UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	:	
Plaintiff,	:	
v.	:	**10 Civ. 457 (GLS/DRH)**
McGINN, SMITH & CO., INC., McGINN, SMITH ADVISORS, LLC, McGINN, SMITH CAPITAL HOLDINGS CORP., FIRST ADVISORY INCOME NOTES, LLC, FIRST EXCELSIOR INCOME NOTES, LLC, FIRST INDEPENDENT INCOME NOTES, LLC, THIRD ALBANY INCOME NOTES, LLC, TIMOTHY M. MCGINN, DAVID L. SMITH, LYNN A. SMITH, DAVID M. WOJESKI, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, GEOFFREY R. SMITH, LAUREN T. SMITH, and NANCY MCGINN,	:	
Defendants,	:	
LYNN A. SMITH, and NANCY MCGINN,	:	
Relief Defendants, and	:	
DAVID M. WOJESKI, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04,	:	
Intervenor.	:	

MEMORANDUM OF LAW IN SUPPORT OF PLAINTIFF'S APPLICATION FOR AN ORDER TO SHOW CAUSE WHY DEFENDANTS TIMOTHY M. MCGINN AND DAVID L. SMITH SHOULD NOT BE HELD IN CONTEMPT

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Plaintiff respectfully submits this memorandum of law in support of its Application for an Order to Show Cause why defendants Timothy M. McGinn and David L. Smith should not be held in contempt for violating the preliminary injunction order dated July 22, 2010 (the "PI Order"), enjoining the current securities offering discussed below, enjoining McGinn and Smith from involvement in any future securities offerings without permission of the Court, freezing and returning any and all investor funds raised through the current security offering and for such further relief as the Court deems appropriate. In order to prevent further potential harm to investors, the SEC respectfully requests that the Order to Show Cause be heard on an expedited basis.

PRELIMINARY STATEMENT

Although they have been enjoined by the Court from violating the antifraud provisions of the federal securities law, McGinn and Smith are engaged in a new offering of securities and have made material misrepresentations and omitted material facts in offering materials provided to investors. Documents received by the SEC in recent weeks show that this new offering violates the Court's injunction; therefore, McGinn and Smith are in contempt of the Preliminary Injunction Order.

The new fraudulent offering involves an issuer recently created by McGinn and Smith named Security Alarm Credit, LLC ("SAC"). Their former administrative assistant, Carolyn Gracey, is named as Chairman and CEO, although she appears to be a figurehead. McGinn and Smith have been attempting to raise $543,000 through the sale of notes offering an interest rate of 11 percent, and $118,000 of investor funds is to be immediately siphoned off for undisclosed "corporate purposes." The remaining $425,000 is to be lent to a company called Anchor Alarm Center, Inc. ("Anchor"), at an interest rate of over 19 percent. The loan allows Anchor to defer

a substantial portion of its repayment obligation until the last year of the 61 month loan, when over $270,000 of principal will be due, including a final balloon payment of $167,143 in the 61st month.

As discussed below, Anchor has experienced significant financial difficulties that raise serious questions regarding its ability to repay the notes offered by McGinn and Smith. These and other material facts are not disclosed in the Private Placement Memorandum ("PPM") already used by McGinn and Smith to solicit potential investors. (Gracey received a handwritten letter from Smith, dated October 19, 2010, purporting to resign from SAC.)

The PPM contains numerous material misrepresentations and omissions. For example, the PPM: (1) fails to provide any specific information concerning Anchor's current income and expenses, information any reasonable investor would need to make an informed decision regarding the risks and benefits of the proposed investment; (2) fails to disclose that Anchor and its president Michael Latty have repeatedly experienced difficulties repaying their existing debt obligations, and have had to refinance both company loans and Latty's personal loans; (3) fails to disclose that many of Anchor's alarm customers are slow to pay invoices which is adversely impacting its cash flow; (4) fails to disclose that a substantial portion of investor funds will be used to pay off personal debt of Latty; (5) fails to disclose that the SEC's present action charges McGinn and Smith with fraud in connection with securities offerings closely resembling the instant offering; and (6) fails to disclose that McGinn and Smith have been enjoined from engaging in any further securities violations and that their assets have been frozen to preserve funds to repay investors previously defrauded by them.

These material misrepresentations and omissions conceal relevant information that any reasonable investor would want to know regarding the likelihood that Anchor will be able to

repay its high-interest loan to SAC. In fact, the paucity of information provided in the PPM makes clear that it is geared toward unsophisticated investors, luring them in through high interest rates, lulling them into complacency through the lower, more achievable payments due in the initial years of the loan and then leaving them exposed to undisclosed risks when Anchor is required to make the large balloon payments due at the end of the loan. The defendants, meanwhile, siphon off $118,000 of investor funds at the outset, free and clear of any risk.

In view of the current fraudulent offering, and the stated intention to conduct additional offerings, the SEC respectfully requests that the Court issue an Order requiring McGinn and Smith to show cause why they should not be found in contempt, enjoining the current SAC offering, prohibiting McGinn and Smith from involvement in any future offers or sales of securities unless prior approval is obtained from the Court and for the additional relief set forth in the proposed Order to Show Cause.

STATEMENT OF FACTS

The SAC Offering

In October 2010, the SEC learned that McGinn and Smith had spent months preparing to launch a new offering of securities through SAC. (Declaration of Paul Zindell, executed on October 26, 2010 ("Zindell Decl."), ¶11.) They have developed offering materials and solicited investments from prospective investors. The SEC has obtained two versions of a PPM describing the SAC offering. The PPM dated September 22, 2010, labeled "draft," states that SAC is a recently created limited liability company that "provides financial advice and capital solutions to businesses engaged in various elements of the Security Alarm industry." (Zindell Decl., Ex. 4, at 4.) Smith and McGinn are listed as Executive Vice Presidents of SAC. (*Id.*)

Carolyn Gracey is identified as the Chairman, Chief Executive Officer and 100% owner of SAC. (*Id*.)

The PPM states that SAC is offering "Senior Subordinate Notes," which will pay investors interest at a fixed annual rate of 11% on the principal amount of their investment. (Zindell Decl., Ex. 4, at 1.) The notes have a term of 61 months. (*Id*.) The purpose of the offering as stated in the PPM is to loan funds to Anchor (the "Anchor Loan") and provide funds to SAC for "corporate purposes". (*Id.* at 8.) The PPM states that Anchor will use the loan proceeds to pay off certain of its existing debts. (*Id.* at 5.) Anchor will pay SAC an annual interest rate of 19.62 percent on the Anchor Loan. (*Id.* at 4.) The notes issued by SAC will be secured by the Anchor Loan, which will be subordinate to an SBA guaranteed loan to Anchor from Quantum National Bank (the "Quantum Loan"). (*Id*.)

The disclosures, terms, and conditions in the subsequent PPM, dated November 1, 2010, also labeled "draft," are substantially similar to those in the initial version, except as follows. Smith's name does not appear in the PPM and he is no longer listed as an Executive Vice President. Only McGinn and Gracey are listed as directors and officers of SAC. (Declaration of David Stoelting ("Stoelting Decl."), Ex. 7, at 4.) The minimum investment amount has been reduced from $50,000 to $10,000. (*Id.* at 5.) The minimum offering amount has also been reduced from $125,000 to $15,000. (*Id.* at 9.) Curiously, the number of accounts serviced by Anchor has been drastically reduced from 25,000 to 5,000. (*Id.*) This is either an egregious typographical error or a substantial alteration of a material fact bearing on Anchor's ability to repay the loan. Finally, the subsequent version states that the Quantum Loan is secured by certain assets that will allegedly be available to secure the Anchor loan, once the Quantum loan is satisfied, and by a personal guarantee by Anchor's president, Michael Latty. Both versions of

the PPM otherwise contain the same material misrepresentations and omit the same material facts.

Furthermore, McGinn and Anchor have taken concrete steps to effectuate the Anchor loan. The September 22, 2010 PPM was sent to Zindell by McGinn in an effort to solicit funds from him. (Zindell Decl. ¶ ¶ 8-11.) On October 12, 2010, it appears that the Credit Agreement, Grid Note and General Security Agreement contemplated by the SAC offering were executed by Carolyn Gracey for SAC and Michael Latty for Anchor. (Stoelting Decl. Exs. 12, 13, 14.) On October 13, 2010, McGinn responded to an email from Latty asking when he could expect funding to begin with respect to the Anchor loan by stating: "My guess is funding on either Monday (the 18th) or Friday (the 15th)." (Stoelting Decl. Ex. 11.)

False and Misleading Statements Concerning Anchor's Financial Condition

The PPM contains false and misleading statements concerning Anchor's financial condition. According to the PPM, Anchor is a Georgia based corporation that provides third-party central station monitoring to alarm dealers. (Zindell Decl., Ex. 4, at 5; Stoelting Decl., Ex. 7, at 5.) The PPM describes Anchor as a successful business, having "grown revenue by 6% per year over the last three years" and having the "current capacity to grow accounts handled by 100% without further capital expenditures." (*Id*.) In addition, the PPM states that the SAC noteholders will be subordinate to the Quantum Loan, currently in the amount of $484,000, and that the monthly debt payment to Quantum is $9,000. (Zindell Decl., Ex. 4, at 4; Stoelting Decl., Ex. 7, at 4.) However, the PPM fails to note that Anchor is a company in financial distress. Moreover, according to documents provided by Quantum, the actual loan balance is $497,264, not $484,000 as the PPM states. (Stoelting Decl., Ex. 1.)

In March 2009, Anchor began making late payments on the Quantum Loan, and has incurred late charges almost every month since then. (Stoelting Decl., Ex. 1.) In addition, from November 2009 to June 2010, Anchor did not make any principal payments on the Quantum Loan. Instead, Anchor procured note modification agreements allowing it to pay only interest from September 2009 to May 2010. (Stoelting Decl. Ex. 2.) Yet even the loan modification did not allow Anchor to catch up on payments – every month this year Anchor has paid late, incurring over $2,600 in late charges. (Stoelting Decl. Ex. 1.) Quantum's internal Annual Review Form dated October 2009 states: "Many of Anchor Alarm's customers are slow to pay invoices due which is affecting the borrower's cash flow." (Stoelting Decl. Ex. 3.)

None of these details are disclosed to investors in the PPM. The PPM is also devoid of any specific details concerning the current financial condition of Anchor. For example, the PPM does not disclose Anchor's current actual revenues, or its non-debt related expenses, or the value of the assets promised as collateral for the Anchor loan once the Quantum loan is satisfied. Thus, the PPM omits precisely the type of specific financial information that any reasonable investor would need and expect in order to make an intelligent, informed investment decision regarding the likelihood that Anchor will be able to repay its high interest rate loan. Instead, as in prior offerings enjoined by this Court, the defendants intended prey appears to be unsophisticated investors who are lured in with high interest rates and optimistic references to current revenue growth, without disclosing Anchor's actual financial difficulties.

Material Omissions Concerning the Use of the Anchor Loan Proceeds

The PPM indicates that Anchor intends to "employ up to $408,000 of the loan proceeds to extinguish existing debt." (Zindell Decl., Ex. 4, at 5.) However, documents provided by Gracey indicate that the Anchor loan is intended, in part, to pay off $120,000 in personal loans

taken out by Latty, Anchor's President. The Anchor term sheet and payoff schedule show that the two largest obligations to be extinguished are $74,355 owed to Bill Knox and $47,395 to the Phil Petty Revocable Trust. (Stoelting Decl., Ex. 8.) The applicable loan notes show that these are not Anchor's obligations, but instead were personal loans to Latty, secured by a percentage of his interest in Anchor.[1] (Stoelting Decl., Ex. 9, Ex. 10.) If the Anchor loan is allowed to proceed, the effect will be to extinguish Latty's personal loans, replacing his individual obligations with Anchor's subordinate corporate debt. The PPM does not disclose this material information.

Significantly, the PPM also fails to disclose that Latty apparently was unable to meet his financial obligations to repay these loans as well. For example, the promissory note to Bill Knox in the amount of $200,000 with a 21.011% interest rate was issued on May 1, 2002. That note states that: "this combines 2 previous loans of $40,000 and $55,000 (copies attached). This actual dollar amount being loaned is an additional $105,000." (Stoelting Decl., Ex. 9.) Indeed, according to the Payoff Schedule, Anchor intends to use the loan proceeds to pay off 25 creditors to whom Latty and Anchor currently owe $409,965.03, and substitute those debts that they have fallen behind on with the Anchor loan. The benefits to McGinn and Smith are clear. They siphon off $118,000 of investor monies for "corporate purposes," up-front and risk-free. The investors are left with only the hope that somehow Anchor will be able to do what it has apparently not been able to do yet -- meet its debt obligations out of current revenues. Alternatively, and far more likely, the investors will not recover their funds unless the defendants are allowed to defraud future investors by raising monies to pay off Anchor's current notes --

[1] Although the Petty note was signed by "Mike Latty, President", it appears to be a personal loan. It does not identify any corporate entity as the obligor. The only reference to Anchor is the term providing that the obligor pledges "10% Ownership in Anchor Alarm Center, Inc." as security for the loan.

precisely the type of scheme McGinn and Smith have used in the past to keep their house of cards afloat.

Material Omissions Concerning the SEC's Action Against Smith and McGinn

The PPM fails to disclose material facts concerning the SEC's case against Smith and McGinn. The SEC's Complaint alleges that Smith and McGinn, through certain entities they controlled, orchestrated a scheme to raise over $136 million from hundreds of investors by conducting more than twenty fraudulent debt offerings in four funds and various trusts. In the PPM, the only disclosure concerning the SEC's case is simply that Smith, McGinn and the company they founded, McGinn, Smith & Co. Inc., are defendants in this action, and that Smith and McGinn believe the SEC's case is "without merit and are executing a vigorous defense." (Stoelting Decl, Ex. 7 at 5.) The PPM then refers investors to the Receiver's website. The PPM does not disclose that the SEC's action alleges fraudulent activities by McGinn and Smith in connection with securities offerings in PPMs, including offerings related to alarm contract receivables. The PPM also fails to disclose that the Court has ordered, among other relief, an asset freeze over all of Smith's and McGinn's assets as well as the assets of numerous entities affiliated with Smith and McGinn. Finally, the PPM also does not disclose that, on July 7, 2010, the Court issued a Memorandum-Decision and Order finding, among other things, that the SEC has demonstrated a substantial likelihood of success on its claims against Smith, McGinn, and the other named defendants.

The Broad Scheme to Conduct Multiple Securities Offerings

The PPM described above is part of a broader scheme orchestrated by McGinn and Smith to conduct multiple securities offerings in the future. This PPM is apparently the first of eight offerings. McGinn informed a potential investor that they plan to engage in additional offerings,

including "four deals in [the] first year" and "four deals in [the] second year." (Zindell Decl., Ex. 2, at 2.)

ARGUMENT

I. McGinn and Smith are in Contempt of the PI Order

It is well-settled that district courts have the inherent power to enforce compliance with their lawful orders through civil contempt. *Shillitani v. United States*, 384 U.S. 364, 370 (1966).[2] Civil contempt is "wholly remedial," and is intended to coerce compliance with an order of the court. *McComb v. Jacksonville Paper Co.*, 336 U.S. 187, 191 (1949). A sanction is considered "civil" and "remedial" if it either coerces the defendant into compliance with a court order or compensates the complainant for losses sustained. *Int'l Union, United Mine Workers of Am. v. Bagwell*, 512 U.S. 821, 827 (1994). Congress codified the power of the federal judiciary to punish with contempt "[d]isobedience or resistance to its lawful writ, process, order rule, decrees, or command." 18 U.S.C. § 401.

In the civil contempt context, a party may be held in contempt if the moving party shows, by clear and convincing evidence, that "the order being enforced is clear and unambiguous, the proof of noncompliance is clear and convincing, and the defendant[] ha[s] not been reasonably diligent and energetic in attempting to accomplish what was ordered." *See EEOC v. Local 638*, 753 F.2d 1172, 1178 (2d Cir. 1985) (citation and internal quotation marks omitted); *United States v. Schulz*, No. 1:07-cv-0352, 2008 WL 2626567, at *1 (N.D.N.Y. April 28, 2008). To meet this initial burden, the plaintiff need only present a *prima facie* case, *United States v. Rylander*, 460 U.S. 752, 755 (1983), and it is not necessary to show that the defendant's

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[2] This Court has the authority to issue an order of contempt for violation of the PI Order under 28 U.S.C. § 636(e)(4). The parties consented under 28 U.S.C. § 636(c) to the Court's jurisdiction over the Commission's Motion for Preliminary Injunction (Dkt. 12) and Smith and McGinn consented to the entry of the PI Order by this Court (Dkt. 61).

disobedience was willful. *See SEC v. Universal Express, Inc.*, 546 F.Supp.2d 132, 134 (S.D.N.Y. 2008) (quoting *EEOC v. Local 638*, 753 F.2d at 1178). In the context of civil contempt, the clear and convincing standard means "a quantum of proof adequate to demonstrate a 'reasonable certainty' that a violation occurred." *Levin v. Tiber Holding Corp.*, 277 F.3d 243, 250 (2nd Cir. 2002). Once this initial burden is met, the burden then shifts to the defendant to come forward with evidence showing "categorically and in detail" why he is unable to comply with the court's order. *Rylander*, 460 U.S. at 755.

Once contempt has been established, a district court has "broad discretion to fashion an appropriate coercive remedy . . . based on the nature of the harm and the probable effect of alternative sanctions." *EEOC v. Local 28*, 247 F. 3d 333, 336 (2d Cir. 2001) (quoting *N.A. Sales Co. v. Chapman Industries Corp.*, 736 F.2d 854, 857 (2d Cir. 1984)). To fashion an appropriate remedy, a Court should consider: "(1) the character and magnitude of the harm threatened by the continued contumacy; (2) the probable effectiveness of any suggested sanction in bringing about compliance; and (3) the contemnor's financial resources and the consequent seriousness of the burden of the sanction." *SEC v. Bremont*, 2003 WL 21398932 at *7 (S.D.N.Y 2003) (quoting *Dole Fresh Fruit Co. v. United Banana Co.*, 821 F.2d 106, 110 (2d Cir. 1987)). Remedies ranging from the use of an escrow requirement to incarceration are clearly within the Court's discretion. *See e.g. Local 28*, 247 F.3d at 336; *SEC v. Margolin*, 1996 WL 447996 at *5

In addition, under Section 20(b) of the Securities Act of 1933 and Section 21(d) of the Securities Exchange Act of 1934, the Court has "broad equitable powers to grant ancillary relief . . . where necessary and proper to effectuate the purposes of the securities laws." *SEC v. American Bd. of Trade, Inc.*, 830 F.2d 431, 438 (2nd Cir. 1987); 15 U.S.C. § 77t(b); 15 U.S.C. §78u(d)(5) ("In any action or proceeding brought or instituted by the Commission under any

provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.").

1. The Commission Has Made a *Prima Facie* Showing that McGinn and Smith Are In Contempt of the Preliminary Injunction Order

This Court should find McGinn and Smith in contempt of the PI Order because they have marketed a new securities offering, in violation of Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. If Smith has in fact severed his ties to SAC, his violative conduct appears to have ceased. (*See* Stoelting Decl. Ex. 4.) In the case of McGinn, however, his conduct is ongoing.

First, the PI Order enjoining Defendants from violating the antifraud provisions of the Federal securities laws is clear and unambiguous. The Commission previously made a proper showing justifying injunctive relief against McGinn and Smith under Section 20(b) of the Securities Act and Section 21(d) of the Securities Exchange Act. (Docket 96 at 2) Accordingly, McGinn and Smith consented to, and the Court entered, the PI Order stating that: "McGinn and Smith, and each of their agents, servants, employees, attorneys [and others] are preliminarily restrained and enjoined from violating, directly or indirectly," Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. (Dkt. 96 at 3)

Second, proof of noncompliance with the PI Order is clear and convincing because McGinn and Smith are involved in a new fraudulent scheme. As set out below, the SAC offering violates Section 17(a) of the Securities Act, and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.

Third, McGinn and Smith have not been reasonably diligent and energetic in attempting to comply with the PI Order. To the contrary, as set out below, they have actively participated in reckless and/or willful violations of the antifraud provisions of the securities laws.

A. The SAC Notes Are Securities Under the Securities Act and Exchange Act

As an initial matter, the SAC notes are securities under *SEC v. Reves*, 494 U.S. 56, 64-67 (1990), which held that notes are presumed to be securities unless Defendants show that the notes fall into certain judicially created categories that are plainly not securities or bear a "family resemblance" to notes in those categories. The Court outlined four factors to consider in making this determination: (1) the motivations that would prompt a reasonable seller and buyer to enter into a transaction; (2) the plan of distribution of the instrument; (3) the reasonable expectations of the investing public; and (4) whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary. *Id.*

As to the first *Reves* factor, the investors primarily would be interested in the profit, in the form of 11% interest, expected from the notes and the stated purpose in selling the notes is twofold: (a) to provide financing to Anchor for a five-year period and (b) for general use to fund SAC's "corporate purposes." As to the second factor, McGinn stated that he was "pitching" the notes (Stoelting Decl. Ex. 6.), and the relatively low $10,000 minimum investment demonstrates that the notes are likely being offered to a broad section of the public. As to the third *Reves* factor, the PPM refers to note holders as "investors" for the purpose of providing financing to Anchor. Based on these representations, a reasonable member of the investing public would consider these notes to be securities because of their fundamental nature as an investment in Anchor. Finally, as to the fourth factor, there is no regulatory scheme aside from the securities laws, or other factors, that would significantly reduce the risk of the investments offered by the Defendants.[3]

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[3] While the latest version of the PPM states that the Anchor loan will be secured by certain collateral currently securing the loan to Quantum, it will only become available if the Quantum loan is paid off in 2015, the current and

B. The SAC Offering Violates Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 Thereunder

Section 17(a) of the Securities Act makes it unlawful for any person in the offer or sale of any security to (1) employ any device, scheme, or artifice to defraud; or (2) to obtain money or property by means of an untrue statement of a material fact or omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit the same conduct in connection with the purchase or sale of securities.

To establish a violation of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5, the Commission must show: (1) a materially false or misleading statement or omission, (2) in connection with the purchase or sale (for purposes of the Exchange Act), or in the offer or sale (for the purposes of Securities Act), of securities, and (3) scienter.[4] *See, e.g., SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999); *Basic, Inc. v. Levinson*, 485 U.S. 224, 235 n.13 (1988).

A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. *Basic,* 485 U.S. at 231. "Scienter" is a "mental state embracing the intent to deceive, manipulate or defraud." *Ernst & Ernst v.*

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future value of that collateral is not described and its availability in the future is speculative. Thus, it does not sufficiently reduce the risk of the investments offered by the defendants.

[4] The Commission must establish scienter to prove violations of Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5. *See Aaron v. SEC,* 446 U.S. 680 (1980). A showing of negligence is sufficient to establish a violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act. *Aaron v. SEC*, 446 U.S. at 695.

Hochfelder, et al., 425 U.S. 185, 193, n. 12 (1976). In the Second Circuit, scienter is established by knowing or reckless conduct. *E.g., Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000).

As set out above, the PPM contains multiple materially false or misleading statements and omissions, including (1) Anchor's current precarious financial condition; (2) the use of funds to pay off Latty's personal loans; (3) the SEC's present action against Smith and McGinn for engaging in fradulent securities offerings and the freeze of their assets to protect previously defrauded investors; and (4) McGinn and Smith's true role in, and control of, SAC.

While the PPM contains certain general caveats and advise investors of certain generic risks inherent in the "investment," such cautions are woefully inadequate to put investors on notice of the actual risks outlined above. "[T]he cautionary language does not shield the defendants from liability because the risks that were disclosed were not the risks that harmed the investors." *SEC v. Pittsford Capital Income Partners*, 2007 WL 2455124, *11 (W.D.N.Y. August 23, 2007). This is consistent with the holding in *In re Colonial Ltd. Partnership Litigation*, 854 F. Supp. 64, 84 (D. Conn. 1994): "The court rejects the defendants' argument that [private placement memoranda] put the plaintiffs on inquiry notice of the likelihood of fraud. While the cautionary language contained in the [memoranda] may have suggested that the investment was risky, it did not warn the plaintiffs of the possibility that the whole scheme was fraudulent." That same principle applies here. Simply stating that there is no assurance Anchor will adhere to the debt service payments schedule is insufficient to advise investors of the concrete and specific risks identified above but not disclosed in the PPMs.

The misrepresentations and material omissions in the SAC PPM can be attributed to McGinn, who actively marketed the PPM to prospective investors. (Zindell Decl.) They can also be attributed to Smith, who served as an Executive Vice President of SAC and allowed his

name to be used for marketing purposes. McGinn and Smith acted with the requisite scienter because, among other things, they knowingly or recklessly included statements in the PPM that had no reasonable basis in fact and were contravened by information known by or available to them and they omitted material information known or available to them that was necessary to make the statements in the PPM accurate.

II. The Court Should Enjoin the SAC Offering and Require McGinn and Smith to Obtain Court Approval Before Participating in Any Future Securities Offerings

In light of McGinn and Smith's ongoing contempt of the PI Order, and as a possible way to cure the contempt, McGinn and Smith should be enjoined from participating in the current SAC offering and they should be required to obtain prior court approval before participating in any further securities offerings. This type of relief falls within the Court's "broad discretion to fashion an appropriate coercive remedy . . . ." *EEOC v. Local 28*, 247 F. 3d 333, 336 (2d Cir. 2001).

The Defendants Are Likely to Continue Their Illegal Conduct in the Absence of Ongoing Contempt Sanctions

Without the requested relief, McGinn and Smith will likely continue to attempt to raise funds, putting potential investor funds at risk. McGinn stated that SAC intends to make seven additional securities offerings over the next two years. Yet Smith and McGinn previously engaged in a five-year scheme of fraudulent securities offerings that defrauded hundreds of investors, and continued to offer new fraudulent Trusts as recently as December 2009. These factors strongly support the imposition of ongoing ancillary sanctions, because "the commission of past illegal conduct is highly suggestive of the likelihood of future violations." *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 807 (2nd Cir. 1975). Because of McGinn and

Smith's prior course of fraudulent conduct, an order requiring each of them to obtain prior Court approval before participating in any future securities offerings is warranted.

McGinn and Smith's current violation of the antifraud provisions of the securities laws and the PI Order is not an isolated occurrence. From at least 2005 through December 2009, McGinn and Smith marketed various Fund and Trust-related securities with promises of attractive interest rates while knowing that the proceeds would be used in a manner that could not support the promoted rates of return and that would waste principal. Among other things, investors' money was used without their knowledge to pay "interest" to other investors; make loans to McGinn and Smith individually and to MS & Co. affiliates; and to make other unauthorized payments to keep the scheme from unraveling. McGinn and Smith should be stopped before they start the cycle again.

CONCLUSION

Wherefore, the SEC respectfully requests that the Court grant its Application for an order to show cause, hold McGinn and Smith, in civil contempt for their violations of the Court's Preliminary Injunction Order, enjoin the current SAC offering and McGinn and Smith from involvement in any future securities offerings without permission of the Court, freeze and return to investors any investor funds raised to date through the SAC offering and order such other relief as the Court deems appropriate.

Dated: New York, NY
November 3, 2010

Respectfully submitted,

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