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,

Respondents.

DIVISION OF ENFORCEMENT'S BRIEF IN RESPONSE TO RESPONDENTS' JOINT BRIEF

Respectfully submitted,

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TABLE OF CONTENTS

PRELIMINARY STATEMENT 1

ARGUMENT 3

- **I. The Commission's Action Is Not Barred by 28 U.S.C. § 2462** 3
  - **A. Section 2462 Is Not Jurisdictional in Nature** 4
  - **B. Pre-September 2008 Events Bear on Relief for Post-September 2008 Violations** 5
- **II. Respondents' Constitutional Challenges Are Without Merit** 6
  - **A. The Appointment and Removal of Commission ALJs Is Not Unconstitutional** 6
  - **B. The Commission's Decision to Pursue Administrative Actions Against Respondents Did Not Deny Them Equal Protection** 6
  - **C. Respondents Were Not Denied Due Process** 8
    1. Respondents Had Ample Time to Prepare for the Hearing 8
    2. Respondents Had Notice of the Charges Against Them 10
    3. Respondents Have Provided No Reason to Question the ALJ's Impartiality 10
    4. Respondents Were Not Denied Due Process by the ALJ's Evidentiary Rulings 12
- **III. Respondents Violated the Antifraud Provisions of the Securities Act and the Exchange Act** 15
  - **A. Respondents Knowingly or Recklessly Recommended MS & Co. Unregistered Offerings Despite Having (1) No Reasonable Basis for Their Recommendations and (2) Knowledge of Red Flags** 15
    1. Respondents Knowingly or Recklessly Failed to Have a Reasonable Basis for Their Recommendations 19
    2. Respondents Knowingly or Recklessly Failed to Investigate Numerous Red Flags 19
    3. Respondents Cannot Credibly Claim Ignorance of the Many Red Flags 22
    4. Respondents Should Not Be Permitted to Shift the Blame to Their Customers 23
  - **B. Respondents Made Material Misrepresentations and Omissions** 25

C. **Respondents Also Violated Rule 10b-5(a) and (c) and Securities Act Section 17(a)(1) and 17(a)(3)** 25

D. **Respondents Were Negligent** 26

IV. **Respondents Violated Section 5(a) and (c) of the Securities Act** 27

A. **The Division's *Prima Facie* Case Against Respondents Is Unchallenged** 27

B. **Respondents Offered No Evidence that a Registration Exemption Applied** 28

C. **Respondents Are Individually Liable for Their Section 5 Violations** 30

CONCLUSION 31

TABLE OF AUTHORITIES

CASES **PAGE**

Anthony, et al., I.D. Rel. No. 745 (Feb. 25, 2015) 1

Anthony, et al., AP Ruling Rel. No. 2528 (Apr. 9, 2015) 11

Anthony Fields, Inv. Advisers Act Rel. No. 4028, 2015 WL 728005 (Feb. 20, 2015) 12

Birkelbach v. SEC, 751 F.3d 472 (7th Cir. 2014) 4

Blinder, Robinson & Co. v. SEC, 837 F.2d 1099 (D.C. Cir. 1988) 8

Bloomfield, et al., Rel. No. 9553, 2014 WL 768828 (Feb. 27, 2014) 28, 31

BNP Paribas Mortgage Corp. v. Bank of America, 866 F. Supp. 2d 257 (S.D.N.Y. 2012) 19

Brady v. Maryland, 373 U.S. 83 (1963) 9

Ralph Calabro, Sec. Act Rel. No. 9798, 2015 WL 3439152 (May 29, 2015) 12

Cady, Roberts & Co., 40 S.E.C. 907 (1961) 25

Carr v. CIGNA Securities, Inc., 95 F.3d 544 (7th Cir. 1996) 24

Crowell v. Benson, 285 U.S. 22 (1932) 3

Cunanan v. INS, 856 F.2d 1373 (2d Cir. 1988) 12

Danny G. Pinkerton, et al., Rel. No. 98, 1996 WL 602648 (Oct. 18, 1996) 16

Edgar B. Alacan, Sec. Act Rel. No. 8436, 2004 WL 1496843 (July 6, 2004) 13

Fog Cutter Cap. Grp. v. SEC, 474 F.3d 822 (D.C. Cir. 2007) 7

Free Enterprise Fund v. PCAOB, 561 U.S. 477 (2010) 6

Gabelli v. SEC, 133 S. Ct. 1216 (2013) 3

Gregory Bartko, Exchange Act Rel. No. 71666, 2014 WL 896758 (Mar. 7, 2014) 4, 5

Gregory M. Dearlove, Rel. No. 2779, 2008 WL 281105 (Jan. 31, 2008) 8

Gregory O. Trautman, Rel. No. 9088-A, 2009 WL 6761741 (Dec. 15, 2009) 5

Gupta v. SEC, 796 F. Supp. 2d 503 (S.D.N.Y. 2011) 7

Guy P. Riordan, Sec. Act Rel. No. 9085, 2009 WL 4731397 (Dec. 11, 2009), *pet. denied* *Riordan v. SEC*, 627 F.3d 1230 (D.C. Cir. 2010) 13

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

Harding Advisory LLC, et al., Rel. No. 3736, 2014 WL 988532 (Mar. 14, 2014) 8

Hartman v. Moore, 547 U.S. 250 (2006) 7

Horning v. SEC, 570 F.3d 337 (D.C. Cir. 2009) 12

In re Bear Stearns Companies, Inc. Sec., Derivative, & ERISA Litig., 763 F. Supp. 2d 423 (S.D.N.Y. 2011) 20

Janus Capital, Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011) 26-27

John P. Flannery et al., Exchange Act Rel. No. 3918, 2014 WL 7145625 (Dec. 15, 2014) .... *passim*

John Thomas Capital Management Group. LLC, Rel. No. 3733, 2013 WL 6384275 (Dec. 6, 2013) 9

Kwiatkowski v. Bear Stearns & Co., 306 F.3d 1293 (2d Cir. 2002) 19, 25

Larry Klein, Rel. No. 37835, 1996 WL 597776 (Oct. 17, 1996) 23

Locurto v. Giuliani, 447 F.3d 159 (2d Cir. 2006) 9

Maria T. Giesige, Rel. No. 359, 2008 WL 4489677 (Oct. 7, 2008) 16

Mathews v. Eldridge, 424 U.S. 319 (1976) 8

McCurdy v. SEC, 396 F.3d 1258 (D.C. Cir. 2005) 20

Meadows v. SEC, 119 F.3d 1219 (5th Cir. 1997) 21, 22

Mitchell H. Fillet, No. 2008011762801, 2013 WL 5503320 (N.A.S.D.R. Oct. 2, 2013) 18

Morris. J. Reiter, Rel. No. 6108, 1959 WL 59479 (Nov. 2, 1959) 10

Raymond J. Lucia Cos., Inc., et al., Release No. 4190, 2015 WL 5172953 .... 2, 6

Rissman v. Rissman, 213 F.3d 381 (7th Cir. 2000) 24

SEC v. Alexander, No. 10-cv-04535, 2015 WL 4397421 (N.D. Cal. July 17, 2015) 30

SEC v. Bravata, No. 09-12950 (DML), 2014 WL 897348 (E.D. Mich. Mar. 6, 2014) 23

SEC v. Cavanagh, 1 F. Supp. 2d 337 (S.D.N.Y. 1998) 27

SEC v. CMKM Diamonds, Inc., 729 F.3d 1248 (9th Cir. 2013) 30

SEC v. Collins & Aikman Corp., 256 F.R.D. 403 (S.D.N.Y. 2009) 9

SEC v. Dain Rauscher, Inc., 254 F.2d 852 (9th Cir. 2001) 18

SEC v. Fitzgerald, 135 F. Supp. 2d 992 (N.D. Cal. 2001) 26

SEC v. Graham, 21 F. Supp. 3d 1300 (S.D. Fla. 2014) 4

SEC v. Hasho, 784 F. Supp. 1059 (S.D.N.Y. 1992) 16, 17-18, 20

SEC v. Infinity Group Co., 212 F.3d 180 (3d Cir. 2000) 22

SEC v. Kenton Capital, Ltd., 69 F. Supp. 2d 1 (D.D.C. 1998) 25, 28

SEC v. Milan Capital Group, Inc., No. 00-cv-108 (DLC), 2000 WL 1682761 (S.D.N.Y. Nov. 9, 2000) 16

SEC v. Morgan Keegan & Co., Inc., 678 F.3d 1233 (11th Cir. 2012) 24

SEC v. Platinum Inv. Corp., No. 02-cv-6093 (JSR), 2006 WL 2707319 (S.D.N.Y. Sept. 20, 2006) 16, 17, 20

SEC v. Pittsford Capital Income Partners, L.L.C., No. 06 Civ. 6353, 2007 WL 2455124, (W.D.N.Y. Aug. 23, 2007), *aff'd in part and dismissed in part*, 305 Fed. Appx. 694 (2d Cir. 2008) 24

SEC v. Ralston Purina Co., 346 U.S. 119 (1953) 28

SEC v. Softpoint, Inc., 958 F. Supp. 846 (S.D.N.Y. 1997), *aff'd*, 159 F.3d 1348 (2d Cir. 1998) 27-28

SEC v. U.N. Dollars Corp., No. 01 Civ. 9059 (AGS), 2003 WL 192181 (S.D.N.Y. Jan. 28, 2003) 30

SEC v. U.S. Pension Trust Corp., No. 07-22570-CIV, 2010 WL 3894082 (S.D. Fla. Sept. 30, 2010) 26

South Cherry Street, LLC v. Hennessee Group LLC, et al., 573 F.3d 98 (2d Cir. 2009) 23

Stires & Co., Inc., Rel. No. 130, 1998 WL 462230 (Aug. 11, 1998) 16

Stoneridge Inv. Partners, LLC v. Scientific-Atlanta Inc., 552 U.S. 148 (2008) 25

Tilton, et al., AP Ruling Rel. No. 2892 (July 1, 2015) 15

Timbervest, LLC, et al., Investment Advisers Act Release No. 4197,
2015 WL 5472520 (Sept. 17, 2015).. *passim*

Upton, Assignee v. Tribilcock, 91 U.S. 45 (1875) 24

U.S. v. Armstrong, 517 U.S. 456 (1996) 7

Williams v. Warden, 713 F.3d 1332 (11th Cir. 2013).. 4-5

Withrow v. Larkin, 421 U.S. 35 10

U.S. CONSTITUTION

Article II, U.S. CONST. 2, 6

Article III, U.S. CONST. 3

STATUTES

28 U.S.C. § 2462 2-5

Securities Act of 1933

Section 4(2), 15 U.S.C. § 77d 28, 29

Section 5, 15 U.S.C. § 77e .... *passim*

Section 1(a), 15 U.S.C. § 77q(a) .... *passim*

Exchange Act

Section 10(b), 15 U.S.C. § 78j 15-16, 25

RULES

Rule 502, Securities Act of 1933, 17 C.F.R. § 230.502 29

Rule 506, Securities Act of 1933, 17 C.F.R. § 230.506 .... 28, 29

Rule 10b-5, Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5 .... 16, 25

Securities and Exchange Commission Rules of Practice

Rule of Practice 200, 17 C.F.R.§ 201.200 10

Rule of Practice 235, 17 C.F.R.§ 201.235 .... 8, 13-14

Rule of Practice 360, 17 C.F.R.§ 201.360 8-9

OTHER AUTHORITIES

FINRA NTM 10-22 .... 18, 19

FINRA Rule 140 18-19

PRELIMINARY STATEMENT

The Petition before the Commission concerns five registered representatives—and their supervisor—who sold millions of dollars of unregistered, non-exempt private placements as part of a long-running Ponzi scheme that cost nearly 900 investors approximately $80 million. These brokers profited by recommending securities to their customers without conducting any reasonable investigation into those financial products—notwithstanding bright red flags warning of potential problems—and by misrepresenting and omitting material facts about those same investments. Through this appeal, Respondents seek to avoid *any* liability for their roles in the Ponzi scheme that led to the demise of McGinn Smith & Co., Inc. ("MS & Co.") by placing the blame for investors' losses entirely on MS & Co. founders and principals Timothy McGinn and David Smith and, in some cases, the investors themselves. The law is clear, however, that McGinn and Smith—who have been sentenced to a combined 25 years in prison following their criminal convictions—should not be the only individuals to face consequences; rather, Respondents must answer for their own misconduct.

In the February 25, 2015 Initial Decision ("ID"), Anthony, et al., I.D. Rel. No. 745 (Feb. 25, 2015), Chief ALJ Brenda Murray found that Respondents Frank Chiappone, William Lex, Thomas Livingston, Brian Mayer, and Philip Rabinovich violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 5(a) and 5(c) and 17(a) of the Securities Act of 1933 by selling fraudulent, unregistered in-house private placements ("McGinn Smith Securities"). She also found their supervisor, Andrew Guzzetti, liable for his failure to supervise. These findings are well supported by the record.[1]

[1] The Division addresses Respondents' specific arguments made in their individual briefs—to the extent that they do not overlap with the arguments herein—in its Response to Respondents' Individual Briefs ("Div. Indiv. Resp.").

Respondents' Joint Brief raises four principal challenges to the ID: (1) the administrative proceeding ("AP") was barred by the statute of limitations found in 28 U.S.C. § 2462; (2) the AP violated Article II, Section 2, Clause 2 of the Constitution and deprived Respondents of equal protection and due process; (3) Respondents had no duty to investigate the securities they recommended and sold to their customers, and, even if they had such a duty, any failure to investigate does not establish that they acted with scienter; and (4) Respondents should not be individually liable for violating Section 5 of the Securities Act where they had no specific intent to do so. None of these arguments warrants reversal.

First, 28 U.S.C. § 2462 does not bar the Commission from considering conduct that occurred before the five-year limitations period began when determining scienter or whether punitive sanctions are appropriate to address conduct occurring within the limitations period.

Second, Respondents' challenges to the AP's validity are equally unsound. Respondents' challenges to the appointment and removal of Commission ALJs fail because, as the Commission found in *Raymond J. Lucia Cos., Inc., et al.*, Rel. No. 4190, 2015 WL 5172953, at *21 (Sept. 3, 2015) and *Timbervest, LLC, et al.*, Investment Advisers Act Rel. No. 4197, 2015 WL 5472520, at *23-26 (Sept. 17, 2015), Commission ALJs are "mere employees" to whom Article II requirements do not apply. Moreover, the Commission and the courts have repeatedly rejected due process and equal protection arguments virtually identical to those Respondents submit here, and Respondents provide no reason to deviate from that precedent.

Third, courts have consistently recognized that registered representatives have a duty to investigate the securities they recommend. Since at least 1969, when the Second Circuit decided *Hanly v. SEC*, registered representatives have been on notice that they "are under a duty to investigate, and their violation of that duty brings them within the term 'willful' in the Exchange

Act." 415 F.2d 589, 595-96 (2d Cir. 1969). As *Hanly* and subsequent cases make clear, a registered representative's duty to investigate is heightened when red flags exist. The record shows Respondents were aware of many red flags.

Fourth, scienter is not an element of a Section 5 violation, and the ID was not breaking any new ground by finding Respondents individually liable for their own sales of non-exempt, unregistered securities.

ARGUMENT

I. The Commission's Action Is Not Barred by 28 U.S.C. § 2462

Respondents' argument that the Commission has no subject matter jurisdiction because the OIP's claims are time-barred under 28 U.S.C. § 2462 and *Gabelli v. SEC,* 133 S. Ct. 1216 (2013), is without merit. *Gabelli* did not hold that Section 2462 barred proceedings in their entirety where, as here, only *some* of the violative conduct occurred more than five years before the filing of the action. Rather, the Supreme Court explicitly narrowed its holding to whether the "discovery rule" applied to cases where the Commission sought civil penalties; the timeliness of claims for "injunctive relief and disgorgement"—which the District Court had found timely because they were not subject to Section 2462—were "not before [the Court]." *See Gabelli*, 133 S. Ct. at 1220 n.1. Additionally, Respondents' reading of *Gabelli* ignores a wealth of Commission and federal court precedent underscoring the limited nature of that holding and affirming that Section 2462's limitations period does not apply to claims for disgorgement or other remedial relief.[2]

[2] Respondents' suggestion (Joint Brief Addressing Certain Legal Issues Filed in Accordance with the Commission's Order ("Joint Br."). at 9) that the Commission cannot impose equitable relief because this would exercise "judicial power" reserved to the judiciary by Article III of the Constitution has been long refuted. *See, e.g., Crowell v. Benson*, 285 U.S. 22, 49-51 (1932) (agency's adjudication of "public rights cases" does not implicate Article III).

A. Section 2462 Is Not Jurisdictional in Nature

The Commission recently reaffirmed that "Section 2462 does not prevent ... equitable sanctions," including associational bars to protect investors, cease-and-desist orders, and disgorgement, even where some conduct occurred more than five years before the institution of proceedings. *Timbervest*, 2015 WL 5472520, at *15-16; *see also Gregory Bartko*, Exchange Act Rel. No. 71666, 2014 WL 896758, at *9 (Mar. 7, 2014) (proceeding seeking a remedial associational bar not time-barred by Section 2462).[3] Thus, non-punitive sanctions are appropriate to address Respondents' violations no matter when those violations occurred.

Nor does Section 2462 bar the Commission from imposing punitive sanctions for Respondents' more recent misconduct, even though Respondents' misconduct began outside of the limitations period and continued within that period. As the Seventh Circuit has explained, if courts were to interpret Section 2462 to mean that violations dating back more than five years immunized subsequent misconduct, "the result would be absurd." *See Birkelbach v. SEC*, 751 F.3d 472, 479 (7th Cir. 2014). Under Respondents' theory , "if [a defendant] were to avoid detection for five years, he could continue his unethical behavior *forever* without FINRA or the SEC being able to discipline him." *Id.* (emphasis in original). Here, a civil penalty is warranted to address Respondents' misconduct within the limitations period; that Respondents' misconduct began before the limitations period is irrelevant.

Respondents' reliance on *Williams v. Warden*, 713 F.3d 1332 (11th Cir. 2013) (Joint Br. at 7) to broaden the scope of Section 2462 is unavailing. The Eleventh Circuit was interpreting the phrase "shall not be entertained" under 28 U.S.C. § 2255(e); it did not analyze claims for enforcement under Section 2462. *See* 713 F.3d at 1334. Moreover, the court held that "whether

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[3] The one district court case Respondents cite in support, *SEC v. Graham*, 21 F. Supp. 3d 1300 (S.D. Fla. 2014), is an "outlier." ID at 89 (collecting cases).

a statutory limitation is jurisdictional is essentially based on whether there is a clear expression of congressional intent to make it so." *Id.* at 1338. The Commission recently examined the text of Section 2462 and held that the statute makes clear that it applies only to the "enforcement of any civil fine, penalty, or forfeiture . . . ."[4] *Timbervest*, 2015 WL 5472520, at *15; *Bartko*, 2014 WL 896758, at *9.

B. Pre-September 2008 Events Bear on Relief for Post-September 2008 Violations

Evidence of Respondents' pre-September 2008 conduct informs whether remedial sanctions are in the public interest. Contrary to Respondents' contention that the ALJ's consideration of such evidence "was highly prejudicial and contaminated the entire proceeding" (Joint Br. at 7-8), the Commission has held that a respondent's knowledge or actions more than five years prior to a proceeding's institution "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 disgorgement or a cease and desist order. *Gregory O. Trautman*, Sec. Act Rel. No. 9088-A, 2009 WL 6761741, at *20 (Dec. 15, 2009). Indeed, "conduct taking place before the five-year limitations period may shed light on the respondent's current competence or future risk to the public." *Timbervest*, 2015 WL 5472520, at *15 n.71 (citations omitted).

Respondents' brief highlights the importance of "older" evidence. Respondents seem to suggest (Joint Br. at 8) that a finding that they "had [the] requisite scienter" by February 1, 2008

[4] Statements by the Division's Director of Enforcement in a separate proceeding do not support any different conclusion. (*See* Joint Br. at 7.) The Director did not announce a rule as to when an AP must be filed in light of when the conduct occurred. He instead opined that "hearings in [APs] usually occur much sooner than trials in district court actions, [thus] the evidence is presented closer in time to the conduct at issue." Ceresney Decl., at ¶ 4 (June 24, 2015) (*Hill v. SEC*, 1:14-cv-01801-LMN (N.D. Ga.)).

should be irrelevant to an examination of their state of mind at the times after September 2008 when they sold additional McGinn Smith Securities. But Respondents did not somehow purge all knowledge of rampant red flags by September 2008. To the contrary, their knowledge of serious problems with McGinn Smith Securities, particularly the Four Funds, is precisely what heightened their duty to investigate new products before defrauding any additional investors. *See infra* at 19-23; Div. Indiv. Resp. at 5-9 (discussing red flags).

II. Respondents' Constitutional Challenges Are Without Merit

A. The Appointment and Removal of Commission ALJs Is Not Unconstitutional

Respondents' contention (Joint Br. at 33) that this proceeding violates Article II's Appointments Clause because (1) the presiding ALJ was not properly appointed, and (2) her "two-layer tenure protection violated the Constitution's separation of powers, specifically the President's ability to exercise Executive power over his inferior officers," fails. ALJs are employees, not constitutional officers, and thus are not subject to Article II's requirements. *Timbervest*, 2015 WL 5472520, at *23-26; *Lucia*, 2015 WL 5172953, at *21-23. Moreover, even if Commission ALJs were "considered officers," the "nature of their duties differs so dramatically from those of the PCAOB"—whose two-tier removal was found unconstitutional in *Free Enterprise Fund v. PCAOB*, 561 U.S. 477 (2010)—"as to obviate any potential concerns about the removal limitations." *Timbervest*, 2015 WL 5472520, at *27.

B. The Commission's Decision to Pursue Administrative Actions Against Respondents Did Not Deny Them Equal Protection.

Respondents' claims (Joint Br. at 28-30) that (i) proceeding against them, but not other MS & Co. brokers, constitutes selective prosecution, and (ii) the institution of this action in an administrative forum violated their equal protection rights, likewise fail.

The Commission has broad discretion in determining whether to pursue an action against particular individuals or entities, and courts presume that the Commission properly discharged its duties in making such decisions. *See Hartman v. Moore*, 547 U.S. 250, 263 (2006) (strong "presumption of regularity" regarding prosecutorial decisions). "To prove selective prosecution, a claimant must be part of a protected class under the Equal Protection Clause [] and show not only that prosecutors acted with bad intent, but also that 'similarly situated individuals [outside the protected category] were not prosecuted.'" *Fog Cutter Cap. Grp. v. SEC*, 474 F.3d 822, 826-27 (D.C. Cir. 2007) (quoting *U.S. v. Armstrong*, 517 U.S. 456, 465 (1996)). Respondents do not suggest that the Commission decided to prosecute them on such an improper basis, and their claim that they were "improperly singl[ed] ... out" is belied by their roles as the top selling MS & Co. brokers during the years the fraudulent scheme persisted.[5] Division Exhibit ("DE") 591 (MS Excel database containing sales and purchaser information for all McGinn Smith private placements); *see also* DE 2 ¶ 12 (describing DE 591).

Respondents' complaint regarding the Commission's forum selection is equally flawed. The Commission recently rejected this exact argument: Congress granted the Commission "broad agency discretion" to determine whether to "initiate administrative proceedings" or "bring civil actions in federal court," and the exercise of this discretion precludes such an equal

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[5] *Gupta v. SEC*, 796 F. Supp. 2d 503 (S.D.N.Y. 2011), is not to the contrary. The *Gupta* court accepted as true allegations that the Commission "singled Gupta out for unequal treatment" only because that case was, procedurally, at the motion to dismiss stage. *Id.* at 513. The court made no findings that Gupta was *actually* deprived of his equal protection rights. Thus, this order cannot support Respondents' alleged equal protection claims here.

protection claim. *Timbervest*, 2015 WL 5472520, at *28-30. Respondents have not—and cannot—present any evidence to overcome deference to the Commission's forum choice.[6]

C. Respondents Were Not Denied Due Process.

Respondents' attack on the supposed "unfairness and unconstitutionality" of the Commission's APs (Joint Br. at 28) is without merit. "Such broad attacks on the procedures of the administrative process have been repeatedly rejected by the courts." *Harding Advisory LLC, et al.*, Rel. No. 3736, 2014 WL 988532, at *8 (Mar. 14, 2014). Those courts have correctly recognized that to accept such challenges "would do considerable violence to Congress['s] purposes in establishing" specialized administrative agencies and would "work a revolution in administrative (not to mention constitutional) law." *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1107 (D.C. Cir. 1988). Due process requires only "the opportunity to be heard 'at a meaningful time and in a meaningful manner,'" *Mathews v. Eldridge*, 424 U.S. 319, 333 (1976), and here Respondents have been afforded such opportunity.

1. Respondents Had Ample Time to Prepare for the Hearing.

Respondents incorrectly claim that the AP violated due process by affording them too little time to prepare. Upon institution, the Commission determined that a 300-day deadline for the initial decision was appropriate under Rule of Practice 360(a)(2).[7] In doing so, the Commission necessarily determined that such a deadline adequately took into account the "nature, complexity, and urgency of the subject matter, and with due regard for the public

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[6] McGinn's and Smith's absence at the hearing (Joint Br. at 28) is of no consequence, especially since Respondents made no efforts to obtain their testimony or to admit their prior sworn statements. *See, e.g.*, Rule of Practice 235 (identifying "imprisonment" as grounds to admit witness's prior sworn statement).

[7] The Commission expressly held that Rule 360(a) does not violate due process. *Gregory M. Dearlove*, Rel. No. 2779, 2008 WL 281105, at *37 (Jan. 31, 2008).

interest and the protection of investors." *See* Rule 360(a)(2). Further, Respondents provide no authority for their argument (Joint Br. at 29) that the Division must produce its investigative file *before* an OIP is issued. Indeed, Respondents' claim of insufficient time to prepare is at odds with their own positions regarding scheduling. The ALJ scheduled the hearing for January 27, 2014 only after *Respondents* requested that date. (Div. Oct. 4, 2013 Letter to Court). The ALJ asked all parties whether "anyone disagree[d] with having the hearing start January 27th." (Oct. 28, 2013 Tr. 13:19-24.) No Respondent objected.[8] *Id.*

The cases Respondents cite are inapposite. In *Locurto v. Giuliani*, 447 F.3d 159 (2d Cir. 2006) (Joint Br. at 29), the court did not hold that limitations on discovery in an administrative hearing were improper, but rather that those restrictions limited the preclusive effect of the administrative court's decision in federal court. And the court in *SEC v. Collins & Aikman Corp.*, 256 F.R.D. 403 (S.D.N.Y. 2009) (Joint Br. at 29) described the Commission's obligations in federal court under the Federal Rules of Civil Procedure ("FRCP"), not the Rules of Practice that apply to APs. *Id.* at 414-15. Moreover, unlike in *Collins*, where the court took issue with the Commission's refusal to search for certain requested documents, the Division did not object to producing documents here; it produced its entire investigative file, and did so in a searchable format.

[8] To the extent that Respondents' argument is premised on a mistaken belief that they might have found material exculpatory evidence in the investigative file if they had more time, the Commission rejected a virtually identical argument in *John Thomas Capital Management Group. LLC*, Rel. No. 3733, 2013 WL 6384275 (Dec. 6, 2013). There, the Division produced a searchable hard drive containing 700 gigabytes of electronic data. 2013 WL 6384275, at *5. The Commission rejected respondents' arguments that it was not "feasible" for them to navigate the data because neither the Rules of Practice nor *Brady v. Maryland*, 373 U.S. 83 (1963) "requires the Division to prepare respondents' case for them." *Id.* at *6. As the Commission explained, "the overwhelming weight of authority holds that *Brady* is not violated when... the government turns over its investigative file—voluminous though it might be—in an electronically searchable format and there is no suggestion of bad faith... ." *Id.*

2. Respondents Had Notice of the Charges Against Them.

Respondents' claim (Joint Br. at 30) that they were never "fully or fairly informed of the claims against them" ignores the OIP's plain allegations. Consistent with Rule 200(b)(3), the OIP "set[s] forth the factual and legal basis alleged therefor in such detail as will permit a specific response thereto." The Commission has long held that "appropriate notice of proceedings is given when the respondent is sufficiently informed of the nature of the charges against him so that he may adequately prepare his defense, and that [a respondent] is not entitled to a disclosure of evidence." *Morris. J. Reiter*, Rel. No. 6108, 1959 WL 59479, at *2 (Nov. 2, 1959) (denying motion for "specific devices, schemes, artifices, untrue statements and omissions ... alleged"). The ALJ thus correctly denied Respondents' Motions for a More Definite Statement because Respondents sought "disclosure of the evidence on which the Division intends to rely." Dec. 12, 2013 Order, AP Ruling Rel. No. 1098, at 4 (collecting cases).[9]

3. Respondents Have Provided No Reason to Question the ALJ's Impartiality.

Respondents' assertion (Joint Br. at 30-32) that the ALJ was somehow biased against them likewise fails. "ALJs are presumed to be unbiased." *Timbervest*, 2015 WL 5472520, at *22 (citing *Schweiker v. McClure*, 456 U.S. 188, 195 (1982) & *Withrow v. Larkin*, 421 U.S. 35, 47 (1975)). "To overcome that presumption, Respondents must show that the ALJ's behavior, in the context of the whole case, was so extreme as to display clear inability to render fair judgment," by showing a "conflict of interest or some other specific reason for disqualification." *Id.* (quotations omitted).

[9] Indeed, the Division exceeded Rule 200(b)(3)'s requirements when it provided Respondents with additional information regarding its fraud and Section 5 claims on numerous occasions, including descriptions of the red flags Respondents were charged with ignoring. *See* Dec. 12, 2013 Order, AP Ruling Rel. No. 1098, at 2.

Respondents' allegations fall short. Indeed, any allegations of prejudgment are directly refuted by the ID, in which the ALJ found Respondent William Gamello not liable for fraud,[10] and narrowed the Division's requested disgorgement to include only post-scienter ill-gotten gains. ID at 101-02, 115; *Anthony, et al.*, AP Ruling Rel. No. 2528 (Apr. 9, 2015) (ALJ Order further limiting Respondents' disgorgement amounts over Division's objections); *see also Timbervest*, 2015 WL 5472520, at *22 (ALJ's rulings in respondents' favor negate any suggestion of bias).

Respondents distort certain of the ALJ's statements in an unsuccessful attempt to support their bias allegations. For example, that the ALJ—in the course of an 18-day hearing—referred to "violations" (Joint Br. at 31) does not suggest prejudgment, as the ALJ merely used that term to ask whether the Division conceded that a court-appointed Receiver charged with selling certain McGinn Smith assets—sales having "nothing to do with the 'violations'" alleged in this OIP—had, in fact, made such sales. Tr. 2411:17-2412:14. The ALJ quickly clarified that she meant "alleged violations" when prompted by counsel to certain Respondents. *Id.* Similarly, the ALJ's statement that she was reluctant to "'second-guess[]' the Commission's decision to hear the case" (Joint Br. at 31) merely referred to the high bar set for motions for summary disposition, and was made when she announced her intent to review Respondents' motions to reconsider her earlier decision denying summary disposition motions. (Jan. 21, 2014 Pre-hearing Tr. 30:13-21.) And the ALJ's reference to Respondents' deposition testimony as "investigative testimony" (Joint Br. at 32) suggests, at most, that she was focused on the fact that Respondents'

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[10] The ALJ found Gamello liable for Section 5 violations, but did not impose any sanctions. *See* ID at 102. Respondents' arguments that the ALJ did not find Gamello liable for anything are not accurate. *See, e.g.*, Guzzetti Br. at 20.

testimony was under oath, and that it was therefore reasonable to consider such testimony in assessing those same Respondents' credibility.

The ALJ's impartiality is also not challenged by the one innocuous statement on which Guzzetti focuses. Guzzetti Br. at 5. When the Division's summary witness, in describing her commission calculations, testified that she used certain identifiers for Guzzetti but not the other Respondents, the ALJ asked: "Because he was a supervisor?" Tr. 315:5-12. This does not show bias or prejudgment as to whether Guzzetti was a supervisor. In fact, Guzzetti calls himself "a supervisor." Guzzetti Br. at 8, 11.

4. Respondents Were Not Denied Due Process by the ALJ's Evidentiary Rulings.

Respondents erroneously argue that the proceeding was unconstitutional simply because the ALJ made certain evidentiary rulings that may have come out differently if the Federal Rules of Evidence ("FRE") applied. The FRE and FRCP do not apply in APs, *Ralph Calabro*, Sec. Act Rel. No. 9798, 2015 WL 3439152, at *10 & n.66 (May 29, 2015), and any suggestion of unfairness has been consistently rejected by the courts. *See, e.g., Cunanan v. INS*, 856 F.2d 1373, 1374 (2d Cir. 1988). Moreover, Respondents have failed to show how the ALJ's admission of certain evidence caused the type of prejudice sufficient to establish a due process violation. *See Horning v. SEC*, 570 F.3d 337, 347 (D.C. Cir. 2009) ("In the absence of any suggestion of prejudice, we cannot conclude that Horning was deprived ... of procedural due process."). The Commission's "de novo review cures any evidentiary error that the law judge may have made." *Anthony Fields*, Inv. Advisers Act Rel. No. 4028, 2015 WL 728005, at *20 (Feb. 20, 2015) (citation omitted); *c.f. Timbervest*, 2015 WL 5472520, at *24 ("'any procedural errors' made by an ALJ in conducting the hearing 'are cured' by our 'thorough, de novo review of the record.'") (citation omitted). In any event, the ALJ's rulings were correct.

a. *The ALJ Properly Admitted Hearsay Testimony*

Respondents claim (Joint Br. at 29) that the ALJ inappropriately admitted the hearsay testimony of investor Vincent O'Brien describing what Respondent Mayer told O'Brien's sister about the safety of McGinn Smith Securities. ID at 53. But "[h]earsay evidence is admissible in our administrative proceedings and 'can provide the basis for findings of violation, regardless of whether the declarants testify.'" *See Guy P. Riordan*, Sec. Act Rel. No. 9085, 2009 WL 4731397, at *14 (Dec. 11, 2009), *pet. denied Riordan v. SEC*, 627 F.3d 1230 (D.C. Cir. 2010) (quotations omitted). In determining whether hearsay is properly admitted, the Commission considers "the probative value, reliability, and the fairness of its use by examining, among other things, the possible bias of the declarant; whether or not the statements are contradicted by direct testimony; the type of hearsay at issue; whether the missing witness was available to testify; and whether or not the hearsay is corroborated." *Edgar B. Alacan*, Sec. Act Rel. No. 8436, 2004 WL 1496843, at *6 (July 6, 2004) (citation omitted). Here, the ALJ found O'Brien to be "credible" and "persuasive," ID at 106, and noted that Mayer made similar misrepresentations to both O'Brien and his sister promising the safety of their MS & Co. investments. ID at 52-53. And there is more than enough evidence to support the findings of violations even if this evidence were ignored.

b. *The ALJ Properly Refused to Admit Non-Party Witness Affidavits*

The ALJ correctly rejected affidavits from non-party witnesses who did not appear at the hearing. Rule 235 permits a party wishing to "introduce a prior, sworn statement ... [to] make a motion setting forth the reasons therefor." Rule 235(a) (listing reasons for admission). As the ALJ correctly explained, under Rule 235 "[i]t's always been sort of a firm standard in these Commission proceedings that if the witness is available, then the [Division] should have an

opportunity to cross-examine the witnesses." Jan. 21, 2014 Tr. 4:12–5:12; *see also* Rule 235 ("due regard shall be given to the presumption that witnesses will testify orally in an open hearing.") Although Respondents belatedly claim (Joint Br. at 31) that each and every affiant was "unable to appear," they never made such a showing below.[11]

c. The ALJ Properly Considered Certain Respondents' Prior Sworn Testimony

Respondents maintain (Joint Br. at 32) that the ALJ erred in considering certain Respondents' prior sworn testimony, even though she limited its use to impeachment. This prior testimony came from depositions in the Commission's federal litigation against McGinn and Smith, when several Respondents—advised by the same counsel that continues to represent them here—testified under oath about the same underlying facts. Respondents cite no authority for their position (Joint Br. at 32) that the staff must provide an SEC Form 1662 to deponents in a federal court litigation and inform all subjects that they are suspected of committing securities violations before issuing Wells notices, and they can offer no credible reason why their own statements *under oath* should not be considered in assessing their respective credibility. Furthermore, the ALJ's ruling limited use of the testimony to impeachment (Jan. 21, 2014 Pre-hearing Tr. at 44:9-17), even though the totality of Respondents' statements would have been admissible in federal court under FRE 801(d)(2) (admissions of party-opponents are not hearsay).

[11] Indeed, the ALJ correctly held the Division to the same burden—namely, to make a "specific request of who it is and why they can't come [to Court]," and, where appropriate, to provide evidence to support any claim of witness unavailability. *See* Tr. 3857:22–3860:13. Under the same standard, the ALJ admitted the affidavits of Respondents' witnesses who testified. *See, e.g.*, Tr. at 4404:11–4405:19.

d. The Division Properly Contacted Investor Witnesses Prior to the Hearing.

Respondents challenge the ALJ's purported failure to sanction the Division for contacting investors after the OIP's issuance. Respondents' reliance on Rule of Practice 230(g), concerning investigatory subpoenas issued after AP institution, is misplaced: the Division did not issue investigatory subpoenas after the AP's institution. Rather, the Division properly spoke to potential witnesses who were willing to communicate *voluntarily* with the Division. *See Tilton, et al.*, AP Ruling Rel. No. 2892 (July 1, 2015) (not improper for Division to contact investors after institution of proceedings because Division properly and timely disclosed the identity of all investor witnesses to be called at the Hearing). And the Division promptly disclosed to Respondents any documents or *Brady* material received from all investors.

III. Respondents Violated the Antifraud Provisions of the Securities Act and the Exchange Act

The parties agree that the scienter requirement for Section 10(b) of the Exchange Act and Section 17(a)(1) of the Securities Act may be satisfied by a showing that conduct is intentional or reckless. (Joint Br. at 10.) Respondents, however, urge the Commission to reject decades of precedent establishing scienter where, as here, registered representatives recommend securities to their customers without first discharging their duty to investigate, particularly where numerous red flags signal potential problems. Respondents further ask the Commission to ignore their repeated material misrepresentations and omissions concerning the McGinn Smith Securities and their crucial role in the fraudulent scheme. Respondents' arguments should be rejected.

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

Respondents' culpable state of mind satisfied the scienter requirements for Section 10(b) and Rule 10b-5 of the Exchange Act and Section 17(a)(1) of the Securities Act, which require

"actual knowledge that [one's] misrepresentations would mislead investors" *or* extreme recklessness. *See John P. Flannery et al.*, Exchange Act Rel. No. 3918, 2014 WL 7145625, at *22 (Dec. 15, 2014). Where, as here, circumstances "raise enough questions," "a person's failure to investigate before recommending that investment [may be considered] reckless." *SEC v. Milan Capital Group, Inc.*, No. 00-cv-108, 2000 WL 1682761, at *5 (S.D.N.Y. Nov. 9, 2000).

Both the federal courts and ALJs have long held that a broker violates the antifraud provisions of the securities laws by recommending a security without an adequate and reasonable basis. *See, e.g., Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969); *SEC v. Platinum Inv. Corp.*, No. 02-cv-6093(JSR), 2006 WL 2707319, at *3 (S.D.N.Y. Sept. 20, 2006) (Rakoff, J.); *SEC v. Hasho,* 784 F. Supp. 1059, 1107 (S.D.N.Y. 1992); *Maria T. Giesige*, Rel. No. 359, 2008 WL 4489677, at *19 (Oct. 7, 2008); *Stires & Co., Inc.*, Rel. No. 130, 1998 WL 462230, at *7 (Aug. 11, 1998); *Danny G. Pinkerton, et al.*, Rel. No. 98, 1996 WL 602648, at *5 (Oct. 18, 1996). Indeed, the Second Circuit described Respondents' obligations nearly 50 years ago:

> Brokers and salesmen are under a duty to investigate, and their violation of that duty brings them within the term "willful" in the Exchange Act. Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. He must analyze sales literature and must not blindly accept recommendations made therein. The fact that his customers may be sophisticated and knowledgeable does not warrant a less stringent standard. Even where the purchaser follows the market activity of the stock and does not rely upon the salesman's statements, remedial sanctions may be imposed since reliance is not an element of fraudulent misrepresentation in this context.

Hanly, 415 F.2d at 595-96 (citations omitted). In short, a "broker is under a duty to investigate the truth of his representations to clients, because 'by his position he implicitly represents he has an adequate basis for the opinions he renders.'" *Milan Capital Group*, 2000 WL 1682761, at *5 (quoting *Hanly*, 415 F.2d 589).

Respondents argue that *Hanly* requires only that "a reasonable investigation has been made" by someone, not necessarily the registered representative. (Joint Br. at 15 (emphasis omitted).) Such a reading of *Hanly* ignores the Second Circuit's plain language, which refers repeatedly to *salesmen*. Moreover, if the law were as Respondents advocate, registered representatives' recommendations could permissibly be grounded in no independent investigation, rendering them worthless. Brokers would be permitted to recommend securities despite obvious red flags they failed to investigate, and could do so without even telling customers that they had not conducted an investigation or sought answers to allay obvious concerns about the products. But that is not the law. "By his recommendation [a registered representative] implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation." *Hanly*, 415 F.2d at 597.

Respondents' argument also departs from precedent that a registered representative's obligations are not met by merely relying on others, particularly in the face of red flags. In *SEC v. Platinum Investment Corporation*, a registered representative argued that he lacked scienter because, although material representations to his customers proved to be false, he was entitled to rely on information from "his broker-dealer superiors" and work performed by "outside accountants and attorneys." 2006 WL 2707319, at *2. Judge Rakoff rejected that argument, and held that a registered representative "has a duty to investigate the truth of the representations he makes to his clients, because, by virtue of his title, clients are entitled to presume that the representations made were the result of a reasonable investigation." *Id.* at *3 (citing *Hanly*, 415 F.2d at 597). Judge Rakoff explicitly held that the registered representative was not entitled to rely on supposed due diligence performed by others. *Id.* at *3. The court in *SEC v. Hasho* reached the same conclusion, holding that registered representatives have an independent duty to

investigate the products they sell. 784 F. Supp. at 1107. "Salesmen or registered representatives have certain duties that they cannot avoid by reliance on either their employer or an issuer." *Id.* "[D]efendants cannot hide behind reliance on employers and issuers to insulate them from liability."[12] *Id.* at 1108.

Respondents, ignoring the foregoing precedent, misidentify 2011 FINRA guidance as "the Division's basis for claiming a 'duty to investigate" for registered representatives. Joint Br. at 12. But FINRA itself has long relied on *Hanly.* FINRA's April 2010 Notice to Members ("NTM") 10-22—citing *Hanly* six times—"***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]." DE 601 at 1 (emphasis added). FINRA's notice unequivocally rejects Respondents' contention that the duty to investigate securities lay only with broker-dealer firms, or "members," stating: "the obligations of a BD firm is also intended to cover the concomitant responsibilities of any registered representative[.]" *Id.* at 10, n.1; *see also* Lex Ex. 150 at 27 n.62 (Regulatory Notice 12-25, May 2012) (reasonable basis suitability duties are same under "the predecessor suitability rule as well.").[13] In fact, FINRA Rule 140—last amended in 2008—states that associated persons such as Respondents "shall have the same duties and obligations as a member under the Rules." DE 603.

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12 *SEC v. Dain Rauscher, Inc.*, 254 F.2d 852 (9th Cir. 2001) does not support Respondents' argument "that individual brokers are not required to independently investigate the securities they offer... ." *See* Joint Br. at 16. There, the court unambiguously explained that as a "securities professional," defendant "has an obligation to investigate the securities he or she offers to customers." *Dain Rauscher,* 254 F.2d at 858.

13 FINRA itself has relied upon NTM 10-22 in describing registered representatives' duties even when adjudicating matters involving conduct pre-dating the 2010 NTM. *See Mitchell H. 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).

The caselaw Respondents cite does not dictate otherwise. *Kwiatkowski v. Bear Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002) requires a broker "to give honest and complete information when recommending a purchase or sale." And *BNP Paribas Mortgage Corp. v. Bank of America*, 866 F. Supp. 2d 257 (S.D.N.Y. 2012) 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. That is not the case here. And while the *BNP Paribas* court distinguished SEC enforcement and private actions because "the standards in the two contexts [are] different," *id.* at 267, the court further explained, relying on FINRA NTM 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.

1. Respondents Knowingly or Recklessly Failed to Have a Reasonable Basis For Their Recommendations.

As discussed in detail in the Division's Response to Respondents' Individual Briefs, the evidence shows that Respondents had no reasonable basis for recommending McGinn Smith Securities.

2. Respondents Knowingly or Recklessly Failed to Investigate Numerous Red Flags.

Respondents acknowledge that the existence of "red flags" imposes a duty of inquiry on registered representatives. Joint Br. at 17 (citing *Hanly*). The evidence shows that over a six year period, Respondents knew or were reckless in not knowing about numerous red flags they should have resolved prior to recommending the MS & Co. offerings to their customers. Instead, Respondents did nothing. The Division's Response to Respondents' Individual Briefs discusses all of these red flags in detail. Div. Indiv. Resp. at 5-9. Courts and industry experts have found many of these red flags to impose a heightened duty on brokers.

- **Conflicts of Interest**: *See* Div. Indiv. Resp. at 5-6. Respondents argue glaring conflicts of interest apparent from the face of the PPMs did not require further investigation. *See* Joint Br. at 20. But disclosure of a conflict of interest does not excuse Respondents from investigating that conflict before recommending securities. *See SEC v. Platinum Inv. Corp.*, 2006 WL 2707319, at *3 (issuer and dealer run by same individuals triggered "duty to investigate independently the propriety of the [] investments").

- **Transactions with Affiliates**: *See* Div. Indiv. Resp. at 6. Courts have long been skeptical of affiliated transactions and have imposed heightened duties on salesmen accordingly. "[T]ransactions between a company and its officers or directors...are viewed with extreme skepticism in all areas of finance." *McCurdy v. SEC*, 396 F.3d 1258, 1261-62 (D.C. Cir. 2005); *see also* Tr. 721:6-16, 1033:14 – 1034:15 (Division's expert witness Robert Lowry testifying that the ability to engage in transactions with affiliates was a red flag warranting further investigation). Indeed, related party transactions should be "evaluated with a high degree of professional skepticism." *See In re Bear Stearns Companies, Inc. Sec., Derivative, & ERISA Litig.*, 763 F. Supp. 2d 423, 472 (S.D.N.Y. 2011).

- **McGinn Smith Entities' Operating History Before the Four Funds**: *See* Div. Indiv. Resp. at 5. Respondents' heavy reliance on MS & Co.'s pre-2003 operating history does not absolve them of their duties. Rather, this very operating history gave rise to a duty to investigate. "MS & Co. was a small company creating newly formed entities." ID at 92. As such, Respondents had a greater duty to conduct a meaningful investigation of McGinn Smith Securities. *See Hanly*, 415 F.2d at 597 ("Securities issued by smaller companies of recent origin obviously require more thorough investigation."); *Hasho*, 784 F. Supp. at 1107 (same).

- **Smith's Refusal to Share Information with Brokers**: Respondents should have been particularly suspicious when Smith refused to share with them critical details about Four Funds investments. Div. Indiv. Resp. at 6-7; *see Meadows v. SEC*, 119 F.3d 1219, 1226 (5th Cir. 1997) (registered representative who recommended company's securities violated antifraud securities laws by failing to disclose he had been temporarily denied access to issuers' books).

- **Redemption Issues for the Four Funds**: *See* Div. Indiv. Resp. at 7-8. Experts on both sides of this case opined that redemption issues facing a broker-dealer present a red flag to brokers. Lex's expert Charles Bennett agreed that "one of the hallmarks of a Ponzi scheme is using fresh money to pay off earlier investors." Tr. 4159:16-21; *see also* Lex Ex. 147-A at 2 (requirement that "brokers [find] a replacement customer, as a condition to redeeming [an] existing customer[], would be a red flag"). Division's expert Robert Lowry concurred. DE 1 at 17 (redeeming investors with new funds was a "significant departure" from the PPM terms and warranted further inquiry).

- **Mounting Evidence of Significant Problems with MS & Co. Offerings**: Respondents knew about the January 2008 event of default concerning the Four Funds and most attended the January 8 meeting. Div. Indiv. Resp. at 8. MS & Co. commenced four post-January 2008 Trust Offerings (other trusts were launched beginning in 2006) for the express purpose of funding payments to prior offerings' noteholders and launched offerings diverting an large proportion of investment proceeds to fees and expenses. *Id.* at 9. Around the same time, the Firstline trust was compromised by a bankruptcy filing, leading MS & Co. to comingle other Four Funds and Trusts' proceeds to satisfy various payment obligations. *Id.* at 9. Respondents had an obligation to investigate these problems before recommending to their customers new Offerings from the same principals and to share reasons for concern about MS & Co. with those

investors. *See Meadows*, 119 F.3d at 1226 (registered representative's failure to disclose numerous reasons for concern, including commingling of funds, supported Commission's fraud findings).

Respondents seek to dismiss the importance of the Four Funds default—and its obvious implications on all MS & Co. deals going forward—by arguing (i) the fraudulent Trusts Respondents sold to their customers were distinct from the Four Funds (Joint Br. at 23), and (ii) the Four Funds defaults were not surprising given a general "economic crisis" at that time. *Id.* at 22. But the fact that the Trusts and Four Funds were different investments did not give Respondents an excuse to simply ignore the important facts they learned as the Four Funds collapsed. The same people (Smith and McGinn) and entities involved in creating the Four Funds played similar roles for the Trusts. Div. Indiv. Resp. at 5-6. And the events of January 2008 should have caused Respondents to pause and investigate subsequent offerings created by McGinn and Smith before blindly trusting those principals' optimistic statements about later Trust deals. Further, Respondents, having been told by Guzzetti that the MS & Co. products had "no correlation" to the equity market as early as 2007 (DE 111), had a duty to investigate the reasons for the Four Funds collapse before blindly accepting Smith's explanation that the market was to blame and recommending more MS & Co. products to their customers.

3. <u>Respondents Cannot Credibly Claim Ignorance of the Many Red Flags</u>

Respondents hardly advance their case by claiming ignorance as to obvious red flags (Joint Br. at 24), such as those apparent from the PPMs: "[I]gnorance provides no defense to recklessness where a reasonable investigation would have revealed the truth to the defendant." *See SEC v. Infinity Group Co.*, 212 F.3d 180, 193 (3d Cir. 2000). And in any event, the record

makes clear that Respondents knew about the red flags concerning the securities they sold. *See generally* Div. Indiv. Resp.

Cases cited by Respondents do not compel any other result. Whereas Respondents' brief represents *South Cherry Street, LLC v. Hennessee Group LLC, et al.*, 573 F.3d 98 (2d Cir. 2009) as stating that red flags must be "'so obvious[ly]' indicative of fraud 'that the defendant must have been aware of [the fraud]'" (Joint Br. at 24 (alteration in original)), the Second Circuit in that case focused not on actual fraud, but "the danger" of fraud. 573 F.3d at 109; *see also* DE 1 at 6 (expert definition of red flags). Here, Respondents faced obvious red flags indicating a "danger" of fraud, warning them of risks or, at a minimum, that something was awry.

4. <u>Respondents' Should Not Be Permitted to Shift the Blame to Their Customers.</u>

Respondents' effort to blame their customers (Joint Br. at 20-21) should fail. That customers signed subscription agreements describing certain red flags, such as the conflicts discussed herein, did not eliminate Respondents' responsibility to investigate the products they pitched before recommending that customers buy the investments *notwithstanding* the red flags. Simply handing a customer a prospectus does not authorize a broker to fail to investigate, lie or omit material facts. *See Larry Klein*, Rel. No. 37835, 1996 WL 597776, at *5 (Oct. 17, 1996) (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"); *SEC v. Bravata*, No. 09-12950 (DML), 2014 WL 897348, at *17 (E.D. Mich. Mar. 6, 2014), ("the PPM materials were 'no cover' against the allegations of fraud;" "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[.]") (citation omitted).

And it was not the customers' responsibility to do their own diligence into questions raised by the PPM when their own brokers were recommending the McGinn Smith Securities regardless of those red flags. *C.f. Flannery*, 2014 WL 7145625, at *21 ("It would send an extraordinarily dangerous message to say that [respondent] was free to make any misstatements ... he wished in his presentations, so long as he could later claim that investors could have obtained accurate information about the fund if they had only known to ask"); *SEC v. Morgan Keegan & Co., Inc.*, 678 F.3d 1233, 1252-53 (11th Cir. 2012) (rejecting defense that accurate disclosures were available to a "reasonably diligent investor"). Moreover, the MS & Co. Offerings were plagued by many problems unrelated to the risks disclosed in the PPMs. *See SEC v. Pittsford Capital Income Partners, L.L.C.*, No. 06 Civ. 6353, 2007 WL 2455124, at *11 (W.D.N.Y. Aug. 23, 2007), *aff'd in part and app. dismissed in part*, 305 Fed. Appx. 694 (2d Cir. 2008) ("the cautionary language does not shield the principals from liability because the risks that were disclosed in the PPMs were not the risks that harmed investors").

Respondents' reliance on *Upton, Assignee v. Tribilcock*, 91 U.S. 45 (1875) (Joint Br. at 21), decided decades before the Securities and Exchange Acts were enacted, is misplaced. *Upton* does not speak to whether signing an agreement that discloses certain risks alters in any way a registered representative's duty to investigate those risks before recommending to his customers. And *Carr v. CIGNA Securities, Inc.*, 95 F.3d 544 (7th Cir. 1996) (Joint Br. at 21), which considers the impact of explicit risk disclosures in the face of contrary oral disclosures, is similarly unpersuasive, as it does not speak to a registered representative's duty to investigate red flags apparent from those written disclosures. *Rissman v. Rissman*, 213 F.3d 381 (7th Cir. 2000) (Joint Br. at 21-22) is also inapposite because it hinges on reliance, which is not an element in

Commission enforcement actions. *See Flannery*, 2014 WL 7145625, at *13 ("In contrast to private parties, the Commission need not show reliance as an element of its claims.")

B. Respondents Made Material Misrepresentations and Omissions.

"It is clear that a salesman must not merely avoid affirmative misstatements when he recommends the stock to a customer; he must also disclose material adverse facts of which he is or should be aware." *Hanly*, 415 F.2d at 592 (citation omitted). Because Respondents recommended the MS & Co. private placements to their customers, they were obligated to disclose all known or reasonably ascertainable material adverse information about the recommended securities. *Id.*; *see also Kwiatkowski v. Bear Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002) (broker "is obliged to give honest and complete information when recommending a purchase or sale"). In addition, a broker who lacks essential information about an issuer or its securities when he makes a recommendation must disclose this fact as well as the risks that arise from its lack of information. *See SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1 (D.D.C. 1998).

As discussed in detail in the Division's Response to Respondents' Individual Briefs, Respondents made material misrepresentations and omissions to their customers in violation of Section 17(a)(1) of the Securities Act and Section 10(b) and Rule 10b-5 of the Exchange Act.

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

Contrary to their arguments in their individual briefs, *see, e.g.*, Livingston Br. at 15, Respondents were the keystone of a scheme to defraud investors. Scheme liability may arise from misstatements alone. *See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta Inc.*, 552 U.S. 148, 158 (2008); *see also Cady, Roberts & Co.*, 40 S.E.C. 907, 913 (1961) ("The three main subdivisions of Section 17 and Rule 10b-5 have been considered to be mutually supporting rather than mutually exclusive."); *Flannery*, 2014 WL 7145625, at *12 (violators are "independently

liable for their own deceptive acts, even if a material misstatement by another person creates the nexus between the scheme and the securities market") (citations omitted).

Here, however, the fraud that victimized Respondents' customers was broader than their misstatements and omissions alone. Each of the Respondents undertook a course of deceptive conduct that involved selling McGinn Smith Securities after numerous red flags made it clear that something was amiss at the broker-dealer. Respondents' robust sales efforts in the face of serious red flags permitted the fraud to continue for years, as did their concealment of the many mounting problems at MS & Co. *See generally* Div. Indiv. Resp.

D. Respondents Were Negligent

At a minimum, as the ALJ found, all of Respondents' sales were negligent. ID at 100, 103, 105, 106, 108. To show that Respondents violated sections 17(a)(2) and 17(a)(3) of the Securities Act, the Commission need only show (i) material misrepresentations or materially misleading omissions, (ii) in the offer or sale of securities, (iii) made with negligence. *SEC v. U.S. Pension Trust Corp.*, No. 07-22570-CIV, 2010 WL 3894082, at *19 (S.D. Fla. Sept. 30, 2010) (citation omitted).

To establish negligence, the Commission must show that Respondents failed to conform to the standards of care applicable to its industry or profession. *See SEC v. Fitzgerald*, 135 F. Supp. 2d 992, 1028 (N.D. Cal. 2001). As explained by expert witness Robert Lowry, Respondents failed to conform to the standards of care applicable to registered representatives confronted with the red flags that existed here. *See, e.g.*, Tr. 721:6-16, 839:19 – 842:18, 1033:14 – 1034:15, 1243:4-20; DE 1 at 11-30.

Respondents argue that they cannot be liable under Section 17(a)(2) or (3) "as a matter of law" because they are not the "makers" of any misrepresentations and did not "obtain money or

property by means of a material misstatement or omission." Joint Br. at 25 (citing *Janus Capital, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011)). First, the Commission has unambiguously rejected Respondents' expansive reading of *Janus*. *See Flannery*, 2014 WL 7145625, at *11. Second, it was Respondents who recommended the securities at issue to their customers—and made other misrepresentations—and earned commissions from the sales made to those customers.[14]

IV. Respondents Violated Section 5(a) and (c) of the Securities Act

The record shows that Respondents violated Section 5. Respondents all sold the Four Funds to unaccredited investors, and all but Livingston sold the Trust Offerings to such investors as well. DE 531-536 (summary charts of Respondents sales to unaccredited investors); 591; DE 2 at 58-122 (charts detailing Respondents' sales). Respondents all argue some version of a lack of scienter "defense" (Chiappone Br. 29-31; Mayer Br. 24-26; Rabinovich Br. 24-26; Lex Br. 27-28; Livingston Br. 20 n.10), but none identify any authority identifying scienter as an element of a Section 5 violation. Individual liability was appropriate, though the ID erred on the side of leniency, imposing no disgorgement on Respondents' ill-gotten gains from their Section 5 violations.

A. The Division's *Prima Facie* Case Against Respondents Is Unchallenged

To establish a *prima facie* case, the Division must prove that: (1) the respondent offered to sell or sold a security; (2) the respondent used the mails or interstate means to sell or offer the security; and (3) no registration statement was filed or was in effect as to the security. *See SEC v. Cavanagh*, 1 F. Supp. 2d 337, 361 (S.D.N.Y. 1998), *aff'd*, 155 F.3d 129 (2d Cir. 1998). Scienter

[14] Section 17(a)(2)'s requirement that one obtain money or property through misstatements or omissions about material facts, *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 861 (S.D.N.Y. 1997), *aff'd*, 159 F.3d 1348 (2d Cir. 1998), is easily satisfied here. *See* Div. Indiv. Resp. at 48 (commissions earned on sales).

is not required to establish a Section 5 violation. *See SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 859-60 (S.D.N.Y. 1997), *aff'd,* 159 F.3d 1348 (2d Cir. 1998). The burden of proof then shifts to the respondent to show that an exemption or safe-harbor from registration was available. *Bloomfield, et al.,* Rel. No. 9553, 2014 WL 768828, at *7 (Feb. 27, 2014) (citations omitted).

The Division's evidence establishing Respondents' *prima facie* Section 5 violation is uncontroverted. Respondents sold the Four Funds and various Trust Offerings. DE 591; DE 2 at 58-121 (charts of Respondents' sales). They recommended and sold these securities to investors throughout the country, and used the means and instrumentalities of interstate commerce to do so. *Id.* Finally, no registration statement was filed with the Commission or in effect with respect to the Four Funds or Trust Offerings. DE 3.

B. Respondents Offered No Evidence that a Registration Exemption Applied

Respondents fail to meet their burden of proof to show that the Four Funds or Trust Offerings qualified for an exemption from registration. *See Bloomfield*, 2014 WL 768828, at *7. Although the Four Funds claimed exemptions under Securities Act Section 4(2) and Rule 506 of Regulation D, and Trust Offerings under Regulation 506 alone, neither exemption applies.

For Section 4(2) to apply, "the Supreme Court has held that courts must examine whether allowing the exemption is consistent with the promotion of 'full disclosure of information thought necessary to informed investment decisions' and whether 'the class of persons affected needs the protection of the [Securities] Act.'" *SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d. 1, 11 (D.D.C. 1998) (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953)). The Court must consider "the number of offerees, the relationship of the offerees to each other and the issuer, the manner of the offering, information disclosure or access, and the sophistication of the offerees." *Id.* Here, that the Four Funds had hundreds of investors who had no relationship with the issuers

was unchallenged. DE 591. Respondents failed to introduce any evidence indicating that Four Funds investors had access to information equivalent to that which would be in a registration statement, and the record indicates otherwise. *See, e.g.*, Tr. 3274:5-17.

For the Rule 506 exemption to apply, the Four Funds could issue securities up to only 35 unaccredited investors. *See* 17 C.F.R. § 230.506(b)(2). Each of the Four Funds, however, had more than 35 unaccredited investors. *See* DE 531, 532, 533, 534. Although Respondents claim that the Division's charts of unaccredited investors were "flawed" (Joint Br. at 26), they offered no tally of unaccredited investors and, thus, failed to meet ***their own burden*** to prove that the Four Funds were exempt. Moreover, the unaccredited investor count was not flawed. The Division presented summary charts based on three independent sources of information: the McGinn Smith investor database (DE 591); purchaser questionnaires eliciting income, net worth, and other information; and information from investors, provided in person and by telephone to the Division. DE 2 ¶ 12; Tr. 227:19—228:10, 1348:24—1371:16.

In addition, offerings under Rule 506 must comply with Rule 502, which requires the provision of substantial financial and non-financial disclosures to unaccredited investors. 17 C.F.R. § 230.502(b), 506(b). Respondents fail to point to any evidence in the record indicating that such disclosures were provided to the Four Funds' many unaccredited investors.

For largely the same reasons, Petitioners' sales of the Trust Offerings also violated Section 5. The Trust Offerings also had unaccredited investors, *see, e.g.*, DE 591, 535, 536, but as with the Four Funds offerings, Respondents introduced no evidence remotely indicating that

unaccredited investors were provided with any meaningful information regarding their investments.[15]

C. Respondents Are Individually Liable for Their Section 5 Violations

The Commission should reject Respondents' baseless argument that Section 5 liability is only appropriate when there is an "obvious failure" by a registered representative to comply with a registration requirement. *See* Joint Br. at 6. Section 5 is a strict liability offense prohibiting anyone from "directly or indirectly" selling unregistered securities; individuals who are substantial factors in the sale of an unregistered, non-exempt security—let alone registered representatives who have actual contact with and solicit the customer—are liable. *See SEC v. U.N. Dollars Corp.*, No. 01 Civ. 9059 (AGS), 2003 WL 192181, at *2 (S.D.N.Y. Jan. 28, 2003) (lack of knowledge no defense to Section 5 violation). *SEC v. CMKM Diamonds, Inc.*, 729 F.3d 1248, 1256-57 (9th Cir. 2013) (reliance on counsel no defense); *see also SEC v. Alexander*, No. 10-cv-04535, 2015 WL 4397421, at *9 (N.D. Cal. July 17, 2015) ("there can be no dispute that Defendants were responsible for personally selling securities to investors and, consequently, were both necessary participants and substantial factors in the sales transactions"). Even under Respondents' own "obvious failure" standard (Joint Br. at 27), Respondents sold the Four Funds to unaccredited investors despite PPM language indicating that "the "notes are being offered only to 'accredited investors,' as that term is defined by Regulation D under the Securities Act . . . who . . . have the expert knowledge to evaluate information and data." *See, e.g.*, DE 5 at 3; *see also id.* at 10, 23.

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15 Respondents' assertion that the ALJ's finding was based on a theory not advanced by the Division (Joint Br. at 27) is unavailing. Respondents do not dispute that they carry the burden of proving any exemption, and the ALJ's finding is based on Respondents' failure to introduce any evidence supporting the existence of such an exemption.

Here, Respondents are a *direct* cause of the violation and are thus liable for their sales of unregistered securities regardless of their knowledge or intentions. All Respondents personally sold the Four Funds and/or the Trust Offerings to unaccredited investors who did not receive sufficient financial and non-financial disclosures regarding their investments.[16] DE 531-36; Tr. 1348:13—1365:2 (summary witness explaining Exhibits). Indeed, disgorgement of Respondents' significant ill-gotten gains stemming from Section 5 violations alone is appropriate. *See, e.g., Bloomfield*, 2014 WL 768828, at *20 (ordering disgorgement of commissions gained in connection with Section 5 violations); Div. Indiv. Resp. at 48 (commission amounts); DE 2 at 48 (commissions summary).

CONCLUSION

For the reasons set forth herein, Respondents' Petitions should be denied.

Dated: New York, NY
September 30, 2015

Respectfully submitted,

DIVISION OF ENFORCEMENT

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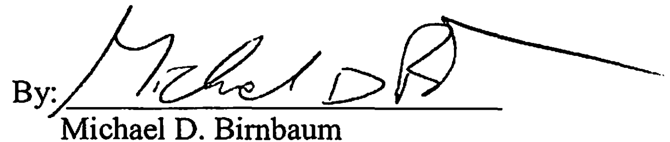
[16] In fact, Livingston and Mayer instructed unaccredited investors to misrepresent their net worth on subscription forms in making unregistered sales. Div. Indiv. Resp. at 26, 32.

CERTIFICATE OF COMPLIANCE

I hereby certify pursuant to Rule 450(d) that the Division of Enforcement's (1) Brief in Response to Respondents' Joint Brief ("Joint Response") and (2) Response to Respondents' Individual Briefs ("Individual Response") both comply with the length limitations set forth in the Commission's July 28, 2015 Order Granting Extensions and Clarifying Prior Orders. The Division's Joint Response, exclusive of pages containing the table of contents and table of authorities is 9,808 words. The Division's Individual Response, exclusive of pages containing the table of contents, table of authorities, and two addenda, is 15,715 words.

By: 
Michael D. Birnbaum

CERTIFICATE OF SERVICE

I hereby certify that on the date set forth below, I filed the foregoing pleadings with the Office of the Secretary of the Commission via facsimile at (202) 772-9324, and served copies on the following persons by UPS Next Day Air to:

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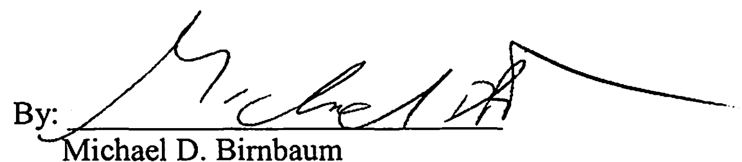
By: 
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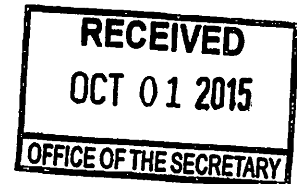

September 30, 2015

BY ELECTRONIC MAIL AND UPS

Office of the Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
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Re: *Matter of Anthony, et al.*, File No. 3-15514

Dear Mr. Fields:

Please find enclosed an original and three copies of the Division of Enforcement's (1) Brief in Response to Respondents' Joint Brief, and (2) Brief in Response to Respondents' Individual Briefs, as well as certificates of compliance and service therefor.

Respectfully submitted,

Michael D. Birnbaum

cc (by email): All Counsel