 229 (discussing "R" offerings, through which investors essentially purchased older investments).

RMR spends three pages discussing *Hanly*, *Giesige*, *Pinkerton* and *Stires* without once discussing those cases' holdings concerning a broker's duty to investigate and understand the securities he recommends, focusing instead on the particular misrepresentations in those cases. RMR Br. at 13-15. The closest RMR comes to touching upon what respondents in those cases knew or should have known when they recommended sales of various securities comes in RMR's description of *Stires*, where RMR describes a respondent as having continued to sell securities "despite receiving a letter indicating that the investment was a 'suspicious, non-confirmable, non-transparent or not readily understood arrangement.'" RMR Br. at 15. Selling Respondents here needed no such letter. Having seen, among other glaring red flags, serious conflicts of interest presented in the Four Funds PPMs, the Four Funds in default, refusals by Smith to provide information necessary to evaluate the MS & Co. products Selling Respondents chose to recommend and, for some Respondents, having learned that the very principals responsible for the Trust Offerings had concealed from them that the assets underlying another

5 Livingston knew by June 2007 that the disastrous decision to fund alseT had exposed him and MS & Co. to liability. FoF ¶¶ 469-70.

offering were subject to bankruptcy proceedings, they knew more than enough to at least pause and ask questions before selling more MS & Co. securities.

Lex's attempts to distinguish *Giesige, Pinkerton* and *Stires* are even more tortured. Perhaps due to Lex's commitment to the view that "there is no plausible argument that 'lack of diligence' can support a claim under Section 10(b) or Rule 10b-5," he strains to characterize each of the aforementioned holdings as focused entirely on misrepresentations. Lex Br. at 70-71. But each of those cases focuses not only on various misrepresentations but also the respondents' failure to conduct "due diligence." Div. Br. at 9-13.

The other cases Respondents rely upon reaffirm brokers' duty of inquiry. For example, RMR cites to *BNP Paribas Mortgage Corp. v. Bank of America*, 866 F. Supp. 2d 257 (S.D.N.Y. 2012), as support for its position that brokers have no duty to investigate. RMR Br. at 8. *BNP Paribas*, however, simply held that a private negligence claim against a broker-dealer was inadequately pleaded because the broker-dealer never recommended that the customer purchase the securities. 866 F. Supp. 2d at 267-68. Selling Respondents' liability, of course, stems from their sales recommendations, which they do not deny making.

BNP Paribas also distinguished between SEC enforcement and private actions because "the standards in the two contexts [are] different." 866. F. Supp. 2d at 267. The court further explained, relying on FINRA Notice to Members 10-22, that "the SEC, FINRA and NASD guidelines indicate that a duty of inquiry is triggered when a broker makes fraudulent statements to induce a sale or makes an affirmative recommendation to purchase." *Id.* at 267-268.

RMR also incorrectly cites to the Commission's opinion in *Matter of F.J. Kaufman & Co., Inc.*, No. 3-6710, 1989 WL 259961 (S.E.C. Dec. 13, 1989), as support for a broker's "more limited duty to have a basic understanding . . . as opposed to a duty to investigate or verify."

RMR Br. at 9. *Kaufman*, relying upon *Hanly* in defining a broker's duties, explained that a broker involved in recommending securities has an "obligation to his customer to investigate and disclose all material facts" and affirmed NASD findings that a registered representative made unsuitable recommendations to investors. 1989 WL 259961 at *7, n.16, 18 (citations omitted).

Selling Respondents also rely on private litigant cases that have no application either because the defendants were found to have no duty to the plaintiffs or because the defendant had no knowledge of the supposed red flags. *See, e.g., MLSMK Investments Co. v. JP Morgan Chase & Co.*, 737 F. Supp. 2d 137 (S.D.N.Y. 2010) (granting motion to dismiss because "Plaintiff has not alleged any facts indicating that Defendants owed a duty of care to Plaintiff"); *Stephenson v. Citgo Group Ltd.*, 700 F. Supp. 2d 599, 623 (S.D.N.Y. 2010) (auditor's failure to follow up on red flags can support an allegation of scienter, but complaint failed to allege facts showing that the auditor was aware of the red flags). Such cases cannot be the basis for departing from decades of precedent imposing a duty to investigate on registered representatives.

2. FINRA Rules Compliment *Hanly* and its Progeny

In arguing that only broker-dealers, and never individual brokers, bear a meaningful duty of inquiry, several Respondents make much of the fact that FINRA Rule 2310, the reasonable-basis suitability rule before 2012,[6] states that "a member shall have reasonable grounds for believing that the recommendation is suitable[.]" Respondents argue that FINRA's use of the word "member" in Rule 2310 indicates that individual brokers to have no duty of inquiry.

This argument is wrong. No court has ever held that due diligence obligation rest solely with a broker-dealer to the exclusion of individual brokers. Indeed, decades of caselaw

[6] Rule 2111, which was adopted in 2012 and replaced Rule 2310, states that "[a] member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer[.]"

recognize that individual brokers have a duty, and that recklessly breaching this duty violates the antifraud provisions of the federal securities laws. This caselaw is not trumped by FINRA rules; in fact, the rules incorporate the caselaw, including *Hanly* and its progeny. Specifically, Notice to Members 10-22—which cites *Hanly* favorably six times, as well as *SEC v. Milan Capital Group, Inc.*, No. 00 CIV. 108 (DLC), 2000 WL 1682761, at *5 (S.D.N.Y. Nov. 9, 2000)—"***reminds*** broker-dealers of their obligation to conduct a reasonable investigation of the issuer and the securities they recommend in offerings made under [Regulation D]." Div. Ex. 601 at 1 (emphasis added). Lex and RMR dismiss NTM 10-22 as "not applicable" because it was issued in 2010. Lex Br. at 59; RMR Br. at 8. But the use of the word "reminds" shows that NTM 10-22 did not create a new standard but rather reinforced preexisting duties. Div. Ex. 601 at 1.

Moreover, NTM 10-22 explicitly rejects Respondents' argument that any duty of investigation rested only with the broker-dealer. It states that "the obligations of a BD firm is also intended to cover the concomitant responsibilities of any registered representative[.]" Div. Ex. 601 at 10, n.1. Lex Ex. 150 at 27 (Regulatory Notice 12-25, May 2012) (reasonable basis suitability duties are same under "the predecessor suitability rule as well").) Tellingly, FINRA itself has relied upon NTM 10-22 in describing registered representatives' duties even when adjudicating matters involving conduct pre-dating the 2010 Notice to Members. *See Matter of Fillet*, No. 2008011762801, 2013 WL 5503320, at *6 (N.A.S.D.R. Oct. 2, 2013) (referring to FINRA NTM 10-22's reminder to "brokers of their obligation to conduct a reasonable investigation" in describing *registered representative's* duties in and before 2009).

In addition, the phrase "member" in Rule 2310 was meant to include associated persons. This is obvious from FINRA Rule 140, last amended in 2008, which states that associated persons "shall have the same duties and obligations as a member under the Rules." Div. Ex. 603.

Moreover, FINRA rules should not be interpreted in a way that would harm investors, and investors clearly would be harmed if brokers had no duty of investigation. *See* Div. Ex. 602 (FINRA Rule 130: FINRA's rules "shall be interpreted in light of the purposes sought to be achieved by the Rules and to further FINRA's regulatory programs").[7] FINRA's "core mission is to pursue investor protection and market integrity," and "to safeguard the investing public against fraud and bad practices."[8]

3. Selling Respondents Knowingly or Recklessly Failed to Have Any Reasonable Basis for their Recommendations

Selling Respondents failed to perform even a minimal investigation that could have provided them with a reasonable basis to recommend MS & Co. products. Div. Br. at 17-25. To the extent Selling Respondents acknowledge any duty to investigate the securities they recommended, they seek to minimize the due diligence that was necessary by disputing that the many red flags[9] identified in the record cried out for further inquiry.[10] Courts have held repeatedly that brokers who become aware of red flags should exercise heightened diligence, and the failure to do so constitutes recklessness under the antifraud provisions of the federal

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7 In addition to the authorities cited above, a 1962 SEC release makes clear that registered representatives have a duty to investigate: "[I]t is a violation of the anti-fraud provisions for a broker-dealer to recommend a security unless there is an adequate and reasonable basis for the recommendations ... as a prerequisite, ***he*** shall have made a reasonable investigation." *Distribution by Broker-Dealers of Unregistered Securities*, Rel. No. 6721, 1962 WL 69442, at *3 (Feb. 2, 1962) (footnotes omitted) (emphasis added). Plainly the pronoun "he" refers to a person, rather than describing any duty for entities alone.

8 FINRA 2012 Year in Review and Annual Financial Report, at 8; http://www.finra.org/AboutFINRA/WhatWeDo/

9 "A red flag is a warning or notice of potential concerns or violations of the securities laws that require a heightened response and investigation." Div. Ex 1 at 6.

10 RMR's brief refers to "the Division's ever-growing list of supposed 'red flags.'" RMR Br. at 16. The red flags in the Division's post-hearing brief, however, are the same ones identified in the OIP and presented at trial.

securities laws. Div. Br. at 10. The evidence shows that the Selling Respondents had actual knowledge of numerous red flags but ignored all of them.

Respondents' briefs generally reject that the red flags called for further inquiry at all, largely based on the flawed premise that McGinn and Smith were so successful and upstanding their endorsement of MS & Co. products was reason enough to recommend those securities. For example, Lex argues that he "had every reason to place full confidence in [Smith] as a skilled and trustworthy manager of investment funds." Lex Br. at 76. Livingston similarly states that the MS & Co. was "a premier independent investment banking house, and its offerings "had every indication that they were legitimate," and that there were "no red flags signifying obvious problems." Livingston Br. at 18, 29. But registered representatives may not simply rely on others to make suitability determinations. *See Everest Securities v. SEC*, 116 F.3d 1235, 1239 (8th Cir. 1997) ("reliance on others does not excuse [the defendants] lack of investigation"); *Giesige*, 2008 WL 4489677, at *19 (rejecting broker's claim that no investigation was needed because her information came from a source that "seemed credible.").

Selling Respondents knew Smith lacked experience managing investment vehicles of the size and scope of the Four Funds, and McGinn was not even involved in managing the Four Funds. Div. Br. at 18. In addition, Selling Respondents knew that the Four Funds were newly created issuers without any operating history and that Smith controlled both the issuers and the broker-dealer. Moreover, Selling Respondents should have known that Smith's complete control over the issuer, placement agent, and trustee of the Four Funds required them to ask more questions about these products before recommending them to their customers.[11]

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[11] "[T]he fact that the person who owned and controlled [the broker-dealer] also owned and controlled the issuer and was the only source of information" constitutes a red flag. *Pinkerton*, 1996 WL 602648, at *7. Livingston argues that this key holding of *Pinkerton*—that the

Selling Respondents' belief that the pre-2003 alarm trusts demonstrated McGinn's and Smith's competence was unfounded. As Chiappone admits, "the fraudulent conduct dated back to at least 1999 or early 2000." Chiappone Br. at 43; *see also* FoF ¶ 35 (Livingston acknowledges "Ponzi scam" began much earlier than September 2003). The pre-2003 alarm note offerings began in the 1990's, and MS & Co. sponsored three or four offerings every year. FoF ¶ 39. Mary Ann Cody testified about shortfalls in collections by the late 1990's, and Brian Shea, MS & Co.'s CFO at the time, testified that the offerings were "not sustainable." FoF ¶¶ 36, 37. David Smith's handwritten letter from 1999, which admits to operating a "Ponzi scheme," states that MS & Co. had "become addicted to the cash flow from the trust business." FoF ¶ 38. As a result, Smith and McGinn used $35 million of proceeds from the IASG IPO to redeem pre-2003 offering investors, a fact that was clearly disclosed in the IASG IPO prospectus. FoF ¶ 39.

Selling Respondents, with the exception of Gamello, sold the pre-2003 alarm note offerings to their customers. They admitted doing no due diligence on these offerings, and never noticing any red flags, not even one obvious red flag which was explicit in the IASG IPO prospectus: the fact that $35 million of the proceeds from the IASG IPO were needed to redeem investors in the pre-2003 offerings. *See* FoF ¶¶ 39, 310-14. Respondents never questioned why, if the offerings were so well run, IPO proceeds were needed to redeem these investors, and they continued to promote the earlier offerings as successful. *See, e.g.* Tr. 1557:14-25 (Lex: "Why

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respondent ignored a "red flag" where the same person owned and controlled the Respondent's broker-dealer and the issuer—was "attributable to the respondent's witness" and was not a finding of the Court. Livingston Br. at 27. Livingston is wrong. The Court's opinion did emphasize that "[e]ven [the Respondent's] own witness . . . faulted [him] for ignoring 'red flags' which he was required to resolve before he could offer" the private placement. The Court's point was that this red flag was so obvious that "[e]ven the Respondent's own witness" agreed that the Respondent was at fault for ignoring it.

would I be concerned if a client got all their money back").

RMR nevertheless insists these factors presented "no red flags" because these arrangements were "ordinary or customary in the industry," RMR FoF ¶ 311, that issuers controlled by the broker-dealer were "commonplace" and that Respondents had "no reasons" to question anything. RMR Br. at 19. Even if the Court were to accept RMR's unsupported description of what is "commonplace" in the market, their failure to consider the specific circumstances relating to the MS & Co. offerings they recommended—*e.g.*, that the broker dealer controlling those new issuers was rife with conflicts and lacked experience with the kind and size of the offerings at issue—undermines any argument they could make excusing their failure to investigate. RMR further stresses that MS & Co. "had been in business since 1980" and had "great success in the securities markets," RMR Br. at 19, but this, too, ignores critical facts in the record, including RMR's knowledge that MS & Co. used IASG proceeds to redeem earlier alarm note investors. FoF ¶ 39.

The fact that David Smith concealed the investments in the Four Funds from the brokers also was a red flag that required the Selling Respondents to ask more questions. *See Matter of Stires & Co., Inc. et al.*, No. 3-9120, 1998 WL 462230, at *6 (Aug. 11, 1998) (promoters' "refusal to provide [Respondent] with documents" was a red flag); *see also* Div. Ex. 1 at 12-13 ("portfolio information is critical information for brokers to consider when making recommendations, and the refusal to provide such information is a sign of deception"). Selling Respondents now claim, contrary to the mountain of evidence to the contrary, FoF ¶¶ 139-47, 281 (Gamello), 327-37 (Lex), 450-54 (Livingston), 220-22 (Chiappone), 770-76 (Guzzetti), that information was not hidden from them. RMR's brief, for example, makes the astonishing claim that even if Smith concealed "from *some* brokers, there was *no* evidence that Smith concealed information requested by Rabinovich, Mayer and Rogers." RMR Br. at 21 (emphasis in original). RMR's claims are not credible, and contradict their own prior sworn testimony FoF ¶¶ 537-543 (Mayer); 625-645 (Rabinovich); 705 (Rogers).

Lex similarly claims that "there was constant communication between Lex and Smith, as well as CFO David Rees, about the investments in question." Lex Br. at 83. Livingston asserts that he "was aware of a substantial amount of the Four Funds' investments." Livingston Br. at 20.[12] But these Respondents cannot explain evidence indicating that Smith "repeatedly told all of those" who asked for information concerning Four Funds investments that this was "confidential." FoF ¶ 144. Smith told the brokers that the information on the Four Funds' investments was subject to confidentiality agreements and could not be disclosed. FoF ¶ 280. Respondents, however, never asked to see these agreements and never sought to determine which portion of the overall portfolio was "confidential." *Id.* Chiappone, who admits Smith refused to disclose information about the Four Funds when Chiappone asked for it, simply concluded Smith's confidentiality "appeared on its face to be reasonable." Chiappone Br. at 58.

Selling Respondents should have been shocked that the Four Funds' investments would be hidden from them. The Four Funds PPMs promised financial information, including an income statement and balance sheet, upon request.[13] FoF ¶ 142. The MS & Co. compliance manual said that the records regarding "due diligence will be kept in the legal files." FoF ¶ 143.

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[12] Gamello claims that he relied on "audited financials" for FIIN, FEIN and TAIN at the time he recommended FAIN to his customers. Gamello Br. at 2. It is unclear what Gamello is referring to (he fails to cite to any evidence) because there is no evidence that any of the brokers ever received audited financials.

[13] Several Respondents seek to justify Smith's secrecy by claiming that the Four Funds were like "blind pools," *e.g.*, Chiappone Br. at 57, although they offered no evidence as to what a blind pools is and how they operate. In any event, the Four Funds were never intended to be blind pools because the PPMs clearly disclose that the Funds' investments would be disclosed upon request. FoF ¶¶ 140-42.

Moreover, investment vehicles such as the Four Funds do not usually keep their investments secret from the brokers who are selling them. *See* Tr. 1285:9-17 (Division's expert testifying that "[funds] make the information available as part of the selling information that the broker needs to help sell the product.").

Respondents other arguments are similarly divorced from the record. They disclaim knowledge of—and even the existence of—the Redemption Policy, but fail to respond to the overwhelming evidence that the Redemption Policy not only existed, but that Selling Respondents complied with it. FoF ¶¶ 148-159, 786-689, 801-807, 817.

Likewise, the default of the Four Funds in January 2008, combined with the previous accumulation of red flags, gave Selling Respondents concrete reasons to investigate what had actually happened with the tens of millions of dollars that had been raised up to that point. Even now, with full knowledge of the fraud, RMR claims that problems with the Four Funds were "unsurprising given the Great Recession of 2008." RMR Br. at 22 n.9; *see also id.* at 23 (RMR "did not consider [the default] a red flag given the economic climate at the time.") But even Lex's expert, Charles Bennett, agreed that the default of the four funds was a red flag. FoF ¶ 166. Moreover, Guzzetti told Selling Respondents that the Four Funds were *not* correlated to the equity markets. FoF ¶ 789. Smith later blamed the 2008 equity markets for causing the Four Funds' default. FoF ¶ 167. This glaring inconsistency should have prompted even more questions. Instead, Selling Respondents continued business as usual.

RMR concede that McGinn and Smith concealing the Firstline bankruptcy from them for eighteen months "was indeed a cause for concern." RMR Br. at 24. Rabinovich and Mayer, however, allowed sales of Trust offerings to consummate even after learning of the bankruptcy.[14] In sum, Selling Respondents were confronted with years of red flags and did nothing.

B. Selling Respondents Made Material Misrepresentations and Omissions

The 13 investors who testified in the Division's case-in-chief described in detail Selling Respondents' misrepresentations and omissions to them, and the devastating price they paid for placing their trust in the Selling Respondents. Selling Respondents argue that their statements to their customers were not material because of certain disclosures in the PPM and because the brokers' statements were too "vague" to be material. Both arguments are wrong.

1. The Risk Disclosures in the PPM Do Not Excuse Misrepresentations and Omissions

Selling Respondents argue that what they told, or failed to tell, their investors was not material because "all of the pertinent risks were disclosed in writing in the PPMs and Subscription Agreements." Lex Br. at 43; *see also* Livingston Br. at 15 ("The fact that investors received disclosures about the significant risks of these investments destroys any materiality."); RMR Br. at 27 (claim that a broker "omitted to disclose information that was provided in a [PPM]" is "legally deficient").

The risk disclosures in the PPMs, however, do not shield Selling Respondents from liability. As the investors' testimony demonstrates, Selling Respondents frequently presented the MS & Co. offerings as safe and secure. *See, e.g.*, FoF ¶¶ 570, 572-73, 726-727. Although the PPMs listed numerous risk factors, the Selling Respondents never said anything about the risks involved, despite the fact that many of their customers were risk-averse. These failures

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[14] Rabinovich and Mayer deny making sales after learning about the bankruptcy. They argue that they made the sales pitches in August 2009, before the September 3, 2009 meeting where the bankruptcy was finally disclosed. RMR Br. at 24. The customers' payments, however, occurred well after September 3, 2009. FoF ¶¶ 576, 666.

constitute material omissions. *See Matter of Mangan*, No. 3-8370, 1995 WL 408761, at *9 (July 5, 1995) ("[Respondent's] failure to disclose risk factors concerning the securities he recommended that persons buy was a failure to state material facts in violation of the antifraud provisions.").

Moreover, "a registered representative [must] make sure that the client has not only read the disclosure documents for an investment, but also that he understood them. It is a deviation from industry standard to do otherwise. Thus, it is not enough just to provide a copy of a prospectus to a customer." *Matter of Frey, et al.*, No. 3-10310, 2003 WL 245560, at *15 (Feb. 5, 2003). In *Matter of Klein*, No. 3-8761, 1996 WL 597776 (Oct. 17, 1996), a broker argued that because he delivered a prospectus to a customer that disclosed the risks, and the customer did not ask any questions, that the broker "had 'no reason to believe'" that the customer did not understand the prospectus. *Id.* at *5. The Commission rejected this defense, and held that "[the broker's] delivery of a prospectus to [his customer] does not excuse his failure to inform her fully of the risks of the investment package he proposed." *Id.*

Federal courts have also rejected the argument that risk disclosures in a PPM vitiate the charges of fraud. For example, in *SEC v. Morgan Keegan & Co.*, 678 F.3d 1233 (11th Cir. 2012), the Eleventh Circuit held that "the brokers' statements must be included in the materiality inquiry." *Id.* at 1248, n.16. And in *SEC v. Bravata*, No. 09-12950, 2014 WL 897348 (E.D. Mich. Mar. 6, 2014), the Court held that "the PPM materials were 'no cover' against the allegations of fraud," and quoted a decision by the Judge in a parallel criminal case, rejecting the same argument: "The fact that a victim received a document–a Subscription Agreement–that contained cautions or warnings, did not give the Defendants a license to defraud[.]" 2014 WL 897348, at *17.

In addition, Selling Respondents emphasize that the PPMs disclose the high degree of risk in the MS & Co. offerings. Livingston Br. at 15; Lex Br. at 39-41; RMR Br. at 18-19. These disclosures, however, cannot shield Selling Respondents from liability "because the risks that were disclosed were not the risks that harmed the investors." *SEC v. Pittsford Capital Income Partners, LLC*, No. 06 Civ. 6353 (MT) 2007 WL 2455124, at *11 (W.D.N.Y. Aug. 23, 2007), *aff'd*, 305 Fed. App'x 694 (2d Cir. 2008). The investors suffered more than $80 million in losses because of McGinn and Smith's criminal conduct, and because Selling Respondents failed to fulfill their duties to understand the products they were selling. No customer assumed these risks. *See Hunt v. Alliance N. Am. Gov't Income Trust, Inc.*, 159 F.3d 723, 729 (2d Cir. 1998) ("The cautionary language contained in the prospectus does not necessarily foreclose liability because it warned investors of a different contingency than that which plaintiffs allege was misrepresented.").

The cases cited by Selling Respondents do not support the proposition that in SEC enforcement cases – where reliance is not an element – brokers who ignore red flags can avoid liability whenever there are risk disclosures in a PPM. *See, e.g., South Cherry Street, LLC v. Hennessee Group LLC*, 573 F.3d 98, 112 (2d Cir. 2009) (affirming dismissal because no allegation of red flags or any indication of wrongdoing); *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1518 (10th Cir. 1983) ("we do not imply that the defendants can disclaim responsibility for their misrepresentations simply by disclosing the risks in the memorandum"); *In re Moody's Corp. Sec. Lit.*, 599 F. Supp. 2d 493, 507 (S.D.N.Y. 2009) ("Optimistic statements however, 'may be actionable upon a showing that the defendants did not genuinely or reasonable believe the positive opinions they touted'").

2. The Misrepresentations and Omissions Concerned Specific Material Facts

Selling Respondents also argue that their statements were immaterial because they were merely optimistic hopes or were too vague. RMR Br. at 26; Lex Br. at 49-51; Livingston Br. at 15-16. This argument is easily refuted by the detail and sincerity with which all the investors testified. In addition, Selling Respondents all omitted material information about the risks of the MS & Co. investments that they knew but the investors did not.

As the record shows, no Selling Respondent told his customers what he knew about the real risks investors faced: *e.g.*, that Smith concealed his Four Funds investments, that they relied entirely on what Smith and McGinn told them and that they did no inquiry into how Smith and McGinn were using investor funds. They also concealed information about the Redemption Policy and other adverse information that was material to an investor in MS & Co. offerings. And Selling Respondents continued to recommend MS & Co. securities even after learning of the Four Funds default in January 2008. In short, Selling Respondents made misrepresentations about critical, specific facts and failed entirely to disclose numerous other material issues. Div. Br. at 26-29; *see also* FoF ¶¶ 264-72 (Chiappone); 301-03 (Gamello); 384-429 (Lex); 501-18 (Livingston); 567-92 (Mayer); 669-83 (Rabinovich); 717-732 (Rogers).

C. Selling Respondents Engaged in a Scheme to Defraud Investors in Violation of Rule 10b-5(a) and (c) and Section 17(a)(1) and (a)(3)

Selling Respondents were an integral part of the Ponzi scheme by committing inherently deceptive acts, such as complying with the Redemption Policy, and making false statements and omissions to peddle the Four Funds and Trust Offerings. RMR and Livingston rely heavily on *SEC v. Kelly*, 817 F. Supp. 2d 340 (S.D.N.Y. 2011) in claiming that the Division must prove that Selling Respondents' deceptive conduct was "separate and distinct" from their misrepresentations and omissions. RMR Br. at 31-32; Livingston Br. at 29-31. *Kelly's* strict separation of false statements and omissions from deceptive acts make it an outlier, even with in the Second Circuit. Numerous courts have held that misrepresentations and omissions can be part of a scheme to defraud investors. *See, e.g., VanCook v. SEC*, 653 F.3d 130, 138 (2d Cir. 2011) (deceptive conduct included both deceptive acts and false statements); *SEC v. Garber*, 959 F. Supp. 2d 374, 381 (S.D.N.Y. 2013) (false statement was an instrumentality of the inherently deceptive act); *SEC v. Loomis*, 969 F. Supp. 2d 1226, 1237 (E.D. Cal. 2013) (SEC established scheme liability by proving defendant misrepresented the solvency of a fund while simultaneously accepting new investors to make payments to older investors).

Selling Respondents' scheme to defraud investors included both inherently deceptive conduct and false statements and omissions. All Selling Respondents were aware of the Redemption Policy and complied with it. FoF ¶¶ 151, 156, 157, 223-226, 287-293, 355-361, 479, 550-552, 625-645, and 705. For example, Rabinovich, Mayer, Chiappone, and Lex sold $600,000 worth of Firstline certificates to redeem Rabinovich's father on his investment. FoF ¶ 95. Indeed, Rabinovich and Mayer were aware that new Firstline investor funds would be used to redeem Rabinovich's father, facilitated this redemption through new sales, and earned commissions on the new sales. FoF ¶ 551, 635, 638. Rabinovich later ensured that his father was redeemed on a $250,000 TDMM Cable 09 investment with the knowledge that this redemption would be paid with money raised from new investors. FoF ¶¶ 641-42. Rabinovich purchased a $25,000 TDM Verifier investment even after learning about Smith and McGinn's concealment of the Firstline bankruptcy in order to ensure the redemption of one of Rogers's clients. Rabinovich, Mayer and Rogers were all aware that Rabinovich's funds were used to redeem Rogers's client. FoF ¶¶ 552, 643-45, 705.

Selling Respondents also engaged in other inherently deceptive acts, such as touting the success of MS & Co. while failing to disclose the failure of the Four Funds to induce new customers to invest in the Trust Offerings. FoF ¶¶ 259 (Chiappone), 366-369 (Lex), 571 (Mayer), 658, 682 (Rabinovich), and 728 (Rogers). The evidence strongly suggests that Livingston instructed one of his unaccredited customers to alter subscription agreements to reflect that the customer was accredited. FoF ¶¶ 511-12. Chiappone avoided "using up" smaller investments on unaccredited investors. FoF ¶ 274. Lex repeatedly secured redemptions for himself and his wife with the knowledge that these redemptions would be funded by new investor money. FoF ¶¶ 362, 364. This evidence belies RMR's and Livingston's arguments that the Division is somehow relying entirely on the same misrepresentations and omissions that form the basis of its Rule 10b-5(b) claim to prove scheme liability.

D. Selling Respondents Acted Negligently and Violated Sections 17(a)(2) and 17(a)(3)

The evidence supports a finding, at the very least, that Selling Respondents were negligent in selling the Four Funds and Trust Offerings. As argued in the Division's opening brief, and shown by the evidence, each of the Selling Respondents made material misrepresentations and/or omissions in connection with the offer or sale of securities in violation of Section 17(a)(2). Division Br. at 30-31; *see also* 15 U.S.C. § 77q(a)(2). Contrary to RMR's argument, *see* RMR Br. at 32-33, each of the Selling Respondents was the "maker" of verbal misleading statements and omissions regarding the Four Funds and Trust Offerings; caselaw discussing whether a defendant is the "maker" of a misstatement found in a prospectus or other document disseminated to investors is not relevant.[15] Selling Respondents' misrepresentations

[15] *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011) does not limit any of the Division's fraud claims because the Division does not "seek to impose

and omissions were, at a minimum, negligent because Selling Respondents failed to investigate the securities they sold to ensure that their very statements about those securities were truthful and complete. *See SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 857-58 (9th Cir. 2001) (relying on *Hanly* as authoritative on the duty of brokers and salesmen in the negligence context).

Moreover, Selling Respondents violated Section 17(a)(3) because their failure to ask even the most basic of questions regarding the Four Funds and Trust Offerings before recommending them to customers, *see Hanly*, 415 F.2d at 595-96, resulted in the perpetration of a massive fraud on those customers to whom they had a duty. Selling Respondents were, at a minimum, "culpably careless" and this is sufficient to establish liability. *See Matter of Optionsxpress, Inc. et al.,* No. 3-14848, 2013 WL 2471113, at *74 (June 7, 2013) (Murray, J.) ("any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, except for conduct that is intentionally, wantonly, or willfully disregardful of others' rights is sufficient to establish a violation of Sections 17(a)(2) and (a)(3)").

III. GUZZETTI FAILED REASONABLY TO SUPERVISE

Although it is well-established that "supervisors must act decisively when an indication of irregularity is brought to their attention,"[16] Guzzetti did absolutely nothing to respond to the steady stream of red flags and irregularities before him. Instead, Guzzetti did Smith's bidding by

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liability based on any misstatements within the PPMs," Livingston Br. at 21. Moreover, *SEC v. Kelly* improperly extended the application of *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) to claims brought by the Commission under Section 17(a)(1) and (a)(3). *See* 817 F. Supp. 2d at 345. The majority of courts that have addressed whether *Janus* reaches claims brought under Section 17 have reached the opposite conclusion. *See, e.g., SEC v. Garber*, 959 F. Supp. 2d at 380 (*Janus* does not affect claims under Section 17(a)(1)); *SEC v. Stoker*, 865 F. Supp. 2d 457, 465 (S.D.N.Y. 2012) ("*Janus* implicitly suggests that Section 17(a)(2) should be read differently from, and more broadly than, Section 10(b)").

16 *Matter of Kolar*, No. 3-9570, 2002 WL 1393652, at *4 (S.E.C. June 26, 2002).

urging the sales staff to recommend MS & Co. private placements to their clients, and by enforcing the Redemption Policy that facilitated the ongoing fraud.

Even now, with full knowledge of the massive fraud that took place on his watch, Guzzetti remains so defiant as to lack any credibility. He insists that he never saw anything that might have caused him to make inquiries, FoF ¶ 845, that he never even heard the term "red flags" in more than 20 years as a securities industry supervisor, FoF ¶ 846, and that he was justified at the time in attributing any problems relating to MS & Co. products to "adverse market performance." Guzzetti Br. at 19, 23. Guzzetti's arguments, however, do not withstand scrutiny in view of the massive amount of evidence against him, including his own emails over many years and his admission that he did nothing at the time to determine the truth. FoF ¶ 847.

Guzzetti's failures were not a momentary lapse of judgment. He consciously failed to conduct any inquiry despite receiving numerous emails over many years that demanded follow up, including those alerting him that redemptions were being paid with new investor funds, which, as Lex's expert testified, was "one of the hallmarks of a Ponzi scheme." FoF ¶ 149.

A. Guzzetti's Argument that, Although he was a Supervisor, He Was Walled Off From the Private Placements, Has No Support

Guzzetti admits that he "was *A* supervisor" and that he "he had limited supervisory responsibilities while employed at MS & Co." Guzzetti Br. at 28 (emphasis in original). He conveniently asserts, however, that his supervisory responsibilities, including as a Branch Manager after October 2008, excluded the particular transactions that defrauded so many MS & Co. investors. Guzzetti Br. at 11-12 (claiming he "was not given supervisory responsibility for the investments at issue."). The record flatly contradicts Guzzetti's contention, particularly the email in which Smith specifically directed Guzzetti to tell the brokers that "[a]ny redemptions have to have replacement sales before hand" and urged that Guzzetti should "handle this with TLC." FoF ¶ 156.

Guzzetti offers several overlapping arguments, which taken together essentially contend that his responsibilities were something other than what the evidence reflects.[17] Guzzetti first argues that there was a sort of wall between him and the fraudulent offerings. He claims that his "only role was to act as a conduit," and that anything he did in connection with the private placements was "in his role as sales manager." Guzzetti Br. at 2, 16. Apart from Guzzetti's own testimony at trial, however, there is no evidence to support this theory. FoF ¶¶ 707, 708. Tellingly, Guzzetti does not cite to any testimony from any other Respondent supporting his claim that his areas of supervision were bifurcated between the private placements and everything else. To the contrary, several Respondents described Guzzetti as a supervisor without qualification or limitation. FoF ¶¶ 764-69.

Apparently realizing this defect in his argument, Guzzetti claims that the reason there is no testimony to support his theory is that the right questions were not asked at the 2011 depositions. Guzzetti Br. at 19-20. At the hearing earlier this year, however, Guzzetti's counsel had the opportunity to elicit that testimony from the other Respondents. None of them testified that Guzzetti's supervisory duties did not include the private placements. FoF ¶¶ 764-69.

Guzzetti also argues that he "spent a significant portion of his time" on activities that were unrelated to the private placements. Guzzetti Br. at 12-14. There is no evidence, however,

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[17] Guzzetti also argues that the cases cited in the Division's brief – *Gutfreund*, *Bloomfield*, *Kolar* and *Murphy* – are "distinguishable" because in those cases the Respondent was found to be a supervisor, where Guzzetti insists he was not. Guzzetti Br. at 9-12. As shown by voluminous evidence at the hearing, however, and as summarized here and in the Division's opening brief, Div. Br. at 31-34, the facts overwhelmingly show that Guzzetti was a supervisor. Moreover, Guzzetti's conduct was in many ways even more egregious than the conduct in *Gutfreund*, *Bloomfield*, *Kolar* and *Murphy* because Guzzetti's supervisory failures occurred over many years and contributed to massive investor losses.

that these projects took a significant amount of Guzzetti's time. In any event, at best it simply shows that "senior managers wear many hats." *See Bloomfield*, 2014 WL 768828, at *11.

Next, Guzzetti argues that the Division misinterprets the compliance manuals naming him as a supervisor. He claims the Division "avoid[s] the clear language" of the 2007 compliance manual and "incorrectly cites" to a provision of the compliance manual stating that Guzzetti "is directly responsible for all outside RR's." Guzzetti Br. at 14. Although the manuals set forth overlapping areas of supervision for Mayer and Smith, the 2007 and 2008 compliance manuals, however, did in fact give Guzzetti specific supervisory tasks. FoF ¶¶ 756, 758, 759. They list Guzzetti as one of the "Supervisory Personnel" "responsible for the supervisory activities of the firm."[18] FoF ¶ 758. As the manuals state, Guzzetti was "responsible for the supervisory activities of [MS & Co.]." *See Matter of Kirk*, No. 3-9786-EAJ, 2001 WL 1618266, at *5 (S.E.C. Oct. 18, 2000) ("the individuals identified as having particular supervisory duties in a firm's written procedures are responsible for discharging those duties") (citation omitted).

Referring to the compliance manuals' section titled "Private Placements/Limited Partnerships," Guzzetti argues that "[i]t is incomprehensible that the Division would misrepresent its own evidence in such a glaring and flagrant fashion." Guzzetti Br. at 22. His argument appears to be that the Division should have pointed out that "Mr. Guzzetti's name does not appear at all in this section," and that subscription agreements must be signed by "a principal of the firm." Guzzetti Br. at 22. However, the "Private Placements/Limited Partnerships," section of the compliance manual says nothing about who has supervisory authority over the

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18 Guzzetti claims that Robert Lowry's report was "fundamentally flawed" and "absurd" because Lowry's report considered the 2008 manual, but not the 2007 manual. Guzzetti Br. at 27. Although Lowry did have both manuals, he testified that in drafting his report he "did not recognize [the 2007 manual] as a different exhibit." Tr. 1156:14-23. Guzzetti does not explain how considering the 2007 manual, which is essentially the same as the 2008 manual, would have affected Lowry's opinion. Indeed, both manuals show that Guzzetti was a supervisor.

private placements, so the fact that Guzzetti's name "does not appear" there is meaningless because nobody else's name appears.[19] Guzzetti Ex. 2 at 45; Div. Ex. 329 at 44.

Finally, Guzzetti dismisses the Division's extensive evidence of his supervisory functions, *see* Div. Br at 31-33, as a mere "laundry list of facts" that have "no relation to supervision." Guzzetti Br. at 17-18. Guzzetti does not appear to dispute the principle that a person's actual responsibilities and authority determine whether he is a supervisor, rather than his job status or title. Div. Br. at 31. Guzzetti, however, fails to explain why these facts have "no relation to supervision." These – including Guzzetti's roles in hiring, recruiting, determining compensation, conducting weekly sales calls, selecting a clearing firm – are quintessential supervisory functions. They prove that Guzzetti's actual responsibility and authority make him a supervisor and that the private placements were not walled off from his supervision.

Similarly, Guzzetti seeks to minimize the many incriminating emails that he sent and received. He claims, for example, that his morning emails "were not an attempt to push MS & Co. proprietary products." Guzzetti Br. at 24. This is contradicted by the plain language of the emails themselves, which do more than simply inform brokers of available offerings. Using all capital letters for emphasis, Guzzetti made clear that the sales staff was expected to recommend MS & Co. private placements to their customers, and that brokers should tell their customers to

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[19] Guzzetti also complains that MS & Co.'s Branch Office Procedures (BOP) manual "was never authenticated and never identified." Guzzetti FoF ¶ 62. The BOP manual make clear that as branch manager in Clifton park, Guzzetti had a responsibly, among other things, to "[e]nsure that . . . no unusual sales practice activities are occurring in connection with the review of daily trading." FoF ¶ 761. At trial, however, Guzzetti agreed to the admission of the BOP without objection, including authenticity. Tr. 9:5-7 and 371:22 - 373:7. Having consented to the admission of the Procedures without objection, Guzzetti has waived any authenticity objection. *McGonigle v. Combs*, 968 F.2d 810, 825 (9th Cir. 1992) (failure to object to authenticity at trial waives that objection); *In re Worldcom*, 357 B.R. 223, 228-29 (S.D.N.Y 2006) (failure to object to authenticity when exhibit is admitted is a waiver); *Gower v. IKON Office Solutions, Inc.*, 177 F. Supp. 2d 1224, 1237-38 (D. Kan. 2001) (authenticity objection not made at trial is waived).

move funds from money markets to MS & Co. private placements. FoF ¶¶ 782, 784, 785, 787, 789, 796, 797, 799, 807, 809, 810. Guzzetti actually calculated the amount customers had in money market funds for this purpose. Tr. 3025: 3-20 (Guzzetti testimony that he used NFS reports to calculate amount in money market accounts).

Guzzetti's morning emails and weekly conference calls with brokers were opportunities to show his leadership in connection with the private placements. FoF ¶¶ 780-81. Accordingly, when an in-house investment banker questioned Guzzetti regarding the wisdom of moving investors' money from money market fund to MS & Co. private placement, Guzzetti reacted indignantly, telling the banker "DON'T EVER QUESTION ME ABOUT MY KNOWLEDGE OF THE RETAIL BROKERAGE BUSINESS." FoF ¶ 785. Even though Guzzetti did not know how the Four Funds were invested, Guzzetti told the inquiring banker that FAIN was "a way of locking in higher returns," *id.*, and Guzzetti even continued to push MS & Co. deals after learning that he and the brokers had been lied to about the Firstline bankruptcy. FoF ¶¶ 839-840.

Furthermore, Guzzetti told the brokers in 2007 that MS & Co. private placements have "NO CORRELATION TO THE SHAKY STOCK MARKET," a message Guzzetti understood brokers would repeat as a sales pitch to customers. FoF ¶¶ 789-790. Six months later, however, notwithstanding Guzzetti's belief that the private placements were not correlated to the stock market, Guzzetti readily accepted Smith's explanation that the default of the Four Funds was due to widespread economic conditions asking any questions. FoF ¶ 847.

Guzzetti tries to minimize his many Redemption Policy emails. Guzzetti Br. at 25 (dismissing emails as simply "a series of emails sent during the final few months of 2007.") Although the 2007 emails certainly establish conclusively Guzzetti's knowledge of and adherence to the Redemption Policy, the evidence of Guzzetti's knowledge of the Redemption

Policy goes back to 2006 (FoF ¶¶ 151-154), and continues in 2008 and 2009. For example, on January 16, 2008, Guzzetti emailed Anthony that "if a client wants to redeem out of a 1 yr piece of paper. We must have the fc replace it." And on November 23, 2009, Smith emailed Guzzetti to say that "Brokers are asked to replace clients seeking redemption." FoF ¶ 841.

In 2008 and 2009, Guzzetti received numerous emails that demanded some kind of inquiry. FoF ¶¶ 806-844. For example, he knew that Lex believed that "the fiduciary responsibility to the clients has been breached;" that the Rabinovich "loan" to Firstline was repaid with new investor funds; that interest payments were not being paid; and that Lex's clients were asking "if they've bought into a Ponzi scheme." FoF ¶¶ 811, 816, 829. Guzzetti never inquired into any of these issues, and instead continued to urge brokers to "make the calls." Guzzetti even advised Smith on which investors should be redeemed with the dwindling funds in 2009, suggesting that an investor should be redeemed with new investor funds "only because he can do more deals." FoF ¶ 832. This conduct proves not only Guzzetti's serious failure as a supervisor, but his actual involvement and knowledge of the fraud.

B. <u>The Opinions of Guzzetti's Expert Deserve Little or No Weight</u>

Kevin Carreno testified that, based on his limited review of the record, which included no emails or any PPMs, Guzzetti's conduct was "reasonable under the circumstances" and that he fulfilled his supervisory duties. Tr. 4798:3-11; 4800:4-24; 4810:10-18. Although Carreno testified he agreed with Lex's expert, Charles Bennett, that the Redemption Policy "would be a red flag to any broker with knowledge of such a policy," Tr. 4816:8-22, Carreno testified that Guzzetti was justified in conducting no investigation because "Guzzetti understood much more about the situation, the product, the manager and market conditions." Tr. 4819:9-4820:8.

Carreno's opinion should be disregarded because, among other reasons, it rests on incorrect facts and wrongly applies the legal duty. First, Carreno overstates Guzzetti's understanding at the time of "the situation, the product, the manager." Guzzetti's knowledge was based purely on information from Smith and McGinn, and he knew nothing about the underlying investments. FoF ¶¶ 770-74. Carreno apparently sees no problem with Guzzetti's blind acceptance of information from McGinn and Smith, and he does not believe Guzzetti ever had any duty to determine whether the problems at MS & Co. were attributable to an overall market decline or to something else. FoF ¶ 847. For Carreno, it is enough that there was an economic crisis at the same time the Four Funds defaulted, and no further inquiry is needed other than an awareness of the economic crisis (Carreno is unaware of, or chooses to ignore, Guzzetti's awareness of red flags in 2006, well before the onset of the economic crisis). In any event, Carreno's opinion is totally inconsistent with the well-established broker's duty of investigation. Guzzetti, in these circumstances, should not have accepted Smith's and McGinn's explanations and was required to dig deeper.

Carreno's opinion – that Guzzetti's conduct conformed to applicable standards – contradicts long-established principles that "the federal securities laws require a vigorous response even to indications of wrongdoing." *See Bloomfield*, 2014 WL 768828, at *11. But there is another issue about Carreno's opinion that is troubling and undermines his credibility. In his testimony, Carreno touted his membership on the "prestigious" FINRA Board of Governors, and he claimed that he was testifying "as an overseer of the nation's primary securities regulator." Tr. 4828:6-4829:9. Over the past five years, however, FINRA has devoted considerable time and resources on behalf of the victims of the MS & Co. fraud. It is puzzling, therefore, that Carreno – who presumably should not act adversely to FINRA – would use his position at FINRA to oppose the interests of investors and to defend someone like Guzzetti, who was in a position to stop the fraud and the investor losses.

Carreno's election to the FINRA Board of Governors in 2013 followed a period of bad blood and dueling lawsuits between Carreno and FINRA. Div. Ex. 661, 662; Tr. 4789:23-4790:10. Carreno testified that he believes that FINRA sabotaged his appointment to a state securities office by falsely accusing him. Tr. 4786:7-4787:7; Div. Ex. 660, 661. Carreno's stated position that he was wronged by a securities regulator suggest that he has a hidden agenda and a bias, which should be considered when assessing his credibility.

C. The Division Did Not Waive Any Relief

Guzzetti argues that, in its Prehearing Brief, "the Division made the conscious choice to specifically exclude Mr. Guzzetti from its requests for disbarment [sic], a cease-and-desist order, or disgorgement . . . As a result, this Court should deny the Division's request in its Post-Hearing brief for disbarment [sic]." Guzzetti Br. at 4.

As a threshold matter, Guzzetti is incorrect that the Division made any "conscious" decision to exclude Guzzetti from any request for relief. The OIP in this matter, as in all Commission administrative proceedings, does not set forth the specific relief being sought. Instead, the OIP states that the hearing will determine what remedial action against Guzzetti and the other Respondents is appropriate "pursuant to Section 15(b) of the Exchange Act." Section 15(b), among other things, authorizes the Commission to bar or suspend a person from association with a broker-dealer "if it finds that such person failed reasonably to supervise[.]"

The Division's Prehearing Brief dated January 17, 2014, argued that "Guzzetti failed reasonably to supervise the Selling Respondents with a view to preventing and detecting violations." Div. Prehearing Br. at 19. The Prehearing Brief argued the Court should impose "meaningful sanctions and other remedies against Respondents," which includes Guzzetti, and also ensure that they "are prevented from future violations victimizing the investing public, and are punished for violating the securities laws." Although Division's brief inadvertently omitted any particularized request for relief concerning Guzzetti, he learned that this omission was unintentional before the Hearing even began. At the January 21, 2014 telephonic prehearing conference, Guzzetti's counsel questioned the absence of any Guzzetti-specific request for relief in the Division's Prehearing Brief, and the Division's counsel clarified that the Division was "seeking equitable relief against Mr. Guzzetti in the form of *at least* a supervisory bar and I believe a C and D as well." Jan. 21, 2014 Conf. Tr. at 37:6-8 (emphasis added).

There is no question that Guzzetti understood the nature of the Division's claims against him—and that the Division would seek a bar—and Guzzetti does not point to any way in which his ability to defend himself was prejudiced. As such, Guzzetti's waiver argument should be rejected. The Court of Appeals for the District of Columbia's decision in *Horning v. SEC*, 570 F.3d 337 (D.C. Cir. 2009), is instructive. In *Horning*, the court held that a respondent was not deprived of his procedural due process rights, or of appropriate notice and opportunity for a hearing, where the Division, after completing its case in chief, "changed the relief it requested to a bar from all supervisory positions." *Id.* at 347. There, as here, the respondent "had notice from the outset of the nature of the charges against him" and was not prejudiced by the Division's change in the relief it requested. *Id.* As Guzzetti does not claim any prejudice, or even that he would have done anything differently had he known of the remedies the Division seeks in this case, his waiver argument should be rejected.

Guzzetti fails to cite any cases to the contrary. The one case he does cite, *U.S. v. McKeon*, 738 F.2d 26 (2d Cir. 1984), held that, under Federal Rule of Evidence 801(d)(2)(B), (C), certain factual representations by a defense lawyer in an opening statement before a jury were admissible against the same defendant in a subsequent trial. *Id.* at 33. The issue in *McKeon* was "the evidentiary use of prior jury argument," *Id.* at 32, and has nothing whatsoever to do with remedies in an administrative proceeding. Other than *McKeon*, which is not remotely relevant, Guzzetti cites to no authority for his argument that failing to seek a remedy in a prehearing brief waives the ability to seek that remedy.

IV. THIS COURT IS AUTHORIZED TO IMPOSE, AND THE RECORD SUPPORTS, ALL SANCTIONS THE DIVISION REQUESTS

Respondents' arguments against the Court imposing remedial relief and sanctions for their misconduct fall into three general categories. First, Respondents contend this Court lacks jurisdiction to "entertain" this action, and therefore may not grant *any* of the relief the Division requests. RMR Br. at 40-41; Guzzetti Br. at 3-4; Lex Br. at 15-27; Livingston Br. at 5-10; Chiappone Br. at 20-34. Second, in an argument advanced primarily by Lex, Respondents maintain that the imposition of remedies commensurate with those imposed in similar fraud cases would violate Respondents' Constitutional rights. Lex Br. at 4-14. Finally, Respondents argue that remedies are unwarranted here because, in their view, they did not violate any securities laws. Each argument should be rejected in its entirety.

A. The Division's Claims Are Not Time-Barred

Respondents argue that the statute of limitations set forth in 28 U.S.C. § 2462 ("Section 2462") precludes this Court from entertaining this action—and, therefore, granting any relief—because *some* of Respondents' conduct took place before September 23, 2008, five years prior to the filing of the OIP in this case. But Respondents offer no authority for the position that recent securities violations are time barred if one accused of misconduct can simply point to additional violations that took place more than five years prior to the commencement of an action.

And Section 2462 pertains only to "any civil fine, penalty, or forfeiture." The Division seeks monetary penalties for post-September 23, 2008 securities law violations, and each Respondent's post-September 2008 misconduct is independently sufficient to warrant significant civil monetary penalties. *See generally* Div. Br.[20] The Division does seek non-punitive, remedial relief for misconduct dating back to 2003, but Respondents do not cite any statute—and none exists—limiting this court's authority to determine liability, and impose *equitable* remedies, for conduct pre-dating September 2008.

1. Neither Section 2462 Nor *Gabelli v. SEC* Offers Any Grounds for <u>Depriving this Court of Jurisdiction to Grant Equitable Relief</u>

Respondents' reliance on *Gabelli v. SEC*, 133 S. Ct. 1216 (2013)—as prohibiting this Court from awarding the Division any relief whatsoever—is misplaced. In *Gabelli*, the Supreme Court expressly limited its holding to whether the discovery rule applied in cases where the Commission seeks civil penalties. The Court explained: "[I]njunctive relief and disgorgement, claims the District Court found timely on the ground that they were not subject to 2462, ... [were] not before [the court]." *Id.* at 1220 n.1. Notably absent from Respondents' briefs are the numerous decisions issued since *Gabelli* where courts noted the holding's limited nature and distinguished penalties from disgorgement and other equitable relief.

For example, defendants in *SEC v. Amerindo Investment Advisors, Inc.*, No. 05 Civ. 5231 (RJS), 2014 WL 405339 (S.D.N.Y. Feb. 3, 2014), made the same argument Respondents do here, claiming Section 2462 prohibits a court from granting any relief in a case involving conduct the defendants claimed accrued more than five years before the Commission filed its

[20] Contrary to Respondents' assertions, while it is Respondents' post-September 2008 misconduct that triggers this Court's authority to impose punitive monetary penalties, their pre-September 2008 misconduct is not *irrelevant* to the Court's penalty analysis. This Court is statutorily authorized to consider prior securities law violations when determining what penalty will most effectively serve the public interest. Div. Br. at 42.

complaint. *Id.* at *9. The *Amerindo* court unambiguously rejected this argument, explaining that Section 2462 does not impact a court's ability to assess *liability* for older conduct:

> ***First, and most importantly, the statute of limitations at issue in Gabelli applies only to civil penalties, and does not prevent a finding of liability or an awarding of other kinds of remedies.*** Therefore, because the March 11 Order and this decision are focused solely on the issue of liability for the violations, and not the appropriateness of civil penalties, *Gabelli* has no bearing.

Id. (citations omitted) (emphasis added).

The District Court for the Eastern District of New York reached precisely the same conclusion in *SEC v. Vuono*, No. 13-MC-405 (JFB), 2013 WL 6837568 (E.D.N.Y. Dec. 26, 2013). In *Vuono*, the defendant, like Respondents here, "argue[d] that 28 U.S.C. § 2462 would bar any enforcement action." *Id.* at *6. But the *Vuono* court explained: "[E]quitable claims which do not constitute a 'civil fine, penalty, or forfeiture' are not subject to the statute of limitations contained in Section 2462. *Id.* (citations omitted).

Yet another court reached the same conclusion in *SEC v. Geswein*, --- F. Supp. 2d ---, 2014 WL 861317 (N.D. Ohio Mar. 5, 2014), where the court rejected the defendants' contention that under *Gabelli*, the SEC's claims for disgorgement and injunctive relief were time barred under Section 2462. *Id.* at *8-9. The *Geswein* court reiterated its initial holding, issued prior to *Gabelli*, that "to the extent that the SEC seeks to enjoin [Defendants] from violating ... securities laws, or an order directing them to disgorge profits to remedy an alleged past wrong and protect the public from future harm, Section 2462 does not apply." *Id.* at *9; *see also SEC v. Syndicated Food Svc. Int'l, Inc.*, No. 014-CV-1303 (NGG), 2014 WL 1311442, at *25 (E.D.N.Y. Mar. 28, 2014) (holding *Gabelli* and Section 2462 permitted disgorgement award dating back more than five years from filing of complaint); *c.f. Donell v. Mojtahedian*, 976 F. Supp. 2d 1183, 1189

(C.D. Cal. 2013) (distinguishing action from *Gabelli* where case "does not involve civil penalties, ... only . . . a return of Defendant's profits").

Several Respondents, apparently aware of the considerable authority interpreting Section 2642 to mean what it says—limiting only actions for "any civil fine, penalty, or forfeiture"—argue that disgorgement is essentially just a penalty by another name. But courts have routinely rejected this argument. As the *Vuono* court noted, "[s]everal courts in the Second Circuit have held that disgorgement is equitable as a matter of law and, therefore, not subject to the limitations period in 28 U.S.C. § 2462 where it is remedial in nature, rather than punitive." 2013 WL 6837568, at *6. (citing *SEC v. Kelly*, 663 F. Supp. 2d 276, 286–87 (S.D.N.Y. 2009)) (citing cases); *SEC v. Power*, 525 F. Supp. 2d 415, 426 (S.D.N.Y. 2007) ("Disgorgement is an equitable remedy to which Section 2642 does not apply.").

Indeed, the Second Circuit in *SEC v. Pentagon Capital Management PLC*, 715 F.3d 279 (2d Cir. 2013), rejected the same argument offered by Respondents with the benefit of the *Gabelli* opinion. The Second Circuit remanded for reconsideration the question of what penalty should be awarded in light of *Gabelli* (which had not yet been decided when the district court issued its initial decision), but affirmed the district court's disgorgement award over appellants' objection that disgorgement should be treated like a penalty. *Id.* at 287-88.

Other courts agree. In *Riordan v. SEC*, 627 F.3d 1230 (D.C. Cir. 2010), for example, the Court rejected appellants' argument that disgorgement should be treated as a penalty under Section 2462. *Id.* at 1234. As the purpose of disgorgement "is to restore the *status quo ante*," Section 2462 does not apply. *Johnson v. SEC*, 87 F.3d 484, 491 (D.C. Cir. 1996); *see also SEC v. Tambone*, 550 F.3d 106, 148 (1st Cir. 2008), *rev'd in part on other grounds*, 597 F.3d 436 (2010) (*en banc*) (Section 2462 does not limit court's authority to disgorge ill-gotten gains).

"[D]isgorgement 'is not a punitive measure; it is intended primarily to prevent unjust enrichment.'" *Matter of Brown, et al.*, No. 3-13532, 2012 WL 625874, at *15 (S.E.C. Feb. 27, 2012) (citing *Zacharias v. SEC*, 569 F.3d 458, 471 (D.C. Cir. 2009)) (citation omitted).

Against this weight of authority, Respondents cite a single case, *SEC v. Graham*, where a court held that Section 2462 deprived the court of jurisdiction over alleged violations of the federal securities laws occurring more than five years prior to filing. No. 13-1011-Civ. (JLK), 2014 WL 1891418 (S.D. Fla. May 12, 2014). *Graham* stands alone in its holding, as is evidenced by the conspicuous absence in both *Graham* and Respondents' Briefs of any citation to another court reaching the same conclusion. Indeed, while several Respondents seek to imbue *Graham* with the authority of the Supreme Court's *Gabelli* holding, the *Graham* court expressly acknowledged that its application of Section 2462 went beyond anything the Supreme Court had decided. *Id.* at *8 (noting the *Gabelli* Court "expressly declined to reach the question whether injunctive relief and disgorgement are also covered by § 2462").

The *Graham* case is also distinguishable for the apparent absence of any alleged misconduct in the five years prior to the Commission filing its complaint. *Id.* at *11. Unlike in *Graham*, where the court did not find any sale transpiring within the "red zone" of five years leading up to the Commission filing its complaint, every Selling Respondent in the case at bar made multiple sales after September 23, 2008. FoF ¶¶ 251, 268, 273, 228 (Chiappone); 302, 302 (Gamello); 309, 369, 430 (Lex); 487 (Livingston); 565, 568, 593 (Mayer); 666, 679, 685 (Rabinovich); and 711, 726 (Rogers).

2. Section 2462 Presents No Obstacle to Issuing Industry Bars Against Each Respondent

The bars the Division seeks here are not sought to punish Respondents' conduct. Rather, the industry bars are to serve the public interest by protecting investors from individuals who defrauded their own clients time and again over the course of several years.

Several Respondents, misconstruing *Johnson v. SEC*, complain that bars are, by their very nature, punitive because they impair broker's ability to earn money in the securities industry. First, as the *Johnson* court itself noted, any remedy may appear punitive when viewed solely from the accused's perspective, but that does not mean the remedy is not equitable in nature. "'[E]ven remedial sanctions carry the sting of punishment.'" *Johnson*, 87 F.3d at 488 (quoting *U.S. v. Halper*, 490 U.S. 435, 447 n.7 (1989)). But "the test for whether a sanction is sufficiently punitive to constitute a 'penalty' within the meaning of § 2462 is an objective one, not measured from the subjective perspective of the accused (which would render virtually every sanction a penalty)." *Id.* at 488. Second, *Johnson* never held that bars are per se punitive. Rather, the *Johnson* court held that before the Commission may impose a bar or suspension it must examine the "current competence or the degree of risk [a respondent] pose[s] to the public." *Id.* at 489. The court vacated the Commission's suspension order only after concluding that the Commission failed to properly consider whether that remedy was in the public interest.

Where the Commission, or Administrative Law Judges, analyze whether a bar would be in the public interest, courts have affirmed such remedial bars. For example, in *Meadows v. SEC*, 119 F.3d 1219 (5th Cir. 1997), the Fifth Circuit rejected a narrow reading of *Johnson* that a suspension was "punitive," explaining that "where the reason for the sanction is the degree of risk petitioner poses to the public and is based upon findings demonstrating [one's] unfitness to serve the investing public," such sanctions are appropriate "remedial" sanctions. *Id.* at 1228 n.20 (affirming suspension); *see also SEC v. Quinlan*, 373 Fed. Appx. 581, 587 (6th Cir. Apr. 21, 2010) (affirming grant of permanent injunction and officer and director bar as remedial, not punitive, sanctions where district court properly considered whether relief would serve the investing public). Indeed, the District of Columbia Court of Appeals itself has rejected the argument that its *Johnson* decision does not permit the Commission to issue bars to protect the investing public. *See McCurdy v. SEC*, 396 F.3d 1258, 1264 (D.C. Cir. 2005) ("The Commission may impose sanctions for a remedial purpose, but not for punishment.") (citations omitted). Whether a bar would serve the public interest depends on what are commonly referred to as the "*Steadman* factors," and those factors weigh heavily in favor of barring Respondents from the securities industry. *See* Div. Br. at 47-50.[21]

3. Events Prior to September 2008 Are Relevant to the Court's Analysis of Post-September 2008 Misconduct

What Respondents did or learned prior to September 2008 is appropriate to consider both to determine liability for that wrongdoing and to understand the context that should inform the Court's analysis of Respondents' post-September 2008 misconduct. Div. Br. at 43-44. Notwithstanding Chiappone's dismissive reference to the Commission's opinions in *Matter of Trautman*, No. 3-12559, 2009 WL 6761741 (Dec. 15, 2009) and *Matter of Warwick Capital Management, Inc.*, No. 3-12357, 2007 WL 505772 (Feb. 15, 2007) as "two non-reported decisions" (Chiappone Br. at 31), the Commission has made clear what a respondent knows or does more than five years prior to the filing of an action "may be considered … to establish [a respondent's] motive, intent, or knowledge in committing violations that are within the statute of limitations period … [and a court] may consider the entirety of [a respondent's] conduct in deciding whether to impose" prospective relief, such as a cease and desist order. *See Trautman*, 2009 WL 6761741, at *20; *Warwick Capital*, 2007 WL 505772, at *2 (older conduct relevant to

[21] The facts relevant to determine whether the Court should issue a cease and desist order are substantially identical to the analysis for bar orders, but the "risk of future violations required to support a cease-and-desist order is significantly less than that required for an injunction." *Trautman*, 2009 WL 6761741, at *21.

motive, intent or knowledge and "may be considered in determining the appropriate sanction if violations are proven").

So, for example, Respondents' awareness, prior to September 2008, that the Four Funds were in default, as well as other accumulated red flags, must be considered when evaluating Respondents' post-September 2008 recommendations of private placements offered by the same entities and principals.

Similarly, RMR's defense of their post-September 2008 sales of the Trust Offerings must be considered in light of their pre-September 2008 knowledge. If they truly knew that the Four Funds held significant investments in alarm contracts and nevertheless embraced Smith's explanation that the Four Funds' default was based on global market failures, then RMR's subsequent recommendations of MS & Co. security alarm Trust Offerings in the throes of the global market meltdown were, at a minimum, reckless. Moreover, had RMR—or any other Respondent—discharged their duty to understand the Four Funds investments, they would have discovered that $12.8 million of Four Funds investor proceeds was used to redeem pre-2003 MS & Co. alarm note investors. Div. Ex. 2 ¶¶ 26-27; at 133 (Palen Ex. 8). This, too, would be relevant to consider in judging Respondents' scienter when they recommended MS & Co. products after September 2008.

B. <u>This Proceeding Does Not Violate Respondents' Constitutional Rights</u>

Lex does not stop at claiming this Court may not award any relief even if Respondents are found to have violated the securities laws; he argues that the "Constitution [f]orbids" this enforcement action entirely. Lex Br. at 4. But while Lex devotes twelve pages of his brief to this contention, he is unable to find a single case that supports his view. Lex Br. at 4-15. As Lex appears to acknowledge, his argument is less a request for this Court to dismiss the Division's claims on constitutional grounds than a plea for some other authority to change the system by which the commission adjudicates matters entirely. Lex Br. at 7 ("Of course, because this tribunal … oversees [this case] entirely subject to the rules and orders dictated by the prosecutor itself – there is only so much that can be done here … .")

The Commission's authority to exercise its civil enforcement power through administrative proceedings is well-settled. Indeed, just last week, the Second Circuit reiterated the Commission's authority to "eschew the involvement of the courts and employ its own arsenal of remedies instead." *SEC v. Citigroup Global Markets, Inc.*, --- F.3d ---, 2014 WL 2486793, at *10 (2d Cir. June 4, 2014). And this week the District of Columbia District Court the rejected an argument similar Lex's from a party who sought to have his case heard in federal court, rather than in an administrative proceeding. *See Jarkesy v. SEC*, --- F. Supp.2d ---, No. 14-114 (BAH), 2014 WL 2584403 (D.D.C. June 10, 2014). The *Jarkesy* Court held that it lacked jurisdiction over the case, explaining that even where litigants assert constitutional due process rights, "the statutory regime embodied in the Securities Act sets forth an exclusive mechanism for the plaintiffs to pursue their claims: first, before an ALJ, then before the SEC's Commissioners, and finally, if necessary, before a Court of Appeals."[22] *Id.* at *6.

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[22] Lex also complains that the Commission's authority is not subject to appropriate "checks, balances, separations of powers, and core due process protections." Lex Br. at 6. To the extent Lex is challenging the constitutionality of the Division pursuing its claims against Respondents at all, courts have rejected that argument too. *See SEC v. Trikilis*, No. 92-1336-RSWL, 1992 WL 301398, at *6 (C.D. Cal. July 28, 1992), *vacated on other grounds*, 1993 WL 43571 (Jan. 22, 1993) (where defendant "claime[ed] that the SEC's law enforcement power violates the constitutional principle of separation of powers," the Court explained: "This claim is meritless."); *see also SEC v. Blinder, Robinson & Co., Inc.*, 855 F.2d 677, 678, 682 (10th Cir. 1988) (rejecting appellants argument that Commission's civil prosecution of them without participation by the Executive Branch "violated the constitutional doctrine of separation of powers"; holding "the civil enforcement power given to the SEC is constitutionally valid."); *SEC v. Sachdeva*, No. 10-C-747, 2011 WL 933967, at *1 (E.D. Wis. Mar. 16, 2011) (accord); *SEC v. Shared Med. Sys. Corp.*, No. 91-6546, 1992 WL 208029, at *4-5 (E.D. Pa. Aug. 17, 1992)

Respondents here have been offered the due process afforded by the Commission's Rules of Practice. Indeed, among the Commission's Rules are those that permit extensions of time to postpone the hearing dates, 17 C.F.R. § 201.161(a), and allow respondents to move for a more definite statement. 17 C.F.R. § 201.220(d). Respondents took advantage of both procedures in this matter, and the Hearing began on the exact date Respondents requested.

Finally, Lex argues that this proceeding is a "penal law enforcement prosecution" seeking penalties and, as such, triggers the Seventh Amendment's right to a jury trial. Lex Br. at 14. Lex claims *Tull v. United States*, 481 U.S. 412 (1987) stands for the proposition that individuals have a "right to a jury trial in [a] civil case where government seeks civil penalties." Lex Br. at 14. But Lex omits any reference to the Supreme Court's explanation in *Tull* that "the Seventh Amendment is not applicable to administrative proceedings." *Id.* at 418 n.4. (citing *Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n*, 430 U.S. 442, 454 (1977)) (additional citation omitted). Just weeks ago the Commission considered Lex's exact argument, when the respondents in *Matter of Harding Advisory LLC*, No. 3-15574, 2014 WL 988532 (S.E.C. Mar. 14, 2014) asserted "that the institution of administrative proceedings has deprived them of their Seventh Amendment right to a jury trial." *Id.* at *8 n.46. The Commission rejected that argument because "the Seventh Amendment does not prohibit Congress from assigning the factfinding function and initial adjudication to an administrative forum with which the jury would be incompatible." *Id.* (citing *Atlas Roofing*, 430 U.S. at 550).

C. <u>Respondents' Other Arguments Concerning Remedies Should Fail</u>

Respondents argue that if this Court is authorized to entertain this case, it should impose

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(accord); *c.f. SEC v. Bilzerian*, 750 F. Supp. 14, 17 (D.D.C. 1990) ("Since the SEC's exercise of civil enforcement responsibilities does not constitute an unconstitutional delegation of enforcement authority, the Commission is authorized to bring this [enforcement] action.").

no remedies because, according to Respondents, no Respondent did anything wrong. The record, however, demonstrates that Respondents violated the securities laws over the course of many years, with many investors and with many different MS & Co. products, and continued to profit from their misconduct until they could no longer successfully pitch MS & Co. products to their clients. The compelling grounds for significant remedies in this case are set forth in the Division's Initial Brief and, in the interest of brevity, are not repeated here. Several aspects of Respondents' briefs, however, warrant a reply.

1. Respondents Continue to Accept No Responsibility and Show No Remorse for Their Misconduct.

Respondents' submissions are particularly notable for the absence of any recognition of their wrongful conduct or any expression of remorse for the impact their sales practices had on Respondents' many clients. Such a failure to recognize, and show remorse for, the wrongfulness of one's misconduct weighs in favor of remedial sanctions such as industry bars issued to serve the public interest. *See Matter of Bluestein*, No. 3-15317, 2013 WL 6175649, at *6 (Nov. 26, 2013) (issuing permanent bar after district court found Respondent participated in a Ponzi scheme for five year period), citing *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). Rather than take responsibility for their actions, Respondents point fingers at individuals including McGinn, Smith and other senior MS & Co. personnel, Division staff, FINRA, and their own clients. While McGinn, Smith and others at MS & Co. certainly shoulder blame, no Respondent has suggested either principal, or anyone on their behalf, ever compelled any Respondent to lie to any investor or ignore his duty to understand the MS & Co. products before recommending them. Indeed, no Respondent claimed at the Hearing that he was pressured by McGinn or Smith to sell MS & Co. private placements. Respondents are responsible for their own failures to investigate the investments they sold and for the misleading recommendations they made to entice clients.

Still, several Respondents blame the defrauded investors for failing to read various PPMs closely enough, to understand risks Respondents never mentioned, or recognize red flags that never prompted Respondents to be more diligent in their own investigation. *See* Lex Br. at 43-49, 53-55; RMR Br. at 28-30; Livingston Br. at 15-16. Respondents' failure to accept any responsibility for their conduct, coupled with their pointing fingers at everyone else, weighs heavily in favor of imposing an industry bar to serve the public interest. *See Matter of Bartko*, No. 3-14700, 2014 WL 896758, at *11 (S.E.C. Mar. 7, 2014).[23] Lex's efforts to portray himself as a victim are particularly galling in this regard. He asks the Court to consider the time and money this and related litigation has cost him, Lex Br. at 103-4, but refers to judgments levied against him only to note that he is "in the process of challenging both awards." Lex Br. at 102.[24]

Finally, as in *Bartko*, it is "particularly noteworthy that [Respondents seek] to shift the focus of the proceeding away from [their] own violative conduct ... to the government's investigation and other procedural claims." *Bartko,* 2014 WL 896758, at *11. Respondents' efforts to shift the focus from their own misconduct to the Commission's Rules in general, and the Division's (entirely appropriate) conduct in particular, is further evidence that Respondents are not prepared to accept any responsibility for their actions, adding additional weight to the case for industry bars to protect the investing public. *Id.* In fact, Respondent Bartko—sounding

[23] Respondents' statements expressing a general sense of regret that investors were harmed that disclaim responsibility for one's role in causing that harm, "fall[] short of an acknowledgement of remorse." *Giesige*, 2008 WL 4489677, at *28 (respondent's "statement that she feels awful about what happened falls short of an acknowledgement of remorse.").

[24] Lex's own losses also should not impact the Court's disgorgement analysis. As the Commission explained in *Giesige*, that a Respondent lost one's own investment "is no reason why she should keep the funds she earned as part of the fraud ... [and provide] no basis for her retaining the illegal gains she received as a result of her illegal acts. *Giesige*, 2008 WL 4489677, at *30 (S.E.C. May 29, 2009).

very much like Respondents here—asserted that "his unwillingness to accept responsibility should not be considered because 'he committed no violations to begin with nor was his conduct unlawful,'" but the Commission nevertheless found Bartko's refusal to accept responsibility for his actions to be "an appropriate measure of fitness for association in the industry." *Id.*

As such, Respondents continued pleas that this Court ignore (i) the substance of their own prior sworn deposition testimony—simply because the Division obtained that testimony in connection with a proceeding against McGinn and Smith—and (ii) investor witnesses' sworn statements, made at the Hearing—because the Division contacted some witnesses after initiating the case against Respondents, rather than some earlier date—should be disregarded. *See, e.g.,* RMR Br. 41, 42. Such appeals are nothing more than the kind of finger pointing and evasion of responsibility that are intended to distract from the egregiousness of Respondents' transgressions and heighten the need for a bar from the securities industry.

2. Respondents' Purported Clean History Before and/or Since the Relevant Time Period Does Not Preclude the Imposition of an Industry Bar.

That some Respondents do not have a prior disciplinary history, *e.g.*, Gamello Br. at 5; RMR Br. at 47—though others do, Div. Br. at 44 (regarding Mayer and Rogers)—does not offer any reason to hesitate from barring those Respondents from the securities industry. As the Commission explained in *Matter of Ludlum, III* in response to a Respondent claiming he had "worked on Wall Street for over 20 years with a perfect record:" A "lack of disciplinary history is not mitigating for purposes of sanctions because an associated person should not be rewarded for acting in accordance with his duties as a securities professional." *Id.*, No. 3-14572, 2013 WL 3479060, at *5 (S.E.C. July 11, 2013) (citations omitted).

Likewise, that certain investors continue to employ certain Respondents, RMR Br. at 45; Chiappone Br. at 55 n.114, does not weigh against imposing the remedies the Division seeks.

See Matter of Giesige, No. 3-12747, 2009 WL 1507584, at *9 (S.E.C. May 29, 2009) (affirming remedies order even though some of respondent's customers "apparently continue to allow Giesige to manage their portfolios.").[25]

As Chiappone concedes: "It is the case that courts have held that fraudulence of past conduct gives rise to an inference of expectation of continued violations, and that cessation of the complained of conduct prior to the granting of [relief] will not necessarily render the request for an injunction moot." Chiappone Br. at 73 (citations omitted). Several Respondents express frustration with courts' reliance on past conduct in determining the likelihood that one will continue to violate the securities laws (and, in turn, whether a bar is appropriate)—Livingston Br. at 43-45; Chiappone Br. at 71-74; RMR Br. at 46—but absent a better way to divine the future courts have consistently focused on past conduct in assessing whether the public interest demands a bar. As the Sixth Circuit accurately explained, "[p]roof of past violations of the securities laws serves as a basis for an inference that future violations may occur." *SEC v. Washington County Utility Dist.*, 676 F.2d 218, 227 (6th Cir. 1982); *see also SEC v. Gabelli*, 653 F.3d 49, 60 (2d Cir. 2011) ("fraudulent past conduct gives rise to an inference of a reasonable expectation of continued violations"), *rev'd on other grounds*, 133 S. Ct. 1216 (2013). As the Court of Appeals for the District of Columbia has explained, "it is difficult to imagine how *any* suspension, remedial or not, could be based on anything but past actions." *Siegel v. SEC*, 592 F.3d 147, 158 (D.C. Cir. 2010), citing *McCurdy v. SEC*, 396 F.3d 1258, 1264 (D.C. Cir. 2005).[26]

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[25] Likewise, Livingston's reliance on "character witnesses" with no knowledge of any facts relevant to this case should not save him.

[26] As Respondents' Section 5 violations offer further evidence of their unwillingness to abide by the laws that govern their industry, those violations are also relevant to the bar analysis. *See Matter of Doxey et al.*, No. 3-15619, 2014 WL 1943919, at *20-28 (May 15, 2014) (ordering respondent to cease-and-desist from Section 5 violations, disgorge ill-gotten gains and pay

3. <u>An Industry Bar Is Necessary to Serve the Public Interest.</u>

Several Respondents question why a remedy "less drastic" than a bar would not suffice to protect the public. *See, e.g.*, RMR Br. at 47. As explained in *Epstein v. SEC*, Fed. Appx. 142 (3d Cir. 2010), permanent bars "may be justified where … 'a violator cannot ever operate in compliance with the law, 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.'" *Id.* at 147 (citation omitted). RMR dismisses out of hand that they committed any egregious violations, and rather than answer the facts spelled out by the Division simply repeats time and again that no sanction is warranted because they committed no violation at all. *See* RMR Br. at 44 ("RMR did not violate any securities law … therefore no sanctions are warranted) (emphasis omitted); *id.* at 45 ("As to [RMR], there was no violation"); *id.* at 46 ("there was no violation"). The record clearly proves otherwise. *See generally* Div. Br. While RMR would prefer that all of their pre-September 2008 conduct be ignored entirely, that RMR and other Respondents violated the anti-fraud provisions of the securities laws for so many years highlights why a lifetime bar is necessary to protect the investing public.

Lex's argument that his conduct does not rise to the level of fraud is similarly unavailing. He contends that even if this tribunal holds, as it has in the past, the registered representatives have a duty to investigate whether the investments he recommended were suitable products, Lex's "failure to fulfill [that duty] still does not rise to the level of fraud or deceit." Lex Br. at 100. Plainly that is not what this Court has repeatedly articulated in holding that registered representatives violate the anti*fraud* provisions of the securities laws were they fail to investigate adequately the products they recommend. Div. Br. at II.A.

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prejudgment interest thereon, and ordering a five-year penny stock bar even where respondent's actions did not involve fraud, deceit, or recklessness).

Lex's other arguments against significant remedies should fail as well. Lex tries to distinguish investor losses caused by his misconduct from losses resulting from otherwise legal conduct or other actors' conduct. Lex Br. at 101. But Lex's analysis ignores the statutory language providing that third-tier penalties may be predicated on both actual investor losses and "risk of substantial losses." 15 U.S.C. § 78u-2(b)(3)(B). It can hardly be gainsaid that selling investors unsuitable products puts them at risk of substantial losses. And for many of Lex's investors, that risk became a reality when they were unable to redeem their investments, so third-tier penalties are warranted under both the "loss" and "risk" prongs of the penalty analysis.[27]

As for Lex's argument that remedies would not promote deterrence, that argument relies on his position that brokers simply do not have an obligation to perform any due diligence on the products they recommend. Lex Br. at 103. Lex is clearly mistaken on this point, but if one takes Lex's argument at face value and registered representatives truly need to be reminded of their duties, then an opinion reaffirming those obligations and making clear the consequences for failing to discharge such duties will serve the public interest considerably.

Finally, while most Respondents' eagerness to continue working in the securities industry is understandable given the profits they can presumably reap if permitted to do so, that desire does not save them from a bar, but underscores the importance of an industry bar to protect unsuspecting investors. *See Matter of Siris*, No. 3-15057, 2013 WL 6528874, at *7 (S.E.C. Dec. 12, 2013) (Respondent "intends to remain in the securities industry, which we have recognized 'presents continual opportunities for dishonesty and abuse and depends heavily on the integrity

[27] Livingston, speaking generally about losses incurred by his investors, seeks to distinguish the money he actually received as a direct payment from those commissions he was paid as an offset to money he otherwise owed McGinn Smith entities, Livingston Br. at 34, but this should not change the Court's penalty analysis at all. Investors' risk of loss and actual losses were the same regardless of the column on which Livingston's profits were entered in MS & Co.'s books.

of its participants and on investors' confidence'") (citation omitted). That certain Respondents maintain they only want to sell certain kinds of securities and not the kinds of private placements at issue here does not militate against a bar order. *Id.* (rejecting request to limit sanction to specific roles in the securities industry where respondent's misconduct "evidences an unfitness to participate in the securities industry" in general).

And despite Lex's statement that he is not currently in the securities business, Lex Br. at 102, he should be barred as well, as he would otherwise be free to return to the industry if he avoids a bar and addresses his outstanding issues in related litigation. *See SEC v. Tzolov*. 08 Civ. 7699 (SAS), 2011 WL 308274, at *5 (S.D.N.Y. Jan. 26, 2011) (granting permanent injunction against securities law violations despite "self-serving statement" that Defendant was "far removed from the securities field"); *see also SEC v. Youmans*, 729 F.2d 413, 415-16 (6th Cir. 1984) (district court erred in focusing too heavily on defendant's change in occupation, as defendant could easily reenter business that required periodic filings with the SEC).[28]

4. Respondents' Conduct Warrants Significant Monetary Penalties.

Respondents offer little argument against the imposition of significant civil monetary penalties beyond the jurisdictional arguments addressed above. That certain courts on the specific facts before them chose not to multiply penalty figures by the number of violations or victims, Livingston Br. at 37-39, should not impact this Court's analysis. Nothing in Livingston's (or any other Respondent's) submission changes the fact that courts are empowered to, and routinely have, multiplied penalty figures where defendants or respondents were found liable for securities violations similar to those in this case. Div. Br. at 46-47. Thus, the relief the

[28] This applies with at least equal force to Chiappone, who asks the Court to credit his absence from the private placement business, but not the securities industry in general, since the misconduct at issue in this case. Chaippone Br. at 73-74.

Division seeks here hardly is "unprecedented." Livingston at 37. In fact, *SEC v. Opulentica, LLC*, 479 F. Supp. 2d 319 (S.D.N.Y. 2007), Livingston at 38, unambiguously recognizes its authority to impose a penalty greater than one times the third tier maximum before concluding, on the specific facts before the court, that a total penalty of $120,000 was appropriate. *Id.* at 332 (finding penalty greater than $120,000 was justified, but arriving at the lower $120,000 figure after considering other financial components of the judgment and the unlikelihood of recovery). Here, where Livingston belittles the amount of ill-gotten gains sought by the Division in his effort to minimize the magnitude of his role in the fraud, the *Opulentica* court's logic works against him, as only a significant penalty will serve the deterrence function that a comparatively low disgorgement figure will not achieve.[29]

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[29] *SEC v. Robinson*, No. 00-civ-7452, 2002 WL 1552049 (S.D.N.Y. July 16, 2002) likewise does not support Livingston's position. There, the court imposed a total monetary penalty of $100,000 rather than multiplying that figure by the number of victims, but Livingston's brief fails to note that the Court arrived at its penalty amount only after considering that the Commission initially asked for $100,000 only in penalties. The multimillion dollar figure Livingston says the court "flatly rejected" was, as described by the court, simply the figure that the Commission "noted" would result if the Court imposed a $110,000 penalty for each of 207 investors while, in the same brief, suggesting that the court arrive at a figure representing "a significant civil penalty." *Id.* at 12.

CONCLUSION

Based on the foregoing, and on the Division's submissions dated April 9, 2014, the Division respectfully requests that this Court enter the Division's proposed findings of fact and conclusions of law and impose the requested sanctions on the Respondents.

Dated: New York, NY
June 12, 2014

Respectfully submitted,

DIVISION OF ENFORCEMENT

David Stoelting
Haimavathi V. Marlier
Michael D. Birnbaum
Securities and Exchange Commission
Brookfield Place
200 Vesey Street, Suite 400
New York, NY 10281
(212) 336-0174 (Stoelting)
(212) 336-1055 (Marlier)
(212) 336-0523 (Birnbaum)