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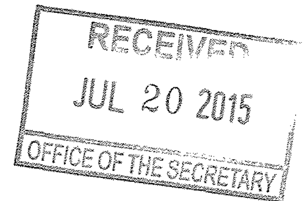
UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION



ADMINISTRATIVE PROCEEDING
File No. 3-15514

In the Matter of,

FRANK H. CHIAPPONE,
ANDREW G. GUZZETTI,
WILLIAM F. LEX,
THOMAS E. LIVINGSTON,
BRIAN T. MAYER, and
PHILIP S. RABINOVICH

JOINT BRIEF ADDRESSING CERTAIN LEGAL ISSUES IN ACCORDANCE WITH THE COMMISSION'S ORDER

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By Order dated May 21, 2015, the Commission *sua sponte* ordered six individual Respondents to submit a joint brief addressing certain legal issues and limited any individual briefs to less than that provided for in the Commission's Rules of Practice. Each Respondent objects to the Order, but nonetheless joins in this brief to the extent the legal issues are applicable to him.[1]

Each Respondent maintains that the overwhelming evidence demonstrated that he (1) did not violate any securities law, and (2) fulfilled his duties as a registered representative (or manager). These factual matters and other issues are addressed in each Respondent's Individual Brief, as limited by the Commission's *sua sponte* Order.

PRELIMINARY STATEMENT

As a matter of law, this proceeding never should have been commenced, let alone in an administrative forum. The proceeding was so fatally flawed and the hearing conducted so prejudicially that the Commission should dismiss the entire proceeding.

The discriminatory premise underlying the proceeding was that 10 out of approximately 50 registered representatives should be singled out for punishment for the fraud perpetrated by Timothy McGinn ("McGinn") and David Smith ("Smith"), even though "[t]he Division's [own] expert had no reason to believe that Respondents were aware of McGinn and Smith's fraud,"[2] and despite the fact that approximately 40 other registered representatives sold over $69 million of McGinn Smith Securities.[3] No enforcement action was taken against those

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[1] There were no allegations, and thus no findings, against Respondent Guzzetti, for the Fraud Claim or the Section 5 Claim (as defined herein).

[2] Decision at 4.

[3] *See* Div. Ex. 591. McGinn Smith Securities refer to the 26 offerings at issue in the OIP, which includes the Four Funds and the Trust Offerings (as defined in the OIP).

registered representatives, and thus Respondents' equal protection and due process rights were violated by the commencement and prosecution of the administrative hearing.[4]

Further, the conduct of the proceeding was rife with prejudicial error and bias against Respondents. Respondents were deprived of their constitutional rights to have their case decided by a jury and presided over by an independent Article III judge of the federal judiciary. The entire proceeding violated Article II, Section 2, Clause 2 of the U.S. Constitution as the hearing officer (the "ALJ") was not appointed by the President, a court of law, or department head, and the ALJ's two-layer tenure protection was unconstitutional, which renders her decision unenforceable.[5]

Fundamental fairness required that parties be "timely" informed "of matters of fact and law asserted"[6] against them. The Order Instituting Proceedings ("OIP"), however, failed to state a claim for securities fraud under well-established federal pleading standards. Respondents were not informed when they supposedly made any material misrepresentation or omission to any investor about any McGinn Smith Security. Yet, the ALJ denied Respondents' separate motions for a more definite statement.

Having failed to inform Respondents "of matters of fact and law asserted" against them, and lacking the basic information necessary to prove any alleged violation, the Division violated SEC Rule of Practice 230(g) by improperly and prejudicially soliciting witnesses and gathering evidence to support the OIP *after* it was filed. In denying Respondents' separate motions to preclude this post-OIP fishing expedition, the ALJ thereby endorsed the Division's violation of the Rule.

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4 *Gupta v. SEC*, 796 F. Supp. 2d 503, 513-14 (S.D.N.Y. 2011).

5 *Free Enter. Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477, 487 (2010).

6 *See* 5 U.S.C. § 554(b).

The ALJ allowed the Division to present evidence about matters pre-dating by years any of the offerings at issue in the OIP. Indeed, of those 26 McGinn Smith Securities that were included in the OIP, *sixteen of them* were offered more than five years before the OIP was filed. The ALJ, however, summarily denied Respondents' separate motions that 28 U.S.C. § 2462 ("Section 2462") barred the Division's claims, all of which "first accrued" prior to September 23, 2008 – five years before the OIP was filed – thus eliminating any subject matter jurisdiction to "entertain" the proceeding.[7] Underscoring that Respondents' due process rights to a fair hearing before an independent and impartial tribunal were violated, the ALJ ruled that "when the Commission sets down a case for hearing ... the agency does not want motions...because you're second guessing their decision that ... there is a legal basis for it...."[8] In other words, instead of an independent and unbiased finder of fact, the ALJ refused to "second guess" the conclusions already reached by the Commission.

The ALJ also ignored that "[t]he fundamental requirement of due process is the opportunity to be heard 'at a meaningful time and in a meaningful manner.'"[9] Despite the stakes of this proceeding – Respondents' professional and financial livelihood – Respondents were denied meaningful time (just four months) to review the Division's gargantuan investigative record – consisting of approximately one *terabyte* (1000 gigabytes) of data and more than 100 cartons of documents. It was literally impossible for Respondents to do so prior to the hearing. Nor did Respondents have the opportunity to conduct depositions or narrow the scope of this proceeding on statute of limitations grounds as they would in federal court. This was especially prejudicial given the complexity of this case – numerous transactions spanning seven years

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7 *Gabelli v. SEC*, 133 S. Ct. 1216 (2013).

8 Pre-Hearing Tr. (Jan. 21, 2014), at 30:13-21.

9 *Mathews v. Eldridge*, 424 U.S. 319, 333 (1976).

(2003-2009) – six years of which fell outside the statute of limitations – with numerous individual Respondents working in four separate locations as part of an investment banking and brokerage firm with about 50 registered representatives. While the Division had four years to prepare, Respondents had four months. Respondents were not accorded sufficient due process.

The ALJ exacerbated the deprivation of Respondents' due process rights by admitting non-party deposition testimony voluntarily given to assist the Commission in its federal court action against McGinn and Smith. Respondents provided testimony voluntarily with the explicit understanding that it was required to assist the Commission in its action against McGinn, Smith and others, and thus did not try to refresh their recollections about events from 2003, did not have MS&Co. records with which to do so, and significantly, had no reason to believe that they needed to inform the Division of each and every action *they* took to demonstrate they fulfilled their obligations as registered representatives, as they were (mis)led to believe they were not a target of any enforcement action. The Division never disclosed that Respondents were or might be a target, never provided them with SEC Form 1662, never showed them a Formal Order of Investigation, and never provided them with their deposition transcripts to review, correct, amplify or sign. Nevertheless, the ALJ denied Respondents' separate motions to exclude the non-party depositions which the Division used purportedly to impeach Respondents and on which the ALJ erroneously relied in making credibility determinations.

While this proceeding was fundamentally flawed and infected with bias and error in the process and procedure, the ALJ also committed numerous legal errors in finding Respondents violated the antifraud provisions of the federal securities laws (the "Fraud Claim") and Section 5 (the "Section 5 Claim") of the Securities Act of 1933 (the "Securities Act").

The Fraud Claim

The ALJ improperly extended the holding of *Hanly*,[10] a case with vastly different facts and circumstances, in concluding that each Respondent violated Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), and Rule 10b-5 thereunder. In so doing, the ALJ erroneously concluded that, during the period of 2003 to 2009, individual registered representatives ("RRs") had a duty to "investigate" and "verify" statements in the private place memoranda ("PPMs") and effectively replicate the due diligence conducted by the member firm's investment banking department. Notably, only conduct during the period of September 23, 2008 to 2009 should have been considered at all.

The ALJ also ignored controlling Supreme Court precedent[11] in concluding that Respondents violated Securities Act Section 17(a)(1), Exchange Act Section 10(b), and Rule 10b-5 thereunder. There was no evidence that Respondents acted with *scienter* – a state of mind embracing the intent to deceive, manipulate or defraud. Indeed, the OIP did not allege, and the Division did not contend, that Respondents had a motive to defraud their clients.

The Section 5 Claim

The ALJ also committed numerous errors in concluding that Respondents violated Securities Act Section 5. First, the ALJ considered evidence regarding the Four Funds' offerings, none of which were sold within five years of the date the OIP was filed. Second, the ALJ ignored the grossly inaccurate information on which the Division based its Section 5 claim – an admittedly inaccurate "investor database" and double hearsay that was allowed to trump the contemporaneous representations of individual investors in their purchaser questionnaires.

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10 *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969).

11 *See Aaron v. SEC*, 446 U.S. 680 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

Third, despite rejecting the Division's arguments about integration of the separate Trust Offerings, the ALJ nonetheless concluded that the Trust Offerings did not comply with Rule 502, despite the financial and non-financial disclosure in the PPMs for the Trust Offerings that was provided to all investors (not just those who may have been unaccredited).[12] Finally, the ALJ ignored that no court or the Commission has ever imposed Section 5 liability on an individual RR in circumstances such as these. Unlike here, the SEC has filed Section 5 charges, and the courts have found Section 5 violations, *only* (a) where there has been an obvious failure to comply with the registration requirement or with any claimed exemption, *and* (b) where there has been knowing or recklessly deceptive conduct.

For all of these reasons, and those set forth in their Individual Briefs, Respondents respectfully request that the Commission reverse and dismiss all charges against them.

ARGUMENT

I.

SECTION 2462 BARS THE CLAIMS ASSERTED IN THE OIP

A controlling federal statute – 28 U.S.C. § 2462 – deprived this (and any other) tribunal of subject matter jurisdiction to "entertain" all of the claims alleged in the OIP. Section 2462 provides in relevant part:

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

Every claim alleged in the OIP "*first accrued*" before September 23, 2008 (i.e., more than five years prior to the date the OIP was filed). Thus, the OIP could not be "*entertained*" here.

[12] Decision at 95-97.

In *Gabelli v. SEC*, the Supreme Court held that a claim "accrues" within the meaning of Section 2462 "when it comes into existence," which occurs "when the plaintiff has a complete and present cause of action." 133 S. Ct. 1216, 1220-21 (2013) (citations omitted). While a claim may accrue on more than a single occasion, the *first* accrual dictates the date from which the proceeding must be commenced. Because all claims alleged "*first accrued*" before September 23, 2008, there was no subject matter jurisdiction to "*entertain*" this case. *See Williams v. Warden*, 713 F.3d 1332, 1337-40 (11th Cir. 2013) ("the great weight of authority" holds that the statutory command – "shall not be entertained" – "is jurisdictional in nature"). In concluding otherwise, the ALJ cited two pre-*Gabelli* Commission opinions, Decision at 89, which are no longer good law following the Supreme Court's decision.

Recently, the Division's Director of Enforcement, Andrew Ceresney, acknowledged in a sworn statement the significant reasons that underscore the line in the sand drawn by Section 2462 and *Gabelli*. As stated by Ceresney, "administrative proceedings typically [but not here] result in presentation of evidence when it is relatively fresh. With the passage of time, witnesses' memories might fade and some types of evidence becomes stale." Declaration of Andrew Ceresney, dated June 24, 2015, ¶ 4 (submitted in *Hill v. SEC*, 1:15-cv-01801-LMN (N.D. Ga.)). These concerns cannot be ignored here.

It is undisputed that any claims based on the Four Funds, whether sounding in fraud or otherwise, first accrued before September 23, 2008. The Four Funds were first offered between 2003 and 2005, and no Respondent sold a Four Funds note after September 23, 2008. Div. Ex. 2. Thus, any alleged "failure to investigate," misrepresentation, or omission necessarily occurred – if at all – before September 23, 2008. Section 2462 plainly bars any claims based on the Four Funds. Further, the ALJ's hearing testimony and admitting exhibits based on conduct

prior to September 23, 2008 – including evidence of McGinn and Smith's criminal acts, some of which allegedly dated back to 1999 – was highly prejudicial and contaminated the entire proceeding. No court would have admitted this irrelevant evidence.

Further, the ALJ determined that the Fraud Claim, whether based on the Four Funds *or* the Trust Offerings, accrued no later than February 1, 2008, because Respondents "had requisite scienter to violate the antifraud provisions" by that date. Decision at 115. The ALJ did not find any specific material misrepresentation or omission by any Respondent *after* February 1, 2008. As the Fraud Claim was based on Respondents' purported scienter as of February 1, 2008 – more than five years before the OIP – the entire Fraud Claim is time-barred. The Division conceded that its claims *first* accrued "from the date each Selling Respondent *first* recommended and sold one of the Four Funds notes," which was a decade ago, and demanded forfeiture of commissions from 2003. Div. Post-Hearing Br. at 37 (emphasis added). The ALJ nevertheless concluded that some (unspecified) claims survive. Decision at 89. That was error.

Moreover, insofar as any claims could be "entertained" – and they cannot – the ALJ erred in concluding that the "disgorgement" sought here – the sole compensation earned by four Respondents – was not a "forfeiture" subject to Section 2462. *SEC v. Graham*, 21 F. Supp. 3d 1300, 1310-11 (S.D. Fla. 2014) ("disgorgement ... can truly be regarded as nothing other than a forfeiture (both pecuniary and otherwise), which remedy is expressly covered by § 2462"), *appeal docketed*, No. 14-13562 (11th Cir. Aug. 8, 2014); *Coghlan v. NTSB*, 470 F.3d 1300, 1305 (11th Cir. 2006); *Johnson v. SEC*, 87 F.3d 484, 491 (D.C. Cir. 1996); *SEC v. Bartek*, 484 F. App'x 949 (5th Cir. 2014); *compare with* 15 U.S.C. § 7243 (Sarbanes-Oxley Act § 304, Forfeiture of Certain Bonuses and Profits). The ALJ recognized that "[c]ivil monetary penalties are clearly subject to the five-year statute of limitations" as are "associational bars, when, as

here, the bars would be imposed punitively rather than remedially." Decision at 89. Yet, the ALJ ignored her own conclusion, as the disgorgement ordered imposed is punitive.

To avoid this result, the ALJ stated that "[d]isgorgement is an equitable remedy," Decision at 114, despite the fact that neither the Commission nor the ALJ have equitable powers, and must abide by statutes of limitations. Having chosen its own captive Article II venue, the Division could not seek *any* equitable remedies, because neither the Commission nor its ALJs have any constitutional power to grant equitable remedies and avoid statutes of limitations. *See* U.S. Const. Art. III, § 1 ("The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish"); *id.* § 2 ("The judicial Power shall extend to all Cases, in Law and Equity, arising under ... the Laws of the United States"). Simply put, the ALJ imposed the punitive remedy of forfeiture, and is not constitutionally permitted to do otherwise.[13]

But whether disgorgement, cease and desist orders, or injunctions are penalties, forfeitures, or permissible at all in an administrative proceeding does not matter here, because all claims alleged *first accrued* before September 23, 2008. Because the proceeding sought penalties for pre-September 23, 2008 conduct, the entire proceeding could *not* be "entertained," including for "non-penal" remedies for post-September 23, 2008 conduct. Section 2462 and *Gabelli*'s reasoning preclude this enforcement action, filed years after memories have faded, regardless of the labels the ALJ attached in her decision. *See United States v. Usery*, 518 U.S. 267, 284 (1996).

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[13] If the Commission concludes that disgorgement here is "equitable" and not a "forfeiture" (which would be error), only clients who purchased after September 23, 2008 could arguably be considered.

II.

THE ALJ APPLIED INCORRECT LEGAL STANDARDS TO THE FRAUD CLAIM

A. Liability Under Exchange Act Section 10(b), Rule 10b-5, and Securities Act Section 17(a)(1) May Be Imposed Only for Intentional or Reckless Conduct Not Present Here

As the Supreme Court has held, the text of Section 10(b) of the Exchange Act "quite clearly evinced a congressional intent to proscribe only 'knowing or intentional misconduct.'" *Aaron v. SEC*, 446 U.S. 680, 690, 695 (1980) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201, 206 (1976)). Similar to Section 10(b), "[t]he language of § 17(a)(1) [of the Securities Act] ... plainly evinces an intent on the part of Congress to proscribe only knowing or intentional misconduct." *Id.* at 696. Accordingly, Supreme Court precedent requires proof that each Respondent acted with *scienter* – a state of mind embracing the intent to deceive, manipulate or defraud. *See id.* at 686 n.5, 697; *Hochfelder*, 425 U.S. at 193. The ALJ did not apply that standard (and the Division did not meet that burden).

The ALJ ignored that to plead (and by extension, prove) the requisite fraudulent intent, a plaintiff must either "show that defendants had both motive and opportunity to commit fraud," or adduce "facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." *Kalnit v. Eichler*, 264 F.3d 131, 138-39 (2d Cir. 2001) (internal quotations omitted). The OIP did not allege, and the Division did not contend, that any Respondent had a motive to defraud his clients. *See, e.g., In re Merrill Lynch Auction Rate Sec. Litig.*, 851 F. Supp. 2d 512, 528 (S.D.N.Y. 2012) (alleged motive "to increase or maintain profit" insufficient as such motive "could be imputed to any for-profit endeavor"). Where, as here, evidence of motive is non-existent, the Division's circumstantial evidence of recklessness "must be correspondingly greater." *Kalnit*, 264 F.3d at 142 (internal quotations omitted).

In this context, courts define "reckless" conduct as an approximation of actual intent to defraud. *See Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d Cir. 1978) (reckless conduct is "at the least, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care *to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.*") (emphasis added and internal quotations omitted); *see also Chill v. Gen. Elec. Co.*, 101 F.3d 263, 269 (2d Cir. 1996) (recklessness "must, in fact, approximate an actual intent to aid in the fraud being perpetrated") (citation omitted); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) ("[R]ecklessness should be viewed as the functional equivalent of intent....").

The Second Circuit recently reiterated that limitation in dismissing a Section 10(b) claim made against an investment advisor who "recklessly" recommended an investment in a Ponzi scheme, because there were no facts to support a finding of *scienter*. Like Respondents here, the investment advisor was not aware of any fraud at the time of the recommendation. *See South Cherry St., LLC v. Hennessee Group LLC*, 573 F.3d 98, 109 (2d Cir. 2009) (defining recklessness as "a state of mind *approximating actual intent,* and *not merely a heightened form of negligence*") (emphasis in original). Nor do grossly negligent failures of diligence approximate an actual intent to defraud. *See, e.g., Gabriel Capital, L.P. v. NatWest Fin., Inc.*, 137 F. Supp. 2d 251, 263 (S.D.N.Y. 2000) ("[a]n investment advisor ... is not required to assume the role of accountant or private investigator and conduct a thorough investigation of the accuracy of the facts contained in the documents that it analyzes for the purpose of recommending an investment. The investment advisor is not the author of those documents and does not purport to certify the accuracy of those documents.").

In short, there was no evidence presented that Respondents acted intentionally or recklessly or with any motive to defraud their clients, and the ALJ's gratuitous use of the word "reckless" does not change this fact.

B. Registered Representatives Are Bound By Suitability Obligations, But Are Not Required To Replicate An Investment Banker's Due Diligence

It is well-settled that "there is no general fiduciary duty inherent in an ordinary broker/customer relationship." *Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 940-41 (2d Cir. 1998). Rather, a RR engaging in transactions in a non-discretionary account "owes duties of diligence and competence in executing the client's trade orders, and is obliged to give honest and complete information when recommending a purchase or sale." *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002).

When an investment recommendation is made by a broker-dealer (member firm) or one of its associated persons, NASD (n/k/a FINRA) rules require that it be *suitable*. Specifically, NASD Rule 2310(a), the operative rule in effect during the relevant time period, provides that "[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." NASD Rule 2310(a).

A review of applicable industry guidance confirms the long-standing distinction between customer-specific suitability determinations made by an individual broker under Rule 2310, and "due diligence investigations" performed by a broker-dealer firm. *See, e.g.*, NASD Notice to Members ("NTM") 03-07. FINRA's new guidance issued in 2011, the Division's basis for claiming a "duty to investigate" exists, is not applicable here. As one testifying expert

explained: FINRA issued a "plethora" of new notices to members in 2011 "because things changed."[14]

Contrary to the ALJ's conclusion, Decision at 90, the securities industry has never imposed a generalized duty to "investigate" on individual RRs, particularly where, as here, they were not involved in the preparation of the PPMs. *See BNP Paribas Mortg. Corp. v. Bank of Am., N.A.*, 866 F. Supp. 2d 257, 268 (S.D.N.Y. 2012) (finding "no duty, under the industry notices and treatise cited ... to investigate or verify representations made in the PPM absent participation in preparation of the PPM") (citing FINRA NTM 10-22 (Apr. 2010) at 4); Charles J. Johnson & Joseph McLaughlin, *Corporate Finance and Securities Laws* 7-79 (4th ed. 2011 Supp.)).

The relevant standard of care requires RRs to have a basic understanding of the features, risks and rewards of the investments.[15] Under this standard – the only one applicable here – Respondents did all that was required of them under the law. *See also* Respondents' Individual Briefs.

C. The ALJ Erroneously Expanded *Hanly*

The ALJ rejected the established products suitability standard and, relying on *Hanly*, *Milan*, and other distinguishable cases involving boiler rooms and other egregious conduct, erroneously concluded that "it is an established principle that a registered representative has a duty to investigate the security she or he recommends to a customer to establish an adequate basis for their recommendation." Decision at 90. The ALJ expressly acknowledged numerous arguments made by some or all Respondents why *Hanly* does not apply here, most notably, that "*Hanly* and its progeny are distinguishable," *id.* at 89, only to categorically reject all

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14 Tr. 3953:20-25 (Tilken).

15 *See, e.g.*, Tr. 3958:19–3961:7 (Tilken).

of these arguments without meaningful analysis. Instead, the ALJ merely parroted language from *Hanly* and rigidly applied it to all Respondents. The ALJ likewise ignored the testimony about the painstaking research conducted by MS&Co.'s due diligence team on the Trust Offerings.[16]

For example, while noting that "[t]he extent of the duty of investigation depends on the facts and circumstances of each situation," the ALJ declared that attending meetings to understand each McGinn Smith Security and reviewing the PPM were insufficient because, supposedly, the "presentations [were] intended to promote sales," "[n]o one from outside MS&Co. offered any divergent or cautionary views," and Smith answered "tough questions" with "optimistic revenue projections." *Id.* The ALJ ignored evidence of the suitability analysis performed by Respondents, and the evidence that investment banking/brokerage firms routinely present private placement securities offerings in the same manner MS&Co. did.

The ALJ expanded *Hanly* to circumstances dramatically unlike the egregious conduct in the cases on which she erroneously relied as support. Under the ALJ's ruling, RRs would have to somehow engage outsiders to review their firms' offerings. If the cases indeed held as the ALJ concluded, brokers would be liable for failing to perform functions that applicable NASD and FINRA Rules clearly advised them were not their responsibility. That has never been the law, let alone industry practice, and no court has so held. Rather, *Hanly* and its progeny hold only that a broker may not blindly pass along factual representations that are obviously false, outlandish or of doubtful veracity, without some reasonable basis supporting the facts represented. *Hanly* does not hold that every stockbroker must personally investigate every

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16 Tr. at 4544–4549 (Cody); 5430–5431, 5447–5448, 5568 (Chiappone).

aspect of every security recommended, and only certain circumstances – not present here – trigger the so-called "duty to investigate."

The applicable standard set forth in *Hanly* states, "[b]y his recommendation, he [registered representative] implies that *a reasonable investigation has been made* and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information." *Hanly*, 415 F.2d at 597 (emphasis added). *Hanly* requires that a reasonable investigation *has been made*; it does not require individual brokers to personally perform the due diligence process.

The ALJ ignored the stark differences between *Hanly*, *Milan*, and other distinguishable cases (where the RRs actively participated in the fraud) and the circumstances here (where Respondents did not participate and were unaware of the secret theft and diversion of funds by McGinn and Smith). In *Hanly*, the brokers made specific misrepresentations and reckless omissions that made their outlandish, highly unreasonable one-sided recommendations false and misleading. *See* 415 F.2d at 592 ("the Commission held that 'the fraud in this case consisted of the optimistic representations or the recommendations ... without disclosure of *known* or *reasonably ascertainable* adverse information which rendered [the brokers' statements] materially misleading....'") (emphasis added). The brokers falsely claimed to have purchased the stock they were recommending for their own accounts. *Id.* at 593. They said the stock would "go from 6 to 12 in two weeks," or would "double after three or four weeks." *Id.* at 593-95. But the brokers knew the company had no working capital and was operating at a loss, and failed to disclose that information to their customers. *Id.* at 594. No such facts were presented here.

Indeed, Respondents and/or their family members purchased McGinn Smith Securities, undermining any suggestion they acted with scienter or were aware of any fraud.

All of the cases imposing Section 10(b) liability against individual brokers for recommending investments to their customers involved highly unreasonable, knowing misrepresentations and omissions, or such obvious misstatements or failures to disclose that the brokers were proceeding in reckless disregard of the truth. *See SEC v. Hasho*, 784 F. Supp. 1059, 1107 (S.D.N.Y. 1992) (defendants "operated a boiler room operation" and "recommended speculative securities to mostly unsophisticated investors using high pressure and fraudulent sales pitches via long distance telephone solicitations"); *SEC v. Platinum Inv.*, 02 Civ. 0626, 2006 U.S. Dist. LEXIS 67460 (S.D.N.Y. Sept. 20, 2006) (defendant was "undoubtedly reckless" because he "failed to take even the most rudimentary steps to make sure his recommendations to his clients were responsible and reasoned," "did nothing to confirm his price or performance predictions," "did nothing to familiarize himself with private placements," and failed to read materials sent to customers); *SEC v. Milan Capital Group, Inc.*, 00 Civ. 108, 2000 U.S. Dist. LEXIS 16204, at *5-6, *13-21(S.D.N.Y. Nov. 9, 2000) (broker enabled the sale of phony IPO securities); *SEC v. Shainberg*, 316 F. App'x 1, 2 (2d Cir. 2008) (broker selling stock he *knew* was an unsound investment); *Graham v. SEC*, 222 F.3d 994, 1005-06 (D.C. Cir. 2000) (stockbroker aided a customer in executing high frequency trading scheme similar to check kiting, whose sole defense was her supervisor never questioned the trades).

SEC v. Dain Rauscher, 254 F.3d 852 (9th Cir. 2001) (cited in the Decision at 90), underscores Respondents' point that individual brokers are not required to independently investigate the securities they offer and conduct the due diligence typically performed by investment banks and others. That case involved an investment firm that underwrote municipal

securities and its lead investment banker, the firm's principal, who structured the deals and prepared offering documents, *the very people who are required to conduct due diligence*. The court, citing *Hanly*, held that, as firm principal and lead underwriter, he had a duty to investigate information provided by the issuer, and failed to do so. 254 F.3d at 857-59.

Moreover, there was no allegation in the OIP or evidence presented here that any PPM included a material misrepresentation or omission (and Respondents did not assist in their preparation in any event). Nor was there evidence that any Respondent made a material misrepresentation or omission to a specific client about a specific McGinn Smith Security. The evidence established that Respondents understood the product and satisfied their suitability obligations.

At its core, this case involved a classic fraud, wherein a few individuals (*i.e.*, McGinn and Smith) went to great lengths to conceal their wrongdoing by misleading and lying to those around them, including their employees (Respondents), regulators (FINRA/NASD and the SEC), and others. It took the Division's summary witness, a certified fraud examiner, three years – with full 20/20 hindsight – to ascertain the fraud. Tr. 392:5–393:18. To punish Respondents for, in the ALJ's words, not "resolv[ing]" the supposed red flags, Decision at 91, is unfair and unwarranted under controlling law.

D. There Were No Red Flags That Altered Respondents Duties As Registered Representatives

Hanly only imposes a duty to inquire when facts are present that would cause a reasonable broker to doubt information he has been given (i.e., "red flags").[17] *Hanly*, 415 F.2d at 596. Here, there were no such facts.

[17] According to the Division's expert, 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.

1. *The PPMs Contained Standard Disclosures*

The disclosures in the PPMs for McGinn Smith Securities were customary in the industry. A comparison of the PPMs for other McGinn Smith private placements not at issue in the OIP with the PPMs for the McGinn Smith Securities (*see e.g.,* RMR Ex. 861) makes clear that the alleged "red flag" disclosures cited by the ALJ (Decision at 91-92) were typical – not red flags. *See South Cherry*, 573 F.3d at 109 (red flag must be "so obvious[ly]" indicative of fraud "that the defendant must have been aware of [the fraud]" and desirous of furthering it).

As an initial matter, that the PPMs explained risks is not indicative of fraud, but instead evidence that MS&Co. complied with its disclosure obligations so that investors could make an informed decision prior to investing. It is not a basis for finding Respondents should have conducted an "independent investigation" to "resolve" these disclosures. Decision at 91. The ALJ's suggestion that Respondents should have uncovered McGinn and Smith's well-concealed fraud, when the SEC, NASD, and others were unable to do so for years, is preposterous.

In any event, the PPMs for McGinn Smith Securities were concise (approximately 15-20 pages) and rich in lucid warnings. The PPMs for the Trust Offerings – the only relevant PPMs here, given that no Respondent sold a Four Funds note after September 23, 2008 – explained the risk factors in considerable detail. For example, the PPM for TDM Cable Trust disclosed, in part, as follows:

- "The Certificates offered hereby are suitable only for those investors whose business and investment experience makes them capable of evaluating the merits and risks of their prospective investment in the Certificates, who can afford to bear the economic risk of their investment for an indefinite period of time and have no need for liquidity in this investment." Div. Ex. 264, at 3.

- "Since there can be no assurance that the Contracts will generate sufficient income necessary to pay the Certificates, investment in the Certificates is suited for persons who have substantial income from other sources." *Id.*

- There is a potential for contract defaults in the underlying contracts in which the Trust is investing, which "would result in an interruption in available cash distributable to Certificateholders." *Id.* at 6.

- "The Trustee of the Trust Fund is McGinn, Smith Capital Holdings Corp., the sales agent for this offering is McGinn, Smith & Co. Inc., and two of the principals of TDM Cable Funding, LLC are Timothy M. McGinn and David L. Smith." *Id.*

- "The purchase of Certificates may be suitable for individuals seeking an investment intended to provide income.... Nevertheless, this investment involves a number of significant risks, including no assurance that the Certificates will be paid and illiquidity." *Id.* at 11.

The Four Funds' PPMs, insofar as they are considered at all, contained similar disclosures, including a bold-faced warning on the very first page that: "**Investing in the notes involves a high degree of risk**." Div. Ex. 5 at 1. The Four Fund PPMs also clearly explained their broad investment mandate, which was unremarkable and not a "red flag":

> We intend to use the net proceeds to acquire various public and/or private investments, which may include, without limitation, debt securities, collateralized debt obligations, bonds, equity securities, trust preferreds, collateralized stock, convertible stock, bridge loans, leases, mortgages, equipment leases, securitized cash flow instruments, and any other investments that may add value to our portfolio. . . .

Div. Ex. 5, at 15. This investment mandate was limited in only two ways: (1) "not … more than 25% of the proceeds of this offering [would be invested] in any single Investment," and (2) if any investment is "purchased from our managing member or any affiliate, we will not pay above the price paid by our managing member or such affiliate for the Investment...." *Id.* There was no evidence that MS&Co. violated the former, and no evidence that any Respondent knew or should have known MS&Co. violated the latter. It was not a red flag.

Contrary to the ALJ's finding (Decision at 91-92), disclosure of the conflicts of interest in the PPMs were not red flags. Two experts, both seasoned veterans of the securities industry, explained that conflicts of interest disclosed in a PPM do not heighten the RRs' obligations, because they were fully disclosed, and a "conflict of interest relative to issuers being affiliated with broker-dealers is almost a daily event. That is what broker-dealers do...." Tr. 3941:2-13 (Tilken). Another expert noted that affiliations between issuer and underwriter in the offer of proprietary product sales "happens all the time." Tr. 4039:21-4040:8 (Bennett). Nor was Smith's level of control over the Four Funds significant because McGinn and Smith were seasoned veterans in the capital markets, and Smith had sufficient experience and background in underwriting to launch private placements such as the Four Funds. Tr. 3921:4-17; 3927:17-25 (Tilken).

In addition, the "affiliated transactions" disclosure represents a *protective limitation* on the potential conflict of interest – *not* a cause for concern. The PPMs expressly stated that "we will not pay above the price paid by our managing member or such affiliate for the Investment." *See* Div. Ex. 5, at 15. Respondents had no reason to question the statements in the PPMs, let alone to undertake the "investigation" required by the ALJ's decision.

Moreover, investors signed subscription agreements, in which they expressly "represent[ed], and warrant[ed]," that they were aware of all of these so-called "red flags," yet chose to nonetheless invest:

- "I have received and have carefully read and understood the [PPM] given to me by the Trust Fund in connection with the offering of Certificates." Div. Ex. 264, at 23.
- "I recognize that investment in the Certificates involves substantial risk factors, including those set forth under 'Risks' in the [PPM]." *Id.*

- "I have adequate means of providing for my current needs and possible personal contingencies, and I have no need for liquidity in my investment in the Certificates." *Id.*
- "I have relied only on the foregoing information and documents in determining to make this subscription, and the decision to acquire Certificates of the Trust Fund has been made based upon my own evaluation of the merits and risks of the Trust Fund." *Id.*

The ALJ ignored these controlling contractual provisions and representations in finding some Respondents made material misrepresentations and omissions to their clients. In so doing, the ALJ accepted vague testimony from a few investors, out of hundreds, who thought McGinn Smith Securities were "safe" or who "did not study [the PPMs] in detail," in concluding that Respondents had acted with *scienter*. Decision at 20. This was plain error as a matter of law.

The Supreme Court explained:

> It will not do for a man to enter into a contract, and, when called upon to respond to its obligations, to say that he did not read it when he signed it, or did not know what it contained. If this were permitted, contracts would not be worth the paper on which they are written. But such is not the law. A contractor must stand by the words of his contract; and, if he will not read what he signs, he alone is responsible for his omission.

Upton, Assignee v. Tribilcock, 91 U.S. 45, 50 (1875) (citations omitted).

The Seventh Circuit more recently explained that "claims [of fraud] are barred by a very simple, very basic, very sensible principle of the law of fraud, both the law of securities fraud and the common law of fraud. If a *literate, competent adult* is given a document *that in readable and comprehensible prose* says X (X might be, 'this is a risky investment'), and the person who hands it to him tells him, orally, not-X ('this is a safe investment'), our literate, competent adult *cannot maintain an action for fraud against the issuer of the document.*" *Carr v. CIGNA Securities, Inc.*, 95 F.3d 544, 548 (7th Cir. 1996) (emphasis added); *see also Rissman*

v. Rissman, 213 F.3d 381, 383 (7th Cir. 2000) ("[s]ecurities law does not permit a party to a stock transaction to disavow such representations – to say, in effect, 'I lied when I told you I wasn't relying on your prior statements' and then to seek damages for their contents.").

2. *The January 2008 Meeting Was Unremarkable Given the Economic Climate At the Time*

The ALJ ignored incontrovertible evidence that the global liquidity and economic crisis adversely affected all securities – blue chip stocks, Triple A bonds, and alternative investments such as the McGinn Smith Securities – in finding that MS&Co.'s reduction of interest on just the *junior* notes of the Four Funds was a red flag that should have caused Respondents to stop offering *all* McGinn Smith Securities. *See* Decision at 115. As reported, there was a "fundamental disruption – a financial upheaval ... – that wreaked havoc ... across the country.... Businesses, large and small, have felt sting of a deep recession."[18] In the midst of this economic crisis, the January 2008 meeting could not be viewed as a red flag (nor was it).

Moreover, the impairments affecting just the *junior* notes had nothing to do with the Trust Offerings which continued to pay interest, as did the senior notes and the senior subordinated notes of the Four Funds, until the SEC commenced its action against McGinn, Smith and others in April 2010 (with the exception of one of the Firstline offerings which ceased paying interest in September 2009).

Nevertheless, according to the ALJ, on learning that the Four Funds' holdings were not diversified (in fact, each Four Fund was diversified) and that an investment by all Four Funds totaled $8 million in one investment (alseT), Respondents had "a duty to investigate ... before selling any Four Funds or Trust Offerings." Decision at 92. The PPMs of the Four

[18] National Commission on the Causes of the Financial and Economic Crisis in the United States, *Financial Crisis Inquiry Report* (2011), at xvi; *see* Tr. 5751:19-5752:8 (taking judicial notice of same); *see also* RMR Ex. 305.

Funds, however, did not state that investments within each Fund would be different from the investments in the other Funds. Further, the alseT investment was consistent with each of the Four Funds' investment mandate and concentration limitations. While the Four Funds' performance in 2008 was disappointing and a cause for concern, as was the performance of numerous debt and equity securities at this time, that did not impose a "duty to investigate" on Respondents under *Hanly* or any other applicable authority.

At a minimum, the January 2008 meeting could not and did not raise a "red flag" regarding the Trust Offerings which the Division's expert admitted "were not at all similar" to the Four Funds.[19] The investigation demanded by the ALJ would transform RRs into accountants and private investigators. Respondents had no reason to conduct such an investigation before presenting different securities (Trust Offerings) and no case authority has imposed such a duty in these circumstances.

3. *Respondents Were Unaware of the Firstline Bankruptcy*

The final red flag alleged by the Division was McGinn and Smith's failure to tell Respondents of the Firstline bankruptcy until September 2009. *See* Decision at 93. The Division admitted that Respondents were unaware of the Firstline bankruptcy before September 2009. *See* Div. FoF ¶ 178. Respondents did not present any McGinn Smith Securities (with a few exceptions) after learning of McGinn and Smith's failure to timely disclose the information and several left MS&Co. shortly thereafter.[20]

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[19] Div. Ex. 1 at 25.

[20] The ALJ correctly concluded that there was no "redemption policy" announced by MS&Co. in December 2006, *see* Decision at 93, and the Division has waived its right to challenge this finding by not filing a cross-petition for review.

4. *As A Matter of Law, the Alleged Red Flags Did Not Establish That Respondents Acted with Scienter*

To establish *scienter* based on red flags, there must be facts showing that (1) the defendant was actually aware of the alleged flags, *and* (2) the flags were "so obvious[ly]" indicative of fraud "that the defendant must have been aware of [the fraud]" and desirous of furthering it. *See South Cherry*, 573 F.3d at 109, 112; *Stephenson v. Citco Group Ltd.*, 700 F. Supp. 2d 599, 622-23 (S.D.N.Y. 2010); *see also MLSMK Invs. Co. v. JP Morgan Chase & Co.*, 737 F. Supp. 2d 137, 145 (S.D.N.Y. 2010) (finding allegations of *scienter* insufficient because "[w]hile it may be true that Defendants could have connected the dots to determine that Madoff was committing fraud, Plaintiff offers no facts to support the claim that they actually reached such a conclusion"); *In re J.P. Jeanneret Assocs.*, 769 F. Supp. 2d 340, 365 (S.D.N.Y. 2011) (mere "existence of 'red flags' does not satisfy the *scienter* requirement"). The ALJ ignored that there was no such showing here. *See Iowa Pub. Employees Ret. Sys. v. Deloitte & Touche LLP*, 919 F. Supp. 2d 321, 334-35 (S.D.N.Y. 2013), *aff'd*, 2014 U.S. App. LEXIS 4918, at *3-4 (2d Cir. Mar. 17, 2014).

Likewise, *disclosed* conflicts of interest, *disclosed* investments in affiliates, and *disclosed* exclusive control over an investment program - routine disclosures - are insufficient to support an inference of *scienter*. *See Stephenson v. PricewaterhouseCoopers, LLP*, 768 F. Supp. 2d 562, 574-75 (S.D.N.Y. 2011) (dismissing claim based on auditor's mere access to information by which it could have discovered warning signs and noting that "flags are not red merely because the plaintiff calls them red"); *Anwar*, 728 F. Supp. 2d at 453 (fact that "all of the Funds' assets were managed by Madoff ... with no checks and balances" was not a "flag" that supported an inference of *scienter*).

III.

RESPONDENTS DID NOT ACT NEGLIGENTLY IN VIOLATION OF SECURITIES ACT SECTION 17(A)(2) AND 17(A)(3)

The Division's claims based on Securities Act Section 17(a)(2) and (3), which present questions of fact unique to each Respondent, are addressed more fully in Respondents' Individual Briefs. Suffice it to say these claims failed because no evidence was presented of a material misstatement or omission of material fact by any Respondent to any client about any specific McGinn Smith Security after September 23, 2008 (or before then, for that matter), and, no evidence was presented showing that each Respondent's conduct "operate[d] as a fraud or deceit upon [any] purchaser." Nor did the ALJ recite evidentiary support for her naked conclusion as to each Respondent.

Moreover, as a matter of law, Section 17(a)(2) and (3) are not applicable to Respondents because, under these Sections, only the "*makers*" of statements who engage in fraudulent practices or who "obtain money or property" by means of a material misstatement or omission are covered by these provisions. *See Janus Capital Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011). Respondents did not author the PPMs, which, in any event, made no material misrepresentations or omissions, and no evidence to the contrary was otherwise adduced at the hearing. Nor did any Respondent make a material misstatement to "obtain money or property," and no evidence was presented that any Respondent had made such a misrepresentation.

IV.

RESPONDENTS DID NOT VIOLATE SECTION 5

The ALJ erred in concluding that Respondents violated Securities Act Section 5. Decision at 95-97. Relying on inaccurate information and incompetent evidence in the form of

summary charts, while disregarding undisputed evidence that financial and non-financial disclosure was provided to investors, the ALJ concluded that Respondents were liable for the Section 5 Claim. Decision at 93-97. In so concluding, the ALJ imposed liability on individual brokers in a manner never before endorsed by the Commission and on conduct that preceded the OIP by far more than five years. This was plainly error.

As a threshold matter, there can be no actionable Section 5 claim regarding the Four Funds, as Respondents did not sell any Four Funds after September 23, 2008. Div. Ex. 2; *see also* 28 U.S.C. § 2462.

Moreover, insofar as the Section 5 Claim could be "entertained" at all, it was based primarily on six charts of allegedly unaccredited investors prepared by a Division paralegal, which were so fundamentally flawed, Div. Exs. 531-36, it was error to consider them. For example, a primary source of information for the charts was the McGinn Smith "investor database," Div. Ex. 591, notwithstanding testimony that the database was inaccurate. Tr. 1379:8–1380:9. And, although the Division did consider individual purchaser questionnaires – indisputably the best evidence of an investor's accredited status since it was a contemporaneous representation by that investor – the ALJ allowed the Division to disregard this information in favor of secondhand oral information provided to the Division's attorneys years later, which the ALJ referred to as "better information." Decision at 72 n.90. The Division's charts were also a moving target, with the number of allegedly unaccredited investors shrinking as Respondents' challenged the Division's evidence. For example, the Division claimed in the OIP that there were "at least 59" unaccredited investors in the fictitious MSF Conduit, then 44 in response to a motion for more definite statement, then 39 at trial.

The ALJ rejected the Division's integration theory as to the Trust Offerings (Decision at 96) – the only way in which the Division could state a Section 5 claim as "[n]one of the Trust Offerings exceeded 35 unaccredited investors" (OIP ¶ 32) – yet crafted her own theory of Section 5 liability: Respondents allegedly failed to comply with the disclosure requirements of Rule 502. Decision at 96. This point was not addressed in detail at the hearings, *as it was not an argument made by the Division.* Nevertheless, the financial and non-financial disclosure in the Trust Offerings' PPMs, *see, e.g.*, Div. Ex. 264 at 7, which were provided to accredited and unaccredited investors alike, satisfied the requirements of Rule 502. *See* 17 C.F.R. § 230.502(b)(2)(A)-(B).

The ALJ also ignored that courts and the Commission have only imposed Section 5 liability on an individual RR where (a) there was an obvious failure to comply with the registration requirement or with any claimed exemption, *and* (b) knowing or recklessly deceptive conduct by the RR. *See, e.g., SEC v. Cavanagh*, 98 Civ. 1818, 2004 U.S. Dist. LEXIS 13372, at *83 (S.D.N.Y. July 16, 2004) (defendants "merged a shell company with a small and not yet successful operating company, sold stock ... in an unregistered transaction, took control of virtually the entire market float, created a false impression of interest in the stock ... issued a false press release, and drove the stock price north of $5 in a 'pump and dump' scheme from which they ... pocketed millions of dollars."); *SEC v. Gagnon*, 10 Civ. 11891, 2012 U.S. Dist. LEXIS 38818, at *2-14, *19-27 (E.D. Mich. Mar. 22, 2012) (defendant helped orchestrate and promote a massive Ponzi scheme and made outlandish recommendations without basis, soliciting investors on his website, via email and in online chatrooms). There are no such facts in the record here.

For these reasons, Respondents did not violate Section 5.[21]

V.

RESPONDENTS WERE DEPRIVED OF THEIR EQUAL PROTECTION AND DUE PROCESS RIGHTS AND THE PROCEEDING WAS UNCONSTITUTIONAL

Although no liability should be imposed based on the evidentiary record here, the Decision should also be reversed and all charges against Respondents dismissed, because the hearing deprived Respondents of equal protection and due process rights, violated Commission rules, and violated Article II, Section 2, Clause 2 of the U.S. Constitution. Numerous examples demonstrate the unfairness and unconstitutionality of this proceeding.

The Commission's failure to bring *this* proceeding in federal court denied Respondents of their equal protection and due process rights. Despite interrelated issues between the OIP and the federal action against McGinn and Smith, the Commission prejudicially authorized this administrative proceeding rather than a federal court action. While McGinn and Smith had the ability to avail themselves of the benefits of depositions and other discovery under the Federal Rules of Civil Procedure, and the protections of the Federal Rules of Evidence, trial by jury, and an Article III judge, the Commission discriminatorily deprived Respondents of those benefits and protections. The prejudicial effect of the Commission's decision was amplified because much of the hearing was devoted to (a) McGinn and Smith, who were not parties to or present for examination, and (b) the records of MS&Co. – that Respondents did not have, but which the Division's summary witnesses spent several years analyzing. The entire basis of the Division's case was that McGinn and Smith, with the aid of inside and outside accountants, secretly stole and diverted funds, which Respondents alone supposedly should have discovered

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[21] Insofar as Respondents took reasonable steps to avoid participation in any distribution violative of Section 5, see Respondents' Individual Briefs.

and thus should have stopped offering McGinn Smith Securities, even though they were suitable securities for their investors.

It is well-settled that "[t]he fundamental requirement of due process is the opportunity to be heard 'at a meaningful time and in a meaningful manner.'" *Mathews,* 424 U.S. at 333. Despite the stakes (a financial death penalty), no meaningful time (just four months) was provided to review the Division's investigative record. Due process requires the opportunity for discovery. Given its size, it was literally impossible to review the materials, which the Division only made available over a few months prior to the commencement of the hearing, and in some instances, on the eve of the hearing. The production of millions of documents that could not be reviewed is effectively producing no documents at all. *Locurto v. Giuliani*, 447 F. 3d 159 (2d Cir. 2006) (party in hearing before administrative law judges does not receive "a full and fair opportunity to litigate" where he was "denied adequate discovery" on the relevant issues); *SEC v. Collins & Aikman Corp.*, 256 F.R.D. 403, 410 (S.D.N.Y. 2009) ("While the responsive documents exist somewhere in the ten million pages produced by the SEC, the production does not respond to the straightforward request to identify documents that support the allegations in the Complaint, documents [defendant] clearly must review to prepare his defense.").

Respondents were also denied the ability to challenge the patent pleading deficiencies in the OIP, which failed even to state the Fraud Claim, as they would have had under the Federal Rules of Civil Procedure in a federal court action. And, unreliable evidence would not have been admitted in a federal court action under the Federal Rules of Evidence. Yet, here, the ALJ admitted double and triple-hearsay. *See, e.g.*, Decision at 53 (accepting testimony from Vincent O'Brien as to what his sister told him that Respondent Mayer supposedly told her at a meeting where O'Brien was not present).

Nor were Respondents ever fully or fairly informed of the claims against them, as fundamental fairness and Supreme Court precedents require. 5 U.S.C. § 554(b). The ALJ denied Respondents' separate motions for a more definite statement for the names of any investor to whom any Respondent allegedly made a material misstatement or omission, about which specific McGinn Smith Security, and when each Respondent supposedly made the material misstatement or omission. The OIP was devoid of these essential factual allegations to state a fraud claim.

Respondents' equal protection rights were further violated by the Division improperly singling them out for prosecution, even though approximately 40 other RRs sold over $69 million of McGinn Smith Securities to investors. *See* Div. Ex. 591. There was no legitimate basis to single out these Respondents when other RRs also offered McGinn Smith Securities, also did not see any red flags, also did not conduct an "investigation," and also did not "verify" statements in the PPM or statements by McGinn and Smith. *Gupta*, 796 F. Supp. 2d at 513-14.

The ALJ also ignored, and effectively sanctioned, the Division's post-OIP fishing expedition for evidence to support its claims. Many of the investor witnesses who testified admitted that they were first contacted by the Division *after* the OIP was filed. This violated Rule 230(g), and was particularly egregious considering the Commission sued McGinn, Smith, and others in federal court in April 2010 and had more than three years to speak with investors prior to filing the OIP. The ALJ nevertheless denied Respondents' separate motions to exclude the testimony of those witnesses first contacted by the Division *after* the OIP was filed.

This was not, however, the ALJ's only tainted evidentiary ruling; there were several others that were arbitrary and capricious. For example, the ALJ erroneously refused to consider or admit client affidavits stating that they did not believe a Respondent had made a

material misrepresentation or omission to them and that they held Respondents in high regard. The affidavits were sworn under oath, and served the purpose of both streamlining the hearings and sparing these witnesses the considerable burden and expense of traveling from out of state to the hearing. The ALJ denied Respondents' separate motions to introduce the affidavits (or otherwise consider them), despite the fact that the clients had been served with subpoenas to appear at the hearing, but were unable to appear. The ALJ instead sustained the Division's pro forma objection to their admission, citing a desire to cross-examine the witnesses. Yet, when called upon to cross-examine those investors who did appear and testify, the Division asked few, if any, questions of those witnesses. *See, e.g.*, Tr. at 5542-43 (asking Favish if statements in his affidavit were based on his own beliefs as opposed to access to internal McGinn Smith documents). On the other hand, the ALJ allowed the Division to elicit triple-hearsay. *See* Decision at 53; *see also* Tr. at 1472 (permitting the Division to elicit testimony from an investor witness via the Division's cellphone speakerphone).

Worse, the ALJ prejudged the case as evidenced by her statement that certain proffered evidence had "nothing to do with *the violations*," Tr. 2412:5-6 (emphasis added), and that she did not want to "second guess[]" the Commission's decision to hear the case. Pre-Hearing Tr. (Jan. 21, 2015), at 30:13-21. This is a blatant violation of due process. *In re Murchison*, 349 U.S. 133, 136 (1955) ("A fair trial in a fair tribunal is a basic requirement of due process.") (internal citations and quotations omitted); *Amos Treat & Co. v. SEC*, 306 F.2d 260, 267 (D.C. Cir. 1962) ("[A]n administrative hearing ... must be attended, not only with every element of fairness but with the very appearance of complete fairness ... [to] meet the basic requirement of due process."); *Caperton v. A.T. Massey Coal Co.*, 556 U.S. 868, 883-84 (2009) (the Due Process Clause does not require "proof of actual bias," but rather whether there is a real

risk of actual bias or prejudgment.); *Jaeger v. Cellco P'ship*, 2010 WL 965730, at *13 (D. Conn. Mar. 16, 2010) *aff'd*, 402 F. App'x 645 (2d Cir. 2010) ("Due process demands strict impartiality on the part of those who function in judicial or quasi-judicial capacity.").

The ALJ also erred in admitting Respondents' non-party deposition testimony voluntarily given in 2011 to assist the Commission in its federal court action against McGinn and Smith.[22] At no time did the Division disclose that Respondents were under investigation and never provided Respondents with SEC Form 1662. Nor were Respondents shown a Formal Order of Investigation that indicated that the Commission was investigating Respondents. Respondents did not try to refresh their recollections, and were not given their deposition transcripts to review, correct, amplify or sign. Despite being misled as to the Division's true intentions, the ALJ denied Respondents' separate motions to exclude their non-party deposition testimony – which she termed "investigative testimony"[23] – and instead used it as a primary basis to determine (erroneously) that Respondents were not credible because they provided additional details that they did not mention in the non-party depositions. Just as the SEC cannot use its investigatory powers to avoid application of the Federal Rules of Civil Procedure in a pending federal case,[24] it should likewise not be permitted to avoid the notice and protections typically afforded to an individual under investigation by purporting to depose him as a non-party witness pursuant to Rule 45.

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[22] Respondents volunteered to assist the Division when they called. In accordance with the Division's practice, it sent a subpoena to Respondents' counsel confirming the non-party depositions. *See, e.g.*, Tr. 5850:9-18.

[23] By contrast, and as further evidence of the arbitrary and capricious nature of this proceeding, Respondent Gamello's testimony was repeatedly referred to as "deposition testimony," who the ALJ found did not violate the antifraud provisions of the federal securities laws.

[24] *See* Order (ECF No. 47), *SEC v. Life Partners Holdings, Inc.*, 12-cv-33 (W.D. Tex. Aug. 27, 2012).

Finally, the administrative proceeding was unconstitutional under Article II of the Constitution because (1) the ALJ's appointment violated the Appointments Clause of Article II, as she was not appointed by the President, a court of law, or a department head, *and* (2) the ALJ's two-layer tenure protection violated the Constitution's separation of powers, specifically the President's ability to exercise Executive power over his inferior officers. *See* U.S. Const. art. II § 2, cl. 2; *Freytag v. Comm'r of Internal Revenue*, 501 U.S. 868, 880 (1991); *Free Enter.*, 561 U.S. at 484, 506. As at least one district court has recently concluded, the SEC's appointment of its ALJs likely violates the Appointments Clause. *See Hill v. SEC*, No. 1:15-cv-01801-LMN, 2015 U.S. Dist. LEXIS 74822, at *51 (N.D. Ga. June 8, 2015) ("Because SEC ALJs are inferior officers, the Court finds Plaintiff has established a likelihood of success on the merits on his Appointments Clause claim.").

CONCLUSION

For these reasons, the Commission should dismiss the proceeding in its entirety.

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CERTIFICATE OF COMPLIANCE

This brief complies with the Commission's Extension and Word Limit Order, dated June 5, 2015. The brief contains 9,978 words, exclusive of the Table of Contents, Table of Authorities, Signature Blocks, and this Certification, as counted by Microsoft Word, the word processing system used to prepare it.

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