UNITED STATES OF AMERICA
Before the SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

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

Respondents.

ADMINISTRATIVE PROCEEDING
File No. 3-15514

CHIAPPONE PETITION FOR REVIEW

Respondent Frank H. Chiappone ("Chiappone" or "Mr. Chiappone") petitions for review of the Initial Decision of Administrative Law Judge Brenda Murray ("ALJ Murray"), dated February 25, 2015, as amended by the Order on Motions To Correct Manifest Error of April 9, 2005, and as further amended by ALJ Murray in her Order Revising and Ratifying Prior Actions, dated March 30, 2018 (hereinafter, the "Ratification Order").

In her Ratification Order, ALJ Murray corrected some provisions of the Initial Decision insofar as it required disgorgement of commissions earned by the respondent brokers, including Mr. Chiappone. With Respect to Chiappone, she reduced the amount of disgorgement from $59,471 to $23,329. See Ratification Order, at pages 12-13. While we do not feel that any disgorgement is supported by the facts established at the hearings, we have no objection to her reduction in the amount of disgorgement as provided in the Ratification Order.

Given the page limitations on this Petition, Mr. Chiappone requests review by the Commissioners on the following issues:

1. The ALJ misconstrued the holdings of *SEC v. Hanly* (and subsequent decisions citing to *Hanly*, on the grounds that (i) the facts in *Hanly* bear no resemblance to the facts present in this matter, and (ii) as construed by ALJ Murray would require the brokers to duplicate the due diligence work done by the McGinn Smith organization ("MS & Co."), including the MS & Co. due diligence team, inside legal counsel, outside counsel, the internal accountant/chief financial officer, as well as the firm's investment bankers (Smith and McGinn). This ignores longstanding industry practices concerning the division of labor. Recent Appellate case law holds that brokers are entitled to rely on the due diligence performed

by other employees of the broker-dealer (*SEC v. Betta,* U.S. Dist. Ct., Southern District of Florida, Case No. 09-80803-CIV-MARRA, March 29, 2018).

2.e 28 USC §2462 bars this proceeding in its' entirety. Furthermore, the fact that the Divisione introduced evidence of transactions that took place much earlier than five years from the date the OIP was issued, required the brokers to defend actions that were beyond the period of limitations set forth in 28 USC §2462, causing prejudice to the Respondent brokers.

3.e The ALJ improperly allowed presentation of evidence of events that occurred before Septembere 23, 2008, which caused Respondents to defend allegations beyond the 5-year statute oflimitations.

4.e Chiappone did not ignore any red flags.e

5.e The finding that Chiappone's alleged "negligence" established *scienter* in violation of thee securities laws was error. The Division's own summary witness testified that she found no written or other evidence that Chiappone participates in any fraudulent activities as to the MS & Co. offerings, or that he was even aware of the fraudulent activities that caused investor losses. The ALJ also ignored that the SEC and NASD/FINRA failed to discover the fraud of Messrs. Smith & McGinn during their own investigations/audits of MS & Co. She further ignored the fact that Smith and McGinn took elaborate steps to conceal their Ponzi-like activities, as established in Div. Ex.350 & Livingston Ex.31.

6. ALJ's finding that MS & Co.'s multiple roles (issuer, broker-dealer and trustee) should havee caused Chiappone not to sell such offerings ignores that all such conflicts were disclosed in PPMs.e

8.e ALJ's finding that Chiappone violated '33 Act §5 because his bosses allowed more than 35e unaccredited investors in some deals ignores that Chiappone was not responsible for counting investors – this was the responsibility of Smith and McGinn and their assistants.e

9.e Failure of a broker to investigate the activities of his superiors does not amount to fraud.e

10.e The 12 month suspension and cease and desist order levied by ALJ on Chiappone is improper.e He has not sold a single private placement in over eight (8) years, and this case involves only private placement securities. Further, aside from this proceeding, has, in his 36 years as a broker, never been the subject of any lawsuit, arbitration proceeding, customer complaint, nor any disciplinary action by the SEC, NASD/FINRA or any other governmental or regulatory agency. While he still sells stocks and bonds, his practice is focused upon products involving insurance, issued by major companies. The

ALJ has not shown Mr. Chiappone any continuing risk to the investing public, given his willingness to forego selling private placements, and his 36 year unblemished record as to other securities. Further, the ALJ's decision ignored or misconstrued the *Steadman* factors on suspensions/bars.

11.e Third tier penalties are not warranted, as Chiappone was not an active participant in any fraud.e

12.e A recent case (*SEC v. Betta,* U.S. District Court, S.D. Florida, Case No. 09-80803-CIV-MARRA) holds that brokers failure to discover the fraud perpetrated by their superiors, did not amounte to *scienter* sufficient to establish fraud, and that the brokers had the right to rely on informatione provided to them by their superiors. As with this case, the broker-dealer in *Betta* was an establishede company that was respected in its community, not a boiler room operation.e

13.e MS & Co. customer losses were not due to broker misrepresentations in the sales process; rathere losses were due to Smith & McGinn using new investor money to prop up failing offerings (Ponzi).e

14.e The ALJ was not properly appointed, in violation of US Constitution, Art.2 section 2, making all of her findings without validity, which cannot be cured by her review and ratification.

15.e ALJ's reliance on Chiappone's sale of Four Funds notes was error, since his last sale of a Foure Funds occurred January 2, 2008 **well beyond** expiration the five-year limitation of September 23, 2008.e

16.e To avoid repetition, and due to lack of space under Rule 201.410(c), Chiappone incorporates bye reference the claims and assertions raised by the other Respondents in their Petitions For Review,e regarding the integrity of the hearing process, the findings and conclusions of fact made by ALJe Murray, and the determinations made as to disgorgement, civil penalties, suspension or revocation ofe registration and issuance of a cease and desist order.e

ORAL ARGUMENT REQUESTED

Dated: April 18, 2018

Tuczinski, Gilchrist, Cavalier & Tingley, PC

By: _____

Roland M. Cavalier, Esq.
Attorneys for Respondent Chiappone
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CERTIFICATE OF SERVICE

I, Roland M. Cavalier, hereby certify that on this 18th day of April, 2018, I served a true and complete copy of Respondent Frank H. Chiappone's Petition For Review upon the following parties in this action as follows:

By Facsimile and One Manually Executed Original to:

Securities and Exchange Commission
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U.S. Securities and Exchange Commission
100 F. Street, NE
Mail Stop 1090
Washington, D.C. 20549
Facsimile (202) 772-9324

One (1) copy via Federal Express and Electronic Mail to:

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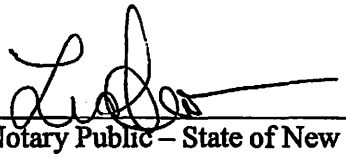
Roland M. Cavalier

Sworn to before me this
18th day of April, 2018



Notary Public – State of New York

LINDSEY A. MEYER
Notary Public, State of New York
No. 01ME6336544
Qualified in Rensselaer County
Commission Expires 02/08/20 20

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Mr. Chiappone continues to object to the findings of ALJ Murray that Mr. Chiappone violated securities laws in selling private placement offerings issued by McGinn Smith and Company (hereinafter "MS & Co."). With but three exceptions detailed below, Mr. Chiappone sees no need to reiterate in this Petition the arguments made in his initial Petition For Review dated April 29, 2015, but we do incorporate by reference the arguments made therein, and request that a copy of the initial Petition For Review be provided to the two new Commissioners.

One of Mr. Chiappone's primary arguments is that ALJ Murray misconstrued the holding of *Hanly v. SEC* in her ruling that the registered representatives failed to fulfill *Hanly's* "duty to investigate" in the sale of private placements to their customers. Elements of that argument are further discussed herein, and are set forth in their entirely in Mr. Chiappone's original Petition For Review.

Another primary argument as concerns ALJ Murray's Ratification Order is her determination that, the fact that Mr. Chiappone has not sold a single private placement security of any kind during the past eight years since his departure from MS & Co. was not sufficient proof that he did not pose a danger to the investing public. She based this finding on her feeling that the fact that he was still working in the securities industry was alone sufficient reason to impose the suspension. Our response to this aspect of the ALJ's Ratification Order is described in detail in Section 1A(6), at pages 10-11. As applied to Mr. Chiappone, this finding is in conflict with the weight of authority, and we are asking the Commission to set aside that holding. As with the misconstruing of *Hanly,* the original arguments pertaining to the 12-month suspension levied on Mr. Chiappone can be found in his original Petition For Review.

The third issue that we wish to further address is the issue of *Scienter.* Although our arguments on the lack of *scienter* are detailed in our original Brief to the Commissioners, a recent case has added to our argument that the ALJ's finding that the brokers had the requisite *scienter* to violate the securities laws, merely because they failed to discover the fraudulent conduct (Ponzi scheme) committed by their superiors was in error. See Section III for the details as to the *scienter* issue.

I. Suspension of Chiappone Does Not Comport With Applicable Case Law. One of thee ALJ's findings that is being further detailed in this Petition is her continued determination that Mr. Chiappone should be suspended from conducting business as a registered representative and otherwise participating in the securities industry. The ALJ's findings and determination on this issue are found at Ratification Order, pages 16, 18-20. We continue to contend that her imposing a 12-month suspension on Mr. Chiappone is neither supported by the evidence, nor in compliance with applicable case law.

A.e The Steadman Factors.e

First, we address her conclusion that the fact that Mr. Chiappone no longer sells private placements does not mitigate imposition of a suspension, because he may sell other types of securities. This totally ignores the Fact that Mr. Chiappone has been working in the securities industry for 36 years and, except for the sale of MS & Co. private placements, he has never been the subject of any customer complaints, lawsuits, arbitrations or other form of disciplinary action, by any person, or by any federal, state or industry regulatory body. So, in spite of the fact .e that for 36 years, he sold stocks, bonds and mutual funds and other investments that were note private placements without ever been the subject of a complaint, ALJ Murray considered him ae

risk to investors to whom he might sell such securities. In so doing, she ignores the fact that the private placements were the only type of securities that were the subject of this proceeding. She also ignores that, as regards Mr. Chiappone's sales of other types of securities, his record is completely unblemished.

ALJ Murray suggests that because the risk to future investors is only one of the *Steadman* factors, Chiappone still presents a risk to investors. However, numerous decisions by various federal courts have stated that danger to the investing public is a requirement for the imposition of a suspension or termination of a broker's license. Her cursory determination that the fact that Mr. Chiappone still works in the industry is sufficient grounds for a suspencion ignores a substantial body of precedent that clearly shows that injunctive relief is not appropriate unless the Commission establishes a significant risk that the broker will likely continue the conduct at issue. An analysis of those precedents follows.

Perhaps the best way to analyze the precedents concerning the factors relevant to imposition of a suspension or permanent bar are the Steadman factors. In *Steadman v. SEC,* the Fifth Circuit enumerated them as follows:

> "We do not agree with Steadman that the Commission has unconstitutionally made a conclusive presumption of future wrongdoing on the basis of past misconduct, but we do agree that a fuller explanation of the need for these sanctions is required. At least the Commission specifically ought to consider and discuss with respect to Steadman the factors that have been deemed relevant to the issuance of an injunction:
>
> The egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations." (*Steadman,* 603 F2d 1126, 1140 (5th Cir. 1979)).

We address these factors in order:

1. Egregiousness of the defendant's actions. Mr. Chiappone can hardly be found to have acted in an egregious fashion, as the claim against him essentially asserts negligence in failing to detect the fraud committed by Messrs. Smith and McGinn. There is not one shred of evidence, nor even any allegation, that he ever participated in, or even knew of the conduct of his superiors that was the driving factor in causing investor losses. Mr. Chiappone is accused of no misrepresentations, false statements, over optimistic projections of gains, "puffing," withholding of known risks, or in any manner misleading clients. The only accusation is that he failed to know of underlying fraud committed by Smith and McGinn at the point in time that he sold private placement investments to clients.

Courts have held that injunctive relief is particularly applicable where the Defendant's conduct involves a high degree of scienter. See, for example, *SEC v. Posner*, 16 F3d 520, 521-522 (2d Cir. 1994); *SEC v. Milan Capital*, 2000 U.S. District Lexis 16204 (SDNY 2000); and *SEC v. Drexler Burnham Lambert*, 837 F. Sup. 587, 611 (SDNY 1993). Here, the Division seeks to suspend Chiappone where there was a complete absence of showing of *any scienter*, much less a high degree of scienter. He was not an active participant in any wrongdoing, and in fact was not accused of such. In fact, the Division has not proven nor even pleaded that Mr. Chiappone was a primary actor or even peripherally involved in the fraudulent activities of Messrs. McGinn and Smith. Nor has the SEC introduced any evidence that that Mr. Chiappone was even *aware* of the fraud being committed by his superiors. In fact, the SEC's summary witness, forensic accountant Kerri Palen, who had extensive experience in fraud investigations, testified that she worked on the MS & Co. case from May 2011 to January 2014 (a period of 33 months) during which time she spend approximately 50% of her time on the MS& Co. investigation.[1] She

[1] See Palen testimony, January 28th Transcript, pp. 389-390, 392-393.

admitted that during the entire time she worked on the MS& Co. investigation, she found no evidence that Mr. Chiappone was involved in the Ponzi-like activities, and she further testified that she found no evidence that Mr. Chiappone was *even aware* of those activities.[2]

Notwithstanding the admissions of their own forensic accountant, the Division seeks to impose a suspension because Mr. Chiappone failed to discover a fraud that was being actively concealed by his superiors. Hence, his alleged failure to unearth the fraud of his bosses does not even come close to rising to the level of *scienter* that would support injunctive relief.

2. Recurrent Nature of the Infraction. Mr. Chiappone sold MS & Co. private placements from October 2003 until November, 2009. While he sold private placements for approximately six years, he was not aware of the fact that there were problems with the instruments he sold until he discovered that the Firstline trust offerings were being sold in spite of the fact that the issuer company had filed bankruptcy. Upon becoming aware that Smith and McGinn had hidden this information from the brokers, he and the other brokers began to explore other options for affiliation with a new broker dealer. He made his last sale of a MS & Co. product on October 29, 2009. Since becoming affiliated with his current broker dealer, he has not sold a single private placement security, and has no desire to do so in the future.

3. Scienter. Similar to the "egregiousness" test, there is no allegation or any evidence that suggests that Mr. Chiappone ever engaged in conduct that was knowingly unlawful. It strains credulity to argue that his failure to know of conduct perpetrated by his superiors, that consisted of propping up failed offerings with moneys from new investors, amounts to *scienter*. That Mr. Chiappone lacked *scienter* was established by the testimony of the SEC's own summary witness,

[2] See Palen testimony, January 28th Transcript, pp. 394-400.

Kerri Palen. Ms. Palen, a CPA who performed fraud examinations for three accounting firms before her employment by the SEC, testified that she had extensive experience in fraud investigations, both at her prior employers, and at the SEC.[3] As noted above, she worked on the McGinn Smith case for almost three full years, during which time she spent almost 50% of her time on the McGinn Smith case.[4] Ms. Palen testified that she found that Messrs. McGinn and Smith used moneys from the certain offerings to redeem failed alarm offerings of earlier vintage, a classic feature of Ponzi schemes. However, under cross-examination, she admitted that she found no documentary evidence that Mr. Chiappone (or any of the other brokers) participated in the misuse of customer funds to prop up earlier offerings. She further admitted that she found no documentary evidence that Mr. Chiappone or other brokers were even aware of this misuse of customer funds. She also admitted that she found no other (i.e., non-documentary) evidence that Mr. Chiappone was aware of the Ponzi-like activities of Messrs. Smith and McGinn, or that he had any connection whatsoever to the misuse of customer funds.[5] It goes without saying that if Mr. Chiappone had no knowledge of the fraudulent conduct, he cannot have had the requisite *scienter* to support a suspension of his right to practice his profession.

4. Sincerity of Defendant's Assurances as to Future Violations. Another factor to be considered in determining the appropriateness of injunctive relief is the lack of assurances on the part of the defendants that the conduct complained of will not be continued. In this regard, see, *SEC v. Posner*, 16 F3d 520, 521-522; *SEC v. Drexler Burnham Lambert*, 837 F. Supp. at 611; *SEC v. Patel*, 61 F3d 137, at 142 (2d Cir. 1995). While his verbal assurances that he has no interest in selling private placements in the future should be taken into consideration, he also

[3] See Palen testimony at Jan 28th Transcript pp. 389-390.
[4] See Palen testimony, at Jan. 28th Transcript pp. 392-393.
[5] Feb. 28th Transcript pp. 393-400. In fact, Ms. Palen admitted that she saw nothing in the SEC's OIP that indicated that Chiappone even knew of the fraudulent transactions documented in her declaration. Feb.8 Tr. 399.

testified that in the four years since he left McGinn Smith and became affiliated with another broker, he has neither sold nor even offered a private placement to any customer at any time. As of the time of this Petition, Mr. Chiappone has gone eight years without selling or offering a private placement security. While he continues to sell stocks, bonds and mutual funds to his clients, the majority of his practice revolves around insurance-based products. An excerpt of his testimony on this subject follows:

> "More of my focus has been on life insurance, fixed and variable annuities, a fair amount of business in long-term care insurance. Still, since I have my RIA designation now I am handling managed portfolios for clients. I am doing consulting for 401-k plans dealing with the employees of various plans that are under my – under my control. Meeting with them on a quarterly basis, working with the individuals that work for the various companies with their financial planning and objectives. Doing a lot of IRA rollover work, and a majority of that has been in the form of variable annuities where there are some guarantees from insurance companies wrapped around the investments for the clients. So the majority of my work, I would say, in the last two years, has been more focusing in on insurance-backed products for my clients."[6]

That his testimony was true is further proved by the fact that as of this date, he has still neither offered nor sold a single private placement security, of any kind, by any issuer. If conduct speaks louder than words, then Mr. Chiappone's conduct surely establishes that there is virtually zero likelihood that he will sell a private placement in the future. And it was private placements, and only private placements, that were the subject of this proceeding. Mr. Chiappone has sold stocks, bonds, funds and other securities for some 36 years, but there has never been a single lawsuit, arbitration proceeding, disciplinary action or any other involvement in the legal or regulatory process that relate to those investments. Hence, one cannot reasonably conclude that he now poses a risk to the investing public.

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

While Mr. Chiappone clearly stated his lack of intent to ever again sell a private placement, the Commission need not take his word for that. In the eight years since he parted company with McGinn, Smith, he has neither sold nor offered a private placement security. Actual conduct speaks louder words.

5. Defendant's Recognition of Acts. Mr. Chiappone never believed that his of selling private placements was wrongful at the time the sales took place. This is the reason Mr. Chiappone purchased MS & Co. private placements for his own account, and for the account of his mother and other close friends. Once he learned that the Four Funds offerings were faltering (in early January of 2008) he immediately stopped selling the Four Funds.[7] While Mr. Chiappone continued to sell the trust offerings, he did so based on his belief that the trust offerings, involving recurring monthly revenues, would be as successful as the pre-2003 offerings that had paid all of his customers in full. It was not until after the federal authorities raided the MS & Co. and began to document the fact that Smith and McGinn had propped up failing offerings with money from new investors that he realized that the purported success of the trust offerings was also an illusion fostered by Messrs. Smith and McGinn.

After the shuttering of the MS & Co. offices, Mr. Chiappone clearly has become aware of the risks inherent in private placements – especially where the issuer and brokerage firm are commonly controlled. Once again, his refusal to offer any private placements in the ensuing

[7] SEC Ex. 2, subsection 4c shows two transactions in the Four Funds in 2008. The March 17, 2008 transaction was simply Mr. Chiappone re-registering a Four Funds investment he owned to indicate that upon his death, the investment would go to his significant other, Donna MacDonand. The other transaction, dated Sep't. 26, 2008 was a transfer by a client from his personal account to his IRA account. See Transcript, pp. 1083-1084.

eight years after he left MS & Co. shows that he recognizes that proprietary product involves an additional layer of risk to the customer.[8]

With respect to cessation of the conduct under review, the SEC cannot claim that Mr. Chiappone only ceased selling private placements in response to the filing of the instant litigation, or even the threat of such filing. In fact, Mr. Chiappone left his employ at McGinn Smith in early 2010, some four years before filing of the OIP in this case, and well before he was advised or became aware that he may be the target of a civil proceeding by the SEC. He stopped selling private placements because the collapse of McGinn Smith and the subsequent revelations of the illegal activities committed by its principals convinced him that he wanted nothing more to do with securities of this nature; not because he foresaw these proceedings.

6. Likelihood that Defendant's Occupation will Result in Future Violations. In her Ratification Order, ALJ Murray notes that private placements are only one type of security, and that the fact that respondent brokers may sell other types of securities, which creates a risk of fraud, stating:

> "I reject Respondents' argument that because the likelihood that a respondent's occupation will present opportunities for future violations is but one of the *Steadman* factors. Respondents emphasize that they no longer sell private placements. The type of security is not determinative; what is determinative is that Respondents violated the anti-fraud provisions of the securities statutes. All aspects of the securities industry present opportunities for fraud, not just private placements. Without some restraint on their activities there is nothing to prevent Respondents from reverting to the activities that caused considerable harm to investors." (Ratification Order, at p.19).

Prior to the institution of this proceeding, and subsequent thereto, Mr. Chiappone's 36 years of employment as a registered representative was completely untarnished. He was never

[8] Chiappone's last sale of a private placement was on Nov. 3, 2009, as shown in Palen Ex. 4-c (a component of SEC Ex. 2).

the subject of any lawsuit, arbitration proceeding or other form of claim or complaint by any customer. He was likewise never the subject of any disciplinary proceeding by NASD, FINRA or any other governmental or regulatory agency in the securities industry. Prior to this proceeding his CRD was completely clean. While he is a fully licensed broker, Mr. Chiappone testified that his current practice is primarily geared towards investment advisory, fee-based relationships (vs. commissions for transactions).[9] He is also much more involved with insurance company product, where the sponsors of the product are well-known, well-capitalized public companies.[10] This is a far cry from the proprietary offerings of MS & Co.

While it may be true that risk to future investors is only one of the *Steadman* factors, it is also clear that injunctive relief cannot be granted unless the SEC establishes that the risk for recurrence is significant. The facts established in this proceeding do not contain any evidence that Mr. Chiappone is likely to cause any harm to any investors. Any perceived inference of future violations from past alleged misconduct is overcome in the present matter by Mr. Chiappone's having never sold or offered a private placement in the eight years since he left MS & Co. and his testimony that he has completely changed the nature of his practice, by eliminating private placements and focusing on insurance-based product and advisory services, and continuing to serve those customers that trade in marketable securities.[11] In conclusion, the ALJ's determination that Mr. Chiappone poses a future risk to investors is not supported by relevant case law:

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[9] Chiappone testimony, Tr., pp. 5612 - 5613.
[10] Tr., pp. 5612.
[11] Chiappone testimony, Transcript of All Hearing Dates, pp. 5612 – 5613.

(i) As to her finding of future risk to investors on the possibility of conduct related to publicly traded securities (as opposed to private placements), Mr. Chiappone's record speaks for itself. He has a record of absolutely pristine conduct over a period of 36 years.

(ii) As to her finding with respect to private placements, the fact that he has shunned such offerings for eight years since his departure from MS & Co., also shows that he has no desire to sell proprietary private placement products.

While a 12-month suspension may be viewed by some as a short time, the fact is that if he is suspended for any time period, his customers will migrate to other brokers, and his 36 years of experience will be of no value. In short, if he is suspended for any time period, his ability to earn a living in the securities industry would be destroyed.

B. <u>Other Cases on Injunctive Relief (suspensions & bars)</u>

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

> It bears mention that this dispute [about whether scienter is required for certain violations], though pressed vigorously by both sides, may be much ado about nothing. This is so because of the requirement in injunctive proceedings of a showing that "there is

a reasonable likelihood that the wrong will be repeated." SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1100 (CA2 1975). Accord, SEC v. Keller Corp., 323 F.2d 397, 402 (CA7 1963). To make such a showing, it will almost always be necessary for the Commission to demonstrate that the defendant's past sins have been the result of more than negligence. *Because the Commission must show some likelihood of a future violation, defendants whose past actions have been in good faith are not likely to be enjoined.* ... That is as it should be. An injunction is a drastic remedy, not a mild prophylactic, and should not be obtained against one acting in good faith." Aaron, 446 U.S. at 703 (emphasis supplied).

Other circuit court decisions likewise focus on the likelihood of future misconduct. See, *SEC v. Culpepper*, 270 F2d 241, 249 (2d Cir. 1959) ("the critical question for the court in cases such as this is whether there is a reasonable expectation that the defendants will thwart the policy of the Act by engaging in activities proscribed thereby"); *SEC v. Commonwealth Chemical Securities*, 574 F2d 90, 99-100 (2d Cir. 1978) ("the ultimate test is whether the defendant's past conduct indicates ... that there is a reasonable likelihood of further violation in the future"). The Second Circuit, in *SEC v. Commonwealth Chemical Securities*,[12] discussed the reasonable likelihood test and its development in some detail, stating:

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

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

Other cases containing essentially identical holdings to that in *Commonwealth Chemical* include *SEC v. Bausch & Lomb*, 565 F2d 8, 18 (2d Circ. 1977) where the Court went so far as to say "the Commission cannot obtain relief without positive proof of a reasonable likelihood that past wrong-doing will recur;" and *SEC v. Parklane Hosiery*, 558 F2d 1083 (2d Cir. 1977) (The Commission cannot obtain injunctive relief where there is no reasonable likelihood of recurrence").

The Ninth Circuit has also held that another consideration in determining the appropriateness of injunctive relief is the remoteness of defendant's violations, stating "A court can and should consider the remoteness of the defendant's past violations in deciding whether to grant the requested equitable relief." (*SEC v. Rind*, 991 F.2d 1486, 1492 (9th Cir. 1993). Applying that test to Chiappone, at the time of the hearings, it had been 4½ years since he sold any private placement. It is now some eight years since he sold a private placement, and he has expressed no intent to do so in the future.[13]

C. **Burden of Proof.** It is clear that the burden of proof on establishing the need for an injunction on the basis of likelihood of further conduct is upon the government. See, *Bausch & Lomb*, 565 F2d 8, 18 (2d Cir. 1977) ("It is well settled that the Commission cannot obtain relief without positive proof of a reasonable likelihood that past wrongdoing will recur."); *SEC v Parklane Hosiery Co., Inc.*, 558 F.2d 1083, 1089 (2d Cir. 1977)("The Commission cannot obtain injunctive relief where there is no reasonable likelihood of recurrence"); *SEC v. Commonwealth Chemical Securities,* 574 F2d 90, at 100 ("our recent decisions have emphasized, perhaps more

[13] Tr., p. 5613. At the time of the hearings, it had been 4½ years since he last sold a private placement. See Div. Ex.2, Schedule 4c (Summary of Chiappone sales).

than older ones, the need for the SEC to go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence").

While giving great deference to the decisions of the SEC in regard to choice of sanctions,[14] the courts have noted that the sanction chosen must be designed to protect investors, but not to punish a regulated person or firm. *Paz Secs., Inc. vs. SEC*, 566 F.3d 1172, 1175 (D.C. Cir 2009) (Paz II) (citing to its earlier decision in *Paz I*, 494 F.3d at 1065). *Paz* involved an appellate court review ofthe SEC's approval of a sanction initially imposed by the NASD. In *Paz I*, the court directed the SEC to explain why imposing the most severe, and therefore apparently punitive sanction is, in fact, remedial, stating:

> "When evaluation whether a sanction imposed ... is excessive or oppressive, as we have stated before, 'the Commission must do more than say, in effect, petitioners are bad and must be punished' (citations omitted); at the least it must give [s]ome explanation addressing the nature of the violation and the mitigating factors presented in the record (citations omitted). ... The Commission must be particularly careful to address the potentially mitigating factors before it affirms an order ...barring an individual from associating with an NASD member firm – the securities industry equivalent of capital punishment (citation omitted)." Paz I, 494 F.3d at 1064-65..e
>
> "We heartily endorse the Commission's view that while scienter is not required to make out violations of several of the statutory sections involved here, *the respondent's state of mind is highly relevant in determining the remedy to impose. It would be a gross abuse of discretion to bar an investment adviser from the industry on the basis of isolated negligent violations.*" (emphasis supplied) (603 F.2d at 1140-41).

In a similar vein, the D.C. Circuit, in *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1113, the court, in vacating certain SEC-imposed sanctions, stated:

> "In this setting [2-year ban on brokerage firm principal] the Commission is not simply rendering a policy judgment; nor is it simply regulating the securities markets; it is,

[14] *See*, e.g., Seghers v. SEC, 548 F.3d 129, 135 (D.C.Cir. 2008); WHX Corp. v. SEC, 362 F.ed 854, 859 (D.C. Cir. 2004).

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

D. Post OIP Conduct. Finally, there is authority for the proposition that a broker'se conduct after the initiation of proceedings can be taken into account in reviewing the sanctions imposed. *See, McCarthy v. SEC,* 406 F.3d 179 (2d Cir. 2005). The *McCarthy* case involved a floor broker given a 2-year suspension. The *McCarthy* court noted the purpose of sanctions being remedial and not punitive in nature, and went on to point out that the defendant had an exemplary record both before and after initiation of proceedings, stating:.

> Indeed, McCarthy has been trading on the floor of the Stock Exchange for the past 11 years (the two-year suspension was stayed pending appeal to the SEC and this Court), and the SEC does not dispute McCarthy's contention that, with the exception of his involvement with Oakford in 1995 and 1996, he has operated lawfully and within the rules. Thus, for nine years McCarthy has proven himself to be a rule-abiding trader. Even at the time the Board summarily imposed the two-year suspension, McCarthy had been trading without incident for six years." (406 F.3d at 188-189).

Applying the facts to the principles noted in *Paz I & II, Steadman, Blinder, Robinson* and *McCarthy* decisions, it becomes apparent that a suspension of any duration for Mr. Chiappone is both overkill and unnecessary for the public protection. Mr. Chiappone has served the investing public since January of 2010, without a hint of misconduct. His actions since he parted company with MNS & Co., and his stated intent to never again offer a proprietary private placement product, render the need for injunctive relief moot.

II. The Interpretation of the *Hanly* case in this Matter was Error. Essentially, all of thee fraud-based allegations relating to the registered representatives hinge on the application of the *Hanly* decision[15] and its progeny. Mr. Chiappone does not dispute that *Hanly* continues to havee precedential value in the specific circumstances found in *Hanly* and its progeny; only that the

[15] *Hanly v. SEC,* 415 F.2d 589 (2d Cir. 1969).

facts of *Hanly* (and its progeny) are not applicable to the much different factual pattern of this matter.

A. The *Hanly* decision does not require that each individual stockbroker personally perform due diligence on each security he recommends. Rather, it states that in recommending a security, a selling stockbroker implies that "a reasonable investigation *has been made* and that his recommendation rests on the conclusions based on such investigation" (*Hanly,* 415 F2d at 597 [emphasis supplied]). The Division, and Judge Murray have misconstrued *Hanly* to hold the individual brokers are bound to duplicate the due diligence investigations conducted by their broker-dealer employer. This is an unwarranted extension of *Hanly* in the present situation, where MS & Co. had a due diligence team, in-house counsel, in-house accountants and investment bankers, all of whom had a role in finding and structuring the product, producing the private placement memorandums and other related offering documents. Upon the conclusion of their work, the brokers were assembled and the features of each offering were explained. The brokers then did their part in the process, being the "customer-specific due diligence to match the offering with those customers for whom the offering was appropriate. Yet, the ALJ held that each broker must duplicate the work done by the persons whose job it was to structure the investments.

B. ALJ Murray ignored credible testimony from Mary Ann Cody, former in-house counsel to McGinn Smith & Co. (hereinafter "MS & Co.") that MS & Co. hired several former employees of a major bank to conduct due diligence, and that MS & Co. did perform extensive due diligence on the initial alarm offerings, including visiting the company whose receivables were purchased, reading all alarm contracts, making calls to customers to verify validity of alarm contracts purchased, and retaining all information in fire-proof safes (Mary Ann Cody, Tr. 4547)

Mr. Chiappone testified that the due diligence team returned after Timothy McGinn rejoined MS & Co. in 2006 and due diligence was conducted as to the Trust Offerings (Chiappone, Tr. 5430).

C. *Hanly* requires that the individual stockbrokers "analyze the sales literature" and not blindly accept the recommendations made. Chiappone testified that he did read the private placement memorandums (Tr. pp. 5452, 5559), and asked questions at the sales meetings (Tr. p. 5426).

D. The facts and circumstances surrounding the Trust Offerings were completely different from the facts in *Hanly*:

(i) in *Hanly,* the issuer sold equity securities in an unseasoned tech company, whereas this case involves debt securities that offered no promises of large gains, but only interest payments on the notes that were the subject of the offerings.

(ii) the *Hanley* brokers projected meteoric rise in the stock price (price would double in 2 weeks), whereas here fixed interest rates were the main feature of the investments; here was no evidence that Mr. Chiappone made false statements to pump up sales.

(iii) the *Hanly* brokers were aware that the issuer had failed in its attempts to be merged or acquired, had operated at a deficit its entire existence and had been adjudicated a bankrupt, whereas no such infirmities applied to the issuers in this case;[16] and

(iv) there was no evidence in *Hanley* that the broker-dealer employed a substantial due diligence team, such as that which existed at MS & Co. before McGinn left and after he returned.

[16] Only facts involving the Firstline offering, bear any resemblance to the security offered in *Hanley.* However, in the present matter, the bankruptcy of the company from which alarm contracts were being purchased was hidden from the brokers by Messrs. McGinn and Smith. In *Hanly,* the brokers knew of the bankruptcy while selling.

E. MS & Co. was, insofar as the respondent brokers knew, a legitimate, seasoned brokerage firm, in operation since 1980, that employed in-house counsel, a chief financial officer, due diligence team and principals with investment banking experience. It was not the boiler room operation that is typical to cases involving the application of the *Hanly* holding.[17] Judge Murray so acknowledged, finding the MS & Co. employed about 50 registered representatives, and had a national reputation in alarm financing (Initial Decision, p.3). Indeed, the Divisions own summary witness (Ms. Palen) testified that she had no reason to believe that the individual brokers knew of the fraud being perpetrated by their bosses (Initial Decision, p.4).

F. Numerous inspections and audits by NASD, FINRA and the SEC (who employ accountants and investigators) failed to unearth any wrongdoing until 2010, yet the Division contends and the Initial Decision implies that the stockbrokers should have unearthed the fraudulent activities of their employer.

G. Cases imposing the *Hanly* duty to inquire involve special circumstances, where it should be clear to a broker of average intelligence that the information being given to him should not be relied upon without further investigation. Those circumstances were not present in this case, particularly with respect to the Trust Offerings.

H. ALJ Murray found the Respondents had a duty to investigate, in spite of the fact that no rule, regulation or other written pronouncement of the SEC, NASD or FINRA, in effect at the time sales were made, clearly and specifically imposed such duty on registered representatives.

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[17] While there is no indication that the broker in *Hanley* was a boiler room, *Hanly's* progeny involving boiler room operations include *SEC v. Hasho,* 784 F. Supp. 1059, 1062 [SDNY 1992]; *Walker v. SEC,* 383 F.2d 344, 345 (2d Cir. 1967); and *Berko v. SEC,* 316 F.2d 137, 142–43 (2d Cir. 1963).

I.e In summary, if the Division's interpretation of *Hanly* were law, every stockbrokere would need to duplicate the due diligence and security analysis performed by the security analysts employed by his broker-dealer firm, even though stockbrokers do not have the education, training or experience that security analysts possess. It would completely turn on its head the structure and division of labor that exists in every significant brokerage firm.

III. **Scienter.** Very recently, the US District Court for the Southern District ofe Florida decided *SEC v. Betta*,[18] et al, a case that is strikingly similar to the present matter. Heree are the similarities:

SEC v. Betta, et al	McGinn Smith
Sold debt securities (collateral mortgage Obligations [CMO's]), that were much riskier than the Notes sold by MS & Co.	Sold debt securities issued by MS & Co.
Brookstreet Securities Corp., was an established brokerage firm and investment advisor, with 750 registered representatives in approximately 300 offices in the U.S.	MS & Co. was an established brokerage firm and investment advisor that was in business since 1980, and had a national reputation in financing burglar alarms and later in triple play (TV, phone & Internet) systems.
Brookstreet had in-house counsel and also used outside counsel in offering the CMO' products to customers.	MS & Co. had inside counsel and also used outside securities counsel on some offerings.
Brookstreet had an in-house compliance department that set the rules for offerings of CMO securities.	MS & Co. had a due diligence team that did extensive due diligence on the pre-2003 trust offerings and again on the 2006 and subsequent trust offerings.
Brookstreet's compliance office set and continually tightened suitability requirements for sales of CMO's to individual investors.	MS & Co. instructed the brokers as to the limitation on customers who were not accredited investors (but MS & Co. hid from the investors the fact that they allowed more than 35 non-accredited investors on some offerings)
Meetings were held by the compliance department at which the each CMO offering was explained and discussed with the brokers.	Meetings were held with Smith and/or McGinn and the due diligence team (and counsel) explaining the features of each offering to the brokers.

[18] *SEC v. Betta, et al.*, U.S. District Court, Southern District of Florida, Case No. 09-80803-CIV-MARRA.

When the CMO securities started to fail, the senior officials, including the compliance department, never told the brokers, and continued to sell the products.	When the pre-2003 trust offerings and later the 2006 and subsequent offerings were unable to pay interest on the Notes, Smith and McGinn hid this information from the brokers.
Brookstreet's brokers considered the compliance department personnel to be active in overseeing the brokers and the clients.	MS & Co. brokers believed in the quality and expertise of the due diligence team that vetted the MS & Co. offerings.
Brookstreet's brokers knew that Brookstreet was a regulated industry and understood that the firm received extensive oversight by the SEC, NASD/FINRA and the internal compliance department.	MS & Co. brokers were aware that the SEC and NASD/FINRA had conducted investigations of MS & Co., but were unaware that any wrongdoing was discovered in those examinations, because no fraud was discovered in those investigations.
Finally, that the SEC brought the case against the brokers (Brookstreet became defunct) on the theory that the individual brokers should have unearthed the wrongdoing hidden by their superiors.	The SEC brought the case against the brokers on the theory that they should have discovered the fraud that was so carefully hidden from them by their superiors.

While finding that the two principals who concocted and ran the CMO investment platform, the court dismissed all of the SEC's claims against the five brokers who sold the product, finding that they lacked the *scienter* to have violated the securities laws. The Court held as follows:

> "[T]he evidence does not lead to the conclusion that Gagliardi, Kautz, McDann, Rubin or Shrago (hereinafter, "the Brokers") either knew, or it was so obvious that they must have known, that Program CMOs were inappropriately risky and complex for investor who had preservation of capital as their main objective. The Commission offered insufficient evidence to demonstrate the level of culpability for *scienter* or severe recklessness as to these five defendants."
>
> "There is an abundance of evidence that it was not unreasonable for Defendants to rely upon the expertise of Brookstreet, which at the time was a large, national firm. Brookstreet had a centralized, fully staffed and active legal and compliance department. . . . Prior to Brookstreet's unexpected collapse in June of 2007, Defendants reasonably relied upon Brookstreet's renowned "expert" CMO Portfolio Manager Popper, along with his 'portfolio management team' to properly manage the CMO accounts."
>
> "Everything Defendants knew about the CMO program they learned at Brookstreet conferences, as well as . . . informational marketing materials . . . ."
>
> "The court does not doubt that [the brokers] sincerely believed that what they were being told regarding the CMO Program, and in particular, that it was suitable for Brookstreet's retail clients. . e . [The brokers] further understood that the CMO Program was being

closely monitored by the firm's compliance and legal department, and that it had also been thoroughly investigated by the Commission without incident, and had also passed multiple compliance examinations from 2004 through 2007 conducted by Commission and FINRA examiners. As a result [the brokers] reasonably believed that the CMO Program complied with all applicable securities laws, rules and regulations and was suitable for Brookstreet's retail clients."

"It was not so obvious that Popper was a master shyster that Defendants must have known he was a fraud because for a period of approximately three years . . . the Program performed as predicted."

"In light of all of the above, it was not an extreme departure from the standards of ordinary car for [the brokers] to recommend investing in the program. . . .[The brokers] did not knowingly or intentionally make misrepresentations or omissions of a material fact to an investor or prospective investor in the CMP Program. And all red flags were consistently and logically explained away by Popper and his team, with the support of the Compliance Department. . . . [The brokers' recommendations to invest in the CMO Program were made in good faith and they had a reasonable basis to make those recommendations when made."

It is submitted that, as in *SEC v. Betta, et al,* the Commission has sought to lay the blame on the brokers for not discovering the fraud perpetrated and hidden from them by Smith and McGinn, when in fact the Commission and NASD/FINRA, who had much greater tools, also failed to discover the fraud until it was much too late.

WHEREFORE, Chiappone respectfully requests that the Commission grant the petition and examine the record. The factors for granting review under Rule 411 (a)(2) are satisfied in this matter, as the ALJ committed prejudicial error in (i) the application of *Hanley* to this situation, (ii) hearing and relying upon evidence of activities beyond the 5-year statute of limitations, (iii) imposing a 12-month suspension and cease and desist order, (iv) ordering disgorgement of commissions earned more than five years distant from the filing of the OIP, (v) imposing third tier penalties, and (vi) most importantly, premising liability and punishing brokers who played no role in the fraudulent conduct, and had no knowledge of the underlying fraud until the FBI closed down MS & Co. These sanctions were levied despite evidence that Mr. Chiappone, who has over eight years of service with his current broker-dealer, has never sold a

private placement or had any other regulatory issues with FINRA, the SEC or any other regulatory body.

ORAL ARGUMENT REQUESTED

Dated: April 18, 2018

Tuczinski, Gilchrist, Cavalier & Tingley, P.C.

By: _____

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CERTIFICATE OF SERVICE

I, Roland M. Cavalier, hereby certify that on this 18th day of April, 2018, I served a true and complete copy of Respondent Frank H. Chiappone's Petition For Review upon the following parties in this action as follows:

By Facsimile and One Manually Executed Original to:

Securities and Exchange Commission
Office of the Secretary
U.S. Securities and Exchange Commission
100 F. Street, NE
Mail Stop 1090
Washington, D.C. 20549
Facsimile (202) 772-9324

One (1) copy via Federal Express and Electronic Mail to:

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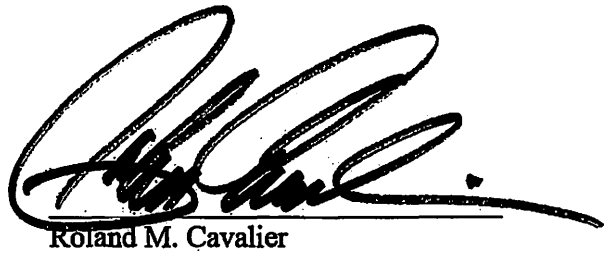
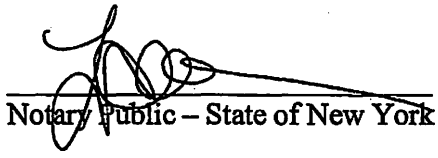


Roland M. Cavalier

Sworn to before me this
18th day of April, 2018



Notary Public – State of New York

LINDSEY A. MEYER
Notary Public, State of New York
No. 01ME6936544
Qualified In Rensselaer County
Commission Expires 02/08/20