HARD COPY

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.

INDIVIDUAL SUR-REPLY BRIEF TO THE COMMISSIONERS OF THE SECURITIES & EXCHANGE COMMISSION, ON BEHALF OF RESPONDENT FRANK CHIAPPONE, IN ACCORDANCE WITH THE COMMISSION'S ORDER

DATED: JUNE 14, 2018

Respectfully submitted:

O'CONNELL & ARONOWITZ
ROLAND M. CAVALIER
ATTORNEY FOR RESPONDENT FRANK CHIAPPONE
54 STATE STREET
ALBANY, NEW YORK 12207
518-462-5601

Table of Contents

TABLE OF AUTHORITIES

Cases

Statutes

PRELIMINARY STATEMENT

Consistent with past briefs filed by Mr. Chiappone and other Respondents, Mr. Chiappone incorporates in this brief the arguments made by other Respondents in their individual briefs and petitions for review, including supplemental briefs authorized by the Commission's Supplemental Briefing Order and Order Granting Request To File Supplemental Response Briefs, except to the extent that any argument pertains only to the specific Respondent filing such brief. Without limitation, Chiappone adopts the arguments made by other Respondents concerning the ALJ ratifying almost all of her findings in the Initial Decision, and the argument that the removal restrictions violate the constitution.

As instructed by the Commission, Chiappone will not repeat arguments made in briefs previously filed with the Commission or ALJ, except to counter arguments made by the Division in its Supplemental Reply Brief ("Reply Brief") recently filed.

ARGUMENT

1. The So-Called "Fraudulent Securities."

Throughout its Reply Brief, the Division refers to securities sold by Respondents as "fraudulent securities." In fact, the securities were legitimate debt instruments designed to pay interest to investors and return principal upon maturity. While investors did lose considerable money on some McGinn Smith & Co. ("MS&CO") private placement securities, there was no evidence that the losses were caused by any wrongful acts on the part of Mr. Chiappone. The losses were caused in their entirely by the fraudulent conduct of Messrs. McGinn and Smith, who – when losses on certain offerings were unable to repay customers in full, chose to prop up failing offerings by paying those investors with monies from later investors, thereby transforming a

legitimate brokerage firm into a Ponzi scheme. In short, the losses were not caused by inherent fault in the offered securities, or sales procedures; it was the post-sale actions of McGinn and Smith in continuing to use customer monies from other deals to support failing offerings. In her Initial Decision (hereinafter "ID") the ALJ noted that the Division's own forensic accountant (Kerri Palen) testified she "had no reason to believe that Respondents were aware of McGinn and Smith's fraud. See, Tr. 5494,5662 and IDp.4

While the Division notes that the securities were unregistered, it fails to note that all offerings were made pursuant to Reg. D, which provides a safe harbor for the sale of private placements. While some offerings did have more than 35 unaccredited investors, Chiappone had no knowledge of this, as sales were made from several offices, and the records were kept by Smith, who never told the brokers that the number of unaccredited investors exceeded Reg. D limits.

2. Allegations that Chiappone Misrepresented and Omitted Material Facts.

It is beyond question that to support a claim for breach of the duty to investigate under *Hanly,* there must be evidence of false statements or omissions to state key facts. There was no evidence that Chiappone misrepresented or omitted to state material facts. The Division ignored or downplayed testimony that Chiappone attended meetings where the due diligence team informed brokers of the nature of the offerings, assets being acquired and other details of each of the Trust Offerings, such as the diversification of the assets acquired and sufficiency of the income stream (known as "Recurring Monthly Revenues" or "RMR)"[1] The Division ignores that all Chiappone customers were first provided with Private Placement Memorandums (PPM's) and

[1] Chiappone testimony, Transcript (Tr) pp 5441:16-18; Rabinowich testimony, Tr.1981:lines12-24.

completed investor questionnaires that confirmed their financial status and ability to assume the risks of private offerings. The Division states no facts that support the claim that material information was withheld or that false statements were made. In fact, one Division witness (Bruce Becker) testified that Chiappone was an honest broker, and he continued to do business with Chiappone after MS&Co. was shut down by federal authorities.[2] The Division cites no testimony as to a specific situation in which Chiappone ever mislead an investor.

Mr. Ardizzone, another Division witness, originally said he thought his purchases of Four Funds offerings were alarm deals, similar to the successful pre-2003 trust offerings (Tr.2796-2797), when in fact he purchased Four Funds, which were blind pools (see Initial Decision [herinafter "ID"] at p.16). However, Chiappone testified that he specifically discussed the blind pool feature of the Four Funds offerings,[3] and upon cross-examination, Ardizzone admitted: (1) Chiappone never told him any Four Funds offerings he bought were alarm deals, (2) documents show that he purchased Four Funds offerings, and (3) he was an accredited investor.[4] As Becker never accused Chiappone of any misstatements or omissions, and Ardizzone admitted Chiappone never told him the Four Funds were similar to the successful Alarm deals, there is no evidence on the record that Chiappone mislead any investors.

3. Chiappone Had The Right to Rely on MS&Co.'s Due Diligence Team.

The ALJ's ID notes that Chiappone attended meetings in which the key features of the MS&Co. offerings were discussed with the brokers:

> "Whenever MS&Co. had a new offering, it would convene sales meetings at which Smith, for the Four Funds, or McGinn, for the Trust Offerings, would explain to

---

[2] Becker testimony, at Tr pp 2946:19-20.
[3] Chiappone testimony,Tr.pp.5485-5486.
[4] Details of Ardizzone's testimony on these matters at Tr.pp.2796-2802.

registered representatives in generalities the types of investments that would be made and the terms and risks of the offering (Tr.5425-26). *Items discussed included the fact that alarm contract were diversified into more than one zip code, and that UCC-1s were put in place to protect collateral, price discounts for the contracts [purchased for the offering], debt servicing and cash flows* Tr.5422-26,5441,5450-52,5457. Registered representatives were allowed to ask questions. Tr.5426-27. . . . Chiappone believes the PPMs for the Trust offerings described the assets in the offerings. Tr.5441." (emphasis supplied).

...

"Chiappone believed private placements made sense for investors who had other investments, would be able to withstand losses and were looking for high-yield alternatives to equities. Tr.5437-38. Chiappone never recommended that a client's entire portfolio be invested in private placements. Tr.5438." (ID, p.12.)

In his brief to ALJ Murray, he noted that that Trust Offerings were vetted by Ms&Co.'s due diligence team (Chiappone 2014 Brief, pp.4,6-8). An excerpt from that brief follows:

"When Tim McGinn left MS&Co. in 2003 to form and operate Integrated Alarm Service Group ("IASG"), most of the due diligence team went with him, where they continued to work on the purchase of alarm company recurring monthly revenues.[5] ... All of the investors in deals that were rolled up into IASG were paid in full. ... [W]hen McGinn returned to MS&Co. in April or May of 2006, the due diligence team came back with him.[6] This included key team members Brian Shea and Doug Keenholtz.[7] That team conducted work on the alarm and triple play offerings ("Trust Offerings") that took place in late 2006 and thereafter, and the quality of that due diligence was similar to that done on the pre-2003 alarm deals."[8]

Even the ALJ noted that personnel hired for the due diligence team were "people experienced in doing due diligence on alarm contracts." (ID p.17). This is consistent with Chiappone's belief that he had the right to rely on information provided by company personnel whose job it was to vet the subsequent Trust Offerings.

---

[5] Cody Testimony, Tr.p.4557.
[6] Chiappone testimony, Tr. pp. 5430–5431, 5447 – 5448 and 5568.
[7] Chiappone testimony, Tr. pp.5447–5448. Ms. Cody did not return to MS & Co. in 2006, having divorced Tim McGinn for reasons unrelated to conduct resulting in his conviction (Tr.p.4558).
[8] Chiappone testimony, Tr.pp.5431–5432.

In summary, Chiappone did take time to know the features and risks of Trust Offerings he sold, and he made independent determinations whether a given offering was suitable for a particular client. This is further shown by the fact that less than one in five (about 19%) of his customers were ever sold a private placement.[9]

4. ALJ Erred in Finding Chiappone Has *Scienter* to Violate Laws.

The ALJ held that "Selling Respondents [which includes Chiappone] willfully violated Securities Act Section 5(a) and (c) with respect to the Four Funds" (ID.p.95). As previously noted, Chiappone never sold a Four Funds product within the five-year limitation period. See Div. Ex. 002, part 4c, showing his last Four Funds Sale on 7/7/2008, over two months before the OIP dated 9/23/2013).

The ALJ also based her finding of *scienter* on Chiappone's allegedly "acting at least negligently ... obtained money by means of untrue material statements, i.e., his recommendation of these private placements ...." Classifying such action as "reckless."[10] She found he "willfully violated Securities Act sections 17(a)(2) and (a)(3) (ID.p.100). However, she never accused him of any actual intent to deceive.

Her *scienter* findings were based solely on sales to Ardizzone and Becker, as no other witness testified that Chiappone mislead them via any statement or omissions to state key facts. She found *scienter* in his recommendation to Ardizzone of FIEN and TAIN (Four Funds products), notwithstanding that (1) he sold no Four Funds within the limitation period, (2) Ardizzone admitted on cross that Chiappone never told him Four Funds notes were similar to alarm deals, and (3) Ardizzone testified that he didn't read the PPM's in full. Further, she noted

[9] Chiappone post-hearing brief to ALJ, p.9, Chiappone testimony,Tr.pp.5441-5443.
[10] ID,at 100.

that Chiappone recommended Fortress (Trust Offering) to Ardizzone after his email to Smith accusing Smith of mismanaging the Four Funds (ID.p.100). She thereby conflates the Four Funds with the Trust Offerings, even though they are entirely different products. The Four Funds were high risk blind pools; the Trust Offerings involved triple play contracts [TV, Internet & phone service], supported by Recurring Monthly Revenues ("RMR." In fact, both Respondent's Expert Witness (Mr. Tilkin) and Division's expert witness (Mr. Lowry), stated the alarm deals, (which provided RMR) were completely unlike the Four Funds, which were blind pools.[11] The Division conceded this in its proposed Findings of Fact, stating: "The Four Funds Had a Totally Different Mandate than the Pre-2003 Trust Offerings.[12]

Becker testified that he only invested in RMR deals [e.g., no Four Funds] (TR.2899-2900) and he received and read the PPM's on all deals with Chiappone (Tr.2904) stating at some point he only read parts of the PPM's because "I had done this several times through the years and it was always exactly as it was sold to me. And the checks came when they were supposed to come and I understood it ....." Becker also testified all MS&Co. offerings he purchased were less than 5% of his net worth (Tr.2936), and that he still did business with Chiappone and considered him to be an honest broker (Tr.2946).

No other witnesses testified that Chiappone ever made a misrepresentation or omitted to state a material fact in connection with the sale of a security.

To the extent the ALJ finds *scienter* from Chiappone's Four Funds sales, her findings must be reversed. No other evidence supports a finding of *scienter*. Moreover, Chiappone did have a reasonable basis for selling the Trust Offerings, being the success of pre-2003 Trust Offerings with

[11] Lowry Report, Div Ex.001
[12] Div. Proposed Findings of Fact,p.32,¶A to Point VIII.

all of his clients having been paid in full. It was only after the arrest and conviction of McGinn and Smith that he learned that his clients had been paid with funds from later investors.

5. ALJ's Ratification is Invalid.

ALJ's Ratification Order is intended to cure her lack of authority in conducting the hearings and rendering the Initial Decision. Chiappone argues that the Ratification Order in a nullity for two reasons:

(1) Even if ratification is permissible, it only applies to conduct that occurred within five years of the date of Ratification. Ratification occurred on March 30, 2018, more than five years from the date of Chiappone's last sale on November 3, 2009 (i.e., 20 months from the last sale).

(2) By reason of Administrative Procedure Act §706, the Commission shall "hold unlawful and set aside agency action, findings, and conclusions found to be not in accordance with the law." Since her acts were all not in accordance with the law prior to the attempted ratification, we submit that the Commission should give no credence to her ratification.

6. Other Misstatements in the Division's Reply Brief.

(1) The Division states that "a broker is under a duty to investigate the truth of his representations to clients, because by his position he implicitly represents that he has an adequate basis for the opinions he renders" (Reply Brief at 12). While this statement is true, no witness testified that he/she was misled by Chiappone, and it is beyond question that (i) the investigation of all Trust Offerings was conducted by the MS&Co. due diligence team, and (ii) all Chiappone clients received PPM's and Investor Questionnaires.

(2) Quoting from *Matter of Bernard E. Young* (Reply Brief p.12), the Division notes that this case involved a broker who relied on a letter from the compliance staff and was found

wanting due to presence of "red flags." The facts in the Young case are dissimilar to the facts in this matter. First, Young was a senior executive who incentivized brokers to sell the Certificates of Deposit (CD's), whereas there is no evidence that Chiappone ever encouraged other brokers to sell the product. The court held that Young had ignored red flags; whereas the ALJ did not find that Chiappone ignored any red flags. Young approved false and misleading assurances despite "red flags" about the CD's, whereas there was not a shred of evidence that Chiappone ever made a false and misleading statement to customers. While the CD's were sold to customers based on extensive marketing materials, the Trust Offerings sold by Chiappone provided Private Placement Memorandums (PPMs) that clearly disclosed the risks inherent in the Trust Offerings. The PPM's (along with some Investor Questionnaires and Subscription Agreements) were all put in evidence by the Division.[13] as Division Exhibits, and a review of those PPM's will show that there are no "pie in the sky" statements touting large gains in value, such as were found in *Hanly*[14] and *SEC in re Young,* above. While Chiappone did have access to marketing materials (see, for example Div. Ex. 430) he did not make representations of instant and substantial returns, as was the case in the vast majority of cases involving broker misconduct, including *Young, Hanly* and the many cases citing to *Hanly.* No witness accused Chiappone of making a false or misleading statement as to the merits of any Trust Offering, and only the Trust Offerings were sold by Chiappone within the five year period of limitations.

(3) Division claims the recent *Betta* case[15] cited by Chiappone was of no import, because *Betta* involved in sale of Collateralized Mortgage Obligations issued by legitimate issuers (Fannie Mae, Ginny Mae & Freddie Mac) and were sold by Brookfield, a national brokerage firm.

---

[13] Samples of the PPM's can be found at Division Exhibits 5-14, 27-28, 59-61,63, 68-69,73,172, 264-269, 434, 438-441, 461,463,465 (among others).

[14] See *Hanly v. Securities and Exchange Commission,* 415F2d589 (2d Cir. 1969).

[15] *Betta v. SEC,* 2018 US Dist. LEXIS 55909.

However, the Division ignores the fact that CMO's, which were sold by major brokerage firms, were the leading cause of the horrendous market crash that took down several major financial institutions, some of which no longer exist. The fact that the broker (Brookstreet) in *Betta* was bigger than MS & Co. is of no significance. Their statement that MS&Co. had only two offices is incorrect – there were offices in Albany, Clifton Park, NY City and King of Prussia, PA (ID p.4) and at times one in Texas.

The Division further downplays *Betta* by stating "[t]he *Betta* court found that the CMO program was 'closely monitored by the firm's compliance and legal department . . . while there is no evidence that MS&Co's understaffed compliance and legal department monitored the McGinn Smith Securities to the extent that Brookstreet's compliance and legal departments monitored the CMOs" (Reply Brief p.13.). The Division supplies no basis for its attempts to discredit *Betta* as different from this case, when in fact it is strikingly similar. Its' statement that the CMO's were superior and less risky to MS&Co. private placements is just plain false. If that was the case, why did the Court in *Betta* state "Between 2004 and 2007, "*Brookstreet invested clients' funds in risky types of CMOs that were not at all guaranteed by the United States government and were only suitable for sophisticated investors with a high-risk investment profile. These risky CMOs were sold to some clients who were relatively unsophisticated and had a conservative, rather than a high risk, profile*" (*Betta*, Findings & Conclusions at p. 5[emphasis supplied]).

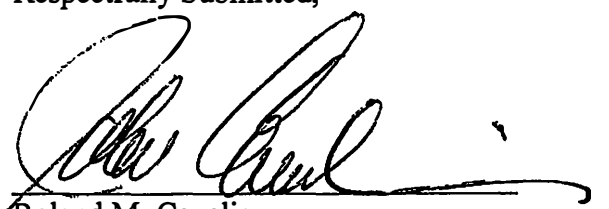
Likewise, the allegation that the McGinn Smith compliance and legal departments were "understaffed" is a statement made with absolutely no basis in fact, as evidenced by the Division's failure to cite any testimony or other evidence that this was in fact the case as to the Trust Offerings. While some due diligence personnel went with McGinn to his new company IASG,

and some stayed with Smith to vet the Four Funds offerings, Chiappone never sold a single Four Funds offering during the five-year period prior to filing of the OIP.

Finally, the Division claims that the *Betta* decision was based in part on the absence of red flags, calling attention to Chiappone's email to Smith accusing him of mismanaging Four Funds assets.[16] Again, the ALJ did not find that Chiappone violated any red flags as to the trust offerings, and he sold no Four Funds within five years prior to filing of the OIP. The Division's constant reference to the Four Funds, at least as applied to Chiappone, is completely irrelevant. It further ignores that once Chiappone learned that the Four Funds were unable to pay interest in full, he immediately stopped selling Four Funds offerings.[17]

Dated: June 14, 2018
Albany, New York

Respectfully Submitted,



Roland M. Cavalier
O'Connell & Aronowitz
54 State Street
Albany, New York 12207
518-462-5601
rcavalier@oalaw.com

[16] Division Reply Brief, p. 13.
[17] See, Chiappone testimony, Tr. Pp. 2639:13-25.

CERTIFICATE OF SERVICE

I, Roland M. Cavalier, hereby certify that on this 14th, day of June, 2018, I served a true and complete copy of Respondent Frank H. Chiappone's Individual Brief to the Commissioners, upon the following parties in this action as follows:

Original and three (3) copies via Federal Express and one (1) copy via Facsimile Transmission to:

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

Also:

One (1) copy via U.S. First Class Mail and Electronic Mail to:

David Stoelting & Haimavathi V. Marlier
Securities & Exchange Commission
Division of Enforcement
200 Vesey Street – Suite 400
New York, NY 10281-1022
stoeltingd@sec.gov
marlierh@sec.gov

Courtesy Copies via Electronic Mail to:

M. William Munno, Esq
Sewell & Kissell, LLP
One Battery Park Plaza
New York, NY 10004
munno@sewkis.com

Gilbert Abramson, Esq.
Gilbert B. Abramson & Associates
111 Presidential Boulevard, Suite 228
Bala Cynwyd, PA 19004
gabramson@gbalaw.com

Mark J. Astarita, Esq.
Salah Astarita & Cox, LLC
60 Pompton Avenue
Verona, NJ 07044
mja@sallahlaw.com

Matthew G. Nielsen, Esq.
Stanton, LLP
9400 North Central Expressway, Suite 1304
Dallas, TX 75231
mnielson@stantonllp.com

Roland M. Cavalier

Sworn to before me this 14
Day of June, 2018:

Notary Public – State of New York

BETH A. HUNTER BOEHLKE
Notary Public, State of New York
Registration No. 01HU6323358
Qualified in Rensselaer County
Commission Expires April 20, 2019

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.

ATTORNEY'S CERTIFICATION REGARDING PAGE REQUIREMENTS

ROLAND M. CAVALIER, states under oath that he is the attorney for Respondent Frank Chiappone in this matter and that he was the person primarily responsible for this individual Brief being submitted on behalf of Mr. Chiappone. According to the electronic word count obtained from the Microsoft Word program upon which the Brief was prepared, the Brief contains less than 3,000 words, excluding cover page, table of contents and table of authorities.

Date: June 14, 2018

O'CONNELL & ARONOWITZ

By:

ROLAND M. CAVALIER