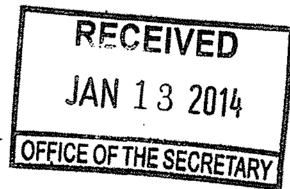

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15514

In the Matter of **DONALD J. ANTHONY, JR., et al.,** **Respondents.**	**MOTION OF RESPONDENT WILLIAM F. LEX FOR LEAVE TO FILE MOTION FOR SUMMARY DISPOSITION**

Respondent William F. Lex respectfully moves, pursuant to Rule 250 of the Commission's Rules of Practice, for leave to file the attached motion for summary disposition prior to the hearing in this matter.

As detailed in the attached motion, a controlling federal statute (28 U.S.C. § 2462) unambiguously prohibits the hearing in this matter from being "entertained" at all, based on the facts and legal theories articulated by the Division of Enforcement in the Order Instituting Proceeding. Moreover, the Supreme Court *unanimously* held less than a year ago (in *Gabelli v. SEC*) that the very same statute means exactly what it says and may not be ignored or relaxed to avoid its consequences. In any event, as further detailed in the motion, several of the Division's predominant legal theories are fatally flawed and futile as a matter of law, and thus any hearing that might lawfully be entertained should be dramatically curtailed to reduce the cost, burden, and complexity of a proceeding (including the four-year underlying investigation) that has already put an enormous financial strain on many of the respondents.

We respectfully urge that the motion be considered and decided before any hearing is commenced, because the primary point of the motion is that entertaining the hearing at all would exceed the lawful power and jurisdiction that Congress has bestowed on the tribunal. In any event, resolution of the motion will serve the interests of fairness and significantly reduce the cost, burden, and complexity of the hearing and any resulting proceedings before the Commission and the federal courts. Deferring consideration of the motion until after completion of the Division's case in chief would largely defeat its purpose and deprive Respondent Lex of his right to be protected against having to devote the time and considerable expense to defending a form of punitive law enforcement proceeding that Congress has explicitly said "shall not be entertained."

Dated: January 10, 2014

Respectfully submitted,

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MOTION OF RESPONDENT WILLIAM F. LEX FOR SUMMARY DISPOSITION

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PRELIMINARY STATEMENT

Respondent William F. Lex respectfully moves for summary disposition pursuant to Rule 250 of the Commission's Rules of Practice. First and foremost, a controlling federal statute *explicitly* and *unambiguously* dictates that this proceeding – under the facts and legal theories articulated by the Division itself in the Order Instituting Proceedings ("OIP") – "*shall not be entertained.*" That controlling statute, 28 U.S.C. § 2462, allows no discretion to "entertain" this proceeding and then, after modest fortunes are spent litigating the case and all the dust settles, picking and choosing among the facts and remedies that could lawfully have been considered. The clear intent of the statute is to deprive federal agencies and courts of the jurisdiction and power even to "entertain" a proceeding like this one at all.

Second, even if fragments of this proceeding could lawfully be entertained, the case should be dramatically curtailed through summary disposition – *before the hearing* – to reduce the burden, complexity, and costs of litigating facts and legal theories that cannot possibly prevail or support the sanctions demanded. For example, the Division presumably concedes that events and transactions prior to September 23, 2008 (i.e., the day five years before the OIP was issued) may not be considered for purposes of imposing any industry bars or civil penalties, but the Division appears to think that such ancient events and transactions *can* support the staggering forfeiture of a decade's worth of brokerage commissions. The Division is wrong – among other reasons, because § 2462 explicitly deprives the Commission and courts of jurisdiction to entertain "forfeiture" proceedings just as much as it does "penalty" proceedings. Thus, even if this case were somehow permitted to proceed to a hearing in defiance of § 2462, it should be strictly limited to events and transactions that occurred after September 23, 2008, thereby

dramatically reducing the duration, complexity, and cost of the proceeding, as well as its dependence upon faded memories purporting to reach back as far as eleven years ago.

Finally, any hearing should be streamlined to eliminate most of the Division's substantive legal theories as well. In particular, the Division's principal legal theories under section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and section 5 of the Securities Act of 1933 (the "Securities Act") are fatally flawed and futile, and thus they should be summarily excised from the case to avoid unnecessary duration, complexity, and cost.

ARGUMENT

I. FEDERAL LAW PROHIBITS THIS "PROCEEDING" FROM BEING "ENTERTAINED."

The principal point of this motion is very straightforward, because the controlling federal statute is so exceptionally unambiguous and because the Supreme Court – in a *unanimous* opinion just last year – unequivocally said the statute must be interpreted and applied in accordance with its plain meaning. The controlling statute, 28 U.S.C. § 2462, provides in relevant part:

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

The instant "proceeding" unquestionably seeks civil penalties and forfeitures.[1] Under the plain language of section 2462, therefore, it "*shall not be entertained*" unless it was commenced less than five years after the date when the asserted claims "*first accrued.*" Because the claims articulated in the OIP unquestionably first accrued more than five years before this proceeding

[1] The penalties sought include statutory monetary penalties, industry sanctions, and purported "disgorgement." As discussed below, the kind of "disgorgement" sought here not only is punitive, but also would constitute a "forfeiture" within the plain meaning and intent of section 2462.

was commenced on September 23, 2013, section 2462 flatly prohibits this "proceeding" from being "entertained" at all.

The OIP asserts three claims: (1) the offer and sale of unregistered securities in violation of Sections 5(a) and 5(c) of the Securities Act; (2) fraud in violation of Securities Act Section 17(a), Exchange Act Section 10(b), and Exchange Act Rule 10b-5; and, as to Respondent Guzzetti only, (3) failure to supervise. OIP ¶¶ 20 and 66-68. Under the facts and theories articulated by the Division, each of these three claims, to the extent viable at all, "*first* accrued" far more than five years before this proceeding was commenced – and likely about a decade before.

The OIP couldn't be clearer in this regard. Beyond a bare-bones listing of the so-called "Trust" offerings in paragraphs 16 and 31, literally every specific date assigned by the OIP to purported wrongdoing or "red flags" is well before September 2008. *See* OIP ¶¶ 15 and 22 ("Four Funds" offerings occurred between 2003 and 2005); ¶ 28 (Smith began "diverting" money in September 2003 to pay "pre-2003 investors"); ¶ 38 fn.3 (letter written in 2000(!) with reference to "pre-2003 offerings"); ¶ 40 (lack of available information from "September 2003 until January 2008"); ¶¶ 43-45 ("Redemption Policy" instituted "[b]y 2006" and known to respondents "at different times beginning in late 2006"); ¶ 46 (allegedly ominous meeting held "[o]n January 8, 2008"); ¶ 51 (trust offerings that occurred in May 2007 and October 2007 and a related bankruptcy filing in January 2008);[2] ¶ 63 (email sent in February 2006); and ¶ 64 (knowledge of the "Redemption Policy by December 2006" and receipt of an email "[i]n November 2007").

[2] Paragraph 51 does mention one date in late September 2009, but this date is irrelevant to any claim against Mr. Lex because, as the Staff presumably concedes, Mr. Lex had stopped selling any of the relevant securities at least two months before then.

Moreover, the Division has candidly admitted that these time-barred "red flags" are the *only* "red flags" upon which it intends to rely in proving its case. In successfully defeating the respondents' motions for a more definite statement, the Division made the following representation:

> [Respondents] complain that they are uncertain whether there are red flags other than the ones identified in the OIP. The OIP, however, should not be read to suggest that there is some category of unnamed and undisclosed red flags. The red flags discussed in the OIP are the red flags that will be presented at trial…."

Division Mem. in Opp. To Motions for More Definite Statement (filed Nov. 25, 2013), at 7.

Given the Division's nearly exclusive citation to offerings, sales, events, and "red flags" that occurred well before September 2008, it is indisputable that the Division's three claims *first* accrued – and were fully chargeable as violations of the relevant securities law provisions – at least as far back as the various so-called "Four Funds" offerings during the period 2003 through 2005. For example, assuming the Division's legal theories are sound and its facts are correct, there was a viable and chargeable section 5 claim as soon the first of the Four Funds offerings was sold because that offering, no less than the ones that followed, was not registered with the SEC and no exemption was available. By its own articulated theory of the case, the Division likewise had a viable fraud charge at that point under Securities Act section 17(a) and Exchange Act section 10(b) because the respondents' alleged failure to conduct a "searching" due diligence investigation any of the Four Fund offerings, in the Division's hindsight view, constituted securities fraud. According to the Division's plainly articulated theory, therefore, all of the offerings were tainted in the exact same way, such that a viable claim *first* accrued and was fully chargeable with the very first offering more than a decade ago. As such, this entire proceeding is barred by the plain language of section 2462.

In fact, under the Division's own theory, it is not just the dispositive *first* sale from the *first* of the Four Fund offerings that resulted in a first accrual of each of the claims asserted in the OIP, thus precluding entertainment of this proceeding. *Every sale* from *every one* of the Four Funds offerings occurred prior to September 23, 2008, rendering it absurd (and illegal under section 2462) for the Division to seek penalties and forfeitures against Mr. Lex and the other respondents for anything having to do with those ancient Four Fund offerings. And this is especially important because nearly all of the purported "red flags" articulated by the Division in the OIP (itemized above) relate solely to those ancient Four Fund offerings, *not* to any of the subsequent Trust offerings. In fact, even a large portion of the subsequent Trust offerings took place before September 2008, so under the Division's own theory – even if the staleness of the Four Fund offerings were completely overlooked, and even if only the Trust offerings were considered – the Division's three asserted claims *still* "first accrued" before September 2008.

In its recent decision in *Gabelli v. SEC*, the Supreme Court unanimously held that a claim "accrues" within the meaning of section 2462 "when it comes into existence" – that is, "when the plaintiff has a complete and present cause of action." 133 S. Ct. 1216, 1220-21 (2013) (citations omitted). It obviously follows that where a claim allegedly accrues on multiple occasions, it *first* accrues for purposes of § 2462 "when it [*first*] comes into existence" or when a plaintiff [*first*] has a complete and present cause of action." In such circumstances, the claim cannot plausibly "*first* accrue" on more than one occasion. Under any plausible reading of the statute, even a claim that further develops after its initial accrual (which might increase the magnitude of potential penalties available against the violator) most certainly would not "*first* accrue" upon any of the subsequent developments. Here, there is no serious question that – at least according

to the Division's theory and facts as articulated in the OIP – each of the Division's three purported claims "first accrued" long before September 2008.

To be sure, before *Gabelli* the SEC had loosely interpreted section 2462 in a number of respects, most notably by inferring the unwritten "discovery rule" that *Gabelli* unanimously rejected. A similarly loose SEC construction has occasionally defied the plain text of section 2462 by allowing "proceedings" for enforcement penalties to be "entertained" even when the asserted claims "first accrued" *more* than five years before commencement of the proceeding – and by allowing time-barred "conduct" to be "considered" but only for limited purposes in the proceeding – so long as the time-barred "conduct" wasn't "considered" when calculating the *amount* of any penalty ultimately imposed. *See, e.g., Gregory O. Trautman*, Exchange Act Release No. 61167, 97 SEC Docket 23492, 23525-26 (Dec. 15, 2009) (citing prior Commission opinions).

That loose reading of the statute is no longer plausible after *Gabelli*. The Supreme Court was crystal clear that section 2462 means what it says, and that neither the Commission nor the courts may even expand upon it to fill perceived gaps, much less engage in the kind of wholesale rewriting of the statute required to allow a proceeding seeking penalties to be "entertained" based on claims that first accrued a decade before the proceeding was commenced. As relevant here, section 2462 unambiguously says that a "*proceeding*" seeking a penalty "*shall not be entertained*" unless the asserted claims "*first accrued*" less than five years before the proceeding was commenced. The pre-*Gabelli* approach exemplified by *Trautman* essentially required the Commission to engaged in three steps of logomachy: First, invert the phrase "shall *not* be entertained" and pretend that it reads "*may* be entertained;" second, rewrite the phrase "unless the claim" and pretend that it reads "so long as any conduct alleged in support of the claim;" and

third, change the phrase "*first* accrued" and pretend that it reads "*last* accrued." We respectfully submit that this wholesale rewrite of the statute is far less plausible than the "discovery rule" the Commission urged in *Gabelli*, and it would suffer an equally grim fate before the Supreme Court. Indeed, we doubt the Commission would risk its credibility with the Court by even arguing the point after *Gabelli*.

Even without the force of the Supreme Court's unanimous *Gabelli* decision interpreting the very statute that applies here, section 2462 is no ordinary statute of limitations. It is uniquely worded in a way that does not merely allow a plaintiff to assert a claim within a prescribed period of time, with the defendant then obliged to raise and prove untimeliness as an affirmative defense. It is an explicit deprivation of the relevant tribunal's jurisdiction and lawful power to act – i.e., to "entertain" the "proceeding" at all – "unless" the conditions set forth in the statute for the exception are met. Because those conditions are not met here, the statute plainly forbids entertainment of the proceeding.

We have found only one other federal statute that contains the same "shall not be entertained" prohibition followed by a "savings clause" that provides an exception to the prohibition if, but only if, certain statutory conditions are met. That statute is 28 U.S.C. § 2255, which limits certain federal habeas corpus relief available under 28 U.S.C. § 2241, and federal courts have left no doubt that this type of statutory locution reflects an explicit legislative intention to deprive the tribunal of subject matter jurisdiction and the lawful power to act unless the "savings clause" applies. The Eleventh Circuit recently articulated this point at length in *Williams v. Warden*, 713 F.3d 1332, 1337-40 (11th Cir. 2013), explaining its reasons for joining with "the great weight of authority" in holding that "the savings clause is jurisdictional in nature."

> The savings clause [of § 2255] states that a § 2241 habeas petition "shall not be entertained...unless it...appears that the remedy by motion is inadequate or ineffective to test the legality of the detention." Based on the text alone, which speaks in imperative terms of what class of cases the district court has the power to hear, not what the petitioner himself must allege or prove in order to state a claim, we are compelled to conclude that the savings clause is a limitation on jurisdiction. It commands the district court not to "entertain[]" a § 2241 petition that raises a claim ordinarily cognizable...except in the exceptional circumstance where the petitioner's first motion was "inadequate" or "ineffective" to test his claim. The provision does everything but use the term "jurisdiction" itself, and there is no magic in that word that renders its use necessary for courts to find a statutory limitation jurisdictional in nature. As we have explained before, "[a] jurisdictional defect is one that strips the court of its power to act and makes its judgment void. *A plain reading of the phrase "shall not entertain" yields the conclusion that Congress stripped the court of subject-matter jurisdiction – in these circumstances unless the savings clause applies.*

Id. at 1338-39 (emphasis added; citations omitted; first two ellipses in original). *Accord Abernathy v. Wandes*, 713 F.3d 538, 557-558 (10th Cir. 1013); *Rice v. Rivera*, 617 F.3d 802, 807 (4th Cir. 2010); *Harrison v. Ollison*, 519 F.3d 952, 961 (9th Cir.), *cert. denied*, 555 U.S. 911 (2008).

Likewise here, Congress has plainly "stripped" the Commission of the jurisdiction and power to act upon "proceedings" that seek penalties or forfeitures, *unless* all conditions of the statutory savings clause are met. Here those conditions clearly are not met, because under any plausible reading of the Division's allegations, none of its three articulated claims "first accrued" less than five years before the proceeding was commenced.

It is patently unfair for a federal law enforcement agency to punish citizens based on claims this old, and that is precisely why statutes of limitations like section 2462 exist. Section 2462 gives the Division only two alternatives for having a proceeding like this lawfully "entertained." One is to seek no "civil fine, penalty, or forfeiture" in the proceeding, in which case the age of the underlying facts is largely irrelevant. The other is to articulate one or more claims that "first accrued" less than five years before the proceeding was commenced, and only

such claims. Here the Division did neither. It commenced a proceeding that unquestionably seeks civil penalties and forfeitures (and little else), and it articulated three claims that each unquestionably *first* accrued more than five years earlier. Section 2462 thus unequivocally forbids the proceeding from being "entertained."

II. EVEN IF THIS "PROCEEDING" COULD LAWFULLY BE "ENTERTAINED," IT SHOULD BE STRICTLY LIMITED TO FACTS AND TRANSACTIONS AFTER SEPTEMBER 23, 2008.

Even if this "proceeding" could somehow be partially "entertained" in defiance of the plain language of section 2462, the Division presumably concedes that civil penalties and industry sanctions cannot lawfully be based on facts or transactions that occurred before September 23, 2008 (i.e., five years before the OIP was issued). *See generally Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996) (censure and industry suspension) , *Gabelli v. SEC*, 133 U.S. 1216, 1219 (2013) (penalties). But it is equally clear that the Division's demand that Mr. Lex forfeit and disgorge a decade's worth of past brokerage commissions is also subject to section 2462. As quoted earlier, section 2462 applies to proceedings seeking "any civil fine, penalty, *or forfeiture....*"

As acknowledged by at least one federal appeals court (with some understatement), "[i]t could be argued that disgorgement is a kind of forfeiture covered by § 2462, at least where the sanctioned party is disgorging profits not to make the wronged party whole, but to fill the Federal Government's coffers." *Riordan v. SEC*, 627 F.3d 1230, 1234 n.1 (D.C. Cir. 2010). That court did not squarely address the issue (which had not been raised by the appellant), noting only that the argument had been "implicitly" rejected by a prior panel decision that likewise had not actually addressed it. We are aware of no case that has squarely and thoughtfully addressed this question, much less attempted to articulate any distinction between a "forfeiture" of

purportedly ill-gotten gains and "disgorgement" of the same amounts. We respectfully submit there is no meaningful distinction whatsoever, especially in a case like this one.

In fact, courts and even the SEC routinely use the terms "forfeiture" and "disgorgement" in tandem and interchangeably. *See, e.g., United States v. Usery*, 518 U.S. 267, 284 (1996) (civil forfeitures "serve a variety of purposes, but are designed primarily to confiscate property used in violation of the law, and to require disgorgement of the fruits of illegal conduct"); *United States v. Davis,* 706 F.3d 1081, 1084 (9th Cir. 2013) (forfeiture sanction requires defendants to "disgorge their ill-gotten gains, even those already spent"); *United States v. Contorinis,* 692 F.3d 136, 146-47 (2d Cir. 2012) (forfeiture "focuses on the disgorgement by a defendant of his 'ill-gotten gains,'" rather than the victim's loss); *United States v. Ben Zander*, 2009 U.S. App. LEXIS 6809, at **7 (3d Cir. 2009) (distinguishing "disgorgement, which is the forfeiture of ill-gotten gains," from "restitution, which is 'a restorative remedy that compensates victims'"); *United States v. Webber*, 536 F.3d 584, 602-03 (7th Cir. 2007) (forfeiture, in contrast to restitution, is "punitive" because it seeks to disgorge any profits that the offender realized from his illegal activity"); *United States v. Hoffer*, 129 F.3d 1196, 1202 (11th Cir. 1997) ("disgorgement" order "was, in fact, a civil forfeiture," and "[t]he district court, at the government's request and with [defendant's] consent, specifically termed the disgorgement a forfeiture"); SEC Press Release No. 2002-126 (Aug. 21, 2002) (announcing Enron-related case in which defendant was ordered to "disgorge and forfeit" approximately $12 million in ill-gotten gains).

The SEC has also successfully argued in federal court that statutory language nearly identical in relevant part to section 2462 is broad enough to encompass disgorgement orders entered in SEC enforcement cases. In *In re Telsey*, 144 B.R. 563, 1992 Bankr. LEXIS 1411

(Bankr. S.D. Fla. 1992), the Commission sought to except a bankrupt debtor's disgorgement obligation from the general discharge of his pre-bankruptcy debts. In particular, the SEC argued that the disgorgement obligation fell within the statutory exception for a debt that "is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss...." *Id.* at 564-65. The court agreed, in large part because disgorgement orders generally serve a deterrent – and thus at least partially penal – purpose even when they also serve a predominantly compensatory purpose. *Id.* at 565. The court found "the deterrence purpose of the disgorgement order sufficiently penal to characterize the resulting debt as a 'fine, penalty, or forfeiture' within the meaning of [the statute]." *Id.* The court further refused, understandably, to draw fine distinctions between the concepts of "fines," "penalties," and "forfeitures" in the context of SEC disgorgement because those terms "are often used loosely and confusedly." *Id.* at 565 n.3 (quoting 36 Am. Jur. 2d Forfeitures and Penalties § 3 (1968)).[3]

And even if *some* kinds of disgorgement orders might arguably be distinguished from forfeitures (none come immediately to mind), orders like the one sought in this case – i.e., designed to claw back past compensation, rather than the typical demand for true "disgorgement" of illicit profits or avoided losses – are quintessential forms of forfeiture. Indeed, without specific statutory authority, this form of purported "disgorgement" is almost certainly impermissible –indeed even calling it "disgorgement" is a complete misnomer – especially when ordered by an Executive Branch law enforcement agency in a penal administrative proceeding rather than by a federal court exercising broad *judicial* powers in *equity* under Article III of the Constitution. Congress has given the SEC power to claw back compensation in only one

[3] Our review of the docket sheet in *Telsey* suggests that the Commission may have later come to regret the persuasiveness of its own argument, as it apparently asked the court to vacate the decision. Unfortunately, due to the age of the case and the resulting unavailability of the relevant court records, we were not able to review or retrieve the pleadings and court orders filed after the published opinion cited herein.

specific statute, which is obviously inapplicable here but is nevertheless instructive in demonstrating that compensation clawbacks constitute forfeitures. We refer to the statutory clawback remedy at section 304 of the Sarbanes-Oxley Act of 2002, which applies only to certain bonuses and stock sale profits received by CEOs and CFOs of public companies that file accounting restatements. *See* 15 U.S.C. § 7243 (codification of Sarbanes-Oxley § 304). That provision leaves no doubt that compensation clawbacks are quintessential examples of forfeitures; indeed, the very title of the provision is "*Forfeiture* of Certain Bonuses and Profits." *Id.* (emphasis added). This is also consistent with the legislative history, during which one of the statute's principal co-authors, Senator Paul Sarbanes, explicitly called the remedy a "forfeiture":

> We have a provision that the CEO and the CFO who make large profits by selling company stock or receiving company bonuses while management is misleading the public about the financial health of the company would have to *forfeit* their profits and bonuses realized after publication of a misleading report.[4]

Because virtually all of the remedies sought by the Division in this proceeding constitute civil fines, penalties, and forfeitures, section 2462 unambiguously prohibits this proceeding from being entertained at all, as previously discussed. But even if the proceeding could be partially entertained notwithstanding the clear language of section 2462, none of the remedies sought by the Division can lawfully be predicated on conduct or transactions that occurred before September 23, 2008. Thus, in the interests of fairness and conservation of time and resources, any hearing should be strictly limited to the 5-year period immediately preceding issuance of the OIP.[5]

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[4] 148 Cong. Rec. S6237, S6332 (daily ed. July 8, 2002) (emphasis added).

[5] The Staff may contend that because the OIP also contemplates a possible cease-and-desist order, section 2462 can be ignored. The Staff would be wrong for all of the reasons stated in section I of the Argument. Moreover, any cease-and-desist order in this case would obviously be more punitive than remedial. As the Staff well knows, Mr. Lex has not sold any securities in nearly 5 years and in fact is currently barred by FINRA from the securities industry. Moreover, the Staff allowed more than three full years to elapse between suing McGinn Smith and

III. THE DIVISION'S FRAUD THEORY UNDER EXCHANGE ACT SECTION 10(b) IS FATALLY FLAWED AND SHOULD BE DISMISSED PRIOR TO THE HEARING.

The Division does not allege that Mr. Lex knew about the fraud, theft, and self-dealing that was apparently perpetrated by the principals of McGinn Smith, and to our knowledge no evidence suggests that he did. And to the extent its purported fraud claim is premised in tiny part on the conventional notion that the respondents allegedly made *specific* misstatements or omissions of material fact to *specific* customers, the OIP contains only one exceptionally vague and conclusory sentence that could never withstand a motion to dismiss in federal court, *see* OIP at 37 ("The Respondents also made material misrepresentations and omissions when recommending the Four Funds and Trust Offerings to their customers"), and we are confident that, at least as to Mr. Lex, this allegation would fail as a matter of proof if permitted to proceed to the hearing.

But that is not what this case is primarily about. Far more troubling is the overwhelmingly predominant Division theory that Mr. Lex (and others) committed scienter-based fraud in violation of Section 10(b) and Rule 10b-5 by selling investments that – due to high fees and other alleged business-model flaws that allegedly were apparent on the face of the PPMs he provided to investors – were supposedly destined to fail, and/or by failing to personally conduct a "searching" due diligence inquiry into those fees and other evident shortcomings. This predominant part of the Division's "fraud"

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commencing this proceeding against Mr. Lex, thus negating any notion that whatever genuinely remedial purpose a cease-and-desist order might serve at this point is anything more than an afterthought. Finally, to the extent any cease-and-desist order is ultimately deemed appropriate here, presumably that would be due in large part to conduct and transactions that occurred *since* September 2008, such that evidence of earlier conduct or transactions would be entirely cumulative for purposes of the cease-and-desist order. The substantial additional time, burden, cost, and complexity of litigating more ancient conduct and transactions is therefore unjustified.

theory is fatally flawed for numerous reasons and should not be permitted to clutter up and complicate the hearing.

The futility of the Division's "fraud" claim should be apparent from the face of the Division's own allegations, because the key underlying premise is that the alleged booby traps in the various investments were *obvious* from the very disclosure documents that were given to investors. With respect to the so-called "Four Funds" investments, the OIP could not possibly be clearer: "The PPMs for the Four Funds .... *made disclosures* that should have caused the Respondents, as associated persons of a broker-dealer, to conduct a searching inquiry prior to recommending the products to their customers." OIP at ¶ 38 (emphasis added). The OIP goes on to acknowledge that the PPMs transparently disclosed the blind-pool nature and associated risks of the Four Funds offerings, noting that the PPMs "*made clear*" that McGinn Smith affiliates and principals effectively had total control and discretion over the funds invested, as well as the investment strategy, and lacked specific experience in identical investment vehicles. *Id.* (emphasis added). The OIP likewise admits that the PPMs on their face transparently "stated that the Four Funds could acquire investments 'from our managing member [MS Advisors] or any affiliate,' could 'purchase securities from issuers in offerings for which [MS & Co.] is acting as underwriter or placement agent,' and that '[a]ffiliates of the placement agent may purchase a portion of the notes offered hereby.'" *Id.* (The PPMs actually contained many additional, similarly transparent and ominous risk disclosures not quoted in the OIP.)

The OIP is equally clear in admitting the transparent risk disclosures in the PPMs for the so-called "Trust" investments: "The Trust PPMs, moreover, like the Four Funds

PPMs, raised red flags that *should have been readily apparent* to the brokers." OIP at ¶ 50 (emphasis added). In the only example cited in support of this proposition, the OIP acknowledges that the relevant PPM *fully disclosed* the relevant fees that, in the Division's hindsight view, obviously doomed the investment from the start. *Id.* Of course, to the extent these risks and fees allegedly were obvious at the time (i.e., without the benefit of 20/20 hindsight gained from a four-year law enforcement investigation), they must have been equally obvious to the investors and regulators who also reviewed the same PPMs during the relevant period.

It is clear from the foregoing that the Division's primary "fraud" theory is, oddly enough, not that alleged investment risks, flaws, and fees were *concealed* from investors, but rather that they were disclosed so transparently that they should have been obvious to anyone who read the PPMs, presumably including the investors themselves. We are aware of no case (or logic) to support a theory that the transparent disclosure of obvious risks in the primary disclosure document can somehow be bootstrapped into a claim of "fraud" against a retail broker who provided that disclosure document to customers. The entire theory is self-contradictory and nonsensical.[6]

Nor can the Division bootstrap a scienter-based fraud charge from a retail broker's failure to personally conduct a "searching" due diligence investigation into purported "red flags" (whether those flags were transparently disclosed in the PPM or not). Apart from the absurdity of requiring every individual retail broker associated with

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[6] In fact, even if the staff's fraud theory were that the PPMs *concealed* or *misrepresented* relevant facts, an individual retail broker like Mr. Lex could not be held liable under Section 10(b) for those statements or omissions because he did not "make" them as required by the Supreme Court's opinion in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011) ("the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it;" "One who prepares or publishes a statement on behalf of another is not its maker").

an SEC-registered broker-dealer firm to independently undertake his own "searching" due diligence investigation before selling an investment product already vetted by the firm and its highly-compensated underwriters and other experts (presumably having to engage his own separate counsel, investment bankers, and other experts where the individual broker's own personal expertise is lacking), there is no legal or logical basis for suggesting that the failure to conduct such "searching" due diligence constitutes intentional or reckless fraud.[7]

In fact, the literal text of section 10(b) *precludes* liability based on the mere failure to conduct a "searching" due diligence inquiry, no matter how unreasonable. Section 10(b) prohibits "manipulative or deceptive device[s] or contrivance[s] in contravention of such rules and regulations as the Commission may prescribe . . . ." 15 U.S.C. § 78j(b). To begin with, as the Supreme Court has repeatedly held, the *sine qua non* of a violation of Section 10(b) and Rule 10b-5 is *deception* – not the mere failure to perform due diligence, even in breach of a fiduciary duty. *See generally United States v. O'Hagan,* 521 U.S. 642, 655 (1997) ("§ 10(b) is not an all-purpose breach of fiduciary duty ban; rather, it trains on conduct involving manipulation or deception"); *Santa Fe Indus. v. Green*, 430 U.S. 462, 473 (1977) ("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception"). Of course, to prove a violation of Section 10(b) and Rule 10b-5, the Division also needs to prove scienter – i.e., *intentional* deception, or at the very least *extremely reckless* deception – something the OIP makes no serious effort to allege with respect to Mr.

[7] This should be obvious from the SEC's approach to violations under the Foreign Corrupt Practices Act ("FCPA"), which are frequently based on failures by U.S. companies and executives to conduct thorough due diligence into foreign business partners or foreign business transactions. If those failures to conduct due diligence constituted fraud, it is impossible to explain why the SEC has never charged a violation of any anti-fraud provision in conjunction with the failures in those cases.

Lex's purported failure to conduct a "searching" inquiry. *See generally Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976).

Returning to the literal text of Section 10(b), the statute cannot be violated unless the intentional deception violates a rule or regulation *promulgated by the SEC itself.* No such SEC rule has ever been promulgated to prescribe the level of due diligence or skepticism an individual retail broker must undertake as part of a customer transaction, much less to require a "searching" due diligence investigation into risks explicitly disclosed in the relevant disclosure documents provided to the customer. The Division presumably intends to rely on the so-called "suitability" rules adopted and amended from time to time *by FINRA* (and its predecessor entities – more about this below), and especially the rules governing so-called "reasonable basis" suitability. But those are *not* rules or regulations promulgated *by the SEC*. Unless and until the SEC promulgates its *own* rules and regulations prescribing suitability and related due diligence obligations for retail brokers, even an unreasonable violation of FINRA suitability rules cannot be bootstrapped into a Section 10(b) fraud violation. *Cf. United States v. Finnerty*, 533 F.3d 143, 148-51 (2d Cir. 2008) (absent any deceptive communication, broker's unfair profiteering through "interpositioning" in violation of NYSE rules was not a section 10(b) fraud violation).

In fact, the Division's "fraud" theory is weaker still, because even FINRA's "reasonable basis" suitability rule did not exist in its current form, or apply to individual retail brokers, during the time period relevant to this case. While individual retail brokers were generally expected to consider *customer-specific* suitability of investments they recommended, so-called "reasonable basis" suitability – i.e., determining that an investment is suitable for at least *some* investors –

has historically been, logically enough, the obligation of the broker-dealer *firm* rather than of each of its individual registered representatives. This distinction was made abundantly clear in NASD Notice to Members 03-71, *Non-Conventional Investments* (November 2003), which reflected the prevailing NASD rule and interpretations *during the relevant period.* In that notice, the NASD referred repeatedly to the obligation of *member firms* to analyze the distinct features, risks, and rewards of the products they offered for sale, clearly distinguishing that obligation from the *separate* obligation of *both* "[m]embers *and their associated persons*" to perform a customer-specific suitability analysis. *Compare id.* at 766 *with id.* at 768 (emphasis added).

While the "supplementary material" that *now* accompanies *current* FINRA Rule 2111 appears to impose a limited form of "reasonable basis" suitability obligation on individual brokers as well as member firms, this feature of new Rule 2111 and its supplementary material did not exist until 2011, more than a year *after* McGinn Smith was shut down and more than two years after Mr. Lex's last securities sale. And even under this new Rule 2111, FINRA recognizes – in an obvious nod to practical reality – that "[i]n general, an associated person may rely on a firm's fair and balanced explanation of the potential risks and rewards of a product." *See* FINRA Notice to Members 11-25, at 8 (Q&A no. 11) (May 2011). Here, for example, the firm provided Mr. Lex and its other brokers with PPMs for each investment that described the features, significant risks, and potential rewards in great detail.

Nothing in those PPMs suggested that the investments were *per se* unsuitable for all investors. To the contrary, hundreds of highly-sophisticated people apparently read those PPMs (including brokers, sophisticated investors, presumably McGinn Smith lawyers, and apparently even SEC and/or FINRA inspection teams[8]), yet to our

[8] As counsel was finalizing this motion, the Division produced reports of OCIE examinations from 2004 reflecting OCIE's close review of McGinn Smith and its private placements, including at least one of the very PPMs at issue in

knowledge *nobody* concluded that the investments, as described in the PPMs, were *per se* unsuitable for all investors. The fact that so many brokers and investors in fact chose to offer and buy the investments based on these PPMs – and that no examining regulator appears to have ever sought to stop any of the associated offerings – negates any plausible argument that Mr. Lex committed "fraud" by not rejecting the investments as *per se* unsuitable for anybody.[9] In fact, as the Division is aware, he actually bought these investments for his own account and the accounts of several family members – ultimately losing most of the money just like everyone else (yet being disqualified from recovering any losses through the receivership).

For all these reasons, the Division's charge of scienter-based fraud under Section 10(b) and Rule 10b-5 is fatally flawed and futile, at least insofar as it is overwhelmingly based on an alleged failure by an individual retail broker to conduct a "searching" due diligence investigation in alleged violation of his purported obligation to comply with FINRA's "reasonable basis" suitability analysis. Eliminating this ill-conceived theory prior to the hearing will substantially narrow the case and reduce the duration, cost, and complexity of the case.

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this proceeding. While we are still evaluating the relevance of those reports, evidently OCIE found no obvious signs that the offerings were fraudulent, destined to fail, or worthy of more searching enforcement inquiry. Neither, apparently, did a FINRA exam two years later.

[9] The Staff appears especially troubled by the blind-pool nature of some of the investments in question. But this blind-pool feature is neither uncommon nor inherently suspicious, particularly where, as here, the investments were sponsored by what appeared at the time to be prominent and respected investment professionals at a reputable, SEC-registered broker-dealer firm boasting a long track record of investment successes. Indeed, during the very time period at issue, the Commission itself explicitly said exactly the opposite about blind pools:

> Neither blind pool offerings nor blank check offerings are inherently fraudulent. *Many responsible business persons sponsor legitimate blind pool and blank check offerings.*

Proposed Rule: *Use of Form S-8 and Form 8-K by Shell Companies*, SEC Rel. Nos. 33-8407 and 34-45966, at fn.18 (April 15, 2004) (emphasis added).

IV. THE DIVISION'S SECTION 5 CLAIM IS FATALLY FLAWED AND SHOULD BE DISMISSED PRIOR TO ANY HEARING.

The Division's section 5 theory is based entirely on the proposition that each of the relevant offerings was disqualified from the Regulation D exemption because securities from each offering were sold to more than 35 non-accredited investors. The Division does not alleged that Mr. Lex (or any of the other respondents) *individually* sold any offering to more than 35 non-accredited investors. The Division likewise does not allege that Mr. Lex actually knew (or should have known, or even *could* have known) that sales by *other* individual brokers to non-accredited investors, when combined with his own, added up to more than 35 in the aggregate for any given offering. To the contrary – as the Division is well aware – Mr. Lex, a non-lawyer, made appropriate inquiries and reasonably relied on the information and recordkeeping of the McGinn Smith firm concerning the aggregate number of non-accredited investors at any given time for each offering, and he took reasonable steps to ensure that sales he personally made to non-accredited investors would not jeopardize the Regulation D exemption for that offering. To our knowledge there is not a scintilla of evidence to the contrary.

Instead, the Division's theory is a "gotcha" theory of *strict liability* that contravenes the SEC's own rules and guidance. We are aware of no precedent supporting the Division's über-aggressive theory of strict liability against an individual retail broker for a section 5 violation based solely on his unwitting role in *an issuer's failure* to stay within the permissible number of non-accredited investors for an offering.

Contrary to the Division's apparent belief, section 5 was never intended to impose strict liability even against issuers, much less for unwitting violations by an individual retail broker acting in good faith reliance on an exemption he reasonably believed was

applicable. In fact, the SEC's own rules say *exactly the opposite*. For example, the SEC's own definition of "accredited investor" includes not just a person who *actually* fits within the relevant categories but also any person "who the issuer *reasonably believes*" fits within the those categories. *See, e.g.*, 17 C.F.R. § 230.501 (emphasis added). In the specific context of counting the number of unaccredited investors, SEC rules are similarly explicit in rejecting any notion of strict liability: The Rule 506 exemption applies if "[t]here are no more than *or the issuer reasonably believes* that there are no more than 35 [non-accredited] purchasers . . . ." 17 C.F.R. § 230.506 (emphasis added). Related SEC rules further emphasize that good faith attempts to comply with an exemption will prevent a forfeiture of the exemption or resulting liability under section 5. *See, e.g.*, 17 C.F.R. § 230.508. These rules, and the absence of any contrary precedent, negate any possibility that the Division could establish strict section 5 liability against Mr. Lex in this case, even if the Division ultimately proved that, unbeknownst to Mr. Lex and despite his good faith efforts to preserve the exemption, the McGinn Smith firm allowed other brokers to sell one or more of the particular offerings to enough non-accredited investors that, when added to Mr. Lex's sales, the total exceeded 35. And even if the Division could conceivably establish such a hyper-technical, no-fault violation, why would any punitive sanctions be necessary or appropriate in the public interest?

Wholly apart from the Division's erroneous reliance on strict liability for alleged section 5 violations arising from all of the offerings, the Division candidly admits that *none* of the so-called "Trust" offerings violated section 5 unless they are now artificially and retroactively deemed "integrated" as if there were actually only two such offerings,

each consisting of multiple parts. *See* OIP ¶ 32. This is particularly important because only *some* of these Trust offerings, but *none* of the Four Funds offerings, occurred within the 5-year period immediately preceding issuance of the OIP. Thus, without the Division's artificial hindsight combination of numerous separate Trust offerings into only two artificially "integrated" Trust offerings, there is no conceivable section 5 violation that even arguably occurred within the 5-year statute of limitations.

But even the Division's attempt at artificially integrating multiple separate Trust offerings falls apart in light of the supplemental information the Division provided in response to the respondents' motions for a more definite statement. First, from the OIP itself, it is clear that the Division is improperly attempting to integrate separate offerings that took place more than six months apart from one another (*see* OIP ¶ 31), which is not permitted in light of the regulatory safe harbor at 17 C.F.R. §230.502(a). For example, with respect to the purportedly integrated offerings artificially bound together by the so-called "McGinn Smith Funding Conduit," the OIP includes four separate offerings that occurred as much as 19 months apart, with the last of them (TDM Verifier Trust '09) commencing a full year after the next earliest one in the allegedly integrated group. *Id.* Subtracting the 11 allegedly unaccredited investors listed for just that last offering (*see* Exhibit 4 to Division Mem. in Opp. to Motions for More Definite Statement) reduces even the *aggregated* total for this purported "conduit" to a number below 35. But the same list on its face also includes some investor names two or more times, and includes other investors sharing identical last names who likely share a common residence; obviously the same person cannot be counted more than once, and the relevant SEC rules dictate that multiple related persons sharing the same primary residence are to be counted

as only one. *See* 17 C.F.R. § 230.501(e)(1)(i). Again, once the double-, triple-, and quadruple-counting is corrected, the aggregate total of non-accredited investors for the so-called "McGinn Smith Funding Conduit" is reduced comfortably below 35.

The so-called "TDM Cable Funding Conduit" fares no better. The Division's list for this purported "conduit" includes numerous investor names several times, along with other investors sharing identical last names (*see* Exh. 4 to Division Mem. In Opp. to Motions for More Definite Statement), and there is a 16-month gap between the first three allegedly integrated offerings for this purported "conduit" and the last five (*see* OIP ¶ 31). Once these obvious layers of overcounting are eliminated, the total number of unaccredited investors falls below 35 even if integration were otherwise deemed legitimate.

Because the Division's attempt to integrate numerous separate Trust offerings is ill-conceived and futile, that part of its section 5 theory should be summarily dismissed so that it does not clutter up and complicate the hearing. Moreover, because any plausible section 5 claim arising from the so-called "Four Fund" offerings obviously "first accrued" more than five years before the OIP was issued, and because any such claim would be premised entirely upon an untenable theory of strict liability that is contradicted by applicable SEC rules, the entire section 5 claim should be dismissed prior to the hearing.

CONCLUSION

"Entertainment" of this proceeding would defy the clear statutory mandate of 28 U.S.C. § 2462 and exceed the lawful power and jurisdiction of the tribunal. And even if limited fragments of the case were permitted to be entertained, events and transactions

that occurred before September 23, 2008 should not be allowed to clutter and complicate the case. In addition, allowing the Division to continue litigating its predominant "fraud" theory under Exchange Act section 10(b), or any of its theories under Securities Act section 5, would be futile and would unnecessarily add significant cost, delay, and complexity to an already expensive and unwieldy proceeding that is predicted to last six weeks or more if left on its current trajectory. We therefore respectfully request that the Division's claims be summarily dismissed, as described herein, in advance of the hearing.

Respectfully submitted,

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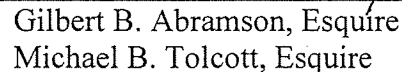

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