UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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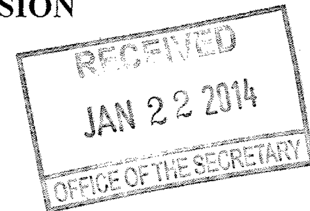

ADMINISTRATIVE PROCEEDING
File No. 3-15514

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 THOMAS LIVINGSTON'S PRE-HEARING BRIEF

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Respondent Thomas Livingston files this Pre-Hearing Brief and respectfully states as follows:

I. INTRODUCTION

David Smith ("Smith") and Timothy McGinn ("McGinn") masterminded a sophisticated and pervasive fraud. They exploited the 20-plus year successful track record and local prominence of their firm, McGinn Smith & Co., Inc. ("M&S" or "the firm"), to perpetuate their fraud. Smith and McGinn colluded with others within the firm -- including senior accounting and legal officers -- to further their fraud and which helped the fraud from being detected for so long. They used "Ponzi-like" payments, false accounting entries, fraudulent tax returns, and created false documents to hide their scheme. And, in selling the offering at issue in this case, Smith and McGinn capitalized on the success of their prior fraudulent offerings with not only those investors, but also the Respondents like Livingston.[1]

Smith and McGinn stole investor proceeds from private securities offerings that they created and controlled. Smith and McGinn skimmed large amounts -- more than $4.1 million -- of investor funds through excessive fees and "personal loans" to line their own pockets. Smith and McGinn also routed large amounts of the investments to in-house entities that they controlled and from which they each personally benefited. Smith and McGinn were tried and the jury found the men guilty on a combined 42 criminal counts.[2] McGinn and Smith were sentenced to 15 and 10 years, respectively, in federal prison for their crimes.

[1] A 1999 28-page letter from Smith to McGinn, which Livingston will introduce at the hearing, shows earlier fraud in prior offerings, including Ponzi-like payments, and a deep concern by Smith of criminal prosecution should their scheme be uncovered. The letter demonstrates, among other things, that Smith and McGinn were fully in charge of the investments and were the only people with knowledge of the true facts.

[2] The Government also indicted Matthew Rogers, Smith and McGinn's partner in the Trust Offerings, who pled guilty to filing a false tax return as part of a plea agreement in which he agreed to cooperate with prosecutors.

Importantly, no one has suggested that Tom Livingston had knowledge of Smith and McGinn's fraudulent activities, nor could they. Just like the M&S investors, the SEC, the NASD and later FINRA, and the IRS, Livingston was completely deceived by Smith and McGinn and was horrified to learn of their fraud after it was revealed and devastated by the losses investors suffered.

Although Livingston was duped by Smith and McGinn just like everyone else, the Division seeks to end his 30-plus year unblemished career in the securities industry. As will be shown at the hearing, the Division's case against Livingston is factually and legally flawed. For example, the Division's case is built on the premise that Livingston ignored alleged "red flags" that were allegedly apparent from the face of the investment documents -- yet, those supposed "red flags" were also apparently missed by experienced SEC and NASD inspectors who looked into the Four Funds themselves. In addition, the Division's claims are untimely because they assert claims that, even if they were valid, first accrued more than five years before this proceeding. In fact, the first alleged sale by Livingston at issue here occurred more than a decade ago.

In sum, Tom Livingston is not to blame for what occurred at M&S. He fulfilled his obligations and was not reckless in selling the offerings at issue here. Rather, Smith and McGinn preyed on Livingston, abusing the trust they had built with him over 20 years, and they fooled him, just like they did the investors, employees, and securities regulators.

II.
SUMMARY OF DIVISION'S CLAIMS

The Division's claims against Livingston appear to be centered on his alleged sales of the Four Funds (as defined in the OIP) between September 2003 and January 2007, all but two of which occurred on or before May 23, 2005. The Division claims that Livingston ignored "red

flags" in the PPMs that should have caused him to do further investigation and, presumably, to not sell the Four Funds. The Division also points to Livingston's involvement with alseT IP, a fund he started and that McGinn Smith subsequently invested in, as a "red flag." The Division's claims relating to Livingston's alleged sales of the Trust Offerings is less clear, as the Division does not suggest anything was inherently wrong with the underlying investments in those Offerings nor does the Division plead any "red flags" in the OIP concerning the Trusts that Livingston sold. Rather, the Division appears to claim that because of the Four Funds' liquidity issues that coincided with the deep US recession, he should not have sold any further offerings sponsored by the firm.[3] As a result, the Division asserts that Livingston violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

The Division also alleges that Livingston violated Section 5 of the Securities Act because (1) more than 35 unaccredited investors purchased the Four Funds and (2) if the Trust Offerings are combined into the two groups established by the Division, then more than 35 unaccredited investors purchased those offerings too. It's unclear whether the Division disputes Livingston had a good faith belief that the offerings were properly exempt from registration.

Below is a summary of the key reasons why the Division's case is both factually and legally flawed.

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[3] The Division has also suggested that Livingston made misrepresentations to investors, but has flatly refused to identify what he allegedly said, to whom he said it, when he said it, or how it was material. It is impossible at this point to address any such claims.

III.
SUMMARY OF KEY FACTUAL AND LEGAL FAILINGS IN DIVISION'S CLAIMS AGAINST LIVINGSTON

A. Livingston Did Not Have Special Access or Control at M&S

Mr. Livingston joined M&S in 1988 as an institutional salesman. He was promoted in 1995 to Syndicate Manager -- Institutional and Retail Sales, a new position that Smith developed in an effort to build the department by selling group syndications for both retail and institutional salesmen. He was later named Executive Vice President. He did not join M&S to sell securities offerings to individual investors; rather, he generally focused on the syndicate world, dealing with accounts from other brokers, and networking for the firm.

The Division's case against Livingston is based upon the false proposition that he was in a position to know more and do more concerning the investments at issue. When Tim McGinn was going through a divorce, he offered to sell Livingston a 20% interest in the firm for $400,000 (an investment he completely lost and never earned a dollar on). The Division has suggested that this ownership interest put Livingston in a better position to learn what Smith and McGinn kept secret. But, as the Division knows, Livingston had no real control of, or say in, the business -- it continued to be run and controlled by its co-founders. Indeed, the Commission has made clear in its civil suit that Smith and McGinn controlled M&S and all related entities -- "Since [2006], [McGinn] and Smith have actively controlled virtually every aspect of the McGinn Smith Entities' operations." Sec. Amend. Compl. at ¶ 38. It cannot be credibly argued that Livingston was ever a true partner in M&S. (At the time, Livingston chalked up his lack of involvement to the fact he was not a founder, rather than to any nefarious intent).

Livingston did not create, manage, or oversee what turned out to be fraudulent securities offerings. He had no role, much less supervisory, in the retail brokerage operations from which

the investments were sold. Livingston had no participation in making the investments or otherwise handling investor proceeds, and he had no role in overseeing or monitoring the investment portfolio. Livingston was not involved in nor did he have special access to the accounting or auditing functions of the firm. And, rather than sharing in the profits of the firm, Livingston received a set draw that was determined by Smith based on his individual revenue generation. In sum, the Division's reliance on Livingston's ownership interest is a red herring. It was an ownership interest only on paper -- the firm was run and controlled by Smith and McGinn.

B. alseT Was a Legitimate Company and Not a "Red Flag"

As we will demonstrate in more detail at the hearing, alseT was a real company with real operations, run by well-respected officers and directors and advised by reputable and well-known legal and financial firms. Although it was ultimately unsuccessful, alseT was a well-conceived company that pursued a number of investments, but ultimately was victim to a lack of capital as a result of the economic downturn. Livingston was paid for his work at alseT, but he earned that compensation and it was reasonable given the work he performed. Livingston never intended that M&S or the Four Funds would make any investments in alseT -- that was subsequently done through insistence by Smith and other alseT management. Nevertheless, because they believed alseT would be successful, Livingston and the other alseT management personally guaranteed the borrowed funds. While he was unaware of the extent of funding by the Four Funds, Livingston believed that investment in alseT was both consistent with the purpose of the Four Funds and was a good investment based on the upside (and real) potential for the company. Livingston also trusted Smith's representation that counsel advised that no additional disclosures were necessary to Fund investors.

C. Livingston Did Not Sell Any of the Four Funds After the So-Called Redemption Policy Was Instituted

A key part of the Division's red flags case is that "Respondents" continued to recommend and sell the Four Funds to clients after learning of a new policy instituted by Smith that a Fund investor could only be redeemed if replaced by a new investor. OIP ¶¶43-45. While the Division claims this policy occurred in late 2006, the evidence indicates this reference relates to an isolated issue with one investor and that if there were any type of "policy" at that time, it was not well known. Rather, the "policy" appears to have been instituted in late 2007, as evidenced in paragraph 64 of the OIP (referencing e-mail from Smith to Guzzetti). Nevertheless, the last sale of any of the Four Funds by Livingston was in January 2007 -- well after the redemption policy was instituted -- but even if there was a "redemption policy" at the time of his last sale, Livingston was not aware of it. Therefore, this key red flag did not relate to any sales of the Four Funds by Livingston.

D. Smith Continued to Lie Concerning the Four Funds When He Disclosed the Funds' Liquidity Issues

It wasn't until late 2007, almost a year after he sold the last investment in the Funds, that Livingston first learned that the Four Funds had liquidity issues. But, instead of honesty, Smith continued to lie to Livingston. Unbeknownst to him, the funds were actually worth less than one-half of the amount owed to investors. It was at this time -- when Smith needed assistance in restructuring the notes because the maturity date was approaching -- that he finally disclosed to Livingston what investments were being made with the monies from the Four Funds. This was the first time that Livingston saw what percentage of the Four Funds had been contributed to alseT. It was also the first time he was informed that many of the investments were not paying. Smith provided a reason as to why each of the interests were, in his opinion, "temporarily"

struggling, and assured him the investments were going to work out at some point. Livingston still trusted Smith. After all, he had seen him run a successful business for nearly 30 years. And, Livingston had seen funds fluctuate significantly, and thought many of the investments could be about to turn the corner, especially based on his own personal experience with alseT, which he understood was about to be funded by Goldman Sachs. In addition, the disclosure by Smith was made at the same time when the global financial crisis was clearly starting and when the U.S. sank into a deep recession. It was, therefore, unsurprising that small to medium sized companies, like Smith indicated the Four Funds' invested in, were having liquidity issues. In sum, Livingston had no reason to suspect the massive fraud that McGinn and Smith were carrying out.

E. The Division's Claims are Time-Barred

Beyond their evidentiary shortcomings, the Division's claims are riddled with fatal legal flaws. As the Supreme Court recently clarified in its unanimous opinion, the Division has two alternatives in pursuing enforcement actions: (i) bring its claim within five years of the date that the claim "first accrued" or (ii) forego any civil fines, penalties, or forfeiture. *See Gabelli v. SEC*, 586 U.S. 133, 133 S.Ct. 1216 (2013); *see also* 28 U.S.C. §2462. Yet, in this action, the Division seeks to ignore this clear mandate. As set forth below, the Division should not be permitted to support its request for relief against Livingston by introducing evidence of claims that accrued more than five years before the commencement of this action, as it is attempting to do.

1. The Division's Claims First Accrued More Than Five Years Before the OIP.

Under the plain language of the controlling statute, 28 U.S.C. § 2462, the Division may only institute a proceeding to seek civil penalties if it brings its claim within five years of "the

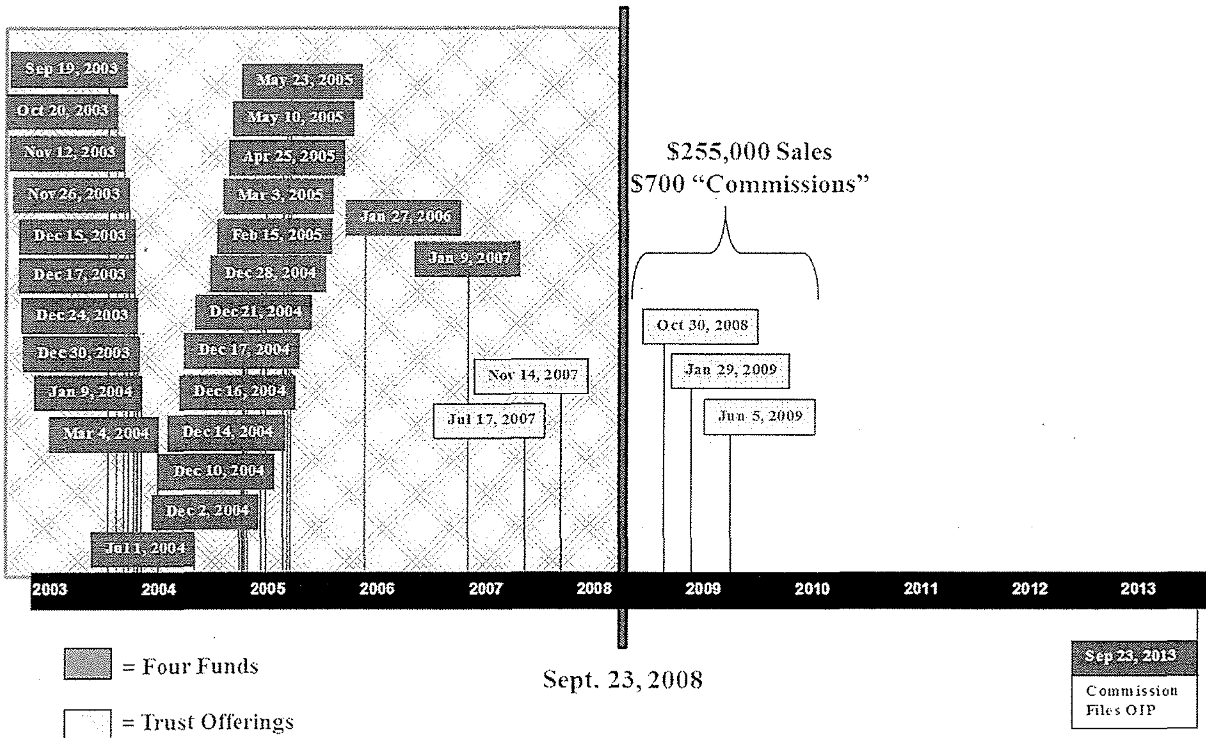
date when the claim *first accrued*." The Supreme Court recently confirmed that the language of the statute should be interpreted narrowly, and that the five-year limitations clock begins on the date the action first accrues, regardless of when the government actually discovers the misconduct. *Gabelli v. SEC*, 586 U.S. 133, 133 S.Ct. 1216 (2013) (citing Black's Law Dictionary 23 (9th ed. 2009) (defining "accrue" as "[to] come into existence as an enforceable claim or right")); *see also SEC v. Bartek*, 484 Fed. Appx. 949, 955, (5th Cir. 2012). In doing so, the Court discussed the importance of the limitation on the government's time in which to bring its claims as "vital to the welfare of society," because even wrongdoers are entitled to a time limit upon which "their sins may be forgotten." *Id.* at 1221. It found that any broader interpretation of Section 2462 would "leave defendants exposed to government enforcement action not only for five years after their misdeeds, but for an additional uncertain period into the future," and "would hinge on speculation about what the government knew, when it knew it and when it should have known it." *Id.* at 1223; *see also U.S. v. Core Labs., Inc.*, 759 F.2d 480, 483 (5th Cir. 1985) (Congress enacted §2462 in large part to ensure a defendant's "right to be free of stale claims, which comes in time to prevail over the right to prosecute them."); *3M Co. v. Browner*, 17 F.3d 1453, 1460-61 (D.C. Cir. 1994) ("An agency's failure to detect violations, for whatever reasons, does not avoid the problems of faded memories, lost witnesses, and discarded documents in penalty actions" brought long after discovery).

Each of the causes of action asserted in the OIP are based on Livingston's (and the other Respondents') sale of interests in the Four Funds and the Trust Offerings. The Division initiated this action on September 23, 2013. Thus, under Section 2462, it may not pursue penalties for claims that "first accrued" prior to September 23, 2008. However, according to the Division's own "evidence," Livingston first sold interests in the Four Funds on September 19, 2003 -- more

than a decade before this OIP was issued -- and last sold one of the Four Funds on January 9, 2007 -- more than 6 1/2 years before this proceeding. *See* Division's chart of alleged sales by Livingston, produced October 23, 2013.

Similarly, any claims based on Livingston's sales of the Trust Offerings first came into existence when he made his first sale on July 17, 2007 -- over 6 years before this proceeding. *See Gabelli*, 133 S. Ct. at 1220-21 (finding a claim "accrues" within the meaning of 2462 "when it comes into existence" -- that is, "when the plaintiff has a complete and present cause of action."). While literally a handful of sales in the Trust Offerings occurred between October of 2008 and June 5, 2009, it is illogical to contend that these impact the accrual date of claims based on Livingston's Trust Offering sales because the claims could not "come into existence" more than once and thus cannot be based on the subsequent sales. *See, e.g., SEC v. Jones*, 2006 U.S. Dist. LEXIS 22800 at *12 (S.D.N.Y. April 25, 2006) (rejecting the SEC's attempts to label each alleged violation -- collections of allegedly excessive fees -- as a new breach by the defendants).

The following timeline clearly shows that the Division's claims first accrued more than five years before the OIP:



In any event, the Division's claims as to the sales in the Trust Offerings are not based on the actual sales, but rooted exclusively on events that occurred well before September 23, 2008. The gravamen of the Division's claims is that the pre-2008 "red flags" and financial difficulties as to the Four Funds should have caused the Respondents to not sell the Trust Offerings. But, the Trust Offerings and the Four Funds were distinct investment programs, managed by different individuals with different investment strategies. In fact, the Division's own purported expert admits that Trusts "were not at all similar to the [Four Funds]." Furthermore, the OIP confirms that every single allegations of purported wrongdoing and any "red flags" occurred prior to September 2008.

2. *The Division's Request for Disgorgement, Industry Bar, and Monetary Penalty Fall Within Section 2462.*

Because the claims set forth in the OIP first accrued more than five years ago, the Division cannot lawfully use these claims to support its request for the imposition of penalties -- meaning civil penalties, industry sanctions, and disgorgement. It is well-established that the limitations under Section 2462 apply to any claim that seeks to punish the offender, rather than merely to provide a private remedy to those injured by the wrong. *See, e.g., Johnson v. SEC*, 87 F.3d 484, 488 (D.C. Cir. 1996). As the D.C. Circuit explained in the landmark *Johnson* decision, "where a legal action is essentially private in nature, seeking only compensation for the damages suffered, it is not an action for a penalty." But where a sanction has "collateral consequences" beyond the immediate sanction, and is based mostly upon past conduct rather than a current "risk [that the defendant] poses to the public," the sanction is a "penalty" subject to section 2462. *Id.* at 488-490. Applying this rationale, a censure and six-month suspension were found to constitute a "penalty" under section 2462 because the suspension had "longer-lasting repercussions on [the manager's] ability to pursue her vocation," and because "the sanctions [] were not based on any general finding of [the defendant's unfitness as a supervisor, nor any showing of risk she posed to the public, but rather on [her past acts]." *Id.*

Numerous courts have followed the *Johnson* two-prong test, finding a sanction is a "penalty" within the meaning of Section 2462 if it: (1) has "collateral consequences" beyond merely remedying a wrong, and (2) is based mostly on the defendant's past misconduct rather than a risk of future violations. *See, e.g., id.* at 488-90. In doing so, each of the types of relief requested by the Division has been deemed a "penalty" within the context of Section 2462, thus subject to the five-year limitations period. *See, e.g., SEC v. Jones*, 476 F. Supp. 2d 374, 381 (S.D.N.Y. 2007) (claim "for civil monetary penalties," is "unquestionably a penalty" under

section 2462, as is "a permanent injunction prohibiting Defendants from committing future violations" of securities laws); *Federal Election Comm'n v. Nat'l Right to Work Comm., Inc.*, 916 F. Supp. 10, 13 15 (D.D.C. 1996) (claim seeking a "permanent injunction" barring defendant from engaging in similar conduct in the future was punitive, where the FEC had not proven that the defendant posed any future threat); *SEC v. Microtune, Inc.*, 783 F. Supp. 2d 867, 885-886 (N.D.Tex. 2011) (injunctive relief, officers and directors bars, and reimbursement of any bonuses or profit were penalties under § 2462 and were all time barred); *Bartek*, 484 Fed. Appx. at 957 (permanent injunction and officer and director bar constitute "penalties" under Section 2462); *SEC v. DiBella*, 409 F. Supp.2d 122, 128 n.3 (D. Conn. 2006) (officer and director bar is a "penalty"); *Proffitt v. Federal Deposit Ins. Corp.*, 200 F.3d 855, 860-62 (D.C. Cir. 2000) (attempt to remove a bank director and bar him from the banking industry was punitive); *Riordan v. SEC*, 627 F.3d 1230, 1234 n. 1 (D.C. Cir. 2010) (noting "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."); *see also In re Telsey*, 144 B.R. 563, 1992 Bankr. LEXIS 1411 (Bankr. S.D. Fla. 1992) (accepting the Commission's argument that a disgorgement obligation constitutes "a fine, penalty, or forfeiture" under another federal statute).

Here, the Division's request for a civil monetary penalty is clearly a penalty within the meaning of Section 2462. *See, e.g., Jones*, 476 F. Supp. 2d at 381. Further, while disgorgement is a penalty/forfeiture itself, it is especially true here because Livingston did not actually receive any commissions from the offerings -- rather he received a set draw. Without actual receipt of the commissions, disgorgement is not appropriate. *See SEC v. Seghers*, 2010 WL 5115674, at *1 (5th Cir. Dec. 13, 2010) ("the party seeking disgorgement must distinguish between gains that

were legally and illegally obtained" and affirming district court's order denying disgorgement due to SEC's failure to distinguish gains).

Lastly, as would be suspected, an order permanently barring Livingston from the securities industry and taking away his career and livelihood is a penalty.[4] *See, e.g., Jones*, 476 F. Supp. 2d at 381; *Johnson*, 87 F.3d at 489; *Microtune*, 783 F. Supp. 2d at 885-886; *Bartek*, 484 Fed. Appx. at 957; *DiBella*, 409 F. Supp.2d at 128 n.3; *Proffitt*, 200 F.3d at 860-62. Aside from depriving him of means to provide for himself and his family, Livingston would forever be forced to disclose the imposition of any injunction or industry bar to future employers and regulatory authorities, and it will "become[] part of [his] permanent public file," creating "long[]-lasting repercussions" to his reputation and career. *Johnson*, 87 F.3d at 489. In the investment community, the collateral consequences of any kind of injunction "are quite serious," effectively "stigmatiz[ing]" the defendant for the rest of his life. *Jones*, 476 F. Supp.2d at 385; *see also SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 99 (2d Cir. 1978); *SEC v. Cenco Inc.*, 436 F. Supp. 193, 199 (N.D. Ill. 1977). Indeed, the fact that the Division seeks permanent injunctive relief here, rather than relief more narrowly tailored to the short period of alleged wrongdoing, reveals the Division's underlying motive – to create long-term fall-out for Livingston and penalize him for alleged conduct that occurred many years ago and that has not been repeated since. *See Proffitt*, 200 F.3d at 860-61 (permanent bar on banker "plainly goes beyond compensation of the wronged party") (internal quotation omitted).

In order to establish a likelihood of recurrence that requires a permanent injunction and bar, the Division must "go beyond the mere facts of past violations and demonstrate a realistic

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[4] An industry bar has been deemed "the most drastic <u>sanction</u> at the Commission's disposal." *Steadman v. SEC*, 603 F. 2d 1126, 1142 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981); *see also* Black's Law Dictionary (9th ed. 2009) (defining "sanction" as "[a] <u>*penalty*</u> or coercive measure that results from failure to comply with a law, rule, or order.") (emphasis added).

likelihood of recurrence." *Jones*, 476 F. Supp.2d at 384. There is no evidence – nor any allegation – that Livingston has engaged in any misconduct since he left M&S in 2009, and nothing demonstrates that he is likely to do so in the future. *See Jones*, 476 F. Supp.2d at 384 (fact that "several years have passed since Defendants' . . . misconduct apparently without incident . . . undercuts [SEC's] assertion that Defendants pose a continuing risk to the public"); *Proffitt*, 200 F.3d at 861 (same); *Johnson*, 87 F.3d at 490 n.9 (same). Likewise, the Division makes no claim concerning Livingston's current competence to serve in the securities industry. *See Microtune*, 783 F. Supp. 2d at 885 (finding requested relief was punitive where it was based solely on defendant's past conduct with no attempt to evaluate his present fitness or competence); *Johnson*, 87 F.3d at 490 (finding Commission's failure to cite a single piece of evidence that suspension was necessary due to plaintiff's current unfitness to be supervisor weighed against finding risk of future violation). Moreover, as in *Microtune*, the Division's delay of over three and a half years in initiating proceedings to enjoin and suspend Livingston is inexplicable if it truly viewed him as a future danger to the investing public.

F. The Division Cannot Show that Livingston Committed Fraud

Liability under section 10(b) and Rule 10b-5 requires proof that Livingston: (1) made a material misrepresentation or employed a fraudulent scheme or device; (2) indicating an intent to deceive or defraud - in other words, with scienter; (3) in connection with the purchase or sale of a security. *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir.1999); *SEC v. First Jersey Secs., Inc.*, 101 F.3d 1450, 1467 (2d Cir.1996). The standard for establishing a violation of Section 17(a) is essentially the same as for establishing a violation of § 10(b) and Rule 10b–5, and to prove a violation of it requires the same elements. *See U.S. SEC v. Universal Exp., Inc.*, 475 F.Supp.2d 412, 422 (S.D.N.Y. 2007) (citing *Monarch*, 192 F.3d at 308). We believe that the

Division will be unable to show that Livingston made any false or material misrepresentations or omissions, or that the facts are anywhere close to showing that he had the requisite intent.

1. Livingston Did Not Make Any Misrepresentations.

It appears through its exhibits that the Division may claim that Livingston told some investors that the investments were "safe." Livingston disputes that he told any investor this. In addition, every investor who purchased interests in the Four Funds or the Trust Offerings received a copy of the Confidential Private Placement Memorandum ("PPM") for that interest. The PPMs accurately state, absent the unknown fraud of Smith and McGinn, the significant risks in the investment and disclose that the interests are uninsured. In fact, the Four Funds PPMs include four full pages outlining the "RISK FACTORS."

The PPMs also informed investors that the Four Funds would acquire various public and/or private investments, which could include loans. *See, e.g.,* TAIN PPM p. 13 "Use of Proceeds." They were told that there were "very limited restrictions" on the investment activities, and that there was no requirement "to maintain any ratio of assets to debts in order to increase the likelihood of timely payments to you under the notes." *Id.* p. 9. In addition, investors were informed that David Smith was the principal officer of the Funds' managing member, and that "[the funds] rely solely on the expertise of our managing member to make the proper investment decisions to generate cash flows." *Id.* p. 21; *see also* p. 13. Potential conflicts of interest and affiliated transactions were also disclosed throughout the PPMs.

The Division cannot overcome the disclosures in the PPMs and the fact that investors received disclosures about the significant risks of these investments destroys any materiality, which is also an essential element of the Division's case. *See, e.g., Phillips v. LCI Int'l*, 190 F.3d 609, 617 (4th Cir. 1999) ("'[E]ven lies are not actionable' when an investor possesses

information sufficient to call the misrepresentation into question. After all, the securities laws impose liability only when there is a 'substantial likelihood' that an alleged misrepresentation 'significantly altered the total mix of information' a reasonable investor (the market) possesses."); *One-O-One Enters., Inc. v. Caruso*, 848 F.2d 1283, 1286 (D.C. Cir. 1988) (Ginsburg, J.) (oral representations "immaterial" when they conflicted with written agreement containing integration clause).

Further, Livingston cannot be liable for any alleged misstatements within the PPMs or those which he repeated because Livingston did not "make" the statements. Based on recent Supreme Court precedent, the only persons that can be liable for securities fraud are those that actually "made" the fraudulent statement -- meaning have "ultimate authority over the statement, including its content and whether and how to communicate it." *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

Here, Livingston did not play *any* role in drafting or developing the PPMs in question. He received the documents from the firm and distributed them to investors interested in the funds in question. Those like Livingston, who merely sell or recommend securities cannot be liable for any misstatements or omissions contained in the offering materials for such securities, which they did not "make." Accordingly, to the extent the Division's 10(b) and 17(a) claims are based on allegations that the PPMs failed to disclose the possibility for related-party transactions, the intended use of funds, and/or the inherent risks in the investments, they must fail. *Janus*, 131 S. Ct. 2296; *see also In re Flannery*, SEC Admin. Proc. 3-14081 (Oct. 28, 2011) (finding that the *Janus* test is the appropriate standard to apply in evaluating defendants' conduct under 10(b) and 17(a), and concluding that defendants did not have ultimate authority or responsibility for documents in which alleged misstatements were made); *SEC v. Kelly*, 817 F.Supp.2d 340, 345

(S.D.N.Y. 2011) (applying *Janus* to Section 17(a) claims as the elements are essentially identical to a rule 10b-5 claim and the only purpose in enacting rule 10b-5 was to extend Section 17(a) liability to "purchasers" of securities).

2. The Division Cannot Show Scienter.

Establishing a violation of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, or Exchange Act Rule 10b-5, requires a showing of scienter. Scienter can be shown by a mental state embracing intent to deceive, manipulate, or defraud, or recklessness. *See Aaron v. SEC*, 446 U.S. 680, 685, 697, 701-02 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). The type of recklessness necessary to satisfy the scienter requirement is "an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers and sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 856 (9th Cir. 2001) (quoting *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990)); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (quoting *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976), cert. denied, 434 U.S. 875 (1977)).

This type of recklessness is "the kind of recklessness that is equivalent to wilful fraud." *Sundstrand*, 553 F.2d at 1045 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J. concurring) (*en banc*). It "should be viewed as the functional equivalent of intent," and requires that "the danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing." *Id.* While this is an objective test, the facts "must be viewed in their contemporaneous configuration rather than in the blazing light of hindsight." *Id.* n.19.

This is not a case where Livingston ignored red flags or obvious signs of fraud. In fact, trained examiners from both the SEC and the NASD were unable to detect any fraud based on better information that Livingston had access to at the time. Livingston was taken by men who whom he had worked with and trusted for many years and who, in his experience, had been legitimately successful. But Smith and McGinn deliberately and systematically concealed their fraud from him. Red flags are always more obvious in hindsight, but at the time, Livingston had been lulled into trusting Smith and McGinn and had no reason to believe he was provided any misinformation.

3. Livingston Complied with His Due Diligence Obligations.

Livingston complied with his due diligence obligations by conducting a reasonable investigation of the M&S products he sold. When a broker-dealer recommends a security to an investor, "he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation." *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969). There are no stringent rules for how a broker-dealer meets his duty of reasonable investigation. *University Hill Found. v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 898 (S.D.N.Y. 1976). "The amount and nature of investigation required in this context is flexible, depending on the nature and strength of the recommendation and the role of the broker-dealer in the transaction, his knowledge of and relation to the issuer, and the size and stability of the issuing company." *Id.* If the broker-dealer does not have all of the essential information about the security, he must communicate that to the investor and identify the risks associated with the absence of this information. *Hanly*, 415 F.2d at 597.

Livingston conducted a reasonable investigation of each security he sold. Among other things, he analyzed the PPMs he had long-term relationships of trust and faith in Smith and

McGinn -- the principals who managed the respective offerings, he knew Smith and McGinn's track record at managing successful private placements, he knew Smith consulted with respected investment bankers, he saw Smith meet with prospective investment candidates, he knew that while he sold the Four Funds that the investments never missed an interest payment nor had any prior private offerings of the firm, he knew the firm used reputable legal counsel in the offerings, and on and on. The PPMs were not questionable on their face and did not contain information inconsistent with what Livingston understood otherwise. *Cf. SEC v. Milan Capital Group, Inc.*, No., 00 CIV. 108, 2000 WL 1682761, at *5 (finding that a duty to investigate is greater when the promotional materials are questionable or potentially misleading); *SEC v. Randy*, 38 F. Supp. 2d 657, 670 (N.D. Ill. 1999) (finding that a minimal investigation would have revealed that the issuer was not licensed as a bank, had no assets, and was not located where it claimed it was located); *Everest Secs., Inc. v. SEC*, 116 F.3d 1235, 1239 (8th Cir. 1997) (finding that a cursory investigation would have revealed facts inconsistent with the PPM). Livingston had no reason to believe the information he received would be unreliable. *See Levine v. SEC*, 436 F.2d 88, 90 (2d Cir. 1971) ('[A]bsent actual knowledge or warning signals, a broker-dealer should not be under a duty to retain his own auditor to re-examine the books of every company, the stock of which he may be offering for sale . . . .") The investments did not fail because of any underlying problems with the investments themselves that Livingston could have known, but rather because the McGinn Smith principals diverted the funds for other purposes. Furthermore, until the principals' illegal activity was discovered, Livingston had every reason to believe that Smith was a credible manager, adept at developing and managing proprietary investment products. Livingston had no reason not to believe Smith when he said the products were performing well. Plus, Livingston had experienced Smith's track record of good management based on his

decades of working alongside him and seeing Smith's other managed funds produce reliable returns.

To the extent Livingston did not have all of the information about the securities, these risks were squarely disclosed to the investors in the PPMs. Any issues of exclusive control, blind pool investments, conflicts of interest, and self-dealing were not red flags prompting Livingston to investigate further. Instead, these issues were clearly communicated to and acknowledged by each investor.

Importantly, while the Division claims that glaring red flags in the PPMs should have caused the Respondents to do a further inquiry, those red flags and the need for additional inquiry was also not apparent to SEC and NASD inspectors. The SEC and NASD inspected the firm in 2004 and 2006, respectively, and examined the Four Funds and the PPMs. Those trained examiners, like Respondents, did not see the supposed glaring red flags that the Division waives in hindsight and after a decade, nor did the examiners believe that heightened inquiry was necessary or suspect that wrongdoing was occurring.

G. <u>Livingston Did Not "Willfully" Violate Section 5</u>

Even if the Division can establish that the Four Funds and Trust Offerings were not exempt, it cannot show that Livingston willfully violated Section 5. For instance, it does not appear that the Division claims that Livingston was aware of the number of unaccredited investors, that the Four Funds exceeded 35 unaccredited investors, or that combining the Trust Offerings into two groups, that they exceeded 35 unaccredited investors.

Livingston relied on the representations of the issuer, the Funds' advisor (Smith), the M&S compliance department, and outside counsel regarding the legality of the offering. And, he had no reason not to. Even if the Division can show a Section 5 violation by the firm, it cannot

show that Livingston willfully sold unregistered securities because he had a good faith belief the offerings were properly exempt from registration.

IV.
CONCLUSION

Smith and McGinn committed a massive fraud and then took great efforts to successfully avoid detection. They lied to hundreds of investors, the SEC, the NASD and FINRA, the government -- and they lied to Tom Livingston too. Livingston was never aware of Smith and McGinn's crimes nor did he share in their spoils, rather he fell victim to trusting and believing his long-time colleagues, which among other things cost him more than half a million dollars. Livingston was not in a position to uncover any issues with the offerings at issue because Smith and McGinn went to great lengths to carry out their fraud. He should not be punished for being fooled like everyone else.

For the foregoing reasons and the evidence to be introduced at the hearing, the Division's case should be dismissed.

Respectfully submitted

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