BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. KCD Financial, Inc. De Pere, WI, Respondent.	DECISION Complaint No. 2011025851501 Dated: August 3, 2016

Firm allowed registered representatives to sell unregistered securities that were not exempt from registration and failed to reasonably supervise the registered representatives who sold the unregistered securities. Department of Enforcement did not prove that the Firm violated FINRA's communications with the public rule. Held, findings affirmed in part, reversed in part. Sanctions vacated in part, modified in part.

Appearances

For the Complainant: Seema Chawla, Esq., Leo F. Orenstein, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: Jill G. Fieldstein, Esq.

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Decision

Between January 2009 and April 2012, two representatives of KCD Financial, Inc. ("KCD") placed newspaper advertisements for FDIC-insured certificates of deposit ("CDs") that advertised rates that were higher than rates actually available from any bank. The two representatives, and one other KCD representative, offered "CD locator" services, in which they assisted investors with finding and purchasing CDs from banks and paid customers "bonuses" in the amount of the difference between the advertised CD rates and available CD rates. The KCD representatives did not sell the CDs or make any money directly from these activities. Instead, the purpose of the CD advertisements was to attract persons who might be interested in purchasing revenue-generating products that the representatives sold, including securities. There is no evidence, however, that KCD directed or encouraged the representatives to offer CD locator services, or that KCD otherwise had any involvement with those services. KCD approved the CD locator services as outside business activities and did not review the CD advertisements or the CD activity. The CD advertisements did not mention KCD or any products that KCD offered.

A separate series of events involved Dallas-based KCD representatives' sales of at least $2 million in unregistered securities. The unregistered securities were purported to be exempt from registration pursuant to a registration exemption under Regulation D that, among other things, prohibited the issuer from engaging in a "general solicitation" or "general advertising" and restricted sales to accredited investors and 35 non-accredited investors who met certain sophistication criteria. Days after the offering began, KCD representatives informed the issuer's and KCD's pre-existing customers about the offering. Around the same time, the issuer generated a press release concerning the launch of the investment fund, which resulted in two newspaper articles that the issuer promptly posted on its affiliate's unrestricted website. The issuer's securities attorney contacted KCD and informed it that the newspaper articles amounted to a breach of the prohibition against general solicitation and advised KCD that the newspaper articles should not be posted on the issuer's website. Although KCD took some efforts to limit sales of the offering to KCD's and the issuer's pre-existing customers, KCD did not prohibit sales of the offering, never ensured that the newspaper articles were taken down from the issuer's affiliate's website, and never investigated whether the purchasers had not seen the newspaper articles.

The Hearing Panel found that KCD was responsible for misleading CD advertisements, engaged in impermissible sales of unregistered securities, and failed to supervise those sales, in violation of FINRA rules. It censured and fined KCD $40,000 for the CD advertisements, and censured and fined KCD $75,000 for selling unregistered securities and related supervisory violations. KCD appealed the Hearing Panel's decision. KCD asks that we reverse the findings of violations and eliminate the sanctions. Enforcement argues that the Hearing Panel's decision should be affirmed.

As explained below, we reverse the findings that KCD violated the communications with the public rule with the CD advertisements and vacate the sanctions that the Hearing Panel imposed for those findings. We affirm, however, the findings that KCD engaged in impermissible sales of unregistered securities and failed to supervise those sales. For those violations, we censure and fine KCD $73,000.

I. KCD

KCD, a broker-dealer since 2003, is a FINRA member firm. KCD is headquartered in De Pere, Wisconsin. As of May 2014, KCD had 61 representatives in 38 branch offices. KCD is what is known as an "independent broker-dealer," and its representatives operate as self-employed independent contractors. The relevant events occurred in three of KCD's offices, located in: (1) Palm Beach Gardens, Florida; (2) Sun City, Arizona; and (3) Dallas, Texas.

II. Procedural History

This disciplinary proceeding arose out of a cause examination that stemmed from a tip concerning advertisements for CDs at above-market rates and a separate cycle examination of KCD. On November 14, 2013, FINRA's Department of Enforcement ("Enforcement") filed the complaint that commenced this proceeding. Cause one of the complaint alleged that, from January 2009 to April 2012, KCD permitted three of its representatives (EW, JK, and LP) to place newspaper advertisements for CDs that promoted above-market annual percentage yields that did not exist and used misleading, exaggerated, and unwarranted statements, and that KCD was aware that these CD advertisements were used to attract customers to KCD branch offices in Palm Beach Gardens and Sun City.[1] Cause one further alleged that KCD failed to include KCD's name in the advertisements. Enforcement alleged that this conduct violated NASD Rule 2210 and FINRA Rule 2010.[2]

The complaint also made allegations concerning the offering of interests in the WRF Distressed Residential Fund 2011 LLC (the "WRF Fund"). The complaint's summary section alleged that in April 2011, KCD "permitted representatives . . . to advertise a Regulation D securities offering during the solicitation stage, contrary to the prohibitions contained in Rule 506 of Regulation D." Cause two of the complaint alleged that, between April and October 2011, Dallas-based KCD representatives sold WRF Fund securities that were neither registered nor qualified for a registration exemption, in violation of FINRA Rule 2010 "by virtue of acting in contravention of Section 5 of the Securities Act of 1933." Cause two further alleged that KCD neglected to supervise its representatives' advertising of the offering, did not learn of or investigate the general solicitation of the WRF Fund and, therefore, failed to supervise reasonably the unregistered securities offering, in violation of NASD Rule 3010.

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[1] Specifically, the complaint alleged that EW (a representative in KCD's Palm Beach Gardens office) placed misleading advertisements from January 2009 to November 2011, and that JK and LP (representatives in KCD's Sun City office) placed misleading advertisements from January 2010 to April 2012.

[2] The conduct rules that apply in this case are those that existed at the time of the conduct at issue.

On May 1, 2014, KCD filed an amended answer.[3] KCD did not respond to the allegations that it violated FINRA rules, on the grounds that those allegations included conclusions of law. KCD also raised three affirmative defenses: (1) that the claims were barred, in whole or in part, by ratification, estoppel, waiver, or laches; (2) that the complaint failed to state a claim upon which relief may be granted; and (3) that FINRA lacked jurisdiction to bring actions regarding FDIC-insured CDs.

The parties engaged in a substantial amount of pre-hearing litigation, including KCD's filing of a motion for summary disposition that the Hearing Officer denied. On December 16-18, 2014, a Hearing Panel presided over an evidentiary hearing.

On June 16, 2015, the Hearing Panel issued its decision. The Hearing Panel found that KCD used false and misleading advertisements concerning CDs and the CD locator services, in violation of NASD Rule 2210 and FINRA Rule 2010. The Hearing Panel also found that there was a "violation of the registration requirements," that "Section 5 imposes strict liability on those who offer or sell unregistered securities," and that KCD's "failure to stop the unlawful distribution of unregistered securities in the face of a clear duty to do so was an abject failure of [KCD's] supervisory and compliance systems," in violation of NASD Rule 3010 and FINRA Rule 2010. The Hearing Panel did not address the complaint's allegations that KCD violated securities laws by advertising a Regulation D securities offering or failing to supervise KCD representatives' purported advertising of the offering. The Hearing Panel censured and fined KCD $40,000 for the use of false and misleading CD advertisements, censured and fined KCD $75,000 for "selling non-exempt unregistered securities," and imposed on KCD $5,556.48 in costs. This appeal followed.

III. Communications with the Public

A. Factual Background

1. The CD Locator Services

a. KCD's Palm Beach Gardens Office

EW, who registered with KCD in 2007, operated a single-person office in Palm Beach Gardens, Florida, under the name "Principal First Trust" and, subsequently, "Principal First" (together, "Principal First"). At that office, EW engaged in various business areas. EW's office was a KCD branch office, and one-third of EW's business involved selling real estate income trusts (REITs), which are securities products.[4] Another third of EW's business involved selling fixed annuities. The final third of EW's activities involved his providing a "CD locator service."

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[3] KCD filed its original answer on February 26, 2014, and then sought leave to file an amended answer.

[4] EW stated that "Principal First" was not a "d/b/a" name for his securities business and that when he sold REITs, "my KCD business card goes out to the client immediately" and "from

[Footnote continued on next page]

EW described, at an on-the-record interview, his CD locator service and how he promoted it. EW searched the internet for "high-yielding CDs" offered by banks and helped customers purchase the CDs from the issuing banks. EW did not sell the CDs himself or receive any compensation for helping customers purchase CDs. Beginning around 2007, and during the relevant period of January 2009 to November 2011, EW advertised his CD locator service in the *Palm Beach Post*, as often as three times a week. The advertisements promoted an "FDIC-Insured" CD and prominently featured—in large, bold font—an annual percentage yield. The fine print in EW's advertisements stated, among other things, "[p]romotional incentive may be included to obtain yield" and "FDIC-Insured to $250,000 per institution." The advertisements included the name "Principal First" and the street address and phone number that EW used for all the business he conducted, including his securities business, but the advertisements did not include KCD's name.

EW used two different methods for choosing the annual percentage yields to include in his advertisements. One method was simply to "find a good rate." The other method was to combine a rate he found in the market with a "bonus" or "incentive." EW elaborated:

> [Y]ou basically go to . . . bankrate.com or Bank CD, or one of these web sites and find a CD, either 6 months or 12 months, depending on which offer that you wanted to run, and you would add maybe 30, 40 basis points, maybe 50 to that and you run the ad based on that.

Notwithstanding EW's assertion that he would advertise rates up to 50 basis points higher than actual rates, on at least one occasion EW advertised an annual percentage yield that was several percentage points above actual prevailing rates. Specifically, a June 28, 2009 advertisement titled "*The* Hottest CD in Town"—with a fire extinguisher in the background—advertised a three-month CD with a 4.51% annual percentage yield. Two FINRA examiners (PF and DW) testified that the prevailing CD rates during the relevant period were only around 1% or 2%.[5]

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that point on we're talking on the basis of KCD." A FINRA examiner testified, however, that Principal First was a "d/b/a" name for EW's KCD branch office, and KCD paid EW's commission checks to a Principal First bank account.

[5] Notwithstanding the June 28, 2009 advertisement, the record does not generally show how much higher EW's advertised rates were above actual rates during the 22-month relevant period. We draw no inferences in this regard from just a single advertisement. Although the record contains a second of EW's advertisements (for a 5.60% CD), there is no indication when EW placed that advertisement or whether it was placed during the relevant period. Likewise, we do not rely on FINRA principal examiner PF's testimony on this particular subject. According to PF, EW explained at both his on-the-record interview and on-site during FINRA's examination that he would find the highest yielding CD he could and "add percentage points to that rate."

[Footnote continued on next page]

Each of EW's advertisements generated calls from potential customers, and EW once received 100 calls. When someone responded to an advertisement, EW scheduled an in-person appointment with the customer, who in almost all instances was a senior. To learn how to obtain a CD, customers had to visit EW in his office and provide "a little bit of information," such as their investment timeline, investment amount, and needs for the money. EW would then show the customer information concerning a CD. For comparison purposes, EW also would show the customer other products that he sold such as fixed annuities or securities.

If a customer wanted to purchase a CD, EW would give the customer the name, location, and FDIC certificate number of the issuing bank, the CD rating, a "breakdown" of what the CD paid, the yield, and information about any "bonus" or "incentive" amounts that EW would be paying himself. When there was an actual CD that paid a better rate than what EW advertised, EW would "make everybody aware of that better rate." When there was no actual CD offering a yield as high as his advertised rate, EW calculated the difference between the available rate and the advertised rate and wrote a check in that amount "up front," drawn on a Principal First account. EW sent this "bonus" or "incentive" check either to the bank issuing the CD or, when the issuing bank would not accept third-party checks, to the customer.

EW earned no compensation from his CD locator service, but he did earn compensation from sales of REITs and fixed annuities. EW's aim in advertising CDs was to create immediate and future opportunities to sell revenue-generating products, "be it an annuity, REIT, stock, whatever." EW admitted that, "obviously you're trying . . . to make [customers] aware that there are other products out there besides CDs that might fit what they're looking for." EW testified that he solicited securities or fixed annuity products to every customer, but that he did not solicit securities to every customer. Explaining why he did not mention revenue-generating products he sold or KCD in his advertisements, EW stated that CDs are "what the ad is for," and that he did not know when he placed the advertisement if a customer would purchase another product. EW did not run any advertisements promoting his securities business or identifying himself as a KCD registered representative.

From 2007 through October 2010 (less than half of which is in the relevant period), EW helped customers place $16.6 million into CDs, and EW paid $36,233 in incentive bonuses, $3,797 of which were paid to 22 customers "who were also KCD customers." From 2009 to October 2010, EW sold 190 CDs using the "promotional incentive," including 18 CDs to KCD customers. According to EW, 70-75% of the customers who responded to the CD advertisements purchased only a CD "the first time around." Although EW admitted that he discussed securities products with some customers who responded to his CD advertisements, there is no specific evidence concerning the extent to which EW's advertisements during the

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Contrary to PF's testimony, however, EW claimed at his on-the-record interview that he would sometimes advertise a yield that added only 20 to 50 *basis* points to actual rates.

relevant period actually resulted in sales of securities.[6] EW terminated his relationship with KCD in October 2011.

b. KCD's Sun City Office

Sun Cities Financial Group was composed of 11 offices in four different states, and its owner and president was JK. Sun Cities Financial Group described itself on its website as "a leader in locating superior insurance and banking products." JK described it as "an insurance financial company" that sells fixed annuities and life insurance and that had a "miniscule" securities business. It also provided a CD locator service.

One of the Sun Cities Financial Group offices was in Sun City, Arizona. Like all the offices within the group, the Sun City office sold fixed insurance products and provided a CD locator service. Unlike the other offices, the Sun City office was a KCD branch office that offered securities products, including mutual funds, REITs, and, according to LP, "probably" stocks and "maybe a couple variable annuities." The Sun City office used the Sun Cities Financial Group name as a "d/b/a" name to conduct business on behalf of KCD.[7] JK and LP worked in the Sun City office and were both KCD registered representatives. LP was the branch manager and one of KCD's top producers.

From 2009 to 2012 (only a portion of which is in the relevant period), Sun Cities Financial Group facilitated 5,426 transactions in CDs, 5,150 transactions in fixed annuities, and 199 transactions in securities. All 199 transactions in securities, and 1,867 of the fixed annuity

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[6] FINRA staff contacted eight of EW's customers (a "small sample") who purchased REITs and learned that seven of those customers established their relationship with EW through a newspaper advertisement for CDs and subsequently "start[ed] a brokerage account with [EW]." There is no evidence, however, concerning the identities of those seven customers, whether they responded to CD advertisements placed during the relevant period, when they invested in REITs, or the amounts they invested. There also is no evidence concerning whether the 22 KCD customers who received incentive bonuses purchased securities after responding to EW's CD advertisements, the volume of any such securities sales, or the portion of EW's overall revenues that such securities sales represented. In fact, a list of the 22 customers suggests that they might have all possibly purchased securities products *before* purchasing CDs.

[7] Sun Cities Financial Group's web site indicated that its only location that offered securities was its Sun City office, and that "[s]ecurities may be offered through KCD Financial, Inc." The website had no pages that discussed securities products.

transactions, were generated by the Sun City office.[8] LP generated 91% of the 199 securities transactions. KCD made money on the securities sales.[9]

JK explained that the CD locator service located higher yielding CDs for seniors who cannot access the internet, and he characterized it as "a good value added service for clients." Sun Cities Financial Group did not sell CDs or charge for locating CDs, and it earned no compensation through the service. To promote its CD locator service, JK placed advertisements in local newspapers near the Sun Cities Financial Group offices, including a local paper in Sun City.[10] JK placed these ads at least weekly and often multiple times a week.

The record contains two examples of these advertisements that were placed during the relevant period. The first example, which JK ran from July to August 2011, promoted a six-month CD at a "guaranteed" rate of 3.01%, with that rate being the advertisement's most prominent feature. The advertisement stated in large font, "Safety & Security" and "FDIC Insured." It included the name "Sun Cities Financial Group," addresses and telephone numbers for three Arizona-based Sun Cities Financial Group offices (including the Sun City office), and Sun Cities Financial Group's web site address. At the bottom and in fine print that JK admitted was "difficult to read," the advertisement stated, "[a]dvertised yield consists of a 1.06% annual percentage yield plus a 1.95% interest bonus which equals the above advertised yield" and "FDIC Insured to $250,000 per institution." The fine print further stated, "Sun Cities is not a bank and checks are not made payable to Sun Cities, only FDIC insured bank you select." The advertised 3.01% rate was higher than market rates; at the time, as PF testified, the highest yielding six-month CDs were paying rates "closer to 1 percent." The advertisement did not mention KCD.[11]

JK testified about how he chose the interest rates to advertise. Sometimes, JK would advertise a CD rate that he had actually located. Other times, JK advertised a CD rate that combined an interest rate that he located with a "bonus" percentage that he added, and JK referred to these CDs as "bonus CDs." JK testified that when he advertised a "bonus CD," the advertisement included the fine-print disclosure that the rate consisted of a specified annual

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[8] There is no evidence concerning the amount of revenues that each business line generated.

[9] LP testified in an on-the-record interview that when he sold securities products, he received 45% of the commissions and JK received 55%.

[10] JK also advertised annuities. LP said, however, that Sun Cities Financial Group's primary form of marketing was CD advertisements.

[11] The second advertisement, which was run in September 2011, was nearly identical, but advertised a rate of 3.15%.

percentage yield with a specified "interest bonus."[12] The record does not demonstrate the extent to which JK's advertisements during the relevant period were for so-called "bonus CDs."[13]

JK and LP explained that the purpose of the CD advertisements was to get customers in the door. JK testified the advertisements would keep Sun Cities Financial Group's name "in the public eye, generate floor traffic, provide service to the clients," and hopefully develop a relationship that could lead to selling revenue-generating products. LP likewise testified that the purpose of the CD advertisements was "to get people to come in to see if there was anything that we had that that client would like to buy," including securities products. LP also said that CD customers would sometimes "come back later" and purchase other products including securities. JK and LP differed, however, on the extent to which a goal of the advertisements was to sell securities products. JK suggested that selling securities products was not his priority, while LP testified that he would talk to customers who responded to the ads about securities.

Customers who responded to the CD advertisements either called a phone number in the advertisement or visited a Sun Cities Financial Group office. Calls to the Sun City offices would be routed, on a rotating basis, to either JK, LP, or a third representative who was not licensed to sell securities, and they would "explain who we are and what we do and how we provide these CDs." To get assistance obtaining a CD, however, a customer had to visit a Sun Cities Financial Group office.

When JK or LP dealt with customers, they would discuss with the customers their financial situation and their objectives. JK would ask the customers questions about their needs for the money they wanted to invest. LP would ask the customers about their income, net worth, liquid net worth, their intention for their money, and other "pertinent financial questions." JK or LP also would explain that Sun Cities Financial Group is "not a bank," but that "we just locate

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[12] In an earlier examination than the one that led to this proceeding, JK was not as forthcoming about the rates he advertised. FINRA requested that KCD provide a narrative from JK addressing whether he "ever advertised a CD with a higher yield than the CD was actually paying" or "offered a customer any extra incentive, rebate, bonus, etc. for purchasing a CD with a lower yield that what you advertised." JK responded that "I can only place an ad for the rate that is available on the date I place the ad," but he did not disclose that the rates he advertised sometimes combined actual rates with bonus amounts. Asked at the hearing whether JK had provided FINRA with "the whole story," JK testified unconvincingly, "I was answering based on what I thought the question was asking, so I don't know if that was the whole story or not."

[13] On the one hand, LP testified that he dealt with "a lot" of bonus CDs and non-bonus CDs. Other evidence suggests, however, that the advertisements for bonus CDs may not have been a high percentage of JK's advertisements. Specifically, the record contains a chart showing Sun Cities Financial Group customers who purchased securities through KCD in 2011 and purchased CDs on the same date or earlier. Of the eight CDs on the chart purchased during the relevant period, only three paid a "bonus," and JK testified that bonuses were sometimes paid for non-bonus CDs when the market rates dropped since an advertisement for a non-bonus CD.

these CDs," "shop . . . thousands of banks," and "try to find the highest rate." JK or LP would tell the customers "everything we can about the banks," including the bank's name, the "financial information," and their "ratings services." They also would explain that, to purchase a CD, the customer would need to open an account with the bank using the bank's paperwork and send everything, including payment, to the bank directly.

JK and LP offered different explanations about the extent to which they discussed securities products with customers who responded to the CD advertisements. JK explained that if a customer expressed an interest in other investment opportunities, JK might "talk about other safe and guaranteed insurance products," but he would "rarely" discuss securities because the customers "want[ed] a guaranteed safe FDIC insured account" and were "not looking for any type of securities where there is any type of loss." JK acknowledged, however, that if a CD customer expressed an interest in a mutual fund, "I would talk about it."[14] In contrast, LP explained that he would analyze whether the customer would want information about other financial products besides CDs, including available "fixed" products or securities, and show the customers anything that was "appropriate." LP further explained that customers who "feel comfortable or . . . like you" will "ask about other investments," which "opens a conversation," and that talking about securities would "[o]ccasionally . . . happen."

Every week, JK picked the CDs that could be sold, and he announced the issuing bank, the rate, and the bonus, if any, that would be paid.[15] If a customer wanted to purchase a CD with the Sun City office's assistance, the process was as follows. JK or LP would help the customer complete the issuing bank's on-line application. Customers would "make their check payable directly to the bank," and JK would "send out all of the paperwork" and the customer's check to the bank. If the "located" CD had a rate that was lower than the advertised rate, JK would write a check making up the difference in the rates and send it either to the customer or to the issuing bank. LP described these "bonuses" as "[j]ust the cost of doing business." FINRA investigator DW testified that it appeared that Sun Cities Financial Group lost money operating the CD locator service. In instances where the bonus check was sent to the bank with the customer's check, the entire amount would be invested in a CD that was FDIC-insured.[16]

It is undisputed that the CD advertisements sometimes led to securities sales by the Sun City office. JK admitted that there were times when a customer might open a CD and "some

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[14] In contrast to his testimony, JK wrote in a letter dated April 17, 2009, to KCD's compliance officer that if a customer asked "what else do I do," JK would tell the customer that he offered insurance and securities.

[15] LP testified that sometimes he would see CDs with better rates and help customers purchase those CDs instead.

[16] JK said that it was typical for customers to buy multiple CDs, over a period of time. If Sun Cities was advertising a bonus, customers who rolled their CDs into new CDs would get a bonus.

point thereafter . . . purchase a . . . security."[17] LP testified that some customers who responded to CD advertisements also bought, or instead bought, a securities product like mutual funds, REITs, or stocks. There is no specific evidence, however, showing specific customers who responded to CD advertisements during the relevant period and then purchased securities products. When securities were discussed, the representatives disclosed their affiliation with KCD.

2. KCD's Treatment of the CD Locator Services

It is undisputed that, prior to the relevant time period, EW and JK notified KCD about their CD locator services, that KCD approved the activities as "outside business activities," and that KCD determined that no subsequent review of the CD advertisements was required. It is also undisputed that KCD never supervised or monitored any of the CD locator services or the advertisements used.

On two occasions, KCD instructed JK to cease his CD locator services. The first time was on April 8, 2009, during a FINRA examination concerning JK's CD activities that was closed several weeks later with no further action. At that time, LB (KCD's chief compliance officer at the time) informed FINRA staff that KCD's position was that JK's CD locator services were "outside business activit[ies]." LB also informed FINRA staff, however, that "[f]or the time being and until further guidance is provided by FINRA on this subject," KCD had placed a cease and desist order on JK's CD locator services. LB concluded that "we hope to get clarification of any obligations KCD has with regard to this activity (if warranted) and provide additional guidance to [JK] before approving this activity any further. We ask for FINRA's guidance." When KCD learned that FINRA staff was closing the 2008-2009 examination for reasons related to FINRA staff's view about FINRA's jurisdiction, KCD lifted the cease and desist order. LB testified that "[l]ogic told us that we were handling things properly, so we allowed [JK] to go ahead and do this CD finder service."

The second occasion was in early 2012, towards the end of the cycle examination that led to this proceeding. LR, KCD's chief compliance officer, informed JK that "FINRA was not happy with [his] ads" and instructed JK to cease using them. JK then terminated his KCD registration. LP remained registered with KCD.

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[17] JK also testified that it was rare that customers interested in CDs would also be interested in securities, but we defer to the Hearing Panel's finding that that testimony was not credible. Indeed, a chart that KCD compiled shows that several customers of Sun Cities Financial Group who opened KCD accounts and purchased securities products in 2011 also purchased CDs on the same date or earlier.

B. Discussion

The Hearing Panel found that KCD was responsible for misleading CD advertisements, in violation of NASD Rule 2210 and FINRA Rule 2010. We reverse.[18]

Enforcement alleges that the CD advertisements violated NASD Rule 2210(d) because the advertisements contained misleadingly high CD rates and included misleading, exaggerated, and unwarranted statements. NASD Rule 2210(d) governs the content standards of "member communications with the public." The rule is "intended to protect investors by ensuring that the communications used by broker-dealers are fair, balanced and not misleading," and it "impose[s] core, principles-based content standards that are consistent with investor protection objectives." FINRA, *Retrospective Rule Review Report, Communications with the Public*, at 2 (Dec. 2014), http://www.finra.org/sites/default/files/p602011.pdf (citing *NASD Notice to Members 80-63*).

By its terms, however, the content standards in NASD Rule 2210(d) apply to "member" communications. Although NASD Rule 2210 contains several definitions, it does not define or discuss whether communications made by a member firm's registered persons regarding outside business activities are "member communications." To answer this question, we focus on the nature of the underlying activities being advertised.

FINRA's rules divide outside activities of associated persons into two categories: private securities transactions and outside business activities. Under NASD Rule 3040, if a member approves a person's participation in a private securities transaction, "the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member."[19] Thus, where a member firm has approved private securities transaction activities, the member firm can be held liable under NASD Rule 2210(d) for the content of an associated person's advertisements of private securities transactions. *Cf. Dep't of Enforcement v. CapWest Sec., Inc.*, Complaint No. 2007010158001, 2013 FINRA Discip. LEXIS 4, at *25 (FINRA NAC Feb. 25, 2013) (holding member firm liable for violating NASD Rule 2210 content standards based on the securities-related communications of its registered representatives), *aff'd*, Exchange Act Release No. 71340, 2014 SEC LEXIS 205 (Jan. 17, 2014); *see also Philippe N. Keyes*, Exchange Act Release No. 54723, 2006 SEC LEXIS 2631, at *11-12 (Nov. 8, 2006) (holding that NASD Rule 2210 applied to representatives' sales literature for private securities transactions). The CD locator services did not involve a securities transaction and therefore NASD Rule 3040 and its supervision requirement did not apply.

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[18] As an initial matter, KCD argues that the Hearing Panel erred in denying KCD's motion for summary disposition of the allegations of violations of NASD Rule 2210. An order denying summary disposition, however, is not appealable following a full evidentiary hearing. *Cf. Ortiz v. Jordan*, 562 U.S. 180, 184 (2011) ("Once the case proceeds to trial, the full record developed . . . supersedes the record existing at the time of the summary-judgment motion.").

[19] Since the relevant period, NASD Rule 3040 was superseded by FINRA Rule 3280.

Outside business activities of registered persons are governed by FINRA Rule 3270.[20] But Enforcement did not allege that KCD violated FINRA Rule 3270, and we do not analyze KCD's conduct under that rule.[21] Thus, whether KCD had obligations concerning its representatives' advertisements under the rule that KCD is alleged to have violated (NASD Rule 2210) turns on whether the CD locator services were not outside business activities.

During the relevant period, there were two definitions of "outside business activities." Prior to December 15, 2010, NASD Rule 3030 provided that "[n]o person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member." Effective December 15, 2010, FINRA Rule 3270 provided that "[n]o registered person may be an employee, independent contractor, sole proprietor, officer, director or partner

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[20] FINRA Rule 3270 superseded NASD Rule 3030.

[21] FINRA Rule 3270 requires registered persons to give prior written notice to their firm of any outside business activity. The rule does not require a firm to provide its approval or disapproval of the outside business activity. Instead, the rule imposes obligations on the firm that has received a notice of an outside business activity to consider whether certain risks are raised by the outside business activity, the nature of the proposed activity, and the manner in which it will be offered, and, based on the firm's review of those factors, to evaluate the advisability of imposing specific conditions or limitations on the outside business activity, including where circumstances warrant, prohibiting the activity. FINRA Rule 3270, Supplementary Material .01.

Although FINRA Rule 3270 obligates a member firm to "evaluate the advisability of imposing specific conditions or limitations on a registered person's outside business activity," the rule does not specifically address the kinds of conditions or limitations a firm can impose (other than indicating that a firm can prohibit the activity) or the extent to which the firm would be required to impose specific conditions or limitations on a registered person's outside business activity. The background and regulatory history of FINRA Rule 3270, however, demonstrates that FINRA's intent when adopting FINRA Rule 3270 was that there would be situations involving a representative's outside non-securities business activities in which member firms would need to take reasonable action. When proposing and approving FINRA Rule 3270, including Supplementary Material .01, FINRA and the SEC explained that the rule required firms "to implement a system to assess the risk . . . and to *manage these risks by taking appropriate action*." 75 Fed. Reg. at 53365 (emphasis added); FINRA, *Response to Comments*, File No. SR-FINRA-2009-042, at p.2 (July 30, 2010). FINRA further explained that "[w]hile FINRA recognizes that a member does not have the same supervisory responsibilities over a registered person's outside non-securities activities as it does for his or her outside securities activities, a member nevertheless has an important regulatory responsibility to evaluate the potential impact of the outside business activities of its registered persons." FINRA, *Response to Comments*, File No. SR-FINRA-2009-042, at p.7 (July 30, 2010) (emphasis added).

of another person, or be compensated, or have the reasonable expectation of compensation, from any other person as a result of any business activity outside the scope of the relationship with his or her member firm, unless he or she has provided prior written notice to the member." Thus, both definitions have three key requirements: (1) employment or compensation criteria; (2) "business activity" criteria; and (3) criteria that the activity be outside the scope of the relationship with the member firm. The CD locator services met the employment criteria and business activity criteria of these definitions.[22] Whether the CD locator services were outside the scope, or within the scope, of the representatives' relationship with KCD, however, is a more difficult factual issue.

The preponderance of the evidence shows that the CD locator services were outside the scope of the representatives' relationship with KCD. There is no evidence that KCD directed or encouraged the representatives to offer the CD locator services or was otherwise involved with providing the CD locator services. KCD had dozens of representatives, but only three provided CD locator services, and EW learned how to offer the CD locator services on his own through a seminar offered by a third-party provider. KCD did not oversee or supervise the CD locator services.

We acknowledge that several facts weigh in favor of finding that the CD locator services were within the scope of the representatives' relationship with KCD. The representatives associated with KCD to sell securities, and the CD advertisements were a primary way that they attracted customers to their offices to sell revenue-generating products, including securities sold through KCD. JK, EW, and LP made no money from their CD locator services unless they resulted in sales of revenue-generating products, including securities.[23] There were significant similarities between how JK and EW offered CD locator services and sold securities products: the CD advertisements included the same "d/b/a names," addresses, and phone numbers that were used for the securities business. EW and JK considered the cost of the advertisements and bonuses to be "marketing" costs for their revenue-generating businesses, which included

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[22] The employment criteria was met because EW, JK, and LP conducted their CD locator services through their employment by, or association with, Principal First and Sun Cities Financial Group. The business activity criteria was met because, although helping to facilitate CD purchases did not generate revenues directly, the only reason why EW, JK, and LP marketed and offered the CD locator services was to attract potential customers with the hope of developing a business relationship with them and selling them revenue-generating insurance or securities products.

[23] KCD argues that for purposes of the scope of NASD Rule 2210, it is "nonsensical" to distinguish between advertisements for money-making activities and advertisements for non-money-making activities because an activity does not need to be compensated to be considered an outside business activity. *See* FINRA Rule 3270. This does not mean, however, that the lack of direct compensation from a representative's business activities is not relevant when analyzing whether activities are outside or inside the scope of the representative's relationship with his or her member firm.

securities business. The representatives discussed securities products with persons who responded to the CD advertisements, and some customers who responded to the CD advertisements purchased securities. The securities purchases were made through KCD, not some other firm. *Cf.* NASD, *Interpretive Letter to Dawn Bond, FSC Securities Corporation* (July 30, 1998), *available at* http://www.finra.org/industry/interpretive-letters/july-30-1998-1200am#sthash.iveOGTBz.dpuf (stating that financial plans written by dually registered persons for a fee, where "securities transactions are being executed through [the member firm]" by customers who purchased the plans, promoted the member's securities business and were subject to NASD Rule 2210).

These facts, however, are outweighed by the absence of KCD's involvement with the provision of the CD locator services. Moreover, we do not place significant weight on the facts that some securities sales resulted from the CD advertisements, that KCD was aware of the CD locator services, or that KCD initially reviewed the advertisements. To rely heavily on the securities sales that resulted would blur the line between outside business activities and member firm activities: securities sales can often result from activities that are widely understood to constitute outside business activities. And KCD's awareness of the CD locator services and its initial review of the CD advertisements is entirely consistent with those activities being outside business activities: FINRA's outside business activities rule *requires* representatives to make their firms aware of their outside business activities and is designed to give firms an opportunity to review the outside activities to determine whether any limitations are warranted. Finally, KCD's willingness during FINRA's investigations of the CD advertisements to stop its representatives from engaging in the CD locator services demonstrates cooperation, not activities that are within the scope of KCD's business. Accordingly, we find that the CD locator services were outside business activities. Because the CD locator services were outside non-securities business activities, we vacate the Hearing Panel's findings that KCD violated NASD Rule 2210.

The two cases relied on by the Hearing Panel in support of its findings that KCD violated NASD Rule 2210, *Robert L. Wallace* and *Sheen Financial Resources, Inc.*, are distinguishable from this case. Unlike the communications in *Wallace*, the CD advertisements did not mention securities, any product or service that KCD offered, or KCD's name. *Robert L. Wallace*, 53 S.E.C. 989, 994-995 (1998) (finding that representative's advertisements for products were covered by the communications with the public rule where the advertisements included, among other things, the name of the representative's broker-dealer and language suggesting that the advertised products were securities). And unlike the communications in *Sheen Financial Resources*, the CD advertisements were not placed by the member firm's president and chief executive officer, and Enforcement did not prove that the essential purpose of the CD advertisements was to sell securities.[24] *Sheen Fin. Res.*, 52 S.E.C. 185, 189 (1995) (finding that

[24] EW, JK, and LP sold securities and non-securities products to persons who responded to the CD advertisements. Only a small portion of the Sun City office's sales were securities products, securities represented only half of EW's revenue-generating business, and as explained above, there is limited specific evidence concerning the extent to which the CD advertisements during the relevant period actually led to securities sales. In fact, the record is devoid of

[Footnote continued on next page]

communications with the public rule covered advertisements placed by firm's president and CEO for radio programs and seminars, where "[t]he essential purpose of the radio programs and seminars . . . was to sell securities through the [broker-dealer]"). Moreover, neither *Wallace* nor *Sheen Financial Resources* directly addressed the extent to which the communications with the public rule applies to advertisements for outside non-securities business activities.

Accordingly, because under these circumstances we do not believe that KCD should be held liable under NASD Rule 2210 for the CD advertisements, we do not address whether the advertisements violated the content standards of NASD Rule 2210(d). We reverse the Hearing Panel's finding that KCD violated NASD Rule 2210 and FINRA Rule 2010 and vacate the sanctions the Hearing Panel imposed for those alleged violations.

IV. Sales of Unregistered Securities and Supervision of the Sales

A. Factual Background

1. The WRF Distressed Residential Fund 2011

The WRF Distressed Residential Fund 2011, LLC (the "WRF Fund") was a securities offering that Dallas-based KCD representatives sold. It was the first offering sponsored by Westmount Realty Finance LLC ("Westmount Realty Finance").[25] Westmount Realty Finance was also a "d/b/a name" for a Dallas, Texas branch office of KCD.

IG was Westmount Realty Finance's senior vice president of capital markets, as well as a registered representative and branch manager with KCD. IG spoke of there being "two sides" at Westmount Realty Finance: an "issuer side" that "puts together the offering," and a "FINRA sales side" comprised of a "captive" team of registered representatives who sold only Westmount Realty Finance's offerings. IG was responsible for overseeing the salespeople in the Dallas office that were also registered representatives of KCD. IG, however, was not a registered

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[cont'd]

evidence of specific customers who responded to CD advertisements during the relevant period who then purchased securities products.

[25] Westmount Realty Finance was launched in 2010 by CB and SK, who were also the principals of Westmount Realty Capital LLC ("Westmount Realty Capital"), and RM, SS, and PA, who were the principals of Realty Capital Partners LLC ("Realty Capital Partners"). CB and SK beneficially owned 51% of Westmount Realty Finance. Prior to 2010, Realty Capital Partners had a KCD-registered sales team (including IG) that handled 30-40 private placements (and about $150 million of private equity). IG testified that the "biggest change" when he left Realty Capital Partners to join Westmount Realty Finance was that CB and SK "had no experience in retail sales whatsoever" and that CB did not understand, and was not interested in adhering to, how private placements were to be sold to retail investors.

principal. The Dallas branch office was under the supervision of KCD's home office and KCD's chief compliance officer.

The WRF Fund planned to invest in distressed and foreclosed properties and then "flip" them. IG testified that the WRF Fund was seeking to "partner with . . . approved bidders with Fannie [Mae] or Freddie [Mac]" and then "invest in . . . bank owned real estate."

The WRF Fund's private placement memorandum was dated March 15, 2011. It indicated that the offering size was $10 million, that the minimum subscription amount of $1 million must be received by July 1, 2011, that that deadline could be extended up to 90 days, and that the offering period would be open up to 90 days after the minimum subscription was reached and escrow was broken. It also stated that the offer and sale of interests were "being made in reliance on an exemption from the registration requirements" under Regulation D. On August 24, 2011, the WRF Fund filed with the SEC a Notice of Exempt Offering of Securities claiming that the offering was exempt pursuant to Rule 506 under Regulation D. To qualify for that exemption, the WRF Fund was not allowed to engage in a general solicitation or general advertising, and could sell interests to accredited investors and no more than 35 persons who met certain sophistication criteria. 17 C.F.R. § 230.506(b)(2)(ii).

The offering memorandum also stated that the interests may be offered "by one or more broker-dealers." IG coordinated KCD's agreement to sell interests in the WRF Fund. After the so-called "issuer side" of Westmount Realty Finance provided IG with the private placement memorandum, the "LLC agreement," and the subscription documents, IG (who worked on the "FINRA sales" side) sent those materials, the "sales documents," the "marketing documents," and the "KCD due diligence form" to KCD. On March 15, 2011, JL, then KCD's chief compliance officer, signed a soliciting dealer agreement in which KCD agreed to solicit purchasers of membership interests in the WRF Fund. IG testified that this meant "we were approved to . . . launch[ ] the project to our base of preexisting investors," and within two to three business days, he sent an e-mail to "roughly 1,200 high net worth individual accredited investors and registered investment advisors."

2. Westmount Realty Finance's Press Release, the Ensuing Newspaper Articles, and the Continuing Sales Efforts

Towards the end of April 2011, Westmount Realty Finance's marketing department issued a press release concerning the WRF Fund. On April 26, 2011, two news agencies, the *Dallas Business Journal* and the *Dallas Morning News*, published articles about the WRF Fund. Both articles were available on the newspapers' unrestricted websites. The *Dallas Business Journal* article read as follows:

> Dallas-based Westmount Realty Finance LLC announced . . . that it launched a $10 million real estate fund to acquire bank-owned residential properties and nonperforming, discounted residential loans.
>
> The private investment firm expects to invest in assets concentrated in U.S. markets with high foreclosure activity. The firm is joining with

> several operators that specialize in bulk acquisition of distressed residential assets.
>
> The fund, named [WRF Fund], will have a 12-month investment period – and due to the short window for the assets to be purchased and resold, the firm expects to reinvest sales proceeds in additional assets during the period.[26]
>
> The firm has continued seeing a steady stream of buying opportunities, said Stephen Kanoff, chief investment officer.

The *Dallas Morning News* article was similar:

> Dallas investor launches residential property investment fund
>
> Dallas-based Westmount Realty Finance LLC said Tuesday that it has set up a special residential investment fund to acquire residential properties and non-performing residential loans from lenders.
>
> The [WRF Fund] will partner with firms that specialize in bulk purchases of distressed residential assets. The $10 million fund will focus on U.S. markets with high foreclosure rates.
>
> "We continue to see a steady stream of buying opportunities," . . . Westmount's chief investment officer . . . said in a statement. "With nearly 4 million foreclosure filings in 2010, not only is the U.S. experiencing record-level foreclosure activity, but most industry experts aren't anticipating a slowdown for at least the next couple of years."
>
> In just over a year, Westmount has purchased more than 530 distressed residential assets.
>
> Westmount Realty Finance is a private real estate investment firm whose principals have been in the property business in the area for more than 25 years.[27]

Shortly after the news articles were published, Westmount Realty Finance's securities attorney contacted IG to make him aware that the newspaper articles were a "breach" of

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[26] FINRA examiner ET agreed that that the "12-month investment period" referred to "the properties that the WRF Fund was purchasing."

[27] Although the press release is not in the record, we can reasonably infer that the information in the newspaper articles derived from the press release.

prohibition against general solicitation."[28] The securities attorney also recommended that Westmount Realty Finance publish a rescission of the article and not post the article on "the Westmount website." IG testified that he did not recall if he had asked the securities attorney if the KCD representatives should not sell the offering.

IG testified that no one at KCD, including him, had any prior knowledge of the newspaper articles being published. IG contacted JL and told him about the conversation with the attorney. IG testified that JL "agreed . . . to continue selling the offering," but that he and JL "decided . . . to have a conversation with the FINRA sales team." IG instructed the KCD representatives to ask persons who contacted them about the WRF Fund but who did not have a prior business relationship with KCD or Westmount Realty Finance how they learned about the offering and to not accept reservations from individuals who gained knowledge of the offering from the press release or newspaper articles. Asked whether he could have instructed the KCD representatives not to sell interests in the fund, IG testified that "[n]obody [including JL] had ever told me that was something that I had to do or that I should do" and that he did not think to do that himself. According to IG, one person contacted KCD in response to the newspaper articles and was not permitted to invest.

Several days after the issuer's attorney contacted IG, IG learned that the two newspaper articles had been posted on Westmount Realty Capital's website, possibly at CB's direction. KCD conceded that the issuer posted the articles on the website, on pages that contained a "Contact Us" link. IG testified that he informed CB and the "marketing department" that the newspaper articles "should have never happened," that "[y]ou should have consulted me," and that the articles "ha[d] to come down from the website." CB showed "very little concern" and "didn't understand why it was a big deal" before finally saying "okay, I get it." IG also asked the "technology department" to remove the articles from the website and understood that that would happen.

3. Newspaper Articles Remained on the Westmount Realty Capital Website as of October 2011

In October or November 2011, FINRA examiner ET, as part of FINRA's examination of KCD, conducted some internet research concerning the WRF Fund and found the two newspaper articles. Both articles were "on the internet," "generally available," and "not strictly limited to accredited investors or anybody that . . . WRF or KCD might know or have a relationship with." ET also found reprints of both articles on the Westmount Realty Capital website.

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[28] IG admitted in a letter dated May 3, 2012, that the issuer's attorney informed him of "the breach of general solicitation." Asked to confirm this at the December 2014 hearing, IG responded that "I don't remember [the securities attorney] black-and-white saying this is absolutely a breach of general solicitation" but recalled that the attorney had expressed concern and that it "could be a breach." We find that IG's statements in his May 3, 2012 letter are more reliable because they were much closer to the relevant conversation.

In October 2011, ET brought the newspaper articles to the attention of LR, who a few weeks earlier succeeded JL as KCD's compliance officer. LR promised to investigate the issue and report back. LR then contacted IG and learned that IG previously asked Westmount Realty Finance to take the articles down from the website, that IG told the KCD representatives not to sell the offering to persons who learned of it from the articles, and that all sales were to clients that had a previous relationship with KCD. LR, however, did not learn if any of the investors learned of the offering from the newspaper articles or if they purchased interests when the articles were on Westmount Realty Capital's website. LR told IG that the articles needed to be removed from the website immediately, but LR did not tell IG that the KCD representatives could not sell the offering anymore. The articles, however, were never removed from the website.[29]

4. Sales of the WRF Fund

KCD salespersons sold the WRF Fund until the conclusion of the subscription period. IG testified about the investment process. Representatives who were contacted by interested persons who had a prior relationship with KCD would provide those interested persons with the private placement memorandum and the LLC agreement. Representatives who were contacted by interested persons who had no prior relationship with KCD would ask the interested persons how they obtained the representative's contact information and investigate whether the interested person was an accredited investor. IG oversaw the sales team, reviewed for completeness the subscription documents and accredited investor forms, and forwarded the materials to KCD for approval.

The first sale of interests occurred on May 5, 2011, nine days after the two newspaper articles were published, and sales continued until sometime after October 2011. At some point, the offering ended. An August 24, 2011 notice filed by the issuer reflected that KCD had raised at least $2 million for the WRF Fund and identified no other broker-dealers. KCD was entitled to a fee of up to 5% of the gross proceeds from all interests sold through its efforts and a share of the carried interest distributions payable to the manager of the offering. IG and LR testified that KCD's representatives sold interests in the WRF Fund only to investors with a prior existing relationship with Westmount Realty Finance or KCD (which included, among others, registered investment advisors who brought in investors to the offering), but KCD provided no

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[29] In a March 21, 2012 response to FINRA staff's report of the 2011 examination of KCD, LR stated that: (1) the newspaper articles had been removed from the Westmount Realty Capital website immediately upon notification by FINRA staff; (2) KCD had informed Westmount Realty Finance that general solicitation articles are not to be used or posted to the website; and (3) KCD now checks the website periodically to ensure that no improper articles are posted. Likewise, during her June 2014 on-the-record interview, LR stated that she periodically reviewed the website. Despite these representations, the two newspaper articles were never removed from Westmount Realty Capital's website. Moreover, LR admitted at the December 2014 hearing that she never checked to see if the articles had been removed from the website and never carefully reviewed the newspaper articles.

documentary evidence supporting that claim. There also is no specific evidence of the investors' identities, their purported accredited investor status, or their level of sophistication. IG did not recall rejecting any subscriptions.

B. Sales of Unregistered Securities

The Hearing Panel found that KCD sold unregistered securities in violation of Section 5 of the Securities Act of 1933 ("Securities Act") and thereby violated FINRA Rule 2010. We affirm.

1. Prima Facie Case

Section 5(a) and (c) of the Securities Act of 1933 ("Securities Act") prohibit any person from offering or selling securities in interstate commerce unless a registration statement is filed or in effect with the SEC or an exemption from registration is available. 15 U.S.C. § 77e(a) & (c)). "'The registration requirements are the heart' of the Securities Act." *ACAP Fin., Inc.*, Exchange Act Release No. 70046, 2013 SEC LEXIS 2156, at *28 (July 26, 2013) (quoting *Pinter v. Dahl*, 486 U.S. 622, 638 (1988)), *aff'd*, 783 F.3d 763 (10th Cir. 2015). "The Securities Act was designed 'to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.'" *Id*. at *28 (citing *SEC v. Ralston Purina Co*., 346 U.S. 119, 124 (1953)).

A prima facie case of a Section 5 violation requires a showing that "(1) the defendant directly or indirectly sold or offered to sell securities; (2) through the use of interstate transportation or communication and the mails; (3) when no registration statement was in effect." *Id*. at *28-29. There is no requirement to show scienter. *Id*. at *29. Enforcement has demonstrated a prima facie case here. There is no dispute that KCD representatives sold and offered to sell interests in the WRF Fund, used interstate communication or the mails to do so, and that no registration statement was in effect.

2. Rule 506 Exemption

Once a prima facie case is established, the burden shifts to the person relying on an exemption from registration as a defense to establish the availability of the exemption. *Id*. at *29. The record demonstrates that the issuer of the WRF Fund sought to sell interests pursuant to the registration exemption in Rule 506 of Regulation D of the Securities Act. That rule provided that offers and sales of securities by an issuer that satisfy the conditions in Rule 506(b) "shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the [Securities] Act" and, therefore, not subject to Section 5 of the Securities Act. 17 C.F.R. § 230.506 (2011); *see* Section 4(2) of the Securities Act, 15 U.S.C. § 77d(a)(2) (2011) ("The provisions of Section 5 shall not apply to . . . transactions by an issuer not involving any public offering."). One of those conditions was that offers and sales "must satisfy all the terms and conditions of" Rules 501 and 502 of Regulation D, including, in pertinent part, that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising." 17 C.F.R. § 230.506(b); 17 C.F.R. § 230.502(c) (2011). Other conditions that must be met include that: (1) "[t]here are no more than or the issuer reasonably believes that there are no more than 35 purchasers of securities from the

issuer" who are not accredited investors; and (2) "[e]ach purchaser who is not an accredited investor . . . is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description." 17 C.F.R. § 230.506(b) (2011).[30] Registration exemptions are strictly construed against the claimant of an exemption. *Charles F. Kirby*, 56 S.E.C. 44, 52 (2003). Proof of an exemption "must be explicit, exact, and not built on mere conclusory statements." *Id.* at 53.

As explained below, KCD did not demonstrate that the issuer refrained from engaging in a general solicitation, and it did not demonstrate that the offering complied with the condition concerning the nature of the purchasers.

a. General Solicitation or General Advertising

KCD argues that the Hearing Panel erred in finding that the issuer of the WRF Fund engaged in a "general solicitation" that prevented the WRF Fund from qualifying for the Rule 506 registration exemption. We find, however, that the issuer did engage in a general solicitation.

A violation of the ban on general solicitation exists where the communications at issue (1) were made or placed by an issuer or person acting on its behalf; (2) were a general solicitation or general advertising (as further explained below); and (3) offered or sold securities. *See Brian Prendergast*, 55 S.E.C. 289, 307 (Aug. 1, 2001); *see also Interpretative Release on Regulation D*, Securities Act Release No. 6455, 1983 SEC LEXIS 2288, at *45 (Mar. 3, 1983). The issuer's press release and its posting of the resulting newspaper articles on its website met all of these elements.

i. Issuer Made the Communications

There is no dispute that the issuer of the WRF Fund made the press release that directly resulted in the two newspaper articles and reprinted those articles on the Westmount Realty Capital website.

ii. Definition of General Solicitation or General Advertising

The issuer's press release and the posting of the two resulting newspaper articles on the issuer's unrestricted web site also met the definition of general solicitation or general advertisement. Rule 502(c) specifically provides that the terms "general solicitation" and "general advertising" includes, but is not limited to, "[a]ny . . . article, notice or other

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[30] In 2013, the Commission adopted Rule 506(c), which deems an additional category of offerings, not subject to limitation on the manner of offering, to be transactions not involving any public offering within the meaning of Section 4(a)(2) of the Securities Act. 17 C.F.R. § 230.506(c). Rule 506(c) does not apply in this case because it was adopted two years after the offering of the WRF Fund.

communication published in any newspaper, magazine, or similar media." 17 C.F.R. § 230.502(c) (2011). While Westmount Realty Finance did not write the two newspaper articles, those articles resulted from a press release that it issued, and it posted the articles on its affiliate's unrestricted web site. Press releases qualify as a general solicitation or a general advertisement. *Remco Sec., Inc*., 1985 SEC No-Act. LEXIS 2455, at *2 (Aug. 20, 1985) (SEC staff interpretative letter indicating that a press release by an issuer could violate Rule 502(c) if it amounted to an offer to sell securities). Likewise, "publicly available media, such as unrestricted websites, also constitute general solicitation and general advertising." *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Securities Act Release No. 9415, 2013 SEC LEXIS 2004, at *8 (July 10, 2013) (citing *Use of Electronic Media for Delivery Purposes*, 60 Fed. Reg. 53458, 53463-64 (Oct. 13, 1995) and *Use of Electronic Media*, 65 Fed. Reg. 25843, 25851-52 (May 4, 2000)).

Our conclusion in this regard is bolstered by the fact that the press release and the posting of the newspaper articles on an unrestricted website were directed at the general public, not just at persons with whom the issuer had a preexisting, substantive relationship. *Robert T. Willis, Jr., P.C*., 1988 SEC No-Act. LEXIS 34, at *2 (Jan. 18, 1988) (SEC staff interpretation that "[i]f interests in [securities] are offered to persons who may not have had a prior existing relationship with the issuer, we would be unable to conclude that there would be no general solicitation for purposes of Rule 502(c)"); *H.B. Shaine & Co*., 1987 SEC No-Act. LEXIS 2004, at *1 (May 1, 1987) (SEC staff interpretative letter stating that to avoid making a general solicitation, in most cases a substantive relationship must exist between the issuer or its agents and the offerees before the solicitation of such offerees); *Mineral Lands Research & Mktg. Corp*., 1985 SEC No-Act. LEXIS 2811, at *2 (Dec. 4, 1985) (SEC staff interpretative letter stating that "[t]he types of relationships with offerees that may be important in establishing that a general solicitation has not taken place are those that would enable the issuer (or a person acting on its behalf) to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or that otherwise are of some substance and duration"); *E.F. Hutton & Co*., 1985 SEC No-Act. LEXIS 2917, at *2 (Dec. 3, 1985) (SEC staff interpretative letter stating substantive, pre-existing relationships with offerees demonstrate that a general solicitation did not occur).

KCD argues that it only sold interests in the WRF Fund to persons with whom it had a pre-existing relationship. Whether there has been a general solicitation, however, looks not just to those who purchased securities but to those who were offered the securities. *SEC v. Murphy*, 626 F.2d 633, 644-45 (9th Cir. 1980) ("The party claiming the [private offering] exemption must show that it is met not only with respect to each purchaser, but also with respect to each offeree."); *Use of Electronic Media*, 65 Fed. Reg. at 25852 (stating the "important and well-known principle" that "a general solicitation is not present when there is a pre-existing, substantive relationship between an issuer, or its broker-dealer, and the *offerees*") (emphasis added).

iii. Offer or Sale

Finally, the press release and the reprints of the newspaper articles on Westmount Realty Capital's unrestricted website "offered" securities.

Section 2(a)(3) of the Securities Act defines "offer" to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." 15 U.S.C.§ 77b(a)(3). This statutory language has been given an "expansive interpretation" by the courts and by the SEC and goes "beyond the common law contract concept of an offer." *Anthony Fields*, Securities Act Release No. 9727, 2015 SEC LEXIS 662, at *21 (Feb. 20, 2015); *Diskin v. Lomasney & Co*., 452 F.2d 871 (2d Cir. 1971); *SEC v. Cavanaugh*, 1 F. Supp. 2d 337 (S.D.N.Y. 1998).

Included in the term "offer" are "communications designed to procure orders for a security, arouse interest in a security, or condition the public mind." *Thoroughbred Racing Stable*, 1976 SEC No-Act. LEXIS 5, at *2 (Jan. 5, 1976) (citing *Carl M. Loeb*, 38 S.E.C. 843, 850 (1959)); *see Securities Offering Reform*, Securities Act Release No. 8591, 2005 SEC LEXIS 1789, at *55 (July 19, 2005); *The Regulation of Securities Offerings*, Securities Act Release No. 7606A, 1998 SEC LEXIS 2858, at *227 n.276 (Nov. 13, 1998) ("The Commission has long interpreted 'offer to sell' broadly to encompass pre-filing publicity efforts that may not be phrased expressly in terms of an offer but condition the market or stimulate interest in the offering."). An offer does not include, however, "factual business information that does not condition the public mind or arouse public interest in a securities offering." *Compliance and Disclosure Interpretations*, *available at* http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (Question and Answer 256.24 and 256.25, updated Aug. 6, 2015) (citing *Guidelines for the Release of Information by Issuers Whose Securities Are in Registration*, Securities Act Release No. 5180, 1971 SEC LEXIS 29 (Aug. 16, 1971)). What constitutes factual business information "depends on the facts and circumstances" but "typically is limited to information about the issuer, its business, financial condition, products, services, or advertisement of such products or services, provided the information is not presented in such a manner as to constitute an offer of the issuer's securities." *Id*.

KCD argues that the newspaper articles did not constitute an offer of securities, asserting that the articles focused on KCD's business activities in distressed real estate properties. In this regard, KCD contends that the articles "implied" that WRF had already raised $10 million in capital and "was poised to start investing in distressed properties"; included no information to indicate that Westmount Realty Finance or KCD was selling interests or seeking investors or that there were investment opportunities in the fund; and could not be read as "conditioning the market" or having the "purpose of ascertaining who would be willing to accept an offer of securities." *See Non-Public Offering Exemption*, Securities Act Release No. 4552, 1962 SEC LEXIS 166, at *3 (Nov. 6, 1962) (stating that "general solicitations of an unrestricted and unrelated group of prospective purchasers for the purpose of ascertaining who would be willing to accept an offer of securities is inconsistent with a claim that the transaction does not involve a public offering even though ultimately there may only be a few knowledgeable purchasers").

The preponderance of the evidence, however, demonstrates that the press release and the reprinting of the resulting newspaper articles on the issuer's website were designed to arouse immediate interest in the WRF Fund, during the same time when interests were being sold. The newspaper articles, which we reasonably infer were based on information in the press release, included information about the WRF Fund's name, issuer, size, and nature, describing it as "a $10 million real estate fund" that would "acquire bank-owned residential properties and nonperforming, discounted residential loans." The articles indicated that the WRF Fund had just

been "launched" and that the issuer was a "private investment firm."[31] That information was coupled with positive information about the issuer, its business relationships, and its recent history, including that the issuer's principals "have been in the property business for more than 25 years," that the issuer "is joining with several operators that specialize in bulk acquisition of distressed residential assets," and that "[i]n just over a year, Westmount has purchased more than 530 distressed residential assets." The articles also touted the favorable market conditions in the distressed real estate market in which the issuer operated, stating that "[w]ith nearly 4 million foreclosure filings in 2010, not only is the U.S. experiencing record-level foreclosure activity, but most industry experts aren't anticipating a slowdown for at least the next couple of years." It also is significant that the newspaper articles referred to a specific investment that was currently being offered. *Cf. Bateman Eichler, Hill Richards, Inc*., 1985 SEC No-Act LEXIS 2918 (Dec. 3, 1985) (concurring that a proposed solicitation that was generic in nature and that did "not make reference to any specific investment currently offered or contemplated for offering" did not constitute an offer to sell securities). Although the newspaper articles may also have informed owners of distressed properties and nonperforming loans that Westmount Realty Finance was a buyer in that market, that does not negate our finding that those communications were designed to arouse interest in the WRF Fund.

Our conclusion in this regard is also supported by the fact that at least one investor contacted KCD after reading the articles. KCD argues that one investor's "purported understanding" is "not enough" to show that the articles involved a general solicitation. While we agree with that, the fact that one person responded to the newspaper articles to inquire about investment opportunities is consistent with our finding that the press release and newspaper articles were designed to arouse an interest in the securities.

That there was an "offer" also is consistent with the SEC's broad interpretation of the "offer or sell" requirement. In *Gearhart & Otis*, the SEC found that a respondent offered unregistered securities for sale in violation of Section 5 of the Securities Act by sending to securities dealers copies of articles regarding lithium, its uses, availability and commercial prospects. The articles did not mention any particular security or company. Nonetheless, the SEC found that sending the articles to the dealers was part of a scheme to "awaken an interest" in lithium securities shortly before the offering of securities in National Lithium Corporation. *Gearhart & Otis, Inc*., 42 S.E.C. 1, 26 (1964), *aff'd*, 348 F.2d 798 (D.C. Cir. 1965). More recently, in *Prendergast*, a representative placed a newspaper advertisement inviting the general public to seminars about hedge funds. The advertisement did not mention a specific hedge fund, but was placed during the time the representative was selling units in a specific hedge fund. The SEC found that the advertisement and the seminar itself were used to offer or sell units in the hedge fund and violated the general solicitation ban in Rule 502(c). *Prendergast*, 55 S.E.C. at

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[31] We disagree with KCD's argument that the newspaper articles "implied" that the $10 million had already been raised. The article stated that the issuer had "announced" that the fund had "launched." If anything, that suggested—accurately—that the fund had only just begun.

308. Westmount Realty Finance's actions present an even stronger example of a general solicitation because the articles mentioned a specific, current securities offering.[32]

KCD argues that it had no intent to offer the securities to any investors other than its own pool of investors with whom it had a prior relationship. Section 5 of the Securities Act, however, does not require evidence of a specific intent to violate the statute. *SEC v. Credit First Fund, LP*, No. CV05-8741, 2006 U.S. Dist. LEXIS 96697, at *39 n.21 (C.D. Cal. Feb. 13, 2006) (citing *SEC v. Alliance Leasing Corp*., No. 98-CV-1810-J, 2000 U.S. Dist. LEXIS 5227, at *21 (S.D. Cal. Mar. 20, 2000), *aff'd*, 28 F. App'x 648 (9th Cir. 2002)); *Swenson v. Engelstad*, 626 F.2d 421, 424 (5th Cir. 1980) ("The Securities Act . . . imposes strict liability on offerors and sellers of unregistered securities."); *SEC v. Pearson*, 426 F.2d 1339, 1343 (10th Cir. 1970). Regardless, KCD was aware, or reckless in being unaware, that the *issuer* had generally offered interests in the WRF Fund. *Ronald G. Sorrell*, 47 S.E.C. 539, 540 (1981) (holding that broker-dealers "have a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements . . ., and should be reasonably certain that such an exemption is available before engaging in transactions which raise a question of compliance with those requirements.") (quotation omitted), *aff'd*, 679 F.2d 1323 (9th Cir. 1982).

iv. Whether the Actual Purchasers of the WRF Fund Were Solicited Through the General Solicitation

KCD argues that the offering did not violate the Rule 502(c) ban against general solicitation because its representatives sold only to "pre-existing customers" who received information about the offering from an e-mail that KCD representatives sent. We reject this argument.

In a 2011 letter written around the time the WRF Fund offering was launched, the Chairperson of the SEC addressed the decision of Facebook and Goldman Sachs & Co. to limit a $1.5 billion private placement of Facebook securities only to investors outside the United States due to the level of media attention to the offering inside the United States. Citing a 2007 release, Chairperson Schapiro wrote that the SEC previously "indicated that the proper analysis of whether a general solicitation occurred focused on whether the *investors* participating in the offering were *actually solicited* through the activities which could be viewed as a general solicitation or if, for example, *the investors were existing clients or those with whom a pre-existing relationship existed*." *Letter dated April 6, 2011, from Mary Schapiro, Chairman, SEC to Darrell E. Issa, Chairman, House Committee on Oversight and Government Reform*, at 8, *available at* https://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf (emphasis added) (citing *Revisions of Limited Offering Exemptions in Regulation D*, Securities Act Release No. 8828, 2007 SEC LEXIS 1730 (Aug. 3, 2007)). As two leading industry experts have noted,

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[32] In *Prendergast*, there also was evidence that the representative had expressed in a letter his intent to use seminars to obtain new investment capital for the hedge fund. 55 S.E.C. at 307-308. However, we do not think the absence of such direct evidence of intent here precludes a finding that Westmount Realty Finance's communications amounted to an offer of securities.

Chairperson Schapiro's letter "seems to be saying that the proper analysis is whether the investors in the offering came into the offering through legitimate means rather than through the general solicitation, and that this analysis applies even if the possible general solicitation is made by means other than a registration statement." 1 Harold S. Blumenthal and Samuel Wolff, *Securities Law Handbook*, at 653 (2014 ed.).

However, even assuming that the SEC Chairperson's letter provides relevant guidance, KCD has not proved with sufficient evidence that the only persons who actually invested in the WRF Fund were ones solicited through "legitimate means" rather than the press release or the newspaper articles, or persons who were preexisting clients. The record does not show that none of the persons who purchased interests had seen the newspaper articles. Moreover, although IG and LR testified that interests in the offering were sold only to persons with whom KCD had a prior business relationship, KCD presented no corroborating evidence of these summary statements.

Accordingly, for the reasons explained above, the WRF Fund was not exempt from registration pursuant to Rule 506 because the issuer engaged in a general solicitation.

b. Limitations on Purchasers

To qualify for the Rule 506 exemption also requires that the unregistered securities be sold only to accredited investors and no more than 35 persons who are "capable of evaluating the merits and risks of the prospective investment." 17 C.F.R. § 230.506(b)(2) (2011); 17 C.F.R. § 230.501(e)(1)(iv) (2011) (excluding from the 35-person count "[a]ny accredited investor"). As the party claiming an exemption, it was KCD's burden to demonstrate that the sales of the WRF Fund were consistent with the criteria concerning the number of purchasers and the nature of the purchasers. KCD, however, has offered no evidence showing that all purchasers of the WRF Fund met these criteria. IG testified that KCD verified that the investors were accredited, and LR testified at her on-the-record interview that she confirmed that the investors were accredited. But the record does not identify the investors or include corroborating evidence that the investors were all accredited investors or met the sophistication criteria of Rule 506. *See Sorrell*, 47 S.E.C. at 541 (explaining that evidence in support of an exemption must be explicit, exact, and not built on conclusory statements).

* * *

For the reasons explained above, KCD sold unregistered securities without the benefit of an available exemption from registration, in violation of Section 5 of the Securities Act. A violation of Section 5 also violates FINRA Rule 2010. *See Midas Sec., LLC*, Exchange Act Release No. 66200, 2012 SEC LEXIS 199, at *46 n.63 (Jan. 20, 2012) (citing *Sorrell*, 679 F.2d at 1326); *Kunz v. SEC*, 64 F. App'x 659, 663-64 (10th Cir. 2003). We dismiss, however, Enforcement's allegations that KCD violated securities laws by advertising a Regulation D securities offering. There is no evidence that KCD's representatives played any role in the press release or the posting of the resulting newspaper articles on the Westmount Realty Capital website.

C. Failure to Supervise

The Hearing Panel found that KCD failed to supervise its representatives' sales of the unregistered WRF Fund securities. We affirm.

NASD Rule 3010(a) provides that "[e]ach member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules." The rule also states that "[f]inal responsibility for proper supervision shall rest with the member."

The duty to supervise requires "reasonable" supervision, which is "determined based on the particular circumstances of each case." *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 SEC LEXIS 2843, at *33 (Dec. 19, 2008) (describing the supervisory responsibilities of NASD members under NASD Rule 3010). The SEC has held that "[t]he duty of supervision includes the responsibility to investigate 'red flags' that suggest that misconduct may be occurring and to act upon the results of such investigation." *Id*. (quoting *Michael T. Studer*, 57 S.E.C. 1011, 1023-24 (2004), *aff'd*, 260 F. App'x 342 (2d Cir. 2008)). "Once indications of irregularity arise, supervisors must respond appropriately." *La Jolla Capital Corp*., 54 S.E.C. 275, 285 (1999). With respect to the registration provisions of the Securities Act, "all registered broker-dealers should establish minimum standard procedures to prevent and detect violations of the federal securities laws and to ensure that the firm meets its continuing responsibility to know both its customers and the securities being sold." *A.G. Becker Paribas, Inc.*, 48 S.E.C. 118, 120-21 (1985) (quoting *Sales of Unregistered Securities by Broker-Dealers*, Securities Act Release No. 5168, 1971 SEC LEXIS 19 (July 7, 1971)). These procedures must be made known to salespersons "and be sufficient to reveal promptly to supervisory officials transactions which may, when examined individually or in the aggregate, indicate that sales in a security should be halted immediately pending further inquiry" for violating the Securities Act. *Sales of Unregistered Securities by Broker-Dealers*, 1971 SEC LEXIS 19, at *4. "Assuring proper supervision is a critical component of broker-dealer operations." *Pellegrino*, 2008 SEC LEXIS 2843, at *33 (quoting *Richard F. Kresge*, Exchange Act Release No. 55988, 2007 SEC LEXIS 1407 (June 29, 2007)).

KCD had relevant supervisory procedures that identified the supervisors for "private offerings" and that required them to "[p]erform reasonable due diligence" and look for compliance with Regulation D. KCD also was aware of the potential problems with sales of the WRF Fund. Early in the offering period, the issuer's attorney contacted IG, informed him that there had been a breach of the ban against general solicitation, recommended that Westmount Realty Finance try to publish a rescission of the article, and advised that the articles not be published on Westmount's web site. IG testified that he assumed the articles were a breach of the general solicitation ban and understood that the issuance of a press release about the offering would render the offering non-exempt. IG informed JL, KCD's compliance officer and the designated supervisor of the Dallas branch office, about the conversation with the issuer's securities attorney. Just days after these events, IG learned that the newspaper articles had been posted on Westmount's web site.

Despite KCD's awareness of indications that its representatives were selling unregistered securities that were not exempt from registration and the existence of relevant supervisory processes, KCD did not respond with reasonable supervisory steps. IG and JL informed the KCD representatives not to sell the WRF Fund to anyone who had responded to the newspaper articles, and IG asked Westmount Realty Finance to take the articles down from the web site. But no one at KCD ever instructed representatives to stop selling interests in the WRF Fund, IG never verified that the newspaper articles were taken down from the web site, and the newspaper articles were never removed from the website.

KCD's supervisory failures continued when, approximately six months later, FINRA staff alerted KCD's new compliance officer, LR, and KCD's owner, JB, about the newspaper articles. LR testified that she understood that the articles constituted a general solicitation in violation of Regulation D. And at her June 2014 OTR, LR testified that the newspaper articles should not have been on the website during the offering or solicitation stage of a private offering. Despite her admitted understanding of the legal problems with the offering, LR did not reasonably respond. LR did not investigate to see if any of the investors learned of the offering from the newspaper articles. She did not instruct IG that KCD could not sell the offering. And although LR instructed IG that the articles needed to be removed immediately from the Westmount website and understood that IG's first attempt to do so was unsuccessful, LR never checked whether the articles were removed and, in fact, they never were. LR even admitted more than three years after learning of the newspaper articles that she had not "carefully" reviewed the newspaper articles.

KCD's defenses lack merit. IG testified that no one at KCD, including him, had control over what was on Westmount Realty Capital's web site. But KCD did have control over its representatives and—as IG admitted—could have instructed them to stop selling the WRF Fund.

Both IG and LR also pleaded ignorance of the requirements at issue. IG explained that none of the "30 or 40 Reg D offerings" in which he participated at Realty Capital Partners was subject to regulatory scrutiny; that he had "never dealt with a . . . potential breach of solicitation"; that "no one ever advised me" to instruct KCD's representatives not to sell the WRF Fund, and that "I don't know the letter law" but "was trying to . . . live up to the spirit of Reg D and make sure that we did not allow anyone to invest . . . that gained knowledge of the offering through the press release." LR testified that she had not previously dealt with any private placement offerings or exemptions from registration under Regulation D. Claimed ignorance of the requirements at issue, however, affords KCD no excuse. *Prime Investors, Inc.*, 53 S.E.C. 1, 5 & n.12 (1997) (citing *Gilbert M. Hair*, 51 S.E.C. 374, 378 n.12 (1993)); *see also Midas Sec., LLC*, 2012 SEC LEXIS 199, at *33 (holding that "[a] broker, as an agent for its customers, ha[s] a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act and should be reasonably certain such an exemption is available") (internal quotation marks omitted). There is no

evidence that KCD ever attempted to learn what its compliance obligations were, such as obtaining legal advice from the attorneys that KCD could call for guidance.[33]

Accordingly, we find that KCD failed to supervise the KCD representatives' sales of unregistered securities, in violation of NASD Rule 3010 and FINRA Rule 2010.

V. Sanctions

For KCD's violations concerning the sales of the WRF Fund, the Hearing Panel censured KCD and fined it $75,000. KCD argues that if a sanction is warranted, we either eliminate the fine or impose a $2,500 fine. As explained below, we impose a $73,000 fine and a censure.

For sales of unregistered securities, the Guidelines recommend imposing a fine between $2,500 and $73,000, and ordering disgorgement. In egregious cases, the Guidelines recommend considering a higher fine and suspending the firm with respect to any or all activities or functions for up to 30 business days or until procedural deficiencies are remedied.[34]

For failing to supervise, the Guidelines recommend imposing a fine between $5,000 and $73,000 and to consider limiting the activities of the appropriate branch office or department for up to 30 business days.[35] In egregious cases, the Guidelines recommend to consider limiting activities of the branch office or department for a longer period or suspending the firm with respect to any or all activities or functions for up to 30 business days.[36] In a case against a member firm involving systemic supervision failures, the Guidelines recommend to consider a

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[33] IG also asserted that it was JL's responsibility, not his, for supervising the registered representatives to ensure their compliance with federal securities laws and FINRA rules. IG's actions and inactions, however, are relevant to our assessment of whether KCD reasonably supervised the sales of the WRF Fund. IG was the branch manager of KCD's Dallas branch office, oversaw the Dallas-based KCD representatives, instructed the KCD representatives how to deal with investors who responded to the articles, and instructed the issuer to remove the newspaper articles from the website. Regardless, JL and LR also were aware of the general solicitation and chose not to halt the selling efforts.

[34] *FINRA Sanction Guidelines* 24 (2015), http://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf [hereinafter Guidelines].

[35] *Id.* at 103. The Hearing Panel relied on only the Guideline for sales of unregistered securities, but that Guideline and the Guideline for supervision violations are both relevant. Because these violations were pled under a single cause of action, we will impose a unitary sanction for both violations.

[36] *Id.*

longer suspension of the firm with respect to any or all activities or functions (of up to two years) or expulsion of the firm.[37]

There are several aggravating factors. KCD raised at least $2 million for the WRF Fund.[38] KCD disregarded information that the sales of interests in the WRF Fund were impermissible sales of unregistered securities, including the communication from the issuer's securities attorney that there had been a "breach" of the prohibition against general solicitation and its awareness that the newspaper articles discussing the WRF Fund had been posted on the issuer's website.[39] The quality and degree of KCD's implementation of its supervisory procedures and controls was weak,[40] and KCD did not implement reasonable procedures to

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[37] *Id.* KCD argues that the 2015 edition of the Guidelines, which raised the high end of the fine ranges, should not be applied because they were adopted after the parties briefed the issues before the Hearing Panel. But the 2015 edition provides that "[t]hese Guidelines are effective as of the date of publication, and apply to all . . . pending matters." *Id*. at 8.

[38] *Id.* at 24 (Principal Considerations in Determining Sanctions, No. 3) (share volume and dollar amount of transactions involved); *Id.* at 103 (Principal Considerations in Determining Sanctions, No. 2) (nature, extent, size, and character of the underlying misconduct).

[39] *Id.* at 24 (Principal Considerations in Determining Sanctions, No. 5), 103 (Principal Considerations in Determining Sanctions, No. 1). Arguing that the Hearing Panel's sanctions analysis inappropriately relied on the securities attorney's communication, KCD argues that "at no time did the attorney advise KCD to cease offering or rescind any interests already received." KCD, however, did not react appropriately to the information and advice provided by the securities attorney, which was that there had been a breach of the general solicitation ban and that the newspaper articles should not be posted on the issuer's website and should be retracted. In this regard, there is no evidence that KCD sought further legal advice to clarify its regulatory obligations, and no one at KCD ever verified that the newspaper articles were removed from Westmount Realty Capital's website. KCD further argues that the securities attorney did not prevent Westmount Realty Finance from filing a notice of registration exemption for the offering months after the newspaper articles had been published. But regardless of whatever role the attorney played regarding that notice—of which there is no evidence—it does not change the fact that the attorney notified KCD of the "breach" of the general solicitation prohibition and that KCD did not take appropriate steps in response to that red flag.

At the same time, we reject Enforcement's argument that KCD is essentially blaming the issuer's securities attorney for KCD's violation. KCD's arguments were a direct, albeit unpersuasive, challenge to the Hearing Panel's finding that KCD disregarded the securities attorney's advice.

[40] *Id.* at 103 (Principal Considerations in Determining Sanctions, No. 3).

ensure that it did not participate in an unregistered distribution.[41] KCD's misconduct resulted in monetary gain.[42]

There are, however, some mitigating factors. KCD argues that it adhered to the purpose of Section 5 when it directed its representatives to sell WRF Fund securities only to those with whom it had a prior existing relationship who had "the sophistication to fend for themselves," and not to any persons who learned of the WRF Fund through a general solicitation. We do not agree that KCD's sales adhered to the purposes of Section 5, and we reiterate that KCD did not actually prove that it sold interests only to pre-existing customers, persons who did not see the newspaper articles, accredited investors, or persons who met the sophistication criteria of Rule 506. Nevertheless, we find that the limiting instructions to KCD's representatives reflected an attempt to comply, at least in part, with the requirements of the Rule 506 registration exemption,[43] and that KCD gave those instructions prior to when FINRA detected the violative conduct.[44] Considering KCD's actions in this regard, we also disagree with the Hearing Panel's findings that KCD's conduct was intentional and find instead that it was reckless.[45]

We do not share the Hearing Panel's view that a "lack of continuity in management contributed to [KCD's] misunderstanding of its obligations" and "bear[s] on the likelihood of future misconduct under current management." Prior to and during the relevant period, KCD experienced significant changes in ownership and management, and had three different compliance officers during the relevant period: LB (who served for two years during the relevant period), JL (who served at least 10 months), and LR (who began serving six to seven months before the end of the relevant period). There is no evidence, however, that the changes and turnover prevented these compliance officers from fulfilling their regulatory obligations. Both JL and LR were well aware of the breach of the general solicitation ban, yet they failed to learn what their compliance obligations actually were and did not follow up on the few supervisory steps that they did take. The turnover at KCD did not prevent them from doing so. Moreover, months after LR began serving as the compliance officer, LR provided misleading information to FINRA staff concerning KCD's new procedures for checking the issuer's web site. These circumstances do not suggest that future misconduct is unlikely.

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41 *Id.* at 24 (Principal Considerations in Determining Sanctions, No. 4). Although LR informed FINRA of certain supervisory procedures that KCD would employ, the record demonstrates that KCD was not following at least some of those procedures.

42 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 17).

43 *Id.* at 24 (Principal Considerations in Determining Sanctions, No. 1).

44 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 4).

45 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 13).

We reject KCD's arguments that there are additional mitigating factors than the ones we identify above. KCD contends that the violative conduct was aberrant.[46] Notwithstanding that there is no evidence that any of its 30 or 40 Regulation D offerings prior to the WRF Fund offering was subject to regulatory scrutiny, KCD's argument is undermined by the facts that KCD's violative conduct—both the sales and the supervisory failures—lasted months[47] and involved supervisory failures by several persons.

We reject KCD's argument that it is mitigating that there is no allegation or evidence of customer harm or other negative consequences. The absence of customer harm is not mitigating, as our public interest analysis focuses on the welfare of investors generally. *Howard Braff*, Exchange Act Release No. 66467, 2012 SEC LEXIS 620, at *26 (Feb. 24, 2012); *Dep't of Enforcement v. Mizenko*, Complaint No. C8B030012, 2004 NASD Discip. LEXIS 20, at *20 (NASD NAC Dec. 21, 2004), *aff'd*, 58 S.E.C. 846 (2005). Citing *SEC v. Mattera*, however, KCD presses that an "unauthorized general solicitation that resulted in *de minimis* consequences may not result in the loss of an issuer's ability to claim an exemption from the registration requirements." The failure to comply with Rule 502(c), however, is deemed to be significant to the offering as a whole. *See* Regulation D, Rule 508(a)(2), 17 C.F.R. § 230.508(a)(2). Regardless, *Mattera* held only that "at least one court has taken the view that if the consequences of the [unauthorized or accidental] solicitation were de minimis, and the issuer took action to correct the error, the issuer may still claim an exemption" from registration. *SEC v. Mattera*, No. 11 Civ. 8323, 2013 U.S. Dist. LEXIS 174163, at *33 (S.D.N.Y. Dec. 6, 2013) (emphasis added) (citing *SEC v. Dunfee*, No. 16114-2, 1966 U.S. Dist. LEXIS 10105, at *3 (W.D. Mo. 1966)). Even assuming that the consequences here were *de minimis*, Westmount Realty Finance's general solicitation was not unauthorized or accidental, and there is no evidence that Westmount Realty Finance took action to correct the general solicitation.

We also reject KCD's argument that it is mitigating that the SEC has not taken enforcement action concerning the WRF Fund. The SEC's inaction conveys no relevant information.[48]

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[46] *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 16).

[47] *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 9).

[48] On January 8, 2016, KCD moved during this appeal to introduce as additional evidence a letter dated August 21, 2014, in which SEC staff informed Westmount Realty Capital that it did not intend to recommend enforcement action against Westmount Realty Capital at that time. KCD asserted that the SEC staff's letter concerned an investigation that, among other things, looked at the general solicitation of the unregistered offering at issue here, and that KCD "had no knowledge" that the SEC staff had investigated this issue until the day it filed its motion. In further support, KCD submitted several other documents, including letters and declarations.

The NAC Subcommittee denied KCD's request to introduce any additional evidence. We adopt the Subcommittee's ruling as our own. Pursuant to FINRA Rule 9346(b), a motion for

[Footnote continued on next page]

Considering the mix of aggravating factors and mitigating factors, a sanction towards the upper end of the Guidelines for non-egregious violations is warranted to deter KCD and others from engaging in sales of unregistered securities and failing to supervise sales of unregistered securities. We impose a censure and a $73,000 fine, which is essentially the same fine imposed by the Hearing Panel, but within the relevant Guidelines' range. A fine at the high end of the Guideline is especially appropriate considering that the fine does not even account for the disgorgement that we also would have ordered had the record contained evidence of the approximate fees KCD earned from its more than $2 million in violative sales.[49]

Finally, we address an issue concerning KCD's ability to pay the $73,000 fine. In its notice of appeal, KCD acknowledged that it did not raise the issue of its ability to pay before the Hearing Panel yet argued that "the Hearing Panel had an obligation to consider whether a small firm like KCD has the resources to pay" the fine. KCD said nothing more about this issue in its appellate briefs. Given the absence of an effort to develop this line of argument, we find that KCD has waived the issue of its ability to pay. *Strahan v. Coxe*, 127 F.3d 155, 172 (1st Cir. 1997) ("Issues adverted to in a perfunctory manner, unaccompanied by some effort at developed argumentation, are deemed waived.")

In any event, it was KCD's burden to demonstrate its inability to pay, and it did not meet that burden. *Dist. Bus. Conduct Comm. v. Escalator Sec., Inc.*, Complaint No. C07930034, 1998 NASD Discip. LEXIS 21, at *12 (NASD NBCC Feb. 19, 1998). Although KCD filed its most recent annual audited financial statements (dated December 31, 2014) pursuant to an order of the

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[cont'd]

leave to introduce additional evidence shall demonstrate that there was good cause for failing to introduce the evidence below and why the evidence is material. Assuming arguendo that KCD had good cause for failing to introduce the August 21, 2014 letter below, the letter is not material. KCD claims that the letter "suggests that the SEC did not find that the newspaper articles constituted a general solicitation." Even if the SEC staff investigated the same issue before us, the letter was specifically provided under guidelines that it "must in no way be construed as indicating that the party has been exonerated or that no action may ultimately result from the staff's investigation of that particular matter." *See Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations*, Securities Act Release No. 5310, 1972 SEC LEXIS 238, at *7 (Sept. 27, 1972).

[49] We acknowledge that we have found mitigating factors that the Hearing Panel did not find yet are imposing essentially the same fine. The Hearing Panel's decision suggests, however, that it may have overlooked that the Guidelines directed it to consider a fine higher than $73,000. In this regard, although the Hearing Panel found the conduct to be "egregious," it did not acknowledge that the Guidelines recommended in egregious cases to "consider a higher fine" than the relevant range, and the Hearing Panel imposed a fine that was only $2,000 above the top $73,000 level for non-egregious violations. Moreover, the Hearing Panel's decision did not acknowledge that the Guidelines also recommend disgorgement.

NAC Subcommittee, those statements do not reflect that KCD had an inability to pay and, in any event, are now outdated.[50] *Cf. Dep't of Enforcement v. Merrimac Corporate Sec., Inc.*, Complaint No. 2007007151101, 2012 FINRA Discip. LEXIS 43, at *44 (FINRA Bd. of Governors May 2, 2012) (holding that a respondent making a claim of inability to pay must show that it is unable to obtain the needed funds by, among other things, reducing expenses and salaries, raising capital, or borrowing money); *ACAP Fin., Inc.*, 2013 SEC LEXIS 2156, at *77 (holding that respondent did not demonstrate that it could not comply with an "appropriate installment payment plan or other alternate payment option"); *Guidelines*, at 11 (describing installment payment plans).

VI. Conclusion

Accordingly, we reverse the Hearing Panel's findings that KCD violated the communications with the public rule, and we vacate the $40,000 fine and censure that the Hearing Panel imposed in connection with those findings. We affirm the Hearing Panel's findings that, in contravention of Section 5 of the Securities Act, KCD sold unregistered securities in violation of FINRA Rule 2010 and failed to supervise those sales in violation of NASD Rule 3010. We censure and fine KCD $73,000 for its sales of unregistered securities and its supervisory violations. Finally, we affirm the Hearing Panel's imposition of $5,556.48 in costs.[51]

On behalf of the National Adjudicatory Council,

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Marcia E. Asquith
Senior Vice President and Corporate Secretary

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[50] KCD's audited statements show that as of December 31, 2014, it had a net income of $54,959 (reflecting $747,325 in operating revenues and $686,555 in expenses), excess net capital of $52,078, and cash of $102,005.

[51] Pursuant to FINRA Rule 8320, any member that fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment.