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.

DIVISION OF ENFORCEMENT'S PREHEARING MEMORANDUM

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The Division of Enforcement respectfully submits this Pre-Hearing Brief.

PRELIMINARY STATEMENT

Like all registered representatives, Respondents Frank H. Chiappone, William P. Gamello, William F. Lex, Thomas E. Livingston, Brian T. Mayer, Philip S. Rabinovich and Ryan C. Rogers had an obligation to conduct a reasonable investigation of securities they offered to their customers to form a reasonable basis for any recommendation. Likewise, their supervisor, Andrew Guzzetti, had a duty to supervise these brokers to prevent violations of the federal securities laws. But as the evidence will show, Respondents failed to fulfill their fundamental duties. They blindly ignored red flags and continued offering and selling unregistered notes to their customers—or in the case of Guzzetti, urged the brokers he supervised to continue peddling private placements—despite failing to perform even minimal due diligence. Respondents conducted business as usual as red flags grew in number and intensity, selling millions of dollars of McGinn Smith & Co., Inc. ("MS & Co.") products without regard for the increasingly loud alarms that should have led them to become more vigilant in investigating the products they pitched to their clients. Then, to make matters worse, Respondents misrepresented and omitted material facts to scores of investors who entrusted them with their retirement accounts, college funds and other savings.

The offerings identified in the OIP raised approximately $127 million from more than 800 investors; investor losses exceed $80 million. The architects of the MS & Co. fraudulent offerings, David Smith and Timothy McGinn, have been sentenced to prison sentences of 10 and 15 years, respectively. Three other individuals pleaded guilty to crimes for their role in the fraudulent scheme. This action seeks to hold accountable (i) the brokers whose sales—and, at best, willful blindness—were necessary to carry out this multi-million dollar fraud, and (ii) the supervisor whose failure to supervise contributed to that same fraud.

Respondents' defense appears to be that they were unwitting dupes who had the bad luck to have sold, or supervised the sale of, millions of dollars in notes that turned out to be fraudulent. This defense is completely at odds with the evidence, which shows that Respondents willfully ignored the red flags all around them; including a policy—a hallmark of Ponzi schemes, which was clearly inconsistent with the terms of the offerings—that required them to "replace" customers seeking to redeem notes with new customers before the redemption would be honored.

The evidence will show that Respondents committed the violations alleged in the OIP.

STATEMENT OF FACTS[1]

The Respondents Knew of Red Flags Surrounding the Four Funds Offerings.

Chiappone, Gamello, Lex, Livingston, Mayer, Rabinovich and Rogers ("Selling Respondents")[2] performed inadequate due diligence prior to recommending the Four Funds to their customers. These Respondents' inquiry was particularly insufficient in light of numerous red flags that should have been readily apparent to each of the Respondents.

First, the Four Funds PPMs made clear that David Smith owned and controlled each of the issuers—which were new, single-purpose entities with no operating history—as well as the placement agent (MS & Co.) and the trustee. Smith also had total control over the disposition of investor funds and the PPMs made clear there was absolutely no oversight of Smith.

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1 The Respondents, MS & Co. and its affiliated entities, and the relevant offerings are described in Sections II.A and II.B of the *Order Instituting Proceedings* dated September 23, 2013. The abbreviations used in the OIP are incorporated herein.

2 Guzzetti sold $505,000 of the Trust Offerings and earned approximately $6,000 in commissions but is not included as a "Selling Respondent" for purposes of this Memorandum.

Second, as Respondents knew or should have known, Smith had never before managed offerings of the size and scope of the Four Funds. The debt offerings that MS & Co. had done before 2003 were small-scale note offerings tied to the income streams from home security alarm contracts. The Four Funds, by contrast, had a broad and non-specific investment mandate.

Third, the PPMs stated that the Four Funds could acquire investments "from our managing member or any affiliate," could "purchase securities from issuers in offerings for which [MS & Co.] is acting as underwriter or placement agent," and that "[a]ffiliates of the placement agent may purchase a portion of the notes offered hereby." Even though Smith controlled all aspects of the issuers, the placement agent and the disposition of investor funds with no oversight, the Respondents failed to respond to these disclosures as red flags by demanding that Smith disclose all transactions with affiliates. If they had, Respondents would have discovered that Smith diverted a total of $12.8 million of the Four Funds proceeds to redeem or pay interest to investors in pre-2003 offerings and to purchase the underlying contracts for more than what Smith knew they were worth. Had they asked appropriate questions, they also would have discovered that Smith invested $8.8 million in Four Funds proceeds in a venture capital investment called alseT IP, a company run and partially owned by Livingston.

Fourth, despite the PPMs' prohibition on sales to unaccredited investors, Respondents knew that sales were being made to unaccredited investors. Indeed, almost all Respondents made such sales to unaccredited investors themselves.

These four factors should have prompted Respondents to conduct a searching inquiry. Instead, they turned a blind eye and sold many millions of dollars of Four Funds offerings with no specific knowledge of how investor funds were being used.

Smith Failed to Disclose to the Brokers How He Had Invested
Four Funds Offering Proceeds.

From the commencement of the FIIN offering in September 2003 until January 2008, Smith provided Respondents with insufficient information about how he invested Four Funds offering proceeds. Smith often deflected brokers' questions by stating that he made loans to local Albany businesses with Four Funds proceeds and those businesses desired anonymity.[3] Indeed, Smith steadfastly refused to give the brokers sufficient information about how he had invested the approximately $86 million offering proceeds. Respondents, rather than demand facts needed to understand the offerings, simply accepted Smith's stonewalling and asked no further questions.

The information blackout Smith imposed was contrary to the PPMs, which stated that an "annual statement of the operations consisting of a balance sheet and income statement" would be provided to investors upon request. And MS & Co.'s compliance manual stated that "it will make a reasonable investigation . . . [and] Paperwork recording the due diligence will be kept in the legal files." It appears, however, that no brokers requested the reports identified in the PPMs the due diligence files before the Four Funds' collapse.

Selling Respondents Continued to Recommend MS & Co. Offerings
Despite Knowledge of the Redemption Policy

By 2006, the Funds began having significant difficulty meeting investors' redemption requests. Smith therefore instituted a policy that required brokers to "replace" customers seeking to redeem Four Funds notes, including maturing notes, with new customers (the "Redemption Policy"). The PPMs, however, did not state that a customer's right to redemption depended on

3 Smith provided limited information to some brokers regarding the types of investments made by the Four Funds, but fell far short of providing any meaningful investment portfolio information.

finding a "replacement."[4] Respondents learned of the policy at different times beginning in late 2006. They testified that they were shocked by the policy and disliked it, and that they knew that it was contrary to the PPMs.

The Redemption Policy was another red flag that put Respondents on notice that the Four Funds were being handled much differently from what the PPMs provided. None of the Respondents, however, undertook any meaningful investigation of the offerings. Instead, they continued to recommend other MS & Co. private placements for several more years, raising millions of dollars. Indeed, Respondents profited if a customer elected to "roll over" —*i.e.*, reinvest proceeds from a maturing investment in additional notes—and Respondents would receive their annual commission for the life of the newly sold notes. Certain Respondents, notably Lex and Rabinovich, not only adhered to the Redemption Policy but sought priority redemptions for themselves and immediate family members at the expense of new investors.

Selling Respondents Continued to Sell the Trust Offerings Despite Red Flags

On January 8, 2008, Smith and McGinn held an all-day meeting to inform the brokers, including Respondents, that the Four Funds were in default and that payments to investors would be curtailed. Smith revealed that the Four Funds investment portfolios consisted of loans to small, local businesses, some of which had already filed for bankruptcy; risky venture capital investments; and other nonperforming investments. Smith also revealed that the Four Funds lent investor money to other Funds and to other McGinn Smith entities. Smith informed Respondents that—clearly as a result of Smith's mismanagement—the Four Funds' assets were a fraction of what was due to noteholders and MS & Co. would need to restructure the notes.

4 The PPMs provided that the Four Funds notes would be redeemable at maturity. The PPMs also noted that the issuer's ability to make interest payments depended on the "ability to find and acquire suitable investments," and cautioned that, depending on the performance of the investments, the assets could be inadequate to repay the notes.

Respondents testified that this meeting left them shocked and angry. None of the Respondents, however, was prompted to demand any kind of probing investigation into what happened to the Four Funds or the ongoing Trust Offerings. Instead, Respondents continued as usual and sold millions of dollars of future Trust Offerings.

There were twelve Trust Offerings after the January 2008 meeting which raised a total of $19.3 million. Rather than respond to the accumulation of red flags since the launch of the Four Funds by conducting a searching inquiry of all MS & Co. private placements, Respondents instead blindly recommended the Trust Offerings to their customers. In fact, as was the case with the Four Funds, during the three years of the Trust Offerings, investor funds were being used in ways contrary to the uses described in the PPMs: for example, approximately $5 million was funneled to Smith, McGinn and MS & Co. Senior Vice President Matthew Rogers, and proceeds were used to redeem and make interest payments to investors in earlier offerings. In all of the Trust offerings, the amount actually invested was far less than the PPM disclosed.

Respondents failed to respond to red flags relating to the Firstline Trust offering. In October 2007, MS & Co. commenced its second Firstline Trust offering (ultimately raising $3.2 million from investors on top of the May 2007 Firstline offering that raised $3.7 million). In this offering, a McGinn Smith affiliate loaned the offering proceeds to Firstline Securities, Inc. ("Firstline"), a Utah corporation that sold residential alarm contracts. By early October 2007, however, Firstline was threatened with crippling litigation by one of its creditors. McGinn was personally involved in trying to resolve the dispute. Litigation ensued and, on January 25, 2008, Firstline filed a voluntary petition for Chapter 11 bankruptcy in the US Bankruptcy Court for the District of Utah. Since the Respondents did not conduct any due diligence in response to red flags (including the January 2008 meeting), they apparently did not discover the lawsuit or the bankruptcy until McGinn finally disclosed it to them in on or around September 7, 2009. Lex, Feldmann, Chiappone, Rabinovich and Mayer all sold Firstline notes after the bankruptcy filing.

The Trust PPMs, moreover, like the Four Funds PPMs, raised red flags that should have been readily apparent to Respondents. For example, the August 2009 TDMM Benchmark Trust 09 ("Benchmark") PPM should have raised at least two red flags. First, Benchmark promised a high rate of return, which ranged from 8% to 12%, during a time when the prime rate was only 3.25%. The PPM, however, disclosed that only $1,950,000 (approximately 65%) of the total $3 million raised would actually be invested, begging the question of how such high rates of return could be achieved. Second, Respondents should have questioned the inconsistency in the PPM's disclosures regarding fees paid. The Benchmark PPM stated on the cover sheet that total fees would be 8% of the total raised (or $240,000 if the maximum $3 million was raised) and that 92% of the proceeds would go to the Trust. The "Sources and Uses" section at page 8 of the same PPM, however, listed fees amounting to $1,050,000 if the maximum $3 million was raised, which is substantially higher than what was disclosed on the cover. None of the Respondents who recommended the Benchmark offering have admitted to even noticing the exorbitant fees, and none of them questioned how MS & Co. planned to make 8-12% interest payments and redeem the principal upon maturity while taking over one-third of the money raised in fees. Finally, the Firstline bankruptcy revelation should have raised an obvious red flag with respect to all late 2009 offerings, including Benchmark. Nevertheless, Rabinovich, Chiappone and Mayer sold Benchmark offerings *after* learning that McGinn and Smith concealed the bankruptcy.

Selling Respondents Each Sold Unregistered Offerings to
<u>Investors Where No Registration Exemption Applied</u>.

No registration statement was ever filed for any of the Four Funds or Trust Offerings that constituted the TDM and MSF Conduits ("Trust Conduits).[5] Each of the Four Funds was sold to more than 35 unaccredited investors, as were both Trust Conduits. Moreover, each of the Respondents sold these offerings to investors.

<u>Guzzetti Failed to Supervise</u>

Guzzetti was the managing director of the McGinn Smith & Co. Private Client Group from 2004 until 2009. Guzzetti supervised brokers in MS & Co.'s New York City and Clifton Park (Albany) offices, as well as brokers in the King of Prussia, PA and Orlando, FL offices. According to the MS & Co. Supervisory Compliance Manual, Guzzetti also acted as the Office Manager of the Clifton Park office. Brokers in various MS & Co. offices reported directly to Mr. Guzzetti and have identified him in depositions as an "immediate supervisor", a "general manager", a "regional manager", a "managing director" and a "principal" of the firm.

Guzzetti carried out many managerial duties, including recruiting and hiring MS & Co. employees; assigning and reassigning customers to brokers; evaluating employee performances and awarding commission; dismissing employees and advising employees about retirement; facilitating the resolution of employee grievances; addressing customer grievances; advising employees about compensation issues; answering employee questions regarding firm policy and investment financials; reviewing broker-customer e-mails and customer accounts for supervisory purposes; reviewing, monitoring, and approving broker accounts and statements; and issuing

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5 The Division will show that the Trust Offerings that constituted the Trust Conduits should be integrated for purpose of the Court's Section 5 analysis. The Trust Offerings Constituting the Trust Conduits are listed in Paragraph 31 of the OIP.

instruction and guidance regarding specific financial products and transactions, administrative issues, and broader firm policy.

Guzzetti also prepared daily e-mails summarizing MS & Co. financial products available for sale to customers. In February 2006 email, for example, Guzzetti stated that "there are many investors sitting in money market accounts (fear of higher interest rates) who are losing return (cost of waiting). Our FAIN'S offer a way of locking in higher returns with $ sitting in money markets waiting for the 'top' in interest rates."

Guzzetti testified that "until this thing broke up, I didn't know what types of private investments were in [the Four Funds.]" Nevertheless, Guzzetti told other brokers that the Four Funds notes had "no correlation to the shaky stock market," even though he had no information regarding the underlying investments. On April 8, 2008, Guzzetti e-mailed all brokers a draft letter addressed to FIIN and TAIN investors, which falsely blamed the Four Funds' problems on "the sub-prime mortgage collapse," the Countrywide collapse, and the ARS crisis (this letter was later sent out to investors by Smith).[6]

The Redemption Policy became clear to Guzzetti in December 2006, when he received an email from Smith stating that Rabinovich "needs to replace the $100,000 before doing the trade. I am running on fumes with all of these redemptions and cannot afford any[]more." In November 2007, Guzzetti received an email from Smith stating: "I do not have the liquidity. Any redemptions have to have replacement sales beforehand. . . . My preference is for there to be no redemptions." Guzzetti nevertheless urged all brokers to "make sure you replace any redemptions promptly." And Guzzetti continued to push brokers to sell and roll over the Four Funds notes while failing to investigate the reasons behind the Redemption Policy or promptly

6 Around this time Smith, suspended the interest payments of the FIIN and TAIN notes.

alert the sales force of such problems, waiting instead for one year to discuss it with the brokers he was responsible for supervising.

On January 16, 2008, the day after the first restructuring letter went out to MS & Co. customers, Guzzetti emailed all MS & Co. to sell FIIN and TAIN 7% notes. Guzzetti testified at his deposition that he never made any independent inquiry into whether it was appropriate to continue to list the Funds on his daily sales email. Guzzetti again emailed MS & Co. brokers to sell Four Funds notes two months after the January 2008 meeting announcing the default.

LEGAL ANALYSIS

I. Selling Respondents Violated Securities Act Sections 5(a) and 5(c).

A. The Evidence Shows a *Prima Facie* Case

Selling Respondents are directly liable for the Section 5 violations because they offered and sold both Four Funds notes and Conduit Entity Trust Offerings (*see* OIP ¶ 31), which had no registration statements or exemption from registration. Sections 5(a) and 5(c) prohibit the offer and sale of securities in interstate commerce unless a registration statement is filed with the Commission or is in effect, or the transactions are exempt or fall within a safe-harbor from registration. To establish a *prima facie* case, the Division must prove that: (1) the defendant offered to sell or sold a security; (2) the defendant used the mails or interstate means to sell or offer the security; and (3) no registration statement was filed or was in effect as to the security. *See SEC v. Cavanagh*, 1 F. Supp. 2d 337, 361 (S.D.N.Y. 1998), *aff'd*, 155 F.2d 129 (2d Cir. 1998). The burden of proof then shifts to Respondents to show that an exemption or safe-harbor from registration was available. *See SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953). Scienter is not required to establish a Section 5 violation, *see SEC v. Softpoint, Inc.,* 958 F. Supp. 846, 859-60 (S.D.N.Y. 1997), *aff'd,* 159 F.3d 1348 (2d Cir. 1998).

The evidence shows a *prima facie* Section 5 violation: Selling Respondents sold the offerings at issue using interstate commerce and no registration statement was in effect.

B. Selling Respondents Cannot Rely on Any Exemption from Registration

The Four Funds' PPMs claimed exemptions from registration under Section 4(2) of the Securities Act and Rule 506 of Regulation D. The applicability of Section 4(2) turns on whether the particular class of person affected needs the protection of the Securities Act. *Ralston Purina*, 346 U.S. at 125. The Four Funds had numerous unaccredited, unsophisticated investors who did not have access to the type of information normally provided in a registration statement, including audited financial information, that would allow them to make an informed investment decision. Thus, the Section 4(2) exemption is unavailable.

For the Rule 506 exemption to apply, the Four Funds could issue securities only to up to 35 unaccredited investors. 17 C.F.R. § 230.506(b)(2). As each of the Four Funds had more than 35 unaccredited investors, the Rule 506 exemption does not apply.

The Trust offerings also violated Section 5. Although no single Trust Offering exceeded 35 unaccredited investors, under the integration doctrine, the TDM Conduit trusts and the MSF Conduit trusts may be integrated. The integration analysis has two parts: issuer integration and offering integration. To determine issuer integration, the factors are common control over the issuer, disregard of entity form, issuer engaged in same type of business, and commingling of assets.[7] These factors favor integration because Smith and McGinn controlled the conduit entities, disregarded entity form, and comingled assets.

Rule 502(a) requires consideration of five factors to determine if offering integration is appropriate: (1) whether the sales are part of a single plan of financing; (2) whether the sales

[7] Equity Programs Investment Corp., No Action Letter (November 27, 1978), 1978 WL 12165 (discussing generally single issuer requirement for integration analysis).

involve issuances 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. *SEC v. Cavanagh*, 445 F.3d 105, 112, n.17 (2d Cir. 2006) (quoting Non-Public Offering Exemption, Rel. No. 33-4552 (Nov. 16, 1962)).

Rule 502(a)'s integration factors are satisfied in this case. The Trust Offerings constituted a single plan of financing for each conduit, and allowed Smith and McGinn to continue to comingle and misuse funds raised from private placement investors. Indeed, the Trust Offerings allowed the scheme to continue because they provided fresh inflows of funds.

The Trust Offerings satisfy the second Rule 502(a) factor because trust certificates were offered and sold in each offering. The third factor is satisfied because the brokers' offers and sales of the trust certificates were continuous and overlapping with no six-month gaps. Fourth, the same consideration was received for each Trust Offering: customers paid in cash by wire. Fifth, and finally, the Trust Offerings, through their respective conduit entity, all were for the same stated purpose: to purchase "triple play" cable, internet, and phone contracts, security alarm contracts, and luxury cruise cabin rentals.

Accordingly, the Trust Offerings linked to the TDM Conduit should be integrated (44 total unaccredited investors), as should the Trust Offerings linked to the MSF Conduit (39 unaccredited investors).[8] Thus, the Trust Offerings do not qualify for any exemptions from registration.

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[8] The Division will offer a summary witness who will describe, among other things, how the proceeds from Respondents' sales of the offerings in the Trust Conduits were used.

C. Selling Respondents Are Strictly Liable for Their Section 5 Violations

Respondents are liable for their sales of unregistered securities regardless of their knowledge or intentions. *See SEC v. U.N. Dollars Corp.*, No. 01 Civ. 9059 (AGS), 2003 WL 192181, at *2 (S.D.N.Y. Jan. 28, 2003) ("[D]efendants' lack of knowledge regarding the registration requirement does not provide them with a meritorious defense" to Section 5 claims); *see also SEC v. CMKM Diamonds, Inc.*, 729 F.3d 1248, 1256-7 (9th Cir. 2013) (affirming that Section 5 is a strict liability statute even where one relies on counsel).

Moreover, Selling Respondents cannot isolate their individual sales and argue that they sold to fewer than 35 unaccredited investors and, therefore, did not violate Section 5. The registration requirements of the Securities Act apply to the "entire process in a public offering through which a block of securities is dispersed and ultimately comes to rest in the hands of the public." *Matter of Carley et al.,* No. 3-11626, 2008 WL 268598, at *7 (Jan. 31, 2008) (affirming finding of Section 5 violation and rejecting respondents attempt to "isolate certain components of the distribution") (citation omitted).

II. Selling Respondents Violated Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5 Thereunder.

Selling Respondents violated the antifraud provisions because they: (1) recommended the Four Funds and Trust Offerings without a reasonable basis and in the face of numerous red flags; (2) made material misrepresentations and omissions; and (3) engaged in a scheme of deceptive conduct.

Section 10(b) of the Exchange Act makes it "unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." To establish a violation of Section 10(b) and Rule 10b-5(b), the

Commission must show: (1) a materially false or misleading statement or omission, (2) in connection with the purchase or sale of securities, and (3) scienter. *See, e.g.*, *Basic, Inc. v. Levinson*, 485 U.S. 224, 235 n.13 (1988); *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999).

Section 17(a) of the Securities Act prohibits fraud in the offer or sale of securities, using the mails or the instruments of interstate commerce. Section 17(a)(1) forbids the direct or indirect use of any device, scheme or artifice to defraud; Section 17(a)(2) makes it unlawful to obtain money or property through misstatements or omissions about material facts; and Section 17(a)(3) proscribes any transaction or course of business that operates as a fraud or deceit upon a securities buyer. *Softpoint*, 958 F. Supp. at 861. While proof of scienter is a necessary element of liability under Section 17(a)(1) of the Securities Act, only negligence is required for liability under Sections 17(a)(2) and 17(a)(3). *Aaron v. SEC*, 446 U.S. 680, 697 (1980).

Rules 10b-5 (a) and (c) prohibit the use of any "device, scheme, or artifice to defraud" or any other "act, practice or course of business which operates . . . as a fraud or deceit" in connection with the purchase or sale of securities, with scienter. *See In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 335-36 (S.D.N.Y. 2004) ("a cause of action exists under [Rule 10b-5] subsections (a) and (c) for behavior that constitutes participation in a fraudulent scheme, even absent a fraudulent statement by the defendant").

A. Selling Respondents Violated the Antifraud Provisions by Failing to Investigate the Offerings' Suitability Before Recommending Them

A broker's duty to investigate offerings he or she markets and sells is "black letter law":

> It is black letter law that: Brokers and salesmen are "under a duty to investigate, and their violation of that duty brings them within the term 'willful' in the Exchange Act." Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. He must analyze

> sales literature and must not blindly accept recommendations made therein. The fact that his customers may be sophisticated and knowledgeable does not warrant a less stringent standard . . . .

Matter of Pinkerton, et al., No. 3-8805, 1996 WL 602648, at *5 (Oct. 18, 1996), citing *Hanly v. SEC*, 415 F.2d 589, 595-97 (2d Cir. 1969).

Indeed, this and other Courts have long found violations of the antifraud provisions where brokers recommend securities without an adequate and reasonable basis to do so. *See, e.g., Matter of Lester Kuznetz*, No. 3-6356, 1986 WL 625417, at *3 (Aug. 12, 1986) (finding violations where broker recommended securities without a reasonable basis); *See also Hanly*, 415 F.2d at 597 (upholding Commission bar of individuals for failing to disclose "known or reasonably ascertainable adverse information" relating to the issuer); *In re Walston & Co.,* No. 3-722, 1967 WL 87755, at *4 (Sept. 22, 1967) (finding violations where broker lacked adequate basis for recommending bonds whose issuer had no reasonable ability to service the bonds). The reasonable basis standard obligates a broker to investigate and have adequate information about a security before recommending it. *See Hanly*, 415 F.2d at 597. By making a recommendation, a broker implicitly represents to a buyer of securities that he has an adequate basis for the recommendation—by virtue of a broker's title, customers are entitled to presume that the representations made were the result of reasonable investigation. *Id. at* 596. Accordingly, a broker must perform appropriate due diligence to ensure that he or she understands the nature of the product, as well as the potential risks and rewards associated with the product.[9]

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[9] *See* Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings, FINRA Notice to Members 10-22 (April 2010).

B. Selling Respondents Recommended MS & Co. Private Placements Despite Having No Reasonable Basis for Their Recommendations.

The amount of independent investigation required varies with the circumstances, but the duty to investigate is greater whenever the legitimacy of an investment is in some way questionable. *SEC v. Milan Capital Group, Inc.*, No. 00 Civ. 108(DLC), 2000 WL 1682761, at *5 (S.D.N.Y. Nov.9, 2000); (where circumstances "raise enough questions," "a person's failure to investigate before recommending that investment [may be considered] reckless."). The red flags present here at the outset, and increasing throughout, called for greater scrutiny of the MS & Co. offerings. The Four Funds PPMs, the restructuring of the Four Funds, the Redemption Policy, and the excessive fees identified in certain Trust Offering PPMs should have, at the very least, "raised enough questions" to cause Respondents to pause and ask questions before selling MS & Co. products to their customers. Moreover, "[s]ecurities issued by smaller companies of recent origin obviously require more thorough investigation." *Hanly,* 415 F.2d at 597. And Smith's failure to disclose to Respondents the investments purchased with Four Funds proceeds demanded investigation. *See SEC v. McNulty,* 137 F.3d 732, 741 (2d Cir. 1998) ("obviously evasive and suspicious statements" by principal should be investigated); *Matter of Stires & Co., et al.*, No. 3-9120, 1998 WL 462230, at *7 (Aug. 11, 1998) ("refusal to provide verifiable information was a bright red flag that would have caused a reasonable person to check further."). Respondents' ongoing sales of MS & Co. offerings without any reasonable basis to determine that those investments were suitable investment products violated the antifraud provisions described herein.

C. Selling Respondents Misrepresented and Omitted Material Facts

Because Respondents recommended the MS & Co. private placement to their customers, they were obligated to disclose all known or reasonably ascertainable material adverse information about the recommended securities. *Hanly,* 415 F.2d at 597; *see also Kwiatkowski v. Bear Stearns & Co.,* 306 F.3d 1293, 1302 (2d Cir. 2002) (broker "is obliged to give honest and complete information when recommending a purchase or sale"). Licensed securities professionals may not simply parrot the marketing information provided to them. *See SEC v. Hasho*, 784 F. Supp. 1059, 1107 (S.D.N.Y. 1992) (citation omitted). Thus, as in *Pinkerton*, it is no defense for any Respondent here that he may have told customers "exactly what [he] was being told." 1996 WL 602648, at *5. And a broker that lacks essential information about an issuer or its securities when she makes a recommendation must disclose this fact as well as the risks that arise from its lack of information. *Id.* Respondents here made no such disclosures.

As evidence presented at the hearing, including investor testimony, will prove, Selling Respondents made numerous misrepresentations and omitted material information in connection with the offer, sale and purchase of the Funds, the Trusts and MSTF. They failed to disclose the risk factors associated with these investments, and they repeatedly told prospective customers that Smith and McGinn had a reliable track record and that their principal would be safe. Respondents failed to disclose to investors adverse information that they knew of or that was reasonably ascertainable.

D. Selling Respondents also Violated Rule 10b-5(a) and (c) and Securities Act Section 17(a)(1) and 17(a)(3)

The Respondents were the necessary component of a scheme to defraud investors. Each of the Respondents undertook a course of deceptive conduct that involved blindly selling MS & Co. unregistered notes after numerous red flags made it clear that something was amiss. Respondents' sales, omissions, and facilitation of the Redemption Policy permitted the undisclosed use of new money to cover losses in old offerings, in the very investment products Respondents lauded as a basis to invest in MS & Co. deals.

E. The Respondents Acted With Scienter.

The Respondents were, at a minimum, severely reckless in continuing to offer MS & Co. notes when they had no reasonable basis to make such representations. Even when confronted with serious red flags, the Respondents did nothing to confirm the accuracy of the representations made regarding the offerings and instead continued to sell MS & Co. private placements to investors. *See Hanly* 415 F.2d at 597; *see also SEC v. Infinity Group Co.*, 212 F.3d 180, 193 (3d Cir. 2000) ("[I]gnorance provides no defense to recklessness where a reasonable investigation would have revealed the truth to the defendant....")

Respondents' claimed lack of knowledge of McGinn's and Smith's fraudulent scheme would not be exculpatory. "Brokers and salesmen are 'under a duty to investigate, and their violation of that duty brings them within the term 'willful' in the Exchange Act." *See Hanly,* 415 F.2d at 595-96 (citation omitted).

III. Selling Respondents Acted Negligently.

Alternatively, the Respondents acted at least negligently. To show that Respondents violated sections 17(a)(2) and 17(a)(3) of the Securities Act, the Commission need only show (i) material misrepresentations or materially misleading omissions, (ii) in the offer or sale of securities, (iii) made with negligence. *See SEC v. U.S. Pension Trust Corp.*, No. 07-22570-CIV, 2010 WL 3894082, at *19 (S. D. Fla. Sept. 30, 2010) (citation omitted). To establish negligence, the Commission must show that the respondents failed to conform to the standards of care applicable to its industry or profession. *See SEC v. Fitzgerald*, 135 F. Supp. 2d 992, 1028 (N.D. Cal. 2001). The standard of care by which to measure conduct, however, is not defined solely by industry practice, "but must be judged by a more expansive standard of reasonable prudence, for which the industry standard is but one factor." *SEC v. Dain Rauscher, Inc.*, 254 F.3d 852, 856

(9th Cir. 2001). As discussed above, a securities professional has a fundamental obligation to investigate a security to ensure that the key statements about the security that are provided to investors are truthful and complete, and each Respondent failed in these obligations and, consequently, their conduct was not reasonable or prudent.

IV. Guzzetti Failed Reasonably to Supervise the Selling Respondents with a View to Preventing and Detecting Violations

Under Section 15(b)(4), supervisors must respond reasonably when confronted with red flags suggesting that an registered representative may be engaging in improper activities. *See George J. Kolar*, No. 3-9570, 2002 WL 1393652, at *6 (June 26, 2002). Moreover, a failure to learn of improprieties when diligent application of supervisory procedures would have uncovered them also constitutes a failure to supervise. *See Matter of Horning*, No. 3-12156, 2007 WL 4236161, at *9-13 & n.17 (Dec. 3, 2007) (supervisor failed to uncover errors because of cursory review of reports), *aff'd*, 570 F.3d 337 (D.C. Cir. 2009).

As explained above, violations by Selling Respondents occurred because Guzzetti ignored red flags that they were offering and selling securities without conducting a reasonable investigation, and he failed to put in place procedures that would have detected and prevented the unlawful conduct. Although Guzzetti had overlapping supervisory responsibilities with McGinn and Smith, that does not absolve him of his own obligation to supervise. *See James J. Pasztor*, No. 3-8511, 1999 WL 820621, at *6 & n.28 (Oct. 14, 1999) (individual not relieved of supervisory duties because supervisory authority was shared with another).

V. The Court Should Impose Meaningful Sanctions and Other Remedies Against Respondents

The Division seeks relief to ensure Respondents do not profit from their misconduct, are prevented from future violations victimizing the investing public, and are punished for violating the securities laws.

A. Selling Respondents Should Be Barred from Association with Any Broker-Dealer

Section 15(b) of the Exchange Act, 15 U.S.C. § 78o(b), authorizes the Commission, if it finds that it is in the public interest, to bar any person from being associated with any broker or dealer. Such actions can be taken against any person who, among other things, willfully violated any provision of the Securities Act, the Exchange Act, or any of the rules and regulations promulgated under those statutes.

The public interest analysis requires consideration of the following factors: (1) the egregiousness of the respondent's actions; (2) the isolated or recurrent nature of the infractions; (3) the degree of scienter involved; (4) the sincerity of the respondent's assurances against future violations; (5) the respondent's recognition of the wrongful nature of their conduct; and (6) the likelihood that their occupation will present opportunities for future violations. *See, e.g., Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979); *Matter of Weeks*, No. 3-9952, 2002 WL 169185, at *53 (Feb. 4, 2002).

As discussed above, Selling Respondents each willfully committed fraud. The violations were not isolated in nature. To the contrary, Respondents sold many different offerings to numerous investors over an extended period of time. And despite the egregious nature of Respondents' violations, no Respondent has taken responsibility for the wrongful nature of his conduct. Furthermore, all are threats to repeat their violations if not prevented from so doing.

Thus, permanent bars against Selling Respondents are in the public interest and warranted in this case in light of their egregious conduct.

B. <u>Cease and Desist Orders Are Warranted Against the Selling Respondents</u>

The Commission is authorized to issue cease and desist orders where a person who has, among other things, been found to have violated any provision of the Securities Act or Exchange Act, or the rules and regulations thereunder. Section 21C of the Exchange Act, 15 U.S.C. § 78u-3; Section 8A of the Securities Act, 15 U.S.C. § 77h-1. As described above, Selling Respondents each willfully violated Securities Act Sections 5(a), (5c) and 17(a), and Exchange Act Section 10(b) and Rule 10b-5 of the Exchange Act. Their actions demonstrate a conscious disregard of the federal securities laws. Accordingly, cease-and-desist orders against Selling Respondents are appropriate to prevent violations and future violations of the statutes and rules set forth above.

C. <u>Selling Respondents Should Be Required to Disgorge Their Ill-Gotten Gains and Pay Prejudgment Interest</u>

Selling Respondents, who received approximately $4 million in commissions from sales of the offerings at issue here, should each be ordered to pay disgorgement plus prejudgment interest. "The primary purpose of disgorgement as a remedy for violation of the securities laws is to deprive violators of their ill-gotten gains, thereby effectuating the deterrence objectives of those laws." *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1474 (2d Cir. 1996) (citations omitted). Moreover, "effective enforcement of the federal securities laws requires that the SEC be able to make violations unprofitable." *Id.* (quoting *SEC v. Manor Nursing Centers, Inc.,* 458 F.2d 1082, 1104 (2d Cir. 1972)). Accordingly, Selling Respondents should each be ordered to disgorge commissions paid in connection with their sales of the offerings detailed in the OIP. *See Matter of Trautman Wasserman & Co.,* No. 3-12559, 2008 WL 149120, at *24-25 (Jan. 14,

2008) (ordering disgorgement of respondent's compensation); *Matter of Kenneth R. Ward*, No. 3-9237, 2003 WL 1447865, at *14 (March 19, 2003) (disgorgement of commissions).

Prejudgment interest deprives a defendant of an interest-free loan in the amount of his ill-gotten gains, thereby preventing unjust enrichment. *SEC v. Grossman*, No. 87 Civ. 1031, 1997 WL 231167, at *11 (S.D.N.Y. May 6, 1997), *aff'd in part and vacated in part on other grounds*, 173 F.3d 846 (2d Cir. 1999).

D. Respondents Should Be Required to Pay Substantial Penalties

Under Section 21B of the Exchange Act, 15 U.S.C. § 78u-2, the Commission may impose civil monetary penalties in proceedings instituted under Section 15(b) of the Exchange Act, against any person who is found to have willfully violated, or aided and abetted, any provision of the Exchange Act if such penalties are in the public interest. Six factors are relevant to determining whether civil monetary penalties are in the public interest: (1) deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) harm to others; (3) unjust enrichment; (4) prior violations; (5) deterrence; and (6) such other matters as justice may require. *See* Section 21B(c) of the Exchange Act. "Not all factors may be relevant in a given case, and the factors need not all carry equal weight." *Matter of Robert G. Weeks,* 2002 WL 169185, at *58.

Section 21B(b) of the Exchange Act specifies a three-tier system identifying the maximum amount of civil penalties, depending on the severity of the respondent's conduct. Second tier penalties are awarded in cases involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. Third-tier penalties are awarded in cases where such state of mind is present, and, in addition, where, as here, the conduct in question directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons, or resulted in substantial pecuniary gain to the person who committed the act or omission. In this proceeding, the Division respectfully submits that third-tier penalties are appropriate against all Respondents for their violations of the securities laws after September 23, 2008.[10]

CONCLUSION

Based on the foregoing, the Division respectfully requests that, following the parties' presentation of evidence at trial, this Court make findings of fact with regard to the misconduct discussed above and that the requested sanctions be imposed on the Respondents.

Dated: New York, NY
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Respectfully submitted,

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10 28 U.S.C. § 2462 prescribes a five-year statute of limitations for civil penalties claims. There is, however, no statute of limitations on the Division's requests for equitable relief, including disgorgement of ill-gotten gains, remedial cease and desist orders, and prophylactic industry bars. *See, e.g., SEC v. Kelly*, 663 F. Supp. 2d 276, 286-87 (S.D.N.Y. 2009) (declining to apply Section 2462's limitations period to SEC's request for permanent injunctive relief, disgorgement, and an officer and director bar); *see also SEC v. Pentagon Cap. Mgmt. PLC*, 725 F.3d 279, 287 (2d Cir. 2013) (remanding SEC's request for civil penalties in light of *Gabelli v. SEC*, 133 S. Ct. 1216 (2013), but not its request for disgorgement). Moreover, the Division will prove that serious violations of the securities laws occurred well-within the applicable limitations period.