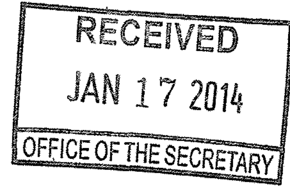
SECURITIES AND EXCHANGE COMMISSION



ADMINISTRATIVE PROCEEDING
File No. 3-15514

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.

RESPONDENT FRANK H. CHIAPPONE'S PREHEARING BRIEF

TUCZINSKI, CAVALIER & GILCHRIST, P.C.
54 State Street, Suite 803
Albany, New York 12207

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PRELIMINARY STATEMENT & STATEMENT OF FACTS

Respondent Frank Chiappone ("Chiappone"), by and through his counsel, Tuczinski, Cavalier & Gilchrist, P.C., submits this prehearing brief in accordance with the Order of Chief Administrative Law Judge Brenda A. Murray, dated January 9, 2014.

The Division of Enforcement of the Securities and Exchange Commission commenced this proceeding on September 23, 2013, seeking unspecified relief, "including, but not limited to, disgorgement and civil penalties" against ten registered representatives that had previously been registered with the now defunct brokerage firm, McGinn, Smith & Co., Inc. ("MS & Co."). As concerns Chiappone, the OIP alleges that:

(a) The Respondents "willfully violated Sections 5(a) and (c) of the Securities Act by offering and selling notes for which no registration statements were in effect;" and

(b) The Respondents "willfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, by knowingly or recklessly, or negligently, failing to perform reasonable due diligence to form a reasonable basis for their recommendations to customers, and made misrepresentations and omissions in recommending the Four Funds and Trust Offerings".[1]

Background

As alleged in the OIP, two of the principals of MS & Co., David Smith and Timothy McGinn, were permanently barred by FINRA in September 2011, and were convicted in February 2013 on multiple counts of mail and wire fraud, securities fraud, and filing false tax

[1] The "Four Funds" were four separate limited liability companies each of which was formed to "identify and acquire various public and/or private investments" and which issued three tranches of notes with differing interest rates (ranging from 5% to 10.25%) and terms (ranging from 1 year to five years).
The "Trust Offerings" consisted of 21 special purpose entities offering two tranches of debt investments with interest rates ranging between 7.75% and 13%. The entities were each established to invest in burglar alarm service contracts, "triple play" (broadband, cable, and telephone) service contracts, or luxury cruise ship charters.

returns. Smith was sentenced to ten years in prison, McGinn was sentenced to fifteen years in prison, and combined, the two were ordered to pay restitution in the total amount of nearly $12 million. The FINRA bar and criminal convictions occurred following several years of intense investigation of McGinn, Smith and MS & Co. by regulators.

MS & Co. was formed in 1980, and operated as a successful investment banking and investment brokerage firm for many year, selling stocks, bonds, mutual funds and other traditional investments. At some point, MS & Co. began to organize, structure and market private placements, often to provide financing for local businesses. As time passed, private placements became a larger part of MS & Co.'s business. For many of those years, MS & Co. and its principals successfully portrayed to investors, employees, and regulators that MS & Co. had truly found its niche in structuring successful investments in recurring monthly receivables, primarily in the home security alarm monitoring business. In fact, most of the early offerings, consisting of debt securities secured by alarm company receivables and recurring contract revenues, performed well, paying interest and returning principal to investors.

The two principals, McGinn and Smith, along with their senior accounting and investment banking staff, had convinced the financial world that they were capable of investigating and analyzing the accounts receivable of home security alarm monitoring companies, purchasing those accounts receivable at an appropriate discount relative to their real value, and using the payment stream from those accounts receivables to yield a lucrative return to their investors.

From the perspective of investors, employees, and regulators, MS & Co. time and again succeeded in structuring such alarm deal offerings. Of 64 private placement investments sold prior to the Four Funds and Trust Offerings, 61 such investments had paid all interest and

principal to investors. Based on this track record, Mr. Chiappone and the other registered representatives in MS & Co.'s various offices came to believe that the bankers and accountants who located, structured and performed due diligence on these deals, knew what they were doing, and were capable of continuing to generate a stream of investments that provided above-average income and were not correlated to the stock markets.

While not relevant to these proceedings, the SEC believes that the various alarm offerings were not in fact performing as expected, and that the investors in the early alarm deals were rescued when MS & Co. formed a corporation that purchased the various debt offerings, with proceeds received from a successful IPO of its stock. What is relevant, regardless of the truth or falsity of the SEC's allegations in this regard, is that neither Mr. Chiappone nor any of the other brokers were ever aware of any infirmity in the finances of the early alarm deals. All that they knew was that their clients had been paid back their invested funds, with interest.

At some point in time, unbeknownst to investors, employees, and regulators, Smith, McGinn, and a small, tightly closed circle of their cohorts, began to mismanage funds raised from investors in some of the alarm receivables investments and in the Four Funds offerings and later alarm/triple play offerings. They may well have operated what Smith would later characterize in a handwritten confession to McGinn, as a Ponzi scheme. In fact, while Chiappone viewed the pre-2003 alarm deal offerings as consistently yielding sufficient recurring monthly revenue income to pay investors their invested principal, plus interest, the OIP alleges that secretly such investors were actually paid off by use of over $12 million of the funds invested in the Four Funds—something which was never disclosed, nor known, to the registered representatives or any investors.

The fraud that was perpetrated without the knowledge or participation of Chiappone or presumably the other registered representatives was shocking in light of the extensive compliance program that had been developed and implemented at MS & Co. The compliance program included a Supervisory Compliance Manual that addressed regulatory compliance matters; a Branch Office Procedures manual; internal compliance meetings, at which registered representatives were educated and trained on regulatory compliance matters; and day-to-day supervision of registered representatives, including review of daily trades to ensure that the trades were suitable for the particular investor. MS & Co. implemented and broadcast a policy of reviewing outgoing and incoming emails. MS & Co. had two compliance officers, including David Smith as the firm's Chief Compliance Officer. Finally, MS & Co. had in-house counsel, utilized outside counsel as needed, had a Chief Financial Officer and an accounting staff, and had a staff of analysts. Smith and McGinn were able to perpetrate their criminal fraud for years despite this compliance program having been in place.

Distilled to its essence, the Division of Enforcement now alleges that the Respondents committed securities fraud because, as associated persons of MS & Co., they allegedly failed to conduct a reasonable investigation of the investments in order to form a reasonable basis for their recommendation to customers regarding the Four Funds and Trust Offerings. The Division further alleges that Respondents sold each of the Four Funds to more than 35 unaccredited investors, and that when certain of the Trust Offerings are "integrated", Respondents sold the two integrated Trust Offerings to more than 35 unaccredited investors, allegedly violating Section 5 of the Securities Act.

Chiappone

Chiappone has been in the securities industry for nearly 35 years. He joined MS & Co. in or about 1989. In the early to mid-1990s, MS & Co. began structuring private placement investments in the home alarm monitoring industry. In sum, MS & Co. would raise capital through debt offerings and would fund an entity (typically controlled by MS & Co.), that would purchase at a discount the rights to the recurring monthly revenues generated by a basket of home alarm monitoring contracts. The recurring monthly revenues would then fund interest and principal payments due to the investors. The success of such investments depended on a number of factors, including the ability of MS & Co. to secure a purchase with a sufficient spread between the discounted value of future revenue streams, and the nominal value of the contracts, as well as the rate of attrition by underlying alarm service subscribers. McGinn, in particular, had developed a keen ability to develop profitable investments in recurring monthly revenues.

For the next decade, Chiappone sold such private placement investments, which yielded great success for his clients, with 61 of 64 such private placements paying investors back in full their investment, plus all promised interest. To be clear, Chiappone did not exclusively (or even primarily) sell private placements, instead only selling them to those investors for whom he determined the investment would be suitable. In fact, Frank Chiappone primarily sold more traditional investments, such as stocks, bonds, and mutual funds. Over the course of his career with MS & Co., Frank Chiappone sold private placements to less than 19% of his client base. He also sold mutual funds and other listed securities to some of his clients who opted to buy privately placed securities.

The success of the alarm receivables contracts over a decade ultimately resulted in a $200 million initial public offering of Integrated Alarm Service Group, Inc. (IASG), which was

structured and underwritten by MS & Co. When IASG went public, McGinn joined it as its Chief Executive Officer.

The Four Funds

Smith continued operating MS & Co. following McGinn's joining IASG, and in September 2003, structured the first of the Four Funds, First Independent Income Notes, LLC ("FIIN"). FIIN offered three tranches of debt investments: a senior note offering 5% interest and maturing in one year; a senior subordinated note offering 7.5% interest and maturing in five years; and a junior note offering 10.25% interest and maturing in five years. The private placement memorandum, prepared by an outside law firm, located in New York City and specializing in securities work, stated that the purpose of FIIN was "to identify and acquire various public and/or private investments, which may include, without limitation, debt securities, collateralized debt obligations, bonds, equity securities, trust preferreds, collateralized stock, convertible stock, bridge loans, leases, mortgages, equipment leases, securitized cash flow instruments, and any other investments that may add value to our portfolio".

The FIIN private placement memorandum explained that "[t]he risks associated with an investment in the notes and the lack of liquidity makes this investment suitable only for an investor who has substantial net worth, no need for liquidity with respect to this investment and who can bear the economic risk of a complete loss of the investment." The FIIN private placement memorandum also listed a number of risk factors, including that "we will not be required to maintain any ratios of assets to debt in order to increase the likelihood of timely payments to you under the notes," that FIIN was a newly formed company with no historical financial information, and that if FIIN encountered insufficient cash flow, it may become necessary to pursue alternative strategies, such as restructuring the notes. The private placement

memorandum also disclosed that adverse economic conditions could materially and adversely affect FIINs ability to pay noteholders. The fact that FIIN would be managed by McGinn, Smith Advisors, LLC, which was a subsidiary of an affiliate of MS & Co., the placement agent, was also disclosed.

Prior to the FIIN offering, Smith told Chiappone that while the investments that would be held by FIIN had not yet been selected, Smith expected that a portion of the investments would include alarm monitoring receivables, as well as investments in a number of local companies, including a clothing store.

After FIIN was offered and sales began, Smith structured three more similar investments, First Excelsior Income Notes, LLC ("FEIN"); First Advisory Income Notes, LLC ("FAIN"); and Third Albany Income Notes, LLC ("TAIN"). Each of FEIN, FAIN, and TAIN had similar offering terms and private placement memoranda to that of FIIN.

Chiappone read the Four Funds' private placement memoranda and recommended them to clients for whom he determined such investments would be suitable. In general, he would contact an existing client and inform them of the availability of the investment, the nature of its terms, and the risks of the investment. If the client was interested in receiving a private placement memorandum, Frank Chiappone would send one to the client, at which time the client would have an opportunity to review the private placement memorandum. If the client determined to purchase the investment, he or she would complete the investor questionnaire, execute the subscription agreement, and return both documents to the MS & Co. Albany office.

Upon receipt, Patricia Sicluna of the MS & Co. Albany office would provide the investor questionnaire and subscription agreement to Smith, who was not only the President of MS & Co., but also its Chief Compliance Officer. Smith would review the documents and if he deemed

it appropriate based on the information contained therein, he would execute the subscription agreement. Because of the significant number of registered representatives in multiple offices selling the Four Funds investments, the responsibility of tracking the number of unaccredited investors in any particular Fund was centralized in Patricia Sicluna and Smith.

Periodically, Chiappone or other registered representatives would seek information from Smith concerning what investments were held by the Four Funds. In response, Smith would provide an outline of the investments held by the Four Funds, broken down by industry, but did not disclose the identity of the actual companies in which the Four Funds invested because, according to Smith, preserving the confidentiality of those companies was of paramount importance to the ability of MS & Co. to continue to invest in the region and to the value of the assets held by the Four Funds. The breakdowns provided by Smith suggested that the Four Funds held a diversified portfolio of investments in various industries.

In late 2006 and into 2007, the housing market bubble burst, setting into motion the worst financial crisis since the Great Depression. In 2007, looming large in the minds of investors and investment professionals, including Chiappone, was the financial crisis, which, unbeknownst to all except those who had a crystal ball, was only then in its infancy.

But from 2003 through November 2007, none of the Four Funds showed any signs of weakness. All interest had been timely paid as it came due, and if any maturing noteholders sought to redeem their notes rather than roll them into a new note, the invested principal had been paid back. In November 2007, however, Andrew Guzzetti, the Managing Director of MS & Co.'s private client group, informed the registered representatives that the Four Funds were encountering liquidity difficulties and were facing an upcoming series of possible note redemptions. In an apparent effort to shore up the Funds' liquidity to carry the Funds through

the financial crisis without incident, Andrew Guzzetti informed the registered representatives that liquidity in the Funds could be preserved by raising additional capital, and that MS & Co. was asking the registered representatives to do so.

As portrayed by Smith, the financial crisis that had already affected so many investments had also caught up to the Four Funds, and the temporary solution rather than allowing the Funds to default on their maturing notes, was to preserve what liquidity could be preserved by raising additional liquid capital.

Shortly later, in January, 2008, Smith (and McGinn, who by then had rejoined MS & Co. after leaving IASG) held a meeting with the registered representatives. Therein, Smith explained that the Four Funds were either in or were approaching default, and that both immediate and longer term remedial measures had to be taken for the benefit of all noteholders. Smith explained that the immediate solution was to reduce the interest payable on the junior notes to 5%, and that the longer term solution—a possible wholesale restructuring of the notes—would be developed and, if conditions did not improve, ultimately implemented.

Sometime later in 2008, Smith revealed to the registered representatives the identity of the investments that had been held by the Four Funds—some of which included entities such as Coventry Care,[2] a company for which MS & Co. had underwritten one or more investments, and SAI Trust, one of the few private placements that had been structured by MS & Co. and had suffered losses.[3] Upon learning about the Four Funds' investment portfolios, including the fact that the Four Funds had each invested in several of the same companies, some of which had previously suffered losses, Chiappone drafted an email to Smith pointing out what he believed

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[2] Unbeknownst to Chiappone, at least one investor in Coventry Care complained to regulators in 2005 and/or 2006, asserting that MS & Co. had defrauded him. But a year later, FINRA notified the investor that it was not taking action, and that he should pursue arbitration. The investor pursued arbitration, but lost.

[3] Chiappone and members of his family had invested in both Coventry Care and SAI Trust.

was Smith's mismanagement of the portfolio, but did not send it because he was concerned he might be fired. Chiappone believed that the failure of the Four Funds was due to mismanagement by Smith, and he never had reason to question the ability of MS & Co. to continue to structure profitable alarm receivables investments.

All of Chiappone's sales of Four Funds investments occurred prior to September 23, 2008.

The Trust Offerings

In 2006, McGinn had returned to MS & Co., and picked up where he left off: structuring and managing recurring monthly receivables investments. But he expanded his reach beyond the home alarm monitoring market and into the market for "triple play contracts", which were recurring monthly revenue contracts for internet, cable, and telephone service. And, rather than purchasing the accounts receivable of individual subscribers, which had relatively high administration costs due to receiving and processing thousands of checks and which were more susceptible to attrition, McGinn was now proposing to purchase the accounts receivable of entire homeowners' associations and apartment complexes—which were less likely to suffer from attrition and which would have lower administration costs due to receiving and processing one large check each month from the homeowners' association or apartment complex, rather than potentially thousands of smaller checks from individual subscribers.

From 2006 through 2009, McGinn structured and managed several investments in alarm receivables and triple play receivables, and also a couple of investments in the luxury cruise charter market (the "Trust Offerings"). By and large, those investments timely paid interest and principal. Many of Chiappone's sales in the Trust Offerings occurred before September 23, 2008.

Firstline Trusts

Additionally, in the Spring and Fall of 2007, McGinn structured and offered investments in the recurring monthly revenues of Firstline, a home alarm monitoring company based in Utah. As had been done on other private placements and as had been MS & Co.'s longstanding practice, MS & Co. due diligence personnel appeared to have fully vetted the underlying Firstline alarm contracts. The Firstline investments paid monthly interest to investors through August, 2009.

But in early September, 2009, McGinn and Smith held a meeting with the registered representatives and revealed to them for the very first time that Firstline had filed for bankruptcy 18 months earlier, and that McGinn and Smith had been making the Firstline interest payments as they came due. Shortly thereafter, FINRA ordered MS & Co. to cease and desist doing business for violation of net capital requirements.

All of Chiappone's sales of Firstline investments occurred before September 23, 2008.

Following several years of investigation, which included a FINRA investigation and enforcement proceeding action, a lengthy civil case against McGinn, Smith, MS & Co., and others, and a criminal prosecution and trial of McGinn and Smith that resulted in convictions and prison terms for both, the SEC commenced this proceeding on September 23, 2013, against Respondents, none of whom have ever been alleged to have participated or known about Smith's and McGinn's calculated and well-concealed[4] criminal fraud.

For the reasons that follow and based on the evidence that will be adduced at the hearing, the Division's case should be dismissed.

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[4] The fraud was so well-concealed that despite complaints from investors, including concerning companies in which the Four Funds had invested, FINRA, the SEC, the Albany County District Attorney's Office and prosecutors did not take concrete investigatory action until 2009. Now, ironically, the SEC's Division of Enforcement is faulting Chiappone, a mere registered representative employee, for having not uncovered the fraud before 2009.

ARGUMENT

POINT I

ANY REQUESTS FOR CIVIL FINES, PENALTIES, AND FORFEITURES, PECUNIARY OR OTHERWISE, ARE BARRED BY THE APPLICABLE STATUTE OF LIMITATIONS TO THE EXTENT THEY ARE BASED ON ACTIONS OR OMISSIONS OCCURRING PRIOR TO SEPTEMBER 23, 2008.

As explained below, this proceeding may not be entertained because it seeks punitive sanctions for claims that first accrued more than five years before this proceeding was commenced. Even if this proceeding may be entertained, the proof submitted in support of the Division's claims must be limited to facts or transactions occurring on or after September 23, 2008.

A. This "Proceeding" May Not Be "Entertained" Because it Seeks Punitive Relief for Claims that "First Accrued" Prior to September 23, 2008.

This proceeding was commenced on September 23, 2013. Because this proceeding seeks civil fines, penalties, and forfeitures, pecuniary and otherwise, based upon claims that "first accrued" before September 23, 2008, it may not be "entertained".

28 U.S.C. § 2462 provides:

> Except as otherwise provided by Act of Congress, ***an action, suit or proceeding*** for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, ***shall not be entertained*** unless commenced within five years from the date when the claim ***first accrued*** if, within the same period, the offender or the property is found within the United States in order that proper service may be made thereon. 28 U.S.C. § 2462 (emphases added).

As noted by the Supreme Court in interpreting the applicability of this provision in the context of SEC enforcement proceedings, "[s]tatutes of limitations are intended to 'promote justice by preventing surprises through the revival of claims that have been allowed to slumber

until evidence has been lost, memories have faded, and witnesses have disappeared.'" Gabelli v. Secs. & Exch. Comm'n, 133 S. Ct. 1216, 1221 (2013) (quoting Railroad Telegraphers v. Railway Express Agency, Inc., 321 U.S. 342, 348–349, 64 S. Ct. 582 (1944)).

Similar statutory language (i.e., "shall not be entertained . . . unless . . .") has been held to deprive the tribunal of subject matter jurisdiction over the proceeding altogether. See 28 U.S.C. § 2255(e) ("An application for a writ of habeas corpus in behalf of a prisoner who is authorized to apply for relief by motion pursuant to this section, *shall not be entertained* if it appears that the applicant has failed to apply for relief, by motion, to the court which sentenced him, or that such court has denied him relief, *unless* it also appears that the remedy by motion is inadequate or ineffective to test the legality of his detention."); Abernathy v. Wandes, 713 F.3d 538, 557–58 (10th Cir. 2013); Williams v. Warden, 713 F.3d 1332, 1338–39 (11th Cir. 2013) ("A plain reading of the phrase "shall not entertain" yields the conclusion that Congress intended to, and unambiguously did strip the district court of the power to act -- that is, Congress stripped the court of subject-matter jurisdiction -- in these circumstances unless the savings clause applies.").

In Gabelli, the Supreme Court ruled that, in the context of an SEC enforcement proceeding, the five-year period begins to run immediately upon the commission of the alleged fraud, not when the alleged fraud is discovered by the SEC. Gabelli, supra, 133 S. Ct. at 1220–24.

Moreover, despite any subjective labels that the SEC seeks to attach to this proceeding, the test for determining whether the proceeding seeks punitive sanctions (and is therefore subject to five year statute of limitations under § 2462) is an objective one. If, viewed objectively, the proceeding is aimed at punishing and labeling the Respondent as a wrongdoer; or would stigmatize the Respondent and destroy his career; or would temporarily or permanently strip him

of the license necessary to continue his profession; then the proceeding is one seeking punitive relief and is subject to § 2462's five-year statute of limitations. Gabelli, supra, 133 S. Ct. at 1223; Securities & Exch. Comm'n v. Bartek, 484 Fed. Appx. 949, 957 (5th Cir. 2012); Johnson v. Securities & Exch. Comm'n, 87 F.3d 484, 488–89 (D.C. Cir. 1996).

The OIP purports to characterize the relief it seeks as "remedial". See OIP, Section III, ¶¶ B, C, D. But the provisions under which it seeks those so-called "remedial" actions are sections that are designed to punish wrongdoers, not to compensate victims for wrongdoing or to return victims to the *status quo ante*. The OIP seeks action against Respondents pursuant to Section 15(b) of the Exchange Act (15 U.S.C. § 78o(b)); Section 21B of the Exchange Act (15 U.S.C. § 78u-2); Section 203 of the Advisers Act (15 U.S.C. § 80b-3); Section 9 of the Investment Company Act (15 U.S.C. § 80a-9); and Section 8A of the Securities Act (15 U.S.C. § 77h-1). Those sections authorize:

- censures (15 U.S.C. § 78o(b)(4), (b)(6); 15 U.S.C. § 80b-3(e), (f));
- limitations on activities, operations and functions (15 U.S.C. § 78o(b)(4), (b)(6); 15 U.S.C. § 80b-3(e), (f));
- suspensions (15 U.S.C. § 78o(b)(4), (b)(6); 15 U.S.C. § 80b-3(e), (f));
- revocations of registration (15 U.S.C. § 78o(b)(4); 15 U.S.C. § 80b-3(e));
- bars on association with brokers, dealers, and investment advisers, among others (15 U.S.C. § 78o(b)(6); 15 U.S.C. § 80b-3(f));
- civil monetary penalties (15 U.S.C. § 77h-1(g); 15 U.S.C. § 78u-2(a); 15 U.S.C. § 80a-9(d); 15 U.S.C. § 80b-3(i));
- bans on serving as an officer or director of public companies (15 U.S.C. § 77h-1(f); 15 U.S.C. § 78u-3(f)); and

- temporary and permanent prohibitions against serving as an employee of a registered investment company or affiliated person (15 U.S.C. § 80a-9(b)).

Here, such sanctions are not designed to remedy violations; they are punitive sanctions designed to punish and label Chiappone. See Gabelli, supra, 133 S. Ct. at 1223; Johnson v. Securities and Exch. Comm'n, 87 F.3d 484, 488–89 (D.C. Cir. 1996); Securities and Exch. Comm'n v. Jones, 476 F. Supp. 2d 374, 381 (S.D.N.Y. 2007); Securities and Exch. Comm'n v. Kovzan, 2013 U.S. Dist. LEXIS 147947, at *10 (D. Kan. October 15, 2013).

The OIP clearly goes much further than merely seeking "remedial action,"; it seeks to strip Chiappone of his livelihood and stigmatize him as having played a role in an expansive Ponzi scheme that even regulators conducting examinations or audits of MS & Co. were unable to uncover during the relevant period. Stripping Chiappone of his livelihood and forever casting him as a foot soldier in Smith's and McGinn's closely guarded criminal fraud bears no rational relationship to remedying the harm that the Division alleges has been done to investors, nor to preventing harm in the future. As such, this proceeding is one that seeks punitive sanctions.

Moreover, this "proceeding" seeking punitive sanctions is premised upon claims that "first accrued" prior to September 23, 2008. In particular, each of the Division's claims "first accrued" when they were fully chargeable as alleged violations of the relevant securities laws provisions.

For the Division's claims relating to the alleged sale of unregistered securities, such claims "first accrued" upon the first sale of a Four Funds investment, which according to the Division, occurred for Chiappone on October 3, 2003, almost ten years before this proceeding was commenced.

For the Division's claims relating to the alleged failure to undertake an investigation of the complained-of investments before selling them to investors, those claims "first accrued" when Chiappone first sold such an investment (October 3, 2003 for Four Funds investments, and in November 2006 for the Trust Offerings), which was almost ten years and seven years, respectively, before this proceeding was commenced.

With respect to the Division's claims that after Respondents learned about the alleged "Redemption Policy", Chiappone allegedly violated the securities laws by continuing to sell MS & Co. investments without conducting an independent investigation, such claims "first accrued" on November 15, 2007, the sale of the first investment after Chiappone allegedly learned of the "Redemption Policy", almost six years before this proceeding was commenced. And even if the Division relies upon the date on which the Division claims that Respondents learned that the Four Funds had been mismanaged (January 8, 2008), the Division's claim that thereafter Chiappone violated the securities laws by failing to investigate future MS & Co. investments, such a claim "first accrued" upon Frank Chiappone's first sale of one of the complained-of investments thereafter, which according to the Division, occurred on January 10, 2008. Even at that late date, this proceeding was required to be commenced on or before January 10, 2013. But rather than timely commence this proceeding despite having investigated this matter and Respondents for several years, the Division waited until September 23, 2013 to commence this proceeding.

Because this "proceeding" seeks punitive sanctions based on claims that "first accrued" before September 23, 2008, it may not be "entertained".

B. <u>Even if this Proceeding May be Entertained, the Proof Submitted in Support of the Division's Claims Must be Limited to Facts or Transactions Occurring on or after September 23, 2008.</u>

Even if the Commission determines that this proceeding may be entertained, the proof on which the Division may rely in seeking punitive sanctions must be strictly limited to proof of facts and transactions occurring after September 23, 2008.

Not satisfied that both Smith and McGinn are sitting in federal prison and will never again engage in the securities business, the Division now seeks extreme punitive sanctions, including a lifetime bar from the securities industry, against Chiappone, but it does so by poisoning the well with grossly inflated allegations of conduct and omissions that occurred long before September 23, 2008, which as a matter of law cannot be the premise for any such penalties. Indeed, the Division seeks to introduce *590 exhibits* and to present the testimony of *55 witnesses*, many of which can *only* provide evidence concerning matters occurring *before* September 23, 2008.

For example, the OIP includes accusations that "Respondents sold the Four Funds to unaccredited investors". <u>OIP</u>, ¶ 27. But according to the SEC's records, Chiappone did not sell a single Four Funds investment to *anyone* on or after September 23, 2008.

Likewise, the Division's OIP alleges that Respondents "performed inadequate due diligence prior to recommending the Four Funds to their customers". <u>OIP</u>, ¶ 38. The Division alleges that "[f]rom the commencement of the FIIN offering in September 2003 until January 2008, Smith . . . steadfastly refused to give the brokers any meaningful information about how he had invested the Four Funds offering proceeds", a "refusal that should have prompted the brokers to further question the propriety of the Four Funds." <u>OIP</u>, ¶ 40. Even the Division's claimed "smoking gun"—what it has coined the "Redemption Policy"—had necessarily ended

by January, 2008, when Smith explained to Respondents that he was going to be restructuring the Four Funds investments. But since Chiappone did not sell even a single Four Funds investment to anyone on or after September 23, 2008, a breach of a duty to perform due diligence prior to recommending the Four Funds investment simply could not have occurred on or after September 23, 2008. Despite these undisputed facts, the Division seeks to present all of the private placement memoranda, reams of pages of correspondence, emails, and the testimony of several witnesses relating exclusively to the Four Funds investments.

The Division's attempt to poison the well by exaggerating the allegations of misconduct or omissions is also shown by an analysis of Paragraph 53 of the OIP, wherein the Division alleges that "Chiappone sold approximately $12 million of the Four Funds offerings and approximately $3.4 million of the Trust Offerings," and "earned approximately $513,000 in commissions." The Division clearly presents those numbers for dramatic effect. But all of the Four Funds were initially offered between 2003 and 2005, and Chiappone never sold a single Four Funds investment on or after September 23, 2008. And of the 21 Trust Offerings at issue, more than half were initially offered and many of Chiappone's sales occurred *before* September 23, 2008.

Rather than presenting an accurate picture of Chiappone's actual sales during the relevant five-year period and tailoring its request for relief to allegations that are within the statute of limitations, the Division seeks the death penalty for Chiappone's career, and in furtherance thereof, indiscriminately lumps all sales together, regardless of their timing. According to the Division's own assertions, however, approximately *93% of Chiappone's sales about which the Division complains occurred prior to September 23, 2008* and are therefore barred by the five-

year statute of limitations. ***Put differently, the Division's OIP exaggerates its case against Chiappone, in terms of sales dollars, by approximately 1300%.***

Permitting the Division to inflate its case for punitive sanctions against Frank Chiappone by 1300% by allowing evidence of pre-September 23, 2008 facts or transactions would constitute reversible error. On the other hand, restricting the Division's proof to post-September 23, 2008 transactions would encourage the Division to *promptly* commence such proceedings. Promptly commenced enforcement proceedings will, in the long run, result in the Division, in some cases, stopping fraud as it occurs, leading to real and direct benefits to the investing public. Accordingly, if the Commission determines that this proceeding is not barred in its entirety by the five-year statute of limitations, at a minimum, it must restrict the Division's proof to facts and transactions occurring on and after September 23, 2008.

POINT II

CHIAPPONE DID NOT WILLFULLY VIOLATE SECTION 17(a) OF THE SECURITIES ACT, SECTION 10(b) OF THE EXCHANGE ACT, OR RULE 10b-5.

The OIP alleges that Respondents "willfully violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, by knowingly or recklessly, or negligently, failing to perform reasonable due diligence to form a reasonable basis for their recommendations to customers, and made misrepresentations and omissions in recommending the Four Funds and Trust Offerings." However, the Division's case in this regard is a classic case of "fraud by hindsight." See Novak v. Kasaks, 216 F.3d 300, 309 (2d Cir. 2000); Stevelman v. Alias Research, Inc., 174 F.3d 79, 85 (2d Cir. 1999).

Chiappone fulfilled his obligations to review and analyze the terms and risks of the various investments and to assess the suitability of the investments for the clients to which he presented the investments. He had a reasonable basis on which to recommend the investments to a select group of his clients for which Frank Chiappone determined the investment would be suitable.

The duty of a registered representative does not require the representative to perform due diligence that has already been performed by brokerage firm on the underlying company, as the Division is alleging in this proceeding. Instead, the applicable standard as set forth in Hanly v. Securities & Exchange Commission is as follows:

> "By his recommendation, he [a securities salesman] implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information." Hanly v. Securities & Exch. Comm'n, 415 F.2d 589, 597 (2d Cir. 1969).

The factual context of Hanly is critical in understanding the scope of such a duty. In Hanly, the representatives made a number of affirmative statements guaranteeing the meteoric success of over-the-counter investments they were selling, despite having known about the subject company's consistent past financial failures. Critically, despite knowing about the subject company's consistent past failures, the representatives nonetheless made affirmative statements of sure success, such as claiming that the stock price "would go from 6 to 12 in two weeks". The guarantee of immediate success was premised exclusively on speculation that one particular product developed by the company would change the company's financial future. But at the same time the representatives were promoting the company based on the allegedly revolutionary product, the company's negotiations in producing, distributing, and licensing the

product were failing, as was the product itself in testing being performed by prospective customers. In that factual context, the Hanly court determined that the representatives—who had no knowledge of the company having ever had any success, had virtually no familiarity with the company's management, had no financial history (other than known failures) on which to base any predictions of success, and had nothing other than pure speculation on which to base their promises of meteoric success—had acted recklessly by failing to investigate the merits of the investment before recommending it.

Hanly's progeny is likewise instructive on the so-called "duty to investigate." In Securities & Exchange Commission v. Hasho, the SEC alleged that the salesmen had engaged in a "boiler room" operation, a temporary operation established only to sell a specific speculative security, exclusively by telephone solicitation to new customers, with the salesmen concealing the risks of the investment while also making favorable earnings projections and predictions of price rises without a factual basis. 784 F. Supp. 1059, 1062 (S.D.N.Y. 1992). In Hasho, the Court held that "[a] registered representative or salesman in a boiler room: (1) may not rely solely on his employer; (2) may not rely blindly upon the issuer for information concerning a company; and (3) cannot avoid his duty to investigate by blindly relying on the employers brochures." Id. at 1107 (citations omitted). The Hasho Court made clear that the scope of a registered representative's duty to investigate depends upon the environment in which the registered representative operates: "[A]n individual in boiler room activities is held to a higher standard". Id. at 1108; see also Walker v. Securities & Exch. Comm'n, 383 F.2d 344, 345 (2d Cir. 1967); Berko v. Securities & Exch. Comm'n, 316 F.2d 137, 142–43 (2d Cir. 1963).

Likewise, in Securities & Exchange Commission v. Milan Capital Group, Inc., the Court found that a broker should have independently investigated a fraudulent investment where (i) the

promoter of the investment had directed the broker to conceal information regarding the investment from his compliance superiors; (ii) trade confirmations were "crude" and "handwritten", and therefore suspicious on their face; and (iii) the promoter of the investment, without disclosure to investors prior to their making the investment, placed the investors' funds in a self-induced pooled account and restricted the investors' control over the investments. 2000 U.S. Dist. LEXIS 16204, at *8, *17–*20 (S.D.N.Y. Nov. 9, 2000). The Court in Milan held that such factual circumstances made the fraud obvious to the broker, which would impose upon him the duty to make a further inquiry into the bona fides of the investment. Id. at *17.

Moreover, for good reason, there are limits to the scope of liability for failure to adequately monitor the allegedly fraudulent conduct of others. Novak, supra, 216 F.3d at 309; South Cherry Street, LLC v. Hennessee Group, LLC, 573 F.3d 98, 100 (2d Cir. 2009). By its very nature, fraud such as that which was perpetrated by Smith and McGinn is secretive. The suggestion that Chiappone's performance of additional due diligence would have revealed the secretive fraud ignores reality, particularly in light of regulatory failures to discover the fraud during the same time period.

Here, the circumstances that were present to give rise to a duty to investigate in Hanly, Hasho, Milan, Berko, and Walker simply were not present at the time Chiappone sold Four Funds investments or the Trust offerings. Only after conducting a several year investigation and securing criminal convictions against the wrongdoers after deciphering millions of pages of internal MS & Co. records to which Chiappone never had access, the Division now, with 20/20 hindsight, simply claims that Chiappone, and the other registered representatives, could have done more. In reality, however, at the time Chiappone was selling the Four Funds investments and Trust offerings, the so-called "red flags" on which the Division relies were not obvious signs

of fraud that gave rise to an expanded duty on the part of Chiappone, as a registered representative, to question the due diligence underlying each investment or the compliance of McGinn, Smith or its principals.

First, unlike in Hanly and other cases cited above, the issuers of the Four Funds investments and the Trust Offerings were not strangers to Chiappone. Chiappone had intimate familiarity with the prior success of the MS & Co. structured investments, had known and worked with MS & Co. management for years, and had personally sold scores of private placement investments structured or underwritten by MS & Co. that had yielded great returns for investors. He had a more than a reasonable basis on which to recommend MS & Co. private placements, particularly those which were based on recurring monthly revenue streams, such as alarm monitoring receivables and triple-play receivables. Prior to the Four Funds offerings, 61 of 64 private placement investments sold by Chiappone had paid all interest due and had returned the principal to the investor. To Chiappone, such a track record spoke volumes for the ability of MS & Co. to appropriately scrutinize companies and to strike profitable deals at precisely the right times and on the right terms, particularly in the recurring monthly revenues market.

Furthermore, as the Division knows, while MS & Co. was finding its niche in structuring recurring monthly revenue investments, it had also implemented a sound institutional due diligence and compliance organizational structure—and Chiappone and the other registered representatives were educated, were trained, and worked within such a structure. MS & Co. had two compliance officers, a chief financial officer, in-house counsel, outside counsel, accounting staff, and research analysts. Each office, including the one that Chiappone worked in, had a branch manager, responsible for supervising the registered representatives and that served as a

critical communication liaison between MS & Co. management and the registered representatives. Given the repeated success of MS & Co. private placements and this institutional compliance and due diligence structure, the registered representatives were reasonable in relying on their firm to perform necessary due diligence and ensuring regulatory compliance in connection with its private placement offerings.

Moreover, the MS & Co. Supervisory Compliance Manual specifically addressed how due diligence would be performed in connection with private placement investments:

> "Due Diligence Procedures
> When McGinn, Smith acts as underwriter in connection with limited partnership and/or private placement offerings, it will make a reasonable investigation of the project to include inspection of completed projects, conversations with in-house counsel where applicable, a complete examination of financial documents and any other documents deemed necessary to deal fairly with the investing public. Paperwork recording the due diligence will be kept in the legal files."

The years of successfully structured private placement investments underwritten by MS & Co. was a reasonable basis on which the registered representatives could rely in trusting that appropriate due diligence had been done as mandated by the MS & Co. Supervisory Compliance Manual.

Additionally, unlike the high-pressure, boiler room sales operations such as those involved in Hasho, Berko, and Walker, MS & Co. was a reputable, longstanding brokerage firm offering a wide array of investments, and had instituted and adhered to a policy requiring the Branch Manager to review and approve daily trades to ensure that each transaction was suitable for the customer. With particular regard to private placement transactions, MS & Co. had instituted a policy requiring management to verify that the subscription information was consistent with the information in the client's records.

And the registered representatives knew about the MS & Co. institutional due diligence and compliance program. MS & Co. held annual compliance meetings, which included training on a number of issues, including among other topics, "Private Placements - Accredited Investor Guidelines and Suitability – Non-accredited investors." MS & Co. instituted a policy that all outgoing and incoming emails would be subject to review, and reminded registered representatives that such emails would be reviewed. MS & Co. management closely supervised the prospecting efforts of registered representatives, requiring registered representatives to seek and obtain approval of management for their prospecting ideas. MS & Co. compliance personnel reached out directly to investors if a transaction was made that appeared either to not be suitable or to be out of the ordinary. It was a highly structured, ostensibly lock-tight due diligence and compliance environment in which Frank Chiappone and the other registered representatives operated at the time the complained-of investments were offered and sold.

In fact, the due diligence and compliance environment at MS & Co. appeared so bullet-proof that when an occasional investor did complain to regulators about an investment underwritten by MS & Co. that did not perform as expected, regulators, including the SEC, did *nothing*—until 2009, after the investments complained of herein had already been offered and sold.

Chiappone had a reasonable basis for recommending the MS & Co. private placements, both because they had been remarkably successful in the past, and because MS & Co. had established what had operated as, and appeared to Chiappone to be, a nearly infallible compliance and due diligence program.

Now, the Division, analyzing the past with microscopic focus, claims that certain so-called "red flags" should have caused Chiappone to "do more". With respect to the Four Funds

investments, the Division even asserts that the mere fact that Smith structured and managed the blind pool of investments held by the Four Funds was enough on its own to require Chiappone to perform an independent investigation of the Four Funds investments. But that assertion ignores the fact that Chiappone had personally witnessed years of success of MS & Co. private placement investments, which necessarily meant that the MS & Co. due diligence team and MS & Co. management had operated with great success. And the fact that the Four Funds held a blind pool of investments was not an obvious fraud that should have alerted Chiappone to second-guess the legitimacy of the Four Funds investments. The Four Funds private placement memoranda fully disclosed that the investments held by each of the Four Funds was not fixed, and would be determined in the discretion of the Fund manager. When information was sought regarding the investments held by the Four Funds, Smith provided information to the registered representatives that showed the breakdown, by industry, of those investments. Chiappone was told that at the very beginning of the Four Funds offerings that the Four Funds investment portfolio would include, among other investments, the recurring monthly revenue alarm receivables—which Chiappone had seen generate great returns to investors. At the time, the registered representatives did not know or have reason to believe that Smith, who also served as one of two compliance officers, was a crook; and therefore, Smith's reluctance to reveal the specific identity of each company appeared to be adequately justified and reasonable.

The Division also asserts that the fact that sales of Four Funds investments were being made to unaccredited investors should have caused Respondents to investigate further. But Chiappone believed that the Four Funds investments were private placement offerings allowing up to 35 unaccredited investors. In fact, Patricia Sicluna and Georgia Goldstein, who were responsible for receiving, tracking, and organizing the subscription agreements, also believed

that each of the MS & Co.'s private placement investments could be sold to 35 unaccredited investors. And given MS & Co.'s institutional compliance program, the registered representatives reasonably relied on management to ensure compliance with Regulation D and the technical terms of the offering as stated in the private placement memoranda.

The Division's primary "red flag" is what it coins the "Redemption Policy." It claims that beginning in 2006, Smith had directed that all redemptions of Four Funds maturing notes be replaced by new sales of Four Funds investments. Chiappone, though, had no knowledge of any such direction at any time in 2006 or at any time until mid-November 2007. For the life of the Four Funds investments until November 2007, interest was timely paid, and to Chiappone's knowledge, redeeming noteholders had received their full principal without incident. Prior to and in November 2007, financial markets worldwide, including credit markets, were in the process of suffering an unprecedented meltdown, a fact that was popular knowledge and certainly on the minds of investment professionals, like Chiappone. So when Smith explained that the Four Funds were having difficulty paying redeeming noteholders because the underlying borrowers in which the Four Funds had invested had cash flow problems and what appeared to be a temporary inability to refinance their debt to the Four Funds, Chiappone reasonably believed Smith, the firm's chief compliance officer, and was not unjustified in assuming that the firm's institutional due diligence and compliance structure had vetted the situation. Also, while it appears that Frank Chiappone was aware of a desire by management that noteholder redemptions, for a temporary period, be met with replacement tickets to shore up the liquidity of the Four Funds for the benefit of all investors in light of the unfolding market crisis, he does not recall there being a specific, universal "Redemption Policy" under which a redeeming noteholder would not be paid until a replacement ticket was sold. Instead, the evidence shows that the registered

representatives believed that in the absence of a replacement ticket, the redeeming noteholders would still be paid. Given the state of the stock and credit markets at that time, outright criminal fraud and diversion of investor funds committed by MS & Co.'s *chief compliance officer* was the furthest possibility from Chiappone's mind as being the cause of the Four Funds' failures. And management's temporary solution to the liquidity and credit crisis that was then unfolding—what the Division refers to as the "Redemption Policy"—was not suggestive in November 2007 that MS & Co.'s chief compliance officer had either mismanaged the Four Funds or had committed any criminal fraud.

The Division also cites as a supposed "red flag" a meeting held on January 8, 2008 wherein Smith and McGinn informed the registered representatives essentially that the Four Funds were in deep financial trouble that would escalate beyond repair if immediate measures were not taken. Management's immediate solution was to reduce the interest payable to junior noteholders to 5% for the foreseeable future, and to develop a more comprehensive restructuring plan that would be implemented later if the situation did not improve. The failure of the Four Funds occurred in the midst of one of the most severe credit market meltdowns ever. This was not a "red flag", but was instead quite consistent with what an investment professional should expect in such an economic environment. Only with the benefit of hindsight—including several subsequent years of regulatory and criminal investigation, full discovery and prosecution in a federal civil case against Smith and McGinn, and a full criminal trial of Smith and McGinn resulting in their convictions and imprisonment—can the Division now claim that the Four Funds' failure in January 2008 was a "red flag" that should have made Chiappone question every single investment ever structured or underwritten thereafter by MS & Co.

And therein lies another fatal flaw in the Division's theory: failure of one investment or a select few investments of one type in the midst of a market collapse cannot impose a duty on the part of the registered representative to perform probing and exacting due diligence on every single investment ever structured or underwritten by the same firm thereafter. The problem with such a theory is that it turns the very duty to make reasonably based investment recommendations on its head. Applied here, that theory would require Chiappone to ignore the longstanding prior success that MS & Co. had generated for investors in recurring monthly revenue receivables investments, which had typically been structured and managed by McGinn, because a completely different type of investment structured and managed by Smith had failed. If the Division's theory in this regard is credited, it would require registered representatives to actually *ignore* what would otherwise constitute a reasonable basis upon which to recommend an investment; to *ignore* the data, analysis, and conclusions of professionals who are trained, have actual experience, and in many cases, have perfected the process of performing due diligence on potential investments; and, believe it or not, to make investment recommendations based upon data, analysis, and conclusions the registered representative makes based upon venturing into a process in which he utterly lacks the necessary education and training.[5]

The Division's shortsighted taste for revenge against these registered representatives for the criminal misdeeds of McGinn and Smith and their close circle of cohorts will in all likelihood actually, in the long run, have adverse effects on the investment advice and recommendations that investors receive from their investment professionals. The evidence will demonstrate that,

[5] For instance, the Division's theory suggests that it was the registered representative's responsibility to conduct their own due diligence on the Firstline Trusts investments. Ultimately, Firstline filed for bankruptcy and the Firstline Trusts investments failed because a creditor arguably possessed a superior claim to the assets that were supposed to generate revenues for the Firstline Trusts. The due diligence staff, which presumably included in-house and/or outside counsel, was unable to discern the risk that a creditor would have a priority claim to the assets, yet the Division posits that the registered representatives could have and would have discerned that risk?

notwithstanding the failure of the Four Funds investments, Chiappone had more than a reasonable basis to recommend the Trust Offerings, which were not only dramatically different in terms of the underlying income generation, but also were dramatically different in terms of the information provided in the private placement memorandum, the individual who structured the investments, and the historical success of such investments.

The evidence will also show that McGinn and Smith went to great lengths to conceal their wrongdoing from the registered representatives and to prop up a façade of legitimacy for as long as they possibly could, deceiving the investing public, their own registered representatives, and indeed, regulators.

For instance, after the two Firstline trusts were created to purchase recurring monthly revenue alarm receivables from Firstline and trust investments were offered to investors beginning in 2007, Firstline filed for bankruptcy in late January 2008, with McGinn and Smith learning of the bankruptcy on February 1, 2008. The revenue from Firstline's receivables stopped being paid into the trusts, which in the normal course would have made payments from the trusts to investors impossible and would have alerted the registered representatives to problems in the investment. But McGinn and Smith concealed the bankruptcy of Firstline from investors and the registered representatives by continuing to make interest payments using non-Firstline funds *for another 18 months*—all while continuing to tell the registered representatives that additional investments in Firstline were available for sale. In fact, neither McGinn nor Smith made the registered representatives aware of the bankruptcy until September 2009. By January 2010, Chiappone was no longer affiliated with MS & Co.

McGinn's and Smith's deliberate concealment of important information from the registered representatives is confirmed in Smith's own handwriting, in an undated "confession" to

Timothy McGinn, wherein David Smith states that he is concerned about criminal and regulatory consequences associated with their actions, and that he and McGinn "are misleading both our own employees and customers" and "are violating the high standards of integrity and ethics that have been the historical standard for us." The Division has possessed this handwritten confession for several years, and of course, with it in hand, can now assert that there were "red flags" that should have made the registered representatives take notice; but at the time of the relevant sales, Chiappone—and presumably the other registered representatives—had no indication that Smith and McGinn, who had for the previous 25 years successfully operated a well-respected investment banking and investment brokerage firm, were in the process of secretly perpetrating a massive, Madoff-like fraud.

The evidence at the hearing will show that Chiappone had a reasonable basis on which to recommend investments in the Four Funds and the various Trust Offerings, and that McGinn's and Smith's massive fraud was so successfully concealed that even regulators *who were asked to investigate MS & Co.* found nothing until 2009.

POINT III

CHIAPPONE DID NOT WILLFULLY VIOLATE SECTION 5(a) AND (c) OF THE SECURITIES ACT BY OFFERING AND SELLING NOTES FOR WHICH NO REGISTRATION STATEMENTS WERE IN EFFECT.

The Division cannot establish a willful violation by Frank Chiappone of Section 5(a) or 5(c) of the Securities Act.

"The provisions of section 5 shall not apply to . . . transactions by an issuer not involving any public offering." 15 U.S.C. § 77d(a)(2). Regulation D provides certain safe harbors, including Rule 506, which deems the offers and sales of securities to be transactions not

involving any public offering within the meaning of 15 U.S.C. § 77d(a)(2) where the security is sold to no more than 35 unaccredited investors. 17 C.F.R. § 230.506(b). Rule 500 provides that "[a]ttempted compliance with any rule in Regulation D does not act as an exclusive election; the issuer can also claim the availability of any other applicable exemption. For instance, an issuer's failure to satisfy all the terms and conditions of rule 506(b) shall not raise any presumption that the exemption provided by section 4(a)(2) of the Act is not available". 17 C.F.R. § 230.500(c).

With respect to each of the Four Funds offerings, the Division alleges that investments therein were sold to more than 35 unaccredited investors, and consequently, the sales are not exempt from registration under Section 4(a)(2). But that argument contradicts Rule 500, which expressly provides that a failure to meet the technical requirements of Rule 506 does not preclude application of the exemption in Section 4(a)(2).

Clearly, there was an effort to comply with Rule 506 with respect to each of the Four Funds offerings: each of the Four Funds offerings had been structured as a private placement investment, with a private placement memorandum having been prepared; Form D was filed with the SEC; and the purchaser questionnaire and subscription agreement were designed to elicit appropriate information from the purchaser to confirm that he or she was an accredited investor, or if not an accredited investor, had sufficient knowledge and experience in financial and business matters that permitted him or her to evaluate the merits and risks of the investment. The investor questionnaires and subscription agreements were to be sent to Smith's assistant, Patricia Sicluna, who was responsible for providing the investor questionnaires and subscription agreements to David Smith to review and sign, and who thereafter was supposed to track the number of accredited and unaccredited investors. Each of the private placement memoranda, on its face, stated that "[t]he notes are offered by virtue of exemptions provided by Section 4(2) of

the Securities Act, Regulation D promulgated under the Securities Act, ..." and explained that [t]he notes may not be resold or otherwise transferred". Thus, the Four Funds were structured with the aim of making a private offering by attempting to qualify for a safe harbor exemption.

This intent to comply with a safe harbor under Regulation D itself bears as one factor in determining whether the offerings were exempt under Section 4(a)(2). Other factors to be considered include (1) the number and sophistication of offerees; (2) the relationship of the offerees to each other and to the issuer; (3) the size of the offering; (4) the manner of offering; (5) ability of offerees to evaluate the merits of the issue or ability of the offerees to bear the financial risk; (6) whether information of the sort that would otherwise be included in a registration is actually disclosed; and (7) whether precautions are taken to prevent offerees from reselling their securities. United States v. Artunoff, 1 F.3d 1112, 1118 (10th Cir. 1993); Doran v. Petroleum Mgt. Corp., 545 F.2d 893 (5th Cir. 1977); SEC v. Empire Dev. Group, LLC, 2008 US Dist. Lexis 43509 (S.D.N.Y. May 30, 2008) citing Western Fed. Corp. v. Erickson, 739 F.3d 1439, 1442 (9th Cir. 1984); SEC v. Manus, 1981 U.S. Dist. Lexis 15317 (S.D.N.Y. Oct. 7, 1981). With respect to the number of offerees, one court has found that an offering was exempt under Section 4(a)(2) as a non-public offering even where there were 415 offerees. Weprin v. Peterson, 736 F. Supp. 1124, 1129 (N.D. Ga. 1988). Thus, all facts and circumstances—not simply whether the offering exceeded a certain number of purchasers or offerees—must be considered in determining whether the offering qualifies for exemption under Section 4(a)(2).

Here, the private placement memoranda for each of the Four Funds were numbered and distribution was controlled. They expressly stated on their respective face pages that the notes or certificates were not registered under the Securities Act of 1933 and were offered by virtue of exemptions provided by Section 4(2) of the Securities Act and Regulation D of the Securities

Act. They explained that there were significant restrictions on any ability to resell the certificates and that there was no public trading market for them. Thus, the re-sale of the securities was clearly not intended or not likely to occur. The private placement memoranda advised potential investors that they could ask for relevant data that would be useful in making an investment decision, and also noted as a risk factor that there were no historical financial statements or results of operations available.

Aside from the written disclosures, the manner in which Chiappone marketed the offerings comport with the requirements of the private offering exemption. The persons to whom Chiappone offered the private placements were sophisticated investors of substantial net worth, able to evaluate the risks (which were disclosed in the private placement memoranda) and merits of the securities without the benefit of a registration statement. Furthermore, less than 19% of Mr. Chiappone's clients bought private placement securities from him. No client was placed in a private offering via discretionary authority; all executed the subscription paperwork, which was designed to elicit information concerning the net worth, income, and investment sophistication of the investor. Chiappone marketed the private placements only via personal contacts; he did not engage in advertising or general solicitation to sell the private placements. To ensure that he complied with regulatory requirements, Chiappone sought the guidance of his supervisor prior to marketing the investments.

In many cases, Chiappone worked with the client's independent accountant. He sold private placements only to those of his clients that had the ability to understand the risks, and the financial wherewithal to absorb any losses.

Because he was not the only broker selling MS & Co. offerings, Chiappone cannot address the total number of offerees, but he limited his own marketing efforts to his more

substantial clients. A number of the offerees in the Four Funds and later offerings had purchased earlier (successful) private offerings, and were familiar with the general nature of the security (fixed income with a defined maturity date) and had experience in investing in non-tradable securities.

With regard to the Trust offerings, the Division concedes in the OIP that "[n]one of the Trust Offerings exceeded 35 unaccredited investors". However, it contends that the Trust Offerings should be integrated on the basis that eight of the Trust Offerings allegedly had a funding structure whereby offering proceeds were paid initially to TDM Cable Funding, LLC, before being paid to the funded entities, and four of the Trust Offerings allegedly had a funding structure whereby offering proceeds were paid initially to McGinn Smith Funding LLC before being paid to the funded entities. But such a characteristic is not enough on its own to "integrate" those various offerings for purposes of determining whether the offering complies with Regulation D. Instead, in addition to considering whether there are any significant time lapses between the offerings, the following factors should be considered: (1) whether the sales are part of a single plan of financing; (2) whether the sales involve issuance of the same class of securities; (3) whether the sales have been made at or about the same time; (4) whether the same type of consideration is being received; and (5) whether the sales are made for the same general purpose. See 17 C.F.R. § 230.502(a).

The Trust Offerings should not be integrated, as proposed by the Division.[6]

Critically, the Division seeks to integrate offerings that were not part of a single plan of financing and that did not have the same purposes. Some of the offerings were structured to finance alarm monitoring companies, whereas others were structured to finance companies

[6] The Division has not asserted that the Four Funds offerings should be integrated.

offering triple-play contracts, whereas even others were structured to finance luxury cruise ship charters.

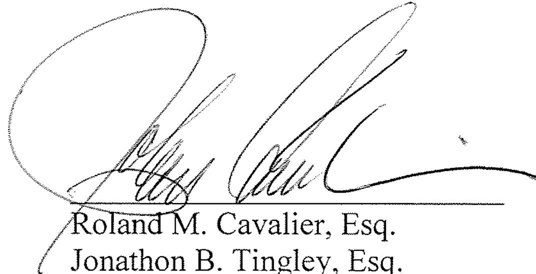
Investments in alarm receivables have different risks and rewards than investments in triple-play contract receivables, which have different risks and rewards than investments in the cruise ship chartering. Moreover, in the case of the offerings the Division seeks to integrate as one offering under the so-called "TDM Conduit," the time period during which the offerings were made spans a total of nearly three full years, with a time lapse between two of the offerings of 16 months. Similarly, for the offerings the Division seeks to integrate under the so-called "MSF Conduit," there exists a time lapse of nearly a full year between the second to last offering and the last offering. Finally, not only were these investments structured as stand-alone investments independent of each other, but also the registered representatives and investors viewed each such offering as a stand-alone investment independent of the others.

Based on the foregoing, the Division cannot establish that Chiappone willfully violated Section 5 of the Securities Act.

CONCLUSION

Based on the foregoing and the evidence to be adduced at the hearing, the Division's claims should be dismissed.

Dated: January 16, 2014
Albany, New York



Roland M. Cavalier, Esq.
Jonathon B. Tingley, Esq.
TUCZINSKI, CAVALIER &
GILCHRIST, P.C.
54 State Street - Suite 803
Albany, New York 12207
Telephone: (518) 463-3990
Facsimile: (518) 426-5067
Email: rcavalier@tcglegal.com
Email: jtingley@tcglegal.com