

BEFORE THE NATIONAL ADJUDICATORY COUNCIL  
FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of

Department of Enforcement,

Complainant,

vs.

William H. Murphy & Co., Inc.  
Houston, TX,

and

William H. Murphy  
Houston, TX,

Respondents.

DECISION

Complaint No. 2012030731802

Dated: October 11, 2018

**Member firm engaged in sales of unregistered, non-exempt securities and member firm and registered principal failed to establish and enforce an adequate supervisory system, including written supervisory procedures. Held, findings affirmed, sanctions modified.**

**Appearances**

For the Complainant: Steve Graham, Esq., Penelope Brobst Blackwell, Esq., Suzanne H. Bertolett, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondents: Dawn R. Meade, Esq., Ashley Spencer, Esq., Bonnie Spencer, Esq.

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## Decision

William H. Murphy & Co., Inc. (“WHM”) and William H. Murphy (“Murphy”) appeal an Extended Hearing Panel decision issued on June 3, 2016. The Extended Hearing Panel found that WHM violated FINRA Rule 2010 by engaging in unregistered sales of securities without the benefit of an available exemption from registration, in violation of FINRA Rule 2010. For this violation, it fined WHM \$50,000 and ordered that WHM disgorge \$78,210.91, plus prejudgment interest. The Extended Hearing Panel also found that WHM and Murphy failed to establish and maintain a supervisory system, including written supervisory procedures, in violation of NASD Rule 3010 and FINRA Rule 2010. For these violations, the Extended Hearing Panel fined WHM \$50,000, fined Murphy \$50,000, suspended Murphy from association with any FINRA member in all capacities for six months, and ordered that he requalify by examination before reentering the securities industry in any registered capacity requiring qualification. After our independent review of the record, we affirm the Extended Hearing Panel’s findings of violation. We, however, modify the sanctions imposed.

### I. Background

WHM is located in Houston, Texas, and became a registered broker-dealer in 1990. During the relevant period, WHM had 19 non-registered locations, 25 registered representatives, and two offices of supervisory jurisdiction (“OSJ”), one of which was located at the office of Liberty Real Estate Advisors (“LREA”), a limited liability company based in Houston, Texas. WHM terminated its FINRA membership in August 2018.

Murphy entered the securities industry in 1968. He worked at several FINRA firms before he founded WHM in 1990. During the relevant period, Murphy was WHM’s acting president, director, and chief compliance officer (“CCO”). At WHM, Murphy also served in several registered capacities, including as a general securities representative, a general securities principal, a municipal securities representative, a municipal securities principal, an investment banking representative, and an operations professional. As a firm registered principal, Murphy was responsible for supervising all WHM associated persons and OSJ branch offices, including the OSJ branch office located on LREA’s premises. In June 2018, WHM voluntarily terminated Murphy’s registrations. He is currently not associated with a FINRA member.

### II. Procedural History

On November 7, 2014, FINRA’s Department of Enforcement (“Enforcement”) filed a complaint alleging two causes of action. The first cause alleged that, from March 2011 to January 2013 (the “Relevant Period”), WHM participated in sales of three unregistered offerings that failed to qualify for an exemption from registration and, as a result, WHM violated FINRA Rule 2010 by acting in contravention of Section 5 of the Securities Act of 1933 (“Securities Act”).<sup>1</sup> The second

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<sup>1</sup> The conduct rules that apply in this case are those that existed at the time of the conduct at issue.

cause of action alleged that WHM, acting through Murphy, failed to establish and maintain a supervisory system, including written supervisory procedures, reasonably designed to ensure compliance with Section 5 of the Securities Act, in violation of NASD Rule 3010 and FINRA Rule 2010. After presiding over an eight-day evidentiary hearing, the Extended Hearing Panel found that WHM and Murphy engaged in the misconduct alleged and imposed the sanctions discussed above. This timely appeal followed.

### III. Facts

#### A. LREA

LREA is a non-registered entity that was created to provide educational and networking opportunities to individuals interested in real estate investing. LREA used radio programs, commercials, workshops, webinars, podcasts, property tours, case studies on real estate transactions, and social functions to market its services.

According to the business plan submitted to FINRA as part of its new membership application, LREA's mission was to "launch a successful media campaign to market its services to potential clients and build a strong and suitable clientele" and "introduce pre-qualified and suitable clients to associated issuers of private placements." To achieve these goals, LREA applied to become a FINRA member in April 2010. LREA, however, withdrew its new membership application after receiving comments from FINRA staff that it lacked sufficient experience in conducting private placement offerings.<sup>2</sup> LREA instead entered into an OSJ arrangement with WHM to have WHM "sponsor certain [LREA] employees who are eligible to be FINRA Registered Representatives" to market and distribute its affiliated real estate private offerings.

#### B. The LREA-Affiliated Private Offerings

During the Relevant Period, LREA was affiliated with three limited liability companies ("LLCs")—the 2011 Guardian Equity Fund, LLC ("GEF"), the 2012 Multi-Family Real Estate Fund II, LLC ("MFREF2"), and the 2012 Multi-Family Real Estate Fund III, LLC ("MFREF3")—that sponsored "pooled real estate private investment offerings" and raised capital to acquire multi-family apartment properties to renovate them, increase their occupancies, and improve their property values.<sup>3</sup> From March 2011 to January 2013, GEF, MFREF2, and MFREF3 offered and sold LLC member interests that were not registered with the SEC or any federal or state agency, but instead were sold in reliance on exemptions from the registration provisions of the Securities Act, in particular, Section 4(2) and Rule 506 of Regulation D. GEF, MFREF2, and MFREF3 had no business operations or sources of funds other than investor funds raised from the offerings.

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<sup>2</sup> LREA's compliance officer, Mark C. Hutton ("Hutton"), had less than one year's experience in private placements.

<sup>3</sup> Trey Stone was the sole owner of LREA, the president of GEF, MFREF2, and MFREF3, and he managed GEF, MFREF2, and MFREF3 through his managing company, Guardian Equity Management, L.L.C.

C. LREA Partners with WHM to Sell Unregistered Securities

According to the “Office of Supervisory Jurisdiction Agreement” dated March 15, 2011 (“OSJ Agreement”), LREA and WHM entered into an arrangement under which WHM would sponsor LREA employees as registered representatives to “engage in the solicitation, purchase, and[/]or sale of securities” under WHM’s direction and supervision in connection with LREA-affiliated private offerings.<sup>4</sup> WHM established an OSJ at LREA’s office, where two WHM registered individuals, Mindy M. Price (“Price”) and Hutton worked.

Price was a WHM registered representative and a LREA salaried employee. She was hired as LREA’s vice president of business development in April 2010 and was associated with WHM from March 2011 to August 2012. Before LREA, Price had a sales marketing and real estate background, but no securities experience. At LREA, Price hosted the LREA radio shows and workshops, conducted one-on-one meetings for those interested in real estate investments, and qualified potential investors in the GEF and MFREF2 offerings, which included completing WHM new account forms.

Hutton was also a WHM representative and LREA salaried employee. Hutton was hired in October 2010 as LREA’s compliance officer. He was also associated with WHM as a registered representative and registered principal and served as the LREA OSJ designated registered principal. As the LREA OSJ designated principal, Hutton was responsible for reviewing and approving Price’s sales transactions and conducting a suitability review of the WHM customers that met with Price one-on-one and completed new account forms. After Price left the firm, Hutton assumed her duties of meeting with potential investors that attended the LREA workshops, qualifying them for investing in the affiliated private offerings and completing the WHM new account forms.

As provided in the confidential private placement memorandums (“PPMs”) and corresponding selling agreements, GEF, MFREF2, and MFREF3 engaged WHM as the exclusive managing placement agent for which WHM received a one percent commission for each sale. The PPMs stated that GEF, MFREF2, and MFREF3 were also affiliated with LREA employees, Price and Hutton, who also received commissions on the unregistered sales.

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<sup>4</sup> WHM and LREA entered into a “Joint Client Services Agreement” in connection with the OSJ Agreement, also dated March 15, 2011, to which the parties agreed to jointly provide certain services, including “structuring and preparation of offering documentation” and “securities activities.” The Joint Client Services Agreement expressed LREA’s desire to “offer securities to investors of related issues of securities” and WHM’s sole responsibility in entering into a selling agreement with each respective issuer and handling all related securities activities through its registered representatives. Around February 2013 and during FINRA’s investigation, WHM’s counsel created an “Amended Joint Client Services Agreement,” which Murphy signed but was left undated. The Amended Joint Client Services Agreement, which stated that it was effective as of March 15, 2011, substantially changed provisions related to LREA’s business by removing any language suggesting that LREA would offer securities to investors, and limiting LREA’s business activities solely to “educational and networking services” that required WHM’s preapproval.

WHM also received compensation from LREA. Pursuant to the OSJ Agreement, LREA was responsible for paying all expenses related to the OSJ arrangement. LREA also paid WHM a non-refundable monthly retainer fee of \$2,666.67.<sup>5</sup> The retainer fee was paid “regardless of whether [WHM] market[ed] any securities issued by affiliates of LREA.” At the hearing, Murphy explained that the retainer fee “came from LREA for compliance with their sales seminar and making sure that people who were referred to them, that we set up a process of strict compliance of the two-hat policy; which just bothered me . . . [i]t had nothing to do with the commission.” During the Relevant Period, WHM received a total of \$54,980.86 in retainer fees.

During the Relevant Period, 23 investors became WHM customers through the LREA radio programs and workshops, and they purchased a total of \$1,031,700 worth of units of the GEF, MFREF2, and MFREF3 LLC member interests. For these sales, GEF, MFREF2, and MFREF3 paid WHM a total of \$23,230.05 in sales commissions. None of the 23 investors who purchased the GEF, MFREF2, and MFREF3 LLC member interests through WHM had a pre-existing substantive relationship with the issuers or WHM before the private offering commenced.

1. GEF Offering

From June 15, 2011, through May 31, 2012, GEF conducted a contingency offering of LLC member interests raising between \$1 and \$10 million. From August 19, 2011, to February 23, 2012, GEF raised \$1,428,775 from 26 investors—11 of whom were WHM customers that, through LREA’s radio shows and workshops, purchased \$545,200 in LLC member interests. For its sales, WHM received \$14,287.75 in commissions.

2. MFREF2 Offering

From May 9, 2012, through May 31, 2013, MFREF2 conducted a contingency offering of LLC member interests raising between \$500,000 and \$20 million. Between May 30, 2012, and September 14, 2012, MFREF2 raised \$1,550,488 from 43 investors. Of those, eight investors were WHM customers that, through LREA’s radio shows and workshops, purchased \$235,000 in LLC member interests. For these transactions, WHM received \$3,845.30 in sales commissions.

3. MFREF3 Offering

MFREF3 conducted a contingency offering of LLC member interests from September 21, 2012, through September 20, 2013, raising between \$500,000 and \$10 million. MFREF3 raised over \$1.7 million from 39 investors who purchased MFREF3 member interests from October 17, 2012, to March 18, 2013. Four of those investors were WHM customers that, through LREA’s radio shows and workshops, purchased \$251,500 in LLC member interests, for which WHM received \$5,097 in sales commissions.

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<sup>5</sup> In July 2012, the monthly retainer fee increased to \$4,000 per month.

D. WHM Representatives Used Radio Shows and Workshops to Solicit Sales of Unregistered Securities

LREA's marketing strategy included soliciting the general public by conducting radio shows and workshops designed to promote interest in real estate investing.<sup>6</sup> WHM, through its registered representatives, used these radio shows and workshops to generate WHM customers to whom it sold the GEF, MFREF2, and MFREF3 offerings. The radio shows were: (1) broadcast over the airways,<sup>7</sup> (2) placed on LREA's website as podcasts and made publicly available for listening over the internet,<sup>8</sup> and (3) sent to potential investors via email as podcast links.<sup>9</sup>

Price primarily hosted the LREA radio shows, but at times, Hutton co-hosted the radio shows with her. The radio shows ranged from general topics such as legislation that could impact multi-family apartment owners, to more targeted discussions about multi-family real estate investments, including whether it could be something that a public listener could add to their portfolio.

On the radio, Price and others used securities investment terminology and securities-related catchphrases such as:

- an alternative to standard investments;
- adding multi-family real estate investments to the listener's portfolio;
- good time to invest in apartments;
- passive investments;
- private placements; and

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<sup>6</sup> According to LREA's business plan: "[LREA's] radio talk shows [would] be aired to the general public and focused on real estate as an investment vehicle . . . the shows [would] feature strategies for participants struggling to find alternatives to the stock market who lack expertise in real estate or desire to enhance their expertise."

<sup>7</sup> During the Relevant Period, LREA broadcast its radio shows on stations in the Houston, Texas and Sacramento Valley, California markets, including 700 AM-KSEV, Business 1110 AM, and Talk 650 AM.

<sup>8</sup> LREA had two unrestricted, publicly accessible websites: [www.whybuyapartments.com](http://www.whybuyapartments.com) and [www.whybuyproperty.com](http://www.whybuyproperty.com). The first website allowed the general public to register to attend a LREA workshop.

<sup>9</sup> LREA radio commercials were also broadcast over the airways and WHM registered representatives communicated with potential investors via email and the telephone. The radio commercials that were aired every week also promoted attending the free LREA workshops and encouraged public listeners to learn more about "a lucrative trend" to "look at what's in your portfolio" and to "buy low and sell high, right now apartments are low."



- free workshops provided by LREA that listeners could attend to learn more about investing in real estate.

Price also spoke in detail about investing in private placements, including who would be qualified to do so. Although Price did not mention the GEF, MFREF2, and MFREF3 offerings specifically, she discussed what a private placement was, what an “accredited investor” means, and how investing in private placements was “another thing” that “now everybody can actually get involved with.” Moreover, referring to her own investment in the GEF offering, Price discussed on the radio how she purchased an apartment complex as an investor in “the La Estancia deal,” a multi-family property that GEF acquired and remarked how great it was to invest in an apartment complex.

Throughout the radio shows, Price repeatedly encouraged listeners to attend a free workshop to learn more about the various topics discussed and, in particular, real estate investment opportunities. During the Relevant Period, 261 individuals who listened to the radio shows subsequently attended the LREA workshops.

During each LREA radio show and workshop, a WHM representative read a disclosure statement stating that securities were sold through WHM, thereby indicating to the general public that listeners and workshop attendees, if interested, could purchase securities from a registered broker-dealer connected to the LREA business.<sup>10</sup> The disclosure did not state that WHM was the exclusive managing selling agent for LREA’s affiliated private offerings, nor did WHM send GEF, MFREF2, or MFREF3 offering materials to any radio listeners or workshop attendees. For the 23 investors at issue in the complaint, the radio shows initiated the process that led each person to become a new customer of WHM and investor in the GEF, MFREF2, and MFREF3 offerings. WHM admitted that it had no pre-existing substantive relationship with any person before they listened to the LREA radio program or attended the LREA workshop.

#### E. LREA Hosts Workshops to Attract Investors in the Unregistered Offerings

LREA also hosted free seminars to attract new customers to whom WHM would sell the GEF, MFREF2, and MFREF3 offerings. During the Relevant Period, Price testified that she conducted the LREA workshops approximately two to three times a week.

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<sup>10</sup> The radio disclaimer stated in part, “Securities sold through William H. Murphy and Company, Incorporated, a registered broker-dealer, member FINRA and SIPC.” The workshop disclaimer stated in part, “Securities transactions are conducted by certain employees of Liberty Real Estate Advisors, LLC that are also registered through Wm. H. Murphy & Co., Inc., Member FINRA/SIPC.” Another workshop disclaimer stated, “Once you have decided real estate is an investment option for you, we can then set up an appointment with Mindy Price or one of the other registered representatives at Wm. H. Murphy and Co. to see if you qualify and meet the suitability requirements for this type of investment.” LREA’s website also contained the disclaimer that securities were offered through WHM.

When Price conducted the workshops, she followed a detailed script that Murphy reviewed and approved. One script, titled “Introductory Workshop,” covered four main topics, one of which was “Private Placements,” including what private placements were and how a workshop attendee could qualify to invest in them.<sup>11</sup> The Introductory Workshop script explained that LREA was focused on educating the public on an “alternative to your traditional 401(k) and IRA investments like stocks, bonds, and mutual funds.” It also explained that LREA’s real estate investing focus was multi-family housing. Multi-family housing happened to be the same targeted properties the GEF, MFREF2, and MFREF3 LLCs intended to acquire. Based on the script, Price would therefore educate “investors” on various aspects of real estate investing, including “how [the attendee] can get involved through private placement offerings.”

Similar to the Introductory Workshop script, the LREA “Quick Start” presentation referenced “real estate investing,” “building streams of passive income,” and LREA’s “affiliate company” that “puts together single family flips and multi-family opportunities with a team of industry professionals,” and asking the attendees “[a]re these type of investments right for you.”<sup>12</sup> The LREA workshop scripts also provided attendees with information about investing in real estate as a means of generating income. Price provided introductory remarks, by stating: “Our sales pitch by asking you to listen to this workshop is this . . . we have come up with an investment vehicle that has allowed many investors to achieve returns that can exceed what your more traditional forms of investing have typically been able to deliver.”

Like the radio shows, the LREA workshops discussed investing in private placements, including who was defined as an accredited investor and the regulatory limitations on how many non-accredited investors could invest in a private placement. In the Introductory Workshop script, Price repeatedly promoted the benefits of passively investing in multi-family housing by highlighting the downsides of owning single family rental properties, using phrases such as “tenants, toilets, and taxes.” Workshop attendees were then provided with examples of how as an investor they could generate a tax-deferred 55% annual rate of return, and achieve an infinite return through net operating income.

A scripted speech given at “The Real Estate Investor Main Event” by a non-registered LREA executive vice president, who became the face of LREA after Price left, included a Q&A section that

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<sup>11</sup> The Extended Hearing Panel’s decision noted the difficulties WHM and Murphy had identifying what was a final, approved script and the record has no evidence of an approved advertising file. Although Price argued that Introductory Workshop script was an old document that “did not go live,” the Extended Hearing Panel concluded that Price had used the Introductory Workshop script, noting that her testimony of what she covered in the workshops was consistent with the content of the script.

<sup>12</sup> At the hearing, WHM and Murphy also asserted that Enforcement’s exhibit of the Quick Start presentation never went live. However, a comparison of Enforcement’s exhibit to WHM and Murphy’s proposed exhibit of the final Quick Start presentation revealed that the two exhibits were identical.

asked, “If the classes are free, how do you keep the doors open and put on events like these?” to which he responded:

Great question.

Liberty Real Estate Advisors provides free education. There is an affiliate company that offers multi-family opportunities for those who are deemed suitable by our 3rd party broker-dealer, William H. Murphy.

If you would like to learn more, please see any of our Liberty employees to set up a time to discuss further.<sup>13</sup>

LREA tracked attendance and the success of its marketing by having workshop attendees complete a “Contact Information” form. The form stated, “Real Investments. Real People. Real Results.” It also included a disclaimer that “Securities transactions are conducted through Wm. H. Murphy & Co., Inc., Member FINRA/SIPC.” The form requested an attendee’s general contact information, the date of the workshop, how the attendee heard about LREA, and an indication of whether they wanted “additional information.” The form did not collect information on an attendee’s financial background or securities investment experience. Murphy testified that, at the workshops, Price and Hutton were wearing “LREA hats.” When Enforcement asked at the hearing whether Price and Hutton could ask the attendees about their financial background and investment experience at the workshop, Murphy replied, “Absolutely not.” Price also testified that she did not request an attendee’s financial information during or after the workshop.

At the end of the workshop, attendees were directed, if interested, to schedule a one-on-one meeting with Price or a WHM representative to learn more about multi-family investing and “move into the application process with the broker dealer review of your application and potentially introduce you to a private placement issuer.”

#### F. One-on-One Meetings with a WHM Representative

During the Relevant Period, 34 LREA workshop attendees expressed an interest in obtaining additional information about real estate investing and met with either Price or Hutton. The one-on-one meetings were held at the LREA OSJ office. Price or Hutton, in their capacity as a WHM representative, discussed the prospective customer’s real estate experience, investment experience, and other financial matters to gauge their level of sophistication and determine whether they were an accredited investor. The attendee was then given a WHM new customer account form to complete. WHM’s new account form requested information about the customer’s financial status and investment experience. Completion of the WHM new account form was the first instance in which WHM could obtain financial information from the prospective customer to form a substantive

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<sup>13</sup> The LREA executive vice president further stated in his speech, “If you have \$50,000 or more of investable capital we recommend speaking with a registered rep of our 3rd party broker-dealer to see if multi-family is suitable for you.”

relationship. Approximately two thirds of the prospective customers who attended the one-on-one meetings completed the new account form during their meeting with a WHM representative.

G. Review and Approval of the WHM New Account Form

As a WHM representative, Price reviewed the new customer account form and conducted an initial review to determine whether the person was suitable to invest in the GEF, MFREF2, and MFREF3 offerings. Hutton thereafter reviewed the new account forms, conducted a suitability review, and approved the potential investor as the OSJ designated principal. Murphy ultimately approved all WHM new account forms. After Price left LREA and the firm, prospective investors met with Hutton, who conducted initial reviews for suitability, reviewed the new account forms, and sent them to Murphy for review and approval.

WHM offered the GEF, MFREF2, and MFREF3 private placements only to customers that came from the LREA workshops. In fact, Murphy refused to offer or sell the GEF, MFREF2, and MFREF3 LLC member interests to existing firm customers. Of the 23 new WHM customers who purchased securities in the GEF, MFREF2, and MFREF3 offerings, 10 were non-accredited investors.

H. Tracking the “Ideal Client”

Because LREA’s marketing methods were costly, LREA used data from its internal systems that tracked workshop attendees to identify which marketing methods produced its “ideal client.” LREA’s tracking system for the ideal client focused on the amount of money the workshop attendees invested in private placements. WHM produced a spreadsheet during FINRA’s examination that included a sampling of who these ideal clients were. The first metric used to identify an ideal client was labeled the “Investment Amount,” which stated the amount that a workshop attendee invested in the affiliated private offerings. The second metric identified was whether the investor was “Accredited [or] Non-Accredited.” While WHM claimed that LREA’s primary business purpose was to educate the general public about real estate, LREA’s “ideal client” spreadsheet did not include a metric on anything education-related, such as the name of the LREA workshop class attended or type of real estate education the attendee needed. Instead, after identifying how much an ideal client invested, other categories of data captured were gender, age, race, occupation, net worth, and the source of LREA’s marketing.

LREA also created monthly “pipeline” spreadsheets. The spreadsheets projected who would invest in the MFREF2 and MFREF3 offerings based on their one-on-one meetings with Price and included the potential dollar amount of each investment and an anticipated “close ratio.” Like the “ideal client” spreadsheet, the “pipeline” spreadsheets projected potential sales in the GEF, MFREF2, and MFREF3 offerings versus LREA’s education or networking opportunities, and they were utilized by LREA, WHM, and the affiliated issuers.

I. WHM’s Supervisory System

Murphy was designated in the firm’s written supervisory procedures (“WSPs”) as responsible for establishing and maintaining WHM’s supervisory system, including its WSPs. Per

the WSPs, Murphy was also responsible for accepting customer accounts and supervising all WHM associated persons, advertising, and private placement activities. Although Murphy assigned Hutton registered principal duties at the LREA OSJ, Murphy was ultimately responsible for its supervision. No WHM new account form was accepted, or securities transaction completed, without Murphy's approval. Murphy was also responsible for monitoring the LREA radio shows and pre-approving the scripts for the LREA workshops.

WHM, through Murphy, did not establish WSPs setting forth procedures and controls to market and sell the GEF, MFREF2, and MFREF3 offerings in compliance with Securities Act Section 5. When WHM embarked on a new business and entered into an OSJ arrangement with LREA, it failed to establish WSPs to address that business activity. WHM's WSPs did not address WHM's arrangement with LREA or any of the issuers, and its supervisory control procedures did not recognize the LREA location as an OSJ.

During the Relevant Period, the LREA OSJ lacked adequate supervision. Hutton had less than one year of experience supervising private placements and Price had no prior securities experience. Despite this, Murphy only provided verbal check-ins to Hutton and Price regarding compliance with Section 5 of the Securities Act, and verbal instructions to Hutton regarding his OSJ designated principal duties. For example, Price and Hutton testified that they had to make sure that the radio shows and workshops did not mention the GEF, MFREF2, and MFREF3 offerings or "securities." Yet, Murphy provided no formal training on what types of public communications could constitute a general solicitation under SEC Rule 502(c). Murphy delegated to Hutton the responsibility of monitoring the one-on-one meetings Price had with prospective WHM customers. Yet, Hutton did not attend Price's one-on-one meetings and Murphy never instructed him on how to monitor discussions in those meetings.

During the one-on-one meetings, Price admitted that she discussed the private placement issuers even though she had never seen or reviewed the PPMs (with the exception of glancing at the GEF PPM because she had personally invested in that offering). Although Price conducted the initial meetings to determine if the prospective WHM customer was qualified to invest in the offerings, neither Murphy nor Hutton required her to read any offering materials. And Murphy testified that he was not concerned about it.

Hutton sent information about each prospective investor in the GEF, MFREF2, and MFREF3 offerings to Murphy, who before accepting a new customer then asked MS, the firm's FINOP and director of regulatory compliance, to provide an additional suitability review. At the hearing, however, MS admitted that he never listened to the LREA radio shows, never attended a LREA workshop, and never visited the LREA OSJ.

WHM received commissions on sales in the GEF, MFREF2, and MFREF3 offerings. WHM reviewed all of LREA's emails, monitored LREA's customer relationships through LREA's data tracking system, and approved all of LREA's communications with the public. However, WHM, acting through Murphy, ignored red flags concerning its participation in sales of unregistered securities under its arrangement with LREA. In particular, at the hearing Murphy admitted to his concern that dual-hatted WHM registered representatives were presenting at radio shows and

workshops to the general public with an interest in qualifying new customers to purchase securities in the LREA-affiliated private offerings.

No one at WHM, however, monitored the radio shows or workshops to make sure that new WHM customers did not purchase securities in any LREA affiliated private offerings that were open at that time. While Hutton agreed at the hearing that one of LREA's services was to find investors for the private placements offered by its affiliated companies, he also testified that he did not take any steps to ensure that WHM's customers were not offered the unregistered GEF, MFREF2, and MFREF3 LLC member interests before first establishing a substantive relationship.

#### IV. Discussion

##### A. Sales of Unregistered Securities in Violation of Section 5

The Extended Hearing Panel found that WHM violated FINRA Rule 2010 by selling unregistered, non-exempt securities in violation of Section 5 of the Securities Act. The Extended Hearing Panel also found that WHM failed to demonstrate that the sales of unregistered securities were exempt from registration.<sup>14</sup> After careful consideration of the evidentiary record, we affirm the Extended Hearing Panel's findings. We first address the Extended Hearing Panel's substantive findings related to unregistered sales and inadequate supervision. We then address the jurisdiction and procedural arguments that the respondents raised on appeal.

##### 1. Enforcement Established a Prima Facie Case

Sections 5(a) and (c) of the Securities Act make it unlawful for any person to, directly or indirectly, use interstate commerce to offer or sell any security unless a registration statement is filed or in effect with the SEC as to such security or there is an available exemption from registration. *See* 15 U.S.C. § 77e(a) and (c). The registration requirements under the federal securities laws are designed to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions." *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953). "Any person who engaged in steps necessary to the distribution of the unregistered security is liable under Section 5." *SEC v. Tecumseh Holdings Corp.*, 2009 U.S. Dist. LEXIS 119869, at \*8 (S.D.N.Y. Dec. 22, 2009). "A violation of Securities Act Section 5 is a violation of FINRA Rule 2010." *KCD Fin. Inc.*, Exchange Act Release No. 80340, 2017 SEC LEXIS 986, at \*13 (Mar. 29, 2017).

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<sup>14</sup> The parties stipulated that Enforcement was alleging only that WHM violated the general solicitation prohibition found in Securities Act Rule 502(c) and that through that conduct, the securities failed to comply with the conditions of Regulation D, Rule 506, and any other applicable exemptions. The parties also stipulated that, while other exemptions might apply, all applicable exemptions require compliance with the general solicitation prohibition found in Securities Act Rule 502(c).

The Securities Act imposes strict liability on violators of Section 5. *Swenson v. Engelstad*, 626 F.2d 421, 424-425 (5th Cir. 1980). To establish a prima facie Section 5 violation, Enforcement must prove that WHM: (1) sold or offered to sell securities; (2) in the absence of a registration statement in effect or filed covering the securities; and (3) used the mails or facilities of interstate commerce in connection with the sale or offer. *Id.* On appeal, WHM challenges only the first element of a prima facie case, by arguing that WHM was not a “seller” of the unregistered securities. A preponderance of evidence in the record demonstrates, however, that WHM’s assertion has no merit and Enforcement has met its burden of establishing a prima facie case.

First, WHM participated in the offer and sale of unregistered securities.<sup>15</sup> Although WHM claims that it was only a referring or “introducing broker,” and not the “seller” of the GEF, MFREF2, and MFREF3 LLC member interests, the record demonstrates otherwise. The evidence supports our finding that WHM was a “necessary participant” in the sale of unregistered securities, and that WHM’s participation was substantial. *SEC v. Calvo*, 378 F.3d 1211, 1215 (11th Cir. 2004) (“To demonstrate that a defendant sold securities, the SEC must prove that the defendant was a necessary participant or substantial factor in the illicit sale.”); *see also SEC v. Murphy*, 626 F.2d 633, 651 (9th Cir. 1980) (defining a “necessary participant” for purposes of Section 5 liability as one who, “but for [their] participation,” the securities transaction would not have taken place).

WHM entered into exclusive selling agreements with GEF, MFREF2, and MFREF3 committing to use its best efforts to engage in the offer and sale of the unregistered securities. WHM did not merely introduce unsolicited buyers to the issuers. WHM representatives Price and Hutton solicited the general public on the radio and at LREA workshops to attract potential investors in the GEF, MFREF2, and MFREF3 offerings. Price and Hutton met individually with prospective customers to discuss their real estate investment goals, financial backgrounds, and investment interests in purchasing private placements. Price and Hutton conducted suitability assessments of prospective customers to determine whether they qualified for the GEF, MFREF2, and MFREF3 offerings and WHM, acting through Murphy, made suitability determinations. Resulting from these sales efforts, 23 investors purchased \$1,031,700 in GEF, MFREF2, or MFREF3 securities for which WHM received commissions. WHM’s role as a seller of the GEF, MFREF2, and MFREF3 offerings is undeniable. Enforcement has satisfied the first element of a prima facie case.

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<sup>15</sup> The parties agree, and we accordingly find, that the GEF, MFREF2, and MFREF3 LLC member interests were securities. Not only did the GEF, MFREF2, and MFREF3 PPMs all regard the LLC member interests as securities, in applying the *Howey* test, the record evidences that the investors purchased membership interests in LLCs that pooled their funds in a common business enterprise of acquiring multi-family apartment properties with a reasonable expectation of receiving a profit solely through the managerial efforts of Trey Stone and his managing company, Guardian Equity Management, L.L.C. *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946) (finding that an investment contract is a security under the Securities Act when the transaction or scheme involves an investment of money in a common enterprise with profits coming solely from the efforts of others). We therefore conclude that the GEF, MFREF2, and MFREF3 LLC member interests are securities.

Second, it is uncontested by the parties that there were no registration statements filed or in effect for the subject securities. In addition, each of the GEF, MFREF2, and MFREF3 PPMs explicitly stated that the LLC member interests being offered were unregistered. Enforcement therefore has established the second element of a prima facie case.

Third, WHM used various instrumentalities of interstate commerce in connection with its securities sales, including the radio, e-mail, internet, and telephone. Furthermore, the WHM customers who purchased interests in GEF, MFREF2, or MFREF3 did so by either wiring funds to the issuer's banking institution or writing a check. *See SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 862 (S.D.N.Y. 1997) (finding that the jurisdictional requirements under the federal securities laws are interpreted broadly to include tangential mailings or intrastate telephone calls, and the wire or mail transfer of funds), *aff'd*, 159 F.3d 1348 (2d Cir. 1998). Thus, Enforcement met the third and final element of a prima facie case.

## 2. WHM Failed to Prove a Regulation D, Rule 506 Exemption

Because Enforcement established a prima facie case that WHM violated Section 5 of the Securities Act, the burden shifts to WHM to demonstrate that the offers and sales of the GEF, MFREF2, and MFREF3 LLC member interests were exempt from the registration requirements. *See Lively v. Hirschfeld*, 440 F.2d 631, 632 (10th Cir. 1971) (“[A] defendant seeking to come within the nonpublic offering exemption has the burden to so prove his position.”). Registration exemptions are strictly construed against the claimant of the exemption, *Gearhart & Otis, Inc.*, 42 S.E.C. 1, 4 n.3 (1964), and proof of the registration exemption must be “explicit, exact, and not built on conclusory statements.” *SEC v. Cont'l Tobacco*, 463 F.2d 137, 156 (5th Cir. 1972) (citation omitted).

Based on the record, GEF, MFREF2, and MFREF3 purportedly offered and sold LLC member interests pursuant to the safe harbor of Regulation D, Rule 506(b). 17 C.F.R. § 230.506(b). That rule exempts sales of unregistered securities of unlimited volume and dollar amount, so long as conditions are satisfied. One condition—which is the primary issue in this case—is that each unregistered offer and sale of securities must satisfy the manner of sale requirements under Securities Act Rule 502(c), 17 C.F.R. § 230.502(c), which provides 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.” Thus, WHM cannot claim that the securities were exempt from registration pursuant to Regulation D, Rule 506(b) if it engaged in any form of general solicitation or general advertising (hereinafter “general solicitation”) under Rule 502(c).

In determining whether a general solicitation has occurred, we analyze two questions of fact. First, whether there was an “offer” or “sale” of securities. Second, whether the offer or sale was made via a “general solicitation or general advertising.” In answering both questions in the affirmative, we conclude that WHM's sales did not qualify for the Rule 506(b) exemption.

### a. The Radio Shows and Workshops Were Offers of Securities

Securities Act Section 2(3) defines “sale” or “sell” to include “every contract of sale or disposition of a security or interest in a security, for value.” It also defines “offer to sell,” “offer for sale” or “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). These statutory terms “which Congress expressly intended to define broadly . . . are expansive enough to encompass the entire selling process, including the seller/agent transaction.” *Pinter v. Dahl*, 486 U.S. 622, 643 (1988).

The evidence in the record overwhelmingly supports the Extended Hearing Panel’s finding that the radio shows and workshops constituted offers to sell securities. While the private placements were open for sale, WHM representatives hosted radio shows and conducted workshops not merely for educational purposes, but to awaken an interest in real estate investment opportunities, with a particular focus on multi-family apartment housing—the same targeted properties that GEF, MFREF2, and MFREF3 were concurrently raising funds to acquire. WHM’s selling agreement best summarized its solicitation efforts. GEF, MFREF2, and MFREF3 appointed WHM as their sole and exclusive agent to use its firm’s best efforts to locate for their accounts, *and not for WHM’s own account*, a select number of investors to purchase securities in the offerings. *See KCD Fin. Inc.*, 2017 SEC LEXIS 986, at \*20 (finding that the statutory definition of “offer to sell” includes “any communication which is designed to procure orders for a security”).

Although LREA’s stated purpose was to educate the general public about real estate, any educational component of the LREA business model coexisted with a chain of solicitation to obtain investors for the GEF, MFREF2, and MFREF3 offerings. The chain began with the radio shows during which Price discussed in detail investing in private placements, including what a private placement was, what the term “accredited investor” means, and how a private placement is an investment that “now everybody can actually get involved with.” Price also remarked favorably about her own private placement investment and it was mentioned that securities were being sold through WHM.

The radio shows and commercials, as Hutton admitted, were a pipeline towards coaxing listeners to attend a LREA workshop. The workshops then continued the solicitation chain by having WHM representatives and other invited hosts discuss more concretely investing in private placements, including what private placements were, who could invest, and why a private placement might be beneficial to an investor’s portfolio. At the end of the workshop, attendees were then invited to meet with a WHM registered representative to learn more about real estate investment opportunities. Short of not mentioning the GEF, MFREF2, and MFREF3 issuers by name, we agree that the radio shows and workshops were offers to buy securities. *See id.* at \*20 (finding a communication an “offer” of securities even if on its face it does not mention a particular offering but is designed to awaken an interest in the security); *see also Gerald F. Gerstenfeld*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2790 (Dec. 3, 1985) (finding a generic advertisement used during the process of offering and selling securities that invites members of the public to call or write for additional information through its syndicator to be an “offer” of securities in violation of Rule 502(c)).

On appeal, WHM argued that the Extended Hearing Panel ignored that LREA changed its business purpose from being a broker-dealer to an education entity that would refer prospective clients to WHM. LREA’s withdrawal of its initial application to become a broker-dealer and refocus on education, however, are immaterial to our conclusion that WHM offered unregistered, non-exempt securities to the general public. Moreover, contrary to WHM’s contention that it was not a seller of securities, and thus not liable, the evidence demonstrates otherwise. WHM received

transaction-based compensation to serve as the sole placement agent for the marketing and sale of the offerings, which included promoting the benefits of real estate investing on the radio and at LREA workshops, soliciting potential investors, opening new customer accounts, and conducting suitability reviews of qualified customers to invest in the GEF, MFREF2, and MFREF3 offerings. As we stated previously, these selling efforts demonstrate that WHM was a necessary participant whose selling efforts were a substantial factor in the unregistered sales of securities.<sup>16</sup> Thus, WHM is liable under Section 5.

b. WHM Offered Unregistered Securities by General Solicitation

Securities Act Rule 502(c) defines a “general solicitation or general advertising” to include “any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio” and “[a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising.” 17 C.F.R. § 230.502(c).

Not all public communications, however, are general solicitations. Indeed, the determination of what constitutes a general solicitation for purposes of Rule 502(b) depends on the existence and substance of the relationship between the issuer, or its agent, and those being solicited. *See NASD Notice to Members 05-18*, 2005 NASD LEXIS 25, at \*18 (Mar. 2005) (explaining that the existence of an adequate pre-existing relationship between a member and the offeree is “[a] critical factor in determining whether a communication is appropriately limited, and thus not a general solicitation”). To successfully rely on an available exemption from registration, claimants must prove that—at the time of the *offer* or sale of securities—the investor whom it solicited did not need the protections of the registration requirements because their relationship with the issuer afforded them “access to or disclosure of the sort of information about the issuer” that registration would cover. *Murphy*, 626 F.2d at 647. The SEC has taken the position that if there exists a “preexisting substantive relationship” between the offeree and the issuer or its agent, then an offer of securities to these offerees will not constitute a general solicitation. *See, e.g., H.B. Shaine & Co. Inc.*, SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2004 (May 1, 1987). However, “a substantive relationship must exist between the issuer or its agents and the offerees before the solicitation of such offerees.” *Id.*; *see also E.F. Hutton & Co.*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2917 (Dec 3, 1985); *Bateman Eichler, Hill Richards, Inc.*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2918 (Dec 3, 1985).

WHM failed to demonstrate that it had a pre-existing substantive relationship with the 23 investors at issue to avoid a general solicitation violation. WHM, through Price and Hutton, used the radio shows and workshops to solicit potential investors by general solicitation. The LREA radio shows, commercials, and workshops fell squarely within the definition of a general solicitation or

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<sup>16</sup> Price and Hutton conducted their LREA securities sales activities under WHM’s supervision and any related investments in the GEF, MFREF2, and MFREF3 offerings were processed under WHM’s direction.

general advertisement.<sup>17</sup> The LREA radio programs were broadcast to the general public and conducted by WHM representatives to awaken interest in investing in the LREA-affiliated private placements. The LREA workshops, which served as a link in the chain of solicitation, were also open to the general public and geared towards the end goal of obtaining indications of interest from the workshop attendees in real estate investing. WHM had not established a substantive relationship with the investors at issue before it participated in the offerings or before soliciting prospective investors on the radio or at the workshops. Thus, a preponderance of the evidence shows that WHM made offers of unregistered securities by general solicitation without the benefit of an available exemption, in violation of Securities Act Section 5.

FINRA Rule 2010 requires members, in its business conduct, to observe high standards of commercial honor and just and equitable principles of trade. Because WHM engaged in unregistered securities sales to 23 investors without an available exemption, in violation of Securities Act Section 5, we affirm the Extended Hearing Panel's findings that WHM violated FINRA Rule 2010.

c. WHM's Arguments Against Liability Are Unavailing

WHM does not contest that radio programs and workshops are communications that meet the definition of a general solicitation. It also does not dispute that no pre-existing substantive relationships existed with any of the 23 investors at issue. WHM argues that, as held in SEC no-action letters *Bateman Eichler* and *IPONET*, because the radio shows or workshops did not mention a specific security, the communications were not general solicitations in violation of Securities Act Rule 502(c). WHM is mistaken.

As early as 1964, the SEC has held that an offer to sell securities is broadly defined to include "any communication which is designed to procure orders for a security . . . even a communication that did not on its face refer to a particular offering" or security. *See KCD Fin. Inc.*, 2017 SEC LEXIS 986, at \*20 (citing *Gearhart*, 42 S.E.C. at 59). Although WHM representatives never specified a particular offering or securities, the LREA radio broadcasts and workshops were conducted during the time the GEF, MFREF2, and MFREF3 LLCs were being sold and were scripted to "awaken an interest" and to attract new investors in the offerings.<sup>18</sup> We therefore uphold

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<sup>17</sup> LREA's posting of the radio shows as podcasts on its website that were freely accessible to the public also constituted a general solicitation. *See In the Matter of Eureka Capital SPC*, Exchange Act Release No. 73569, 2014 SEC LEXIS 4278, at \*4 (Nov. 10, 2014) (finding that offering securities on an unrestricted website constituted a general solicitation).

<sup>18</sup> A closer read of the *Bateman Eichler* and *IPONET* SEC no-action letters supports this view. In addition to not mentioning a specific investment, *Bateman Eichler* had to ensure that persons at the time of the solicitation were not offered securities in a *current* offering or securities contemplated for offering—which is distinguishable from the facts in the present case. *See Bateman Eichler*, 1985 SEC No-Act. LEXIS 2918, at \*1. WHM, through its representatives, solicited the general public and sold to 23 investors unregistered securities while the GEF, MFREF2 and MFREF2 offerings were open at the time of the solicitations.

the Extended Hearing Panel's finding that the radio shows and workshops were "offers" made by general solicitation in violation of Rule 502(c). *Accord KCD Fin. Inc.*, 2017 SEC LEXIS 986, at \*21 (finding that generic news articles regarding a real estate investment fund constituted offers and thus a general solicitation violation when posted for the general public as a publicity effort designed to "arouse public interest" to invest in the Fund); *Brian Prendergast*, 55 S.E.C. 289, 308 (2001) (finding that a generic advertisement announcing a hedge fund seminar to attract new investors constituted an offer of securities and thus a general solicitation violation); *Gearhart*, 42 S.E.C. at 59 (finding generic new articles on the subject of lithium were "the first step in a campaign to sell National Lithium stock" and to "awaken an interest in lithium securities" and thus constituted offers of unregistered securities in violation of Section 5).

WHM next argues that the Extended Hearing Panel ignored evidence that LREA's purpose was to be an education entity that *might* refer potential clients to WHM for investment purposes. While education might have been one aspect of the LREA business model, a preponderance of the evidence convincingly demonstrates that dual-hatted WHM representatives used the radio shows and workshops to attract potential investors for the GEF, MFREF2 and MFREF2 offerings. As FINRA explained in *NASD Notice to Members 05-18*, if a dual registered representative and real estate agent (or real estate broker) solicits potential investors by advertising a "real estate" seminar, and at the seminar, attendees are given a presentation on tenant-in-common ("TIC") exchanges generally, and are informed that the member offers TIC investments to its "customers," then the advertisement for the seminar constitutes a general solicitation and the references to TIC investments offered by the member are deemed offers of those securities. *See* 2005 NASD LEXIS 25, at \*20-22. "[S]uch offerings would not be able to rely on the exemption from registration for private placements under Regulation D." *Id.* at \*21.

So too here. During the Relevant Period, the only securities that Price and Hutton, as WHM representatives, were authorized to offer and sell were the LREA-affiliated private offerings. The general public was informed during the LREA radio shows and workshops through disclaimers that securities were being offered and sold through WHM. New WHM customers that came from the radio shows and workshops, however, were only offered the GEF, MFREF2, and MFREF3 offerings. Both the radio shows and workshops used securities investment terminology and securities-related catchphrases to attract potential investors. And strikingly, the data tracked by LREA and WHM to determine the "ideal client" did not include the educational segment of LREA,

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Similarly, the SEC in *IPONET* permitted announcements that satisfied the requirements of Securities Act Rule 134(d) to accept indications of interest. *See IPONET*, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 642, at \*1 (July 26, 1996). The private offerings on the IPONET website, however, could only be offered and sold to accredited or sophisticated investors who accessed the password-protected web page *after* the firm had determined, through the use of a generic questionnaire (mentioning no securities or particular offerings), that the potential investor met such accreditation standards. *See id.* at \*1-2. We distinguish *IPONET* from this case because WHM did not use a generic questionnaire determining accreditation standards *before* it solicited the general public on the radio or at the workshops.

such as the name or number of educational seminars an attendee took advantage of, but instead focused on how many attendees invested in the GEF, MFREF2, and MFREF3 offerings and their investment amounts.<sup>19</sup> The evidence strongly supports our finding that WHM made offers to sell unregistered securities by general solicitation, in violation of Securities Act Section 5 and, consequently, FINRA Rule 2010.

WHM next argues that SEC no-action letters, such as *Bateman Eichler, E.F. Hutton, H.B. Shaine, IPONET*, and *Lamp Technologies*, state that a general solicitation violation “may be eradicated” once there is a “cooling off” period and the firm establishes a substantive relationship “between the general solicitation and the subsequent private offer with the investors.” The SEC no-action letters, however, stand for no such proposition. The interval referenced in those letters determines which private placements of unregistered securities a broker-dealer may offer to a prospective customer, based on the date a substantive relationship with the customer is established.

In *E.F. Hutton*, for example, the SEC explained that “it is important that there be sufficient time between [the] establishment of the relationship and an offer so that the offer is not considered made by general solicitation or advertising.” 1985 SEC No-Act. LEXIS 2917, at \*2. The SEC then held that a violation of Rule 502(c) would not occur “if the relationship was established prior to the time Hutton began participating in the Regulation D offering.” *Id.*; see also *SEC Compliance and Disclosure Interpretations: Securities Act Rules*, Question 256.30, <https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm> (last visited Aug. 13, 2018) (stating “[w]hile there is no minimum waiting period, the issuer must establish such a relationship prior to the commencement of the offering, or, if the relationship was established through either a registered broker-dealer . . . the relationship must be established prior to the time the registered broker-dealer . . . began participating in the offering”).

Similarly, in *Lamp Technologies* and *IPONET*, the interval applied before any private offers were extended to subscribers through a password-protected website, and only after it was established from a generic questionnaire that the subscriber was an accredited or sophisticated investor. See *Lamp Technologies, Inc.*, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 638, at \*3-5 (May 29, 1997); *IPONET*, 1996 SEC No-Act. LEXIS 642, at \*3-4. In *Bateman Eichler*, select prospective offerees who completed a generic questionnaire were unable to purchase securities currently offered or contemplated for offering and the 45-day period was applied before purchases of later offerings. See 1985 SEC No-Act. LEXIS 2918, at \*5-6. The SEC in *H.B. Shaine* required that sufficient time elapsed between the completion of a questionnaire and the contemplation or inception of any particular offering. See 1987 SEC No-Act. LEXIS 2004, at \*1-2. These letters make clear that the firm must ensure that any persons solicited as part of a program to establish relationships with new clients “are not offered any securities that were offered or contemplated for offering at the time of the solicitation.” *Bateman Eichler*, 1985 SEC No-Act. LEXIS 2918, at \*1. In this case, WHM not only contemplated offering GEF, MFREF2 and MFREF3 LLC member interests at the time it

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<sup>19</sup> Price testified that LREA tracked whether a workshop attendee was interested in education seminars only, but WHM never produced evidence supporting her claim.

initiated contact with prospective customers, but it entered into arrangements with LREA and the issuers designed for that solicitation purpose.

Indeed, none of the SEC no-action letters stated that “sufficient time eradicates a general solicitation violation,” which WHM erroneously quoted in its appeal brief. In any event, the SEC no-action letters that WHM cites are distinguishable from the present case. WHM was already participating in the GEF, MFREF2 and MFREF3 offerings as a selling agent when the LREA radio shows and workshops took place. The Extended Hearing Panel correctly found, and so do we, that the radio shows and workshops were solicitations of an offer to buy securities, at which time WHM had no substantive relationships with 23 attendees who became new customers and purchased the unregistered securities. Any cooling period that WHM attempted to employ came well after a general solicitation occurred. *Cf. KCD Fin. Inc.*, 2017 SEC LEXIS 986, at \*27 (holding that, once respondent engaged in general solicitation in violation of Securities Act Rule 502(c), “the Rule 506 exemption was not available for any subsequent sales,” regardless of attempts to thereafter limit sales). Therefore the SEC’s no-action letters are no defense to WHM’s liability.

WHM next cites to the Jumpstart Our Business Startups (“JOBS”) Act to argue that the trend has been to gradually permit general solicitations in the sale of private offerings. During the Relevant Period, however, all of the available exemptions from Section 5 of Securities Act prohibited general solicitation, and of the 23 investors that purchased LLC member interests in the GEF, MFREF2 and MFREF2 offerings, 10 of them were non-accredited. Therefore, even if Regulation D, Rule 506(c), promulgated in July 2013 to permit general solicitation in certain private placements pursuant to Section 201(a) of the JOBS Act, could be retroactively applied to the present case—which it cannot—the exemption was inapplicable because it only applies to sales of unregistered securities solely made to accredited investors.

Lastly, WHM attempts to rely on language in Securities Act Rule 508, which provides that a failure to comply with certain terms or requirements of Regulation D will not result in the loss of a Section 5 exemption if the failure “was insignificant with respect to the offering as a whole.” WHM recognized, however, that Rule 508 explicitly excludes general solicitation violations, finding them “to be significant to the offering as a whole.” WHM nevertheless argues that its general solicitation violation should be deemed insignificant. Relying on a statement in the SEC’s adopting release that, if one prospective investor did not have a pre-existing substantive relationship, such an innocuous mistake would not result in a general solicitation, WHM argues that its deviations from Securities Act Rule 502(c) were also insignificant since WHM had substantive relationships with the 23 investors before they were provided with the issuer’s offering materials.

WHM is mistaken for several reasons. First, Rule 502(c) violations *are* significant to an entire offering and thus the Rule 508 safe harbor does not apply. Second, providing offering materials to investors after-the-fact does not void a general solicitation. The substantive relationship must pre-exist the *offer* of unregistered sales. Third, WHM’s violation was not an inadvertent mistake that involved only one investor. WHM offered securities to the general public without first

establishing a pre-existing substantive relationship with any of the investors.<sup>20</sup> Therefore our finding that WHM engaged in the misconduct as alleged must stand. WHM violated FINRA Rule 2010 when it acted in contravention of Securities Act Section 5.

B. WHM Had an Inadequate Supervisory System and WSPs

As alleged in the second cause of action, the Extended Hearing Panel found that WHM and Murphy violated NASD Rule 3010 and FINRA Rule 2010 by failing to establish and maintain a supervisory system, including WSPs, reasonably designed to ensure compliance with Section 5 of the Securities Act. Respondents argue that they had reasonable supervisory procedures to ensure that no general solicitation violation occurred. Based on the record, however, we affirm the Extended Hearing Panel's findings.

NASD Rule 3010(a) requires member firms to establish and maintain a supervisory system to supervise the activities of its registered representatives, registered principals, and associated persons that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. An adequate supervisory system must include written procedures tailored to the business lines the firm engages in. However, "[i]t is well established that the presence of procedures alone is not enough. Without sufficient implementation, guidelines and strictures do not ensure compliance." *KCD Fin. Inc.*, 2017 SEC LEXIS 986, at \*34. Thus, the written procedures must set forth mechanisms for ensuring compliance and detecting violations. Indeed, "[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." *Michael T. Studer*, 57 S.E.C. 1011, 1023-24 (2004). Final responsibility for proper supervision rests with the member.

During the Relevant Period, WHM, acting through Murphy, failed to implement and enforce a supervisory system, including WSPs, for the marketing and sales of the LREA-affiliated private placements that was reasonably designed to achieve compliance with Section 5 of the Securities Act and FINRA rules. Murphy, under the firm's procedures, was responsible for maintaining current WSPs. Murphy supervised all private placements sold by WHM. He reviewed and approved all advertising, including the scripts used by LREA, Price, and Hutton, and thus he was aware of the

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<sup>20</sup> We also reject WHM's argument that the Extended Hearing Panel failed to apply "Section 4(a)(2) and the safe harbor protections under Rule 502(c) and Rule 506(c)" for two reasons. First, WHM and Murphy stipulated early in the proceeding that, while other registration exemptions such as Section 4(a)(2) of the Securities Act might apply, Enforcement was alleging only that WHM violated the general prohibition found in Securities Act Rule 502(c), and through that misconduct, it failed to satisfy the registration exemption under Regulation D, Rule 506. Moreover, Section 4(a)(2) also prohibits general solicitation and Rule 506(c) solely applies to sales to accredited investors, so those exemptions do not support WHM's defense. Second, the exclusions under Rule 502(c) are inapplicable to WHM's case. WHM proffered no substantial evidence that it published Securities Act Rule 135 notices, 17 C.F.R. § 230.135, and any "good faith and reasonable attempt" made by the *issuers* to comply with the requirements of the Form D filings with the SEC, 17 C.F.R. § 239.500, is irrelevant to WHM's violation.

general solicitation being conducted. Murphy was also responsible for accepting new customer accounts and supervising all sales related activities. He was also ultimately responsible for the supervision of the LREA OSJ, including registered personnel and associated persons and their securities-related activities.

The firm's existing WSPs failed to provide adequate procedures regarding its LREA-related activities to prevent sales of unregistered, non-exempt securities. WHM had no detailed written procedures to ensure that WHM registered persons did not solicit potential investors via the radio shows and workshops in violation of the general solicitation prohibition. In fact, the WSPs neither addressed WHM's arrangement with LREA, nor did the supervisory control procedures identify LREA as a branch office of WHM. The WSPs also failed to detail the compliance functions that WHM provided to LREA.

WHM had no procedures for detecting red flags that Hutton should have been aware of when supervising radio shows, workshops, or private placement sales. The only firm procedure Hutton could identify was a generic section in the WSPs stating that WHM would hold meetings to "discuss thoroughly the nature of any security or underwriting or offering in which the Company participates." WHM also failed to establish procedures that require a registered principal, such as Hutton, to verify compliance with Regulation D or any relied upon exemption from registration before an offer or sale of unregistered securities commenced.

Murphy failed to conduct a reasonable evaluation of LREA's marketing model to ensure compliance with the federal securities laws and FINRA rules. Murphy testified that he was admittedly concerned about "conditioning the market" through the LREA radio shows and workshops, yet he failed to investigate these obvious red flags. For example, WHM's WSPs stated that registered representatives could not participate in seminars or meetings whose attendees were invited by general solicitation, unless written consent was provided by Murphy. However, all of WHM customers that bought the GEF, MFREF2 and MFREF3 private offerings came from the LREA real estate seminars, which should have raised a red flag. Nonetheless, Murphy gave written permission for WHM representatives to present at each LREA workshop and pre-approved scripts that referenced private placements, passively investing in real estate, and by inference, investing in the LREA-affiliated offerings.

There were no firm supervisory controls prohibiting WHM customers generated from LREA radio shows and workshops from purchasing in current offerings before the customer established a substantive relationship with WHM or the issuer. WHM and Murphy, attempted to establish a "cooling off" period of 30 days in which a substantive relationship could be established before sales of unregistered securities were made. Even if such an interval would have sufficed to establish availability of an exemption—which as noted above, was not the case here—WHM had no written procedures requiring Price or Hutton to comply with the cooling off period or explaining when the period commenced and ended. WHM also failed to establish an appropriate review process whereby a designated firm principal could verify and document that customers waited an acceptable period before purchasing unregistered securities. As a result, four investors in the GEF, MFREF2, and MFREF3 offerings purchased securities before the cooling-off period ended.



We find that Murphy, who was ultimately responsible for supervising the LREA OSJ, including Hutton, failed in his supervision duties. Murphy testified that he conducted one annual examination of the OSJ at LREA, but never conducted a formal branch review. He scantily reviewed LREA's website and could not recall reviewing LREA's videos and podcasts. Instead of documenting in writing any discussions or meetings regarding Section 5 compliance, in particular the marketing or sale of the GEF, MFREF2 and MFREF3 private placements, Murphy denied selling private placements and stated that he orally discussed scenarios with Hutton as they arose. Murphy's testimony was confirmed when Hutton pointed to generic language in the firm's procedures stating that WHM would hold meetings to "discuss thoroughly the nature of any security or underwriting or offering in which the Company participates."

Murphy also failed to properly supervise Price and her solicitation activities. Murphy repeatedly approved scripts and other LREA marketing materials that Price and others used to promote multi-family real estate investing and investing in private placements on the radio and at the LREA workshops. With no written procedures established on the nature and content of discussions at the one-on-one meetings, Price testified that she never had read—much less referenced—the PPMs of the GEF, MFREF2 and MFREF3 offerings (except for the private placement of which she personally invested) in connection with her sales pitches to potential investors. When Enforcement questioned Murphy about this, he responded that he was not concerned. But, as a long-standing securities professional dealing closely with the investing public, Murphy was "expected to secure compliance with the requirements of the [Securities] Act to protect the public from illegal offerings." *Quinn v. SEC*, 452 F.2d 943, 946 (10th Cir. 1971).

In light of these foregoing facts, we affirm the Extended Hearing Panel's findings that WHM and Murphy violated NASD Rule 3010 and FINRA Rule 2010.<sup>21</sup>

C. FINRA Has Jurisdiction over WHM's Misconduct

On appeal, Respondents argue that the Exchange Act does not provide FINRA, a self-regulatory organization ("SRO"), with the authority to discipline members for violating the Securities Act. They are mistaken. FINRA unequivocally has the authority to discipline WHM for its Section 5 violation or any other violation of the federal securities laws.

FINRA has jurisdiction over WHM's misconduct pursuant to FINRA Rule 2010, which requires members in their business-related conduct to observe high standards of commercial honor and just and equitable principles of trade. "A violation of Rule 2010 may be based on any conduct, not simply conduct that violates the Exchange Act." *KCD Fin. Inc.*, 2017 SEC LEXIS 986, at \*13. It is well established that participating in sales of unregistered, non-exempt securities in violation of

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<sup>21</sup> "It is well settled that a violation of another NASD or FINRA rule is a violation of FINRA Rule 2010." *Dep't of Enforcement v. Meyers Assocs., L.P.*, Complaint No. 2013035533701, 2017 FINRA Discip. LEXIS 47, at \*19 n.10 (FINRA Bd. of Governors Dec. 22, 2017), *appeal docketed*, SEC Admin. Proc. No. 3-18350 (Jan. 23, 2018).

Securities Act Section 5 is conduct contrary to just and equitable principles of trade.<sup>22</sup> *See, e.g., Midas Sec. LLC*, Exchange Act Release No. 66200, 2012 SEC LEXIS 199, at \*46 n.63 (Jan. 20, 2012) (“A violation of Securities Act Section 5 also violates [FINRA] Rule 2[0]10.”) (citing *Sorrell v. SEC*, 679 F.2d 1323, 1326 (9th Cir. 1982)). Indeed, FINRA Rule 2010, the rule violation that was charged in the complaint, governs WHM’s misconduct.

D. WHM and Murphy’s Procedural Arguments Lack Merit

WHM and Murphy also raise several procedural arguments on appeal. They argue that the Extended Hearing Panel lacked the expertise and training to preside over this disciplinary action; that the Hearing Officer was not appointed by the President, a court of law, or department head; that WHM and Murphy were denied the opportunity to present expert testimony on industry legal and regulatory standards; that the Hearing Officer abused her discretion; that the Extended Hearing Panel erred in denying WHM and Murphy’s reliance on counsel’s advice claim; that the proceeding violated WHM and Murphy’s due process rights; that the proceeding was biased against WHM and Murphy; and that WHM and Murphy had no fair notice of the charged conduct and no procedural safeguards in place to protect its interests. We find that all of their arguments lack merit.

We reject the contention that the Extended Hearing Panel lacked expertise because the Hearing Officer determined that WHM’s cooling off periods were irrelevant to the general solicitation violation. Not only do respondents lack the right to dictate the qualification of panel members, *see Dep’t of Enforcement v. Sathianathan*, Complaint No. C9B030076, 2006 NASD Discip. LEXIS 3, at \*53 (NASD NAC Feb. 21, 2006), *aff’d*, Exchange Act Release No. 54722, 2006 SEC LEXIS 2572 (Nov. 8, 2006), *aff’d*, 304 F. App’x 883 (D.C. Cir. 2008), but the Hearing Officer’s determination of relevant evidence in this case has no bearing on whether all of the panelists possessed the expertise to evaluate applicable federal securities laws and FINRA rules to render a fair decision.

We also reject the argument that the disciplinary proceeding violated the Appointments Clause because the Hearing Officer was not appointed by the President, a court of law, or department head. It is well-settled that “self-regulatory organizations, such as FINRA, are not Government-created, Government-appointed entit[ies], and therefore do not unlawfully usurp power reserved to the executive branch.” *Manuel P. Asensio*, Exchange Act Release No. 62645, 2010 SEC LEXIS 2521, at \*6-7 (Aug. 4, 2010).

Furthermore, we support the Extended Hearing Panel’s decision to deny expert testimony on legal and regulatory standards. FINRA Rule 9263 gives Hearing Officers broad discretion to accept or reject expert testimony. *See Dep’t of Enforcement v. Dratel*, Complaint No. 2008012925001, 2014 FINRA Discip. LEXIS 6, at \*94 (FINRA NAC May 2, 2014), *aff’d*, Exchange Act Release No.

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<sup>22</sup> Moreover, Section 15A of the Exchange Act authorizes FINRA to adopt its own rules and enforce compliance with them. *See* 15 U.S.C. § 78o-3(b)(2) and (h). Pursuant to FINRA’s By-Laws, members agree to, among other things, “comply with the federal securities laws, [and] the rules and regulations thereunder.” FINRA By-Laws Art. IV, Sec. 1(a)(1) and Art. V, Sec. 2(a)(1).

77396, 2016 SEC LEXIS 1035 (Mar. 17, 2016). “Because this discretion is broad, the party arguing abuse of discretion assumes a heavy burden that can be overcome only upon showing that the Hearing Officer’s reasons to admit or exclude the evidence were so insubstantial as to render . . . [the admission or exclusion] an abuse of discretion.” *Id.* Expert testimony that solely provides legal standards and conclusions, however, is generally disfavored. *U.S. v. Russo*, 74 F.3d 1383, 1395 (2nd Cir. 1996) (“[E]xpert testimony must not usurp the roles of judge and jury by offering legal conclusions.”). Given that the securities laws on broker-dealer obligations when selling unregistered securities are not obscure, the Extended Hearing Panel did not abuse its discretion here.

WHM and Murphy argue that the Hearing Officer “hindered, blocked, and arbitrarily denied WHM the opportunity to effectively cross examine” FINRA lead investigator Eric Beck. Our review of the record shows that Enforcement called Beck as a witness to narrowly authenticate exhibits collected during his examination and a summary exhibit he prepared for the hearing. For the reasons we discussed above, the Hearing Officer correctly limited respondents’ counsel’s line of questioning that asked for legal opinions and conclusions on the allegations, rather than cross examining Beck on the exhibits that were admitted into evidence. It was also within the Hearing Officer’s discretion to curtail questions on cross examination that focused on the process of Beck’s investigation. *See Dep’t of Enforcement v. Epstein*, Complaint No. C9B040098, 2007 FINRA Discip. LEXIS 18, at \*90 (FINRA NAC Dec. 20, 2007) (finding no error in the Hearing Officer’s decision to limit questions concerning the scope and adequacy of the staff’s investigation), *aff’d*, Exchange Act Release No. 59328, 2009 SEC LEXIS 217 (Jan. 30, 2009), *aff’d*, 416 F. App’x 142 (3d Cir. 2010). We therefore find no abuse of discretion here.<sup>23</sup>

WHM and Murphy claim that they relied on advice of counsel, and the Extended Hearing Panel decision failed to consider it as a mitigating factor for liability. But reliance on advice of counsel is not a valid liability defense to this cause of action because scienter is not an element of a Section 5 violation. *See Swenson*, 626 F.2d at 424 (“The Securities Act of 1933 imposes strict liability on offerors and sellers of unregistered securities.”); *Dep’t of Market Regulation v. Proudian*, Complaint No. CMS040165, 2008 FINRA Discip. LEXIS 21, at \*43 n.37 (FINRA NAC Aug. 7, 2008) (“A showing of scienter is not required to establish a violation of Section 5.”). We therefore conclude that the Extended Hearing Panel’s denial of such claim as a defense to WHM’s liability was entirely appropriate.

We also find no evidence supporting the claim that WHM and Murphy’s due process rights were violated or that the proceeding was biased against them. As an initial matter, “due process arguments fail, in their entirety, because FINRA is not subject to constitutional and common law due process requirements.” *Dep’t of Enforcement v. Sears*, Complaint No. C07050042, 2007 FINRA Discip. LEXIS 1, at \*11 (FINRA NAC Sept. 24, 2007), *remanded on other grounds*, 2008

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<sup>23</sup> Similarly, we reject WHM’s argument that the Hearing Officer’s rulings against cross examination also violated the Sixth Amendment confrontation clause because it is widely held that protections under the Sixth Amendment of the U.S. Constitution apply solely to *criminal* proceedings and not FINRA adjudications. *See, e.g., SEC v. Jerry T. O’Brien, Inc.*, 467 U.S. 735, 742 (1984).

SEC LEXIS 1521 (July 1, 2008); *see also Benjamin Werner*, 44 S.E.C. 622, 625 (1971) (“[T]he Fourteenth Amendment imposes certain restraints on state action and is not applicable to [FINRA] proceedings.”). FINRA, however, is required to provide a fair procedure in disciplinary proceedings. *See Exchange Act Section 15A(b)(8)*, 15 U.S.C. § 78o-3(b)(8) (requiring that self-regulatory organizations provide fair procedures).

WHM and Murphy have not shown that the proceeding contravened the Code of Procedure. WHM and Murphy broadly claim that, none of the Extended Hearing Panel’s legal interpretations were found in favor of WHM, that Enforcement is virtually successful in every disciplinary proceeding, and the Hearing Officer’s history of past rulings demonstrates her bias. But “[a]dverse rulings, by themselves, generally do not establish improper bias” or unfair treatment. *Scott Epstein*, 2009 SEC LEXIS 217, at \*62; *accord Liteky v. United States*, 510 U.S. 540, 555 (1994) (stating that “judicial rulings alone almost never constitute a valid basis for a bias or partiality motion”). WHM and Murphy have failed to state with particularity how the Hearing Officer or disciplinary proceeding was unfair. Regardless, “our de novo review would cure [a Hearing Officer’s] prejudice if any had existed.” *Dep’t of Enforcement v. Padilla*, Complaint No. 2006005786501, 2012 FINRA Discip. LEXIS 46, at \*34 (FINRA NAC Aug. 1, 2012). We therefore conclude that the Extended Hearing Panel provided fair procedures in this case.

Similarly, any claim of bias requires demonstration that the proceeding was motivated by a discriminatory purpose, such as race, religion, or the “desire to prevent the exercise of a constitutionally protected right.” *David Kristian Evansen*, Exchange Act Release No. 75531, 2015 SEC LEXIS 3080, at \*44 (July 27, 2015). We find no such evidence of bias here. Providing statistics on the number of disciplinary proceedings or Hearing Officer rulings that were resolved in favor of a respondent does not prove a bias claim against WHM and Murphy in this proceeding. *See, e.g., Steven Robert Tomlinson*, Exchange Act Release No. 73825, 2014 SEC LEXIS 4982, at \*27-28 (Dec. 11, 2014) (noting that because respondent did not obtain the result he wanted or expected in the case did not in itself support a bias claim), *aff’d*, 637 F. App’x 49 (2d Cir. 2016).

Contrary to their assertion, WHM and Murphy had fair notice of the securities laws and regulations that were at issue in this hearing. The Securities Act registration requirements are “a keystone of the entire system of securities regulation, and set forth basic requirements for the protection of investors.” *Sirianni v. SEC*, 677 F.2d 1284, 1289 (9th Cir. 1982). The allegations charged against the respondents were plainly articulated in the complaint. WHM and Murphy were represented by counsel at the hearing and allowed to present their defenses before the Extended Hearing Panel. After an eight-day evidentiary hearing was conducted, the Extended Hearing Panel issued a decision. Moreover, the Extended Hearing Panel’s decision did not disregard the SEC staff’s views addressed in the *Bateman Eichler, IPONET, Lamp Technologies, and E.F. Hutton* no-action letters, but, as we do here, it explained how those SEC no-action letters were distinguishable from this case.

Lastly, our review of the record also does not find that FINRA deviated from any procedural safeguards in this case. As FINRA members, WHM and Murphy agreed to comply with FINRA’s rules, including its code of procedure governing disciplinary proceedings. *See FINRA Rule 0140(a)* (providing that FINRA rules “shall apply to all members and persons associated with a member” and that “[p]ersons associated with a member shall have the same duties and obligations as a member

under the Rules”). FINRA’s Code of Procedure, which the Commission has approved, is designed to eliminate perceived conflicts of interest. *See, e.g.*, FINRA Rule 9144 (providing the separation of functions in FINRA disciplinary proceedings). WHM and Murphy were afforded the full opportunity to litigate and defend themselves in accordance with FINRA’s Code of Procedure and the Exchange Act.<sup>24</sup> We reject WHM and Murphy’s claim that no procedural safeguards existed in protection of its interests.

E. Respondents’ Motion to Adduce Additional Evidence

WHM and Murphy sought to introduce fifteen categories of evidence to support their claim that the Extended Hearing Panel did not provide them with a “fair and impartial forum within which to resolve” Enforcement’s allegations against them. WHM and Murphy argued that, because there was no avenue to challenge the “inherent unfairness of FINRA’s process, the Hearing Panel or the DOE before or during a disciplinary proceeding,” there was good cause to supplement the record on appeal.

FINRA Rule 9346(b) permits a party to apply for leave to introduce additional evidence by a motion filed not later than 30 days after the Office of Hearing Officers transmits to the National Adjudicatory Council (“NAC”), and serves upon all parties, the index to the record. A motion made pursuant to FINRA Rule 9346(b) must describe each item of proposed new evidence, demonstrate that there was good cause for failing to introduce it below, and demonstrate why the evidence is material to the proceeding. A party may introduce additional evidence with the approval of the NAC Subcommittee only upon showing that extraordinary circumstances exist.

After careful consideration of the arguments, the NAC Subcommittee empaneled to preside over this proceeding granted WHM and Murphy’s motion in part. The Subcommittee admitted as additional evidence an examination disposition letter sent to WHM and Murphy by FINRA staff, which explained the results of the staff’s cycle examination, finding it material and non-prejudicial to either party. The Subcommittee took judicial notice of five public documents obtained from FINRA’s website, including hearing officer biographies, FINRA statistics, and FINRA disciplinary actions online—an online search engine for FINRA cases. The Subcommittee denied WHM and Murphy’s motion with respect to the introduction of all other additional evidence, finding either that WHM and Murphy did not show good cause for failing to introduce the evidence below or that the additional evidence was immaterial to the issue of liability for the violations alleged in

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<sup>24</sup> While WHM and Murphy generally assert that “Hearing Officers have undeniable conflicts of interests,” we find no evidence showing with particularity that WHM and Murphy moved to recuse or disqualify the Hearing Officer based on bias or a conflict of interest pursuant to FINRA rules. *See* FINRA Rule 9233(b) (“Recusal and Disqualification of Hearing Officers”). The respondents therefore waived this issue.

Enforcement's complaint.<sup>25</sup> We agree with the NAC Subcommittee's findings and adopt its rulings as our own.

## V. Sanctions

For unregistered sales of securities, the Extended Hearing Panel fined WHM \$50,000 and ordered it to disgorge \$78,210.91, plus interest, to be paid to FINRA. For their failure to supervise, the Extended Hearing Panel fined WHM and Murphy each \$50,000, suspended Murphy from associating with any FINRA member firm in all capacities for six months, and ordered that he requalify by examination before reentering the securities industry in any capacity.

Based on our independent review of the record, we have determined to modify the sanctions the Extended Hearing Panel imposed. As discussed below, for WHM's unregistered securities sales, we affirm the \$50,000 fine, but reduce the disgorgement amount to \$23,230.05. For their failure to supervise, we affirm Murphy's six-month suspension and order of requalification by examination, but fine WHM and Murphy \$50,000, jointly and severally.

### A. Unregistered Sales of Securities

FINRA's Sanction Guidelines ("Guidelines") for the sale of unregistered securities instruct us to consider a fine of \$2,500 to \$73,000, to consider suspending a firm with respect to any and all activities or functions for up to 30 business days or until procedural deficiencies are remedied, and when appropriate, to order disgorgement.<sup>26</sup> Where aggravating factors predominate, the Guidelines recommend that we consider imposing a higher fine and longer suspension, or the firm's expulsion.

In addition to the general principles for all sanction determinations, the Guidelines set forth specific considerations for unregistered sales of securities that include: the share volume and dollar amount of transactions involved; whether the respondent disregarded "red flags" suggesting the presence of unregistered distribution; and whether the sales resulted from the respondent's intentional act, recklessness or negligence.<sup>27</sup> We find these factors to be aggravating.

First, for three related offerings, WHM offered and sold over \$1 million in unregistered, non-exempt securities to 23 investors in the GEF, MFREF2, and MFREF3 offerings, which we find to be

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<sup>25</sup> The additional evidence the Subcommittee denied included: (1) compilations of other disciplinary rulings by the Hearing Officer; (2) compilations of past FINRA disciplinary proceedings; (3) the respondents' Wells submission; (4) an unexecuted Letter of Acceptance, Waiver, and Consent; and (5) two BrokerCheck reports of non-parties to the case.

<sup>26</sup> See *FINRA Sanction Guidelines* 24 (2017), [https://www.finra.org/sites/default/files/2017\\_Sanction\\_Guidelines.pdf](https://www.finra.org/sites/default/files/2017_Sanction_Guidelines.pdf) [hereinafter *Guidelines*].

<sup>27</sup> See *Guidelines*, at 24 (hereafter "Specific Considerations").

substantial.<sup>28</sup> While the one percent commission WHM earned on the sales transactions is less than what placement agents typically receive, this factor does not lessen the seriousness of WHM's misconduct. *See KCD Fin. Inc.*, 2017 SEC LEXIS 986, at \*46 (finding respondent's misconduct serious because conducting unregistered sales of securities without an available exemption undermines the investor protection purpose of Securities Act Section 5).

Second, we find that WHM's disregard of obvious red flags that suggested sales of unregistered securities were made by general solicitation is aggravating.<sup>29</sup> WHM ignored the plain language of Securities Act Rule 502(c) that prohibits general solicitation and, in particular, any offers or solicitations by radio broadcast or any seminars whose attendees were invited by the radio or similar media. WHM also ignored other red flags that should have alerted it that it was running afoul of Section 5 and participating in a general solicitation of unregistered securities. Murphy admitted that LREA's business model of having WHM representatives host radio shows and workshops to educate the public on real estate investing, while simultaneously qualifying them to invest in live LREA-affiliated private placements "bothered" him, calling it an "original red flag." Murphy even testified that, given his concerns with LREA's existing model, he asked his counsel, "okay, how do we paper this up so we don't have potential problems down the road." Despite LREA's risky model, WHM and Murphy, failed to put adequate safeguards in place to address potential red flags and ensure that it not engage in selling unregistered securities.<sup>30</sup>

Third, we agree with the Extended Hearing Panel that WHM's disregard of complying with the securities laws was intentional or, at a minimum, reckless.<sup>31</sup> Moreover, WHM's violation was not contained to a single offering or an incidental transaction, but rather covered three offerings over a three-year period during which unregistered sales were made to 23 investors without an available exemption from registration.<sup>32</sup>

We also find a number of aggravating factors present under the principal considerations for all sanction determinations. First, while we do not agree with the Extended Hearing Panel that WHM "created" the LREA business model, we do find that WHM financially benefited from the improper unregistered sales that resulted from LREA's model.<sup>33</sup>

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<sup>28</sup> The Extended Hearing Panel decision assessed the entire volume and dollar amounts sold in the GEF, MFREF2, and MFREF3 offerings (approximately \$3 million), which included investments made outside of WHM. Although it is still substantial, we find that the more relevant consideration in determining an appropriate sanction for WHM's violation should be based on the share volume and dollar amount attributed to WHM's sales transactions.

<sup>29</sup> *See Guidelines*, at 24 (Specific Consideration No. 6).

<sup>30</sup> *See id.* (Specific Consideration Nos. 5, 6).

<sup>31</sup> *See id.* (Specific Consideration No. 1).

<sup>32</sup> *See id.* (Specific Consideration No. 3).

<sup>33</sup> *See id.* at 8 (Principal Considerations in Determining Sanctions, No. 16).

Second, we find it troubling that WHM repeatedly refused to accept responsibility for its participation in the sales of the unregistered securities.<sup>34</sup> It is clear from LREA's business plan, the selling agreements, and other offering materials that WHM was retained to distribute unregistered securities, including obtaining new customers to purchase the GEF, MFREF2, and MFREF3 offerings through public advertising. WHM continues to deny, however, that it was a seller of securities on behalf of the GEF, MFREF2, and MFREF3 offerings.<sup>35</sup>

Conversely, there are no mitigating factors. In the proceeding below, WHM and Murphy argued that its reliance on outside counsel's advice should be a mitigating factor.<sup>36</sup> In particular, the respondents claim they relied on their counsel to design a model in doing business with LREA and their counsel represented to them that the model complied with all securities laws and FINRA rules. Although the Guidelines provide that reasonable reliance on competent legal advice can be mitigating for purposes of assessing sanctions, the respondents did not provide sufficient details or evidence of how counsel's advice was sought to ensure compliance with the Securities Act's exemption requirements in order to give this claim any credit for mitigation. At the hearing, Murphy

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<sup>34</sup> See *id.* at 7 (Principal Considerations in Determining Sanctions, No. 2).

<sup>35</sup> We also acknowledge that the Extended Hearing Panel was "extremely troubled" by what they deemed to be WHM's "creation" of the Amended Joint Client Services Agreement to "improperly give the appearance that" LREA was not involved in the sale of its affiliated offerings. See *id.* at 7-8 (Principal Considerations in Determining Sanctions, Nos. 10, 12). The Extended Hearing Panel observed that Amended Joint Client Services Agreement, was created around February 2013, approximately four months after the original Joint Client Services Agreement was produced to FINRA staff, and at the prompting of respondents' counsel. The Amended Joint Client Services Agreement removed language contained in the original Joint Client Services Agreement pertaining to LREA offering securities of related issuers. It also added an entire section labeled "Educational Activities" and other language related to the workshops to change the appearance of LREA's activities away from participating in selling unregistered securities of affiliated issuers. Further, according to the Extended Hearing Panel, the Amended Joint Client Services Agreement was not produced to FINRA staff during the investigation. It was instead first proffered when respondents filed their proposed exhibits in preparation for the hearing, and upon doing so, WHM and Murphy referred to it as the Joint Client Services Agreement—and not as an *amended* agreement. Thus, the Extended Hearing Panel concluded that the submission of the agreement as evidence was an attempt by the respondents "to mislead the Panel with this document," which was a significant aggravating factor. On appeal, WHM and Murphy claim that the Amended Joint Client Services Agreement was produced to FINRA staff "prior to the hearing" and created to correct inaccuracies in describing LREA's business, as was accurately reflected in other relevant documents. Their assertions, however, do not obviate the Extended Hearing Panel's concerns surrounding the nature and timing of its creation and its first submission as evidence post-filing of the complaint. We therefore find no reason to overturn the Extended Hearing Panel's findings in this regard.

<sup>36</sup> See *id.* at 7 (Principal Considerations in Determining Sanctions, No. 7).



admitted that he did not seek his counsel's advice on whether the LREA radio shows and workshops constituted general solicitation. Additionally, there is no evidence in the record that WHM sought counsel's advice on ensuring that it provided adequate supervision, including comprehensive WSPs covering the LREA unregistered sales to ensure compliance with Regulation D. Accordingly, we affirm the Extended Hearing Panel's conclusion that WHM and Murphy's reliance on the advice of counsel is not mitigating.

Without pinpointing a specific violation, WHM and Murphy generally argue that the sanctions the Extended Hearing Panel imposed are punitive, rather than remedial, because no party in this case was damaged or injured. Although the level of injury or harm is one principal consideration in determining appropriate sanctions, *see Guidelines*, at 7 (Principal Considerations in Determining Sanctions, No. 11), sanctions can be imposed based on any other principal consideration. *See ACAP Fin., Inc. v. SEC*, 783 F.3d 763, 769 (10th Cir. 2015) (noting several balancing factors that are considered when "fashioning a remedial sanction," including the seriousness of the offense); *Dep't of Enforcement v. Kresge*, Complaint No. CMS030182, 2008 FINRA Discip. LEXIS 46, at \*35 n.32 (FINRA NAC Oct. 9, 2008) ("Whether a sanction is punitive or remedial . . . depends on the facts and circumstances of the case."); *see generally Guidelines*, at 7 (listing factors that should be considered in determining appropriate sanctions with respect to all violations). Given the seriousness of WHM's unregistered sales violation and the aggravating factors that are present, we find that WHM's \$50,000 fine is an appropriately remedial sanction that is consistent with the Guidelines.

For WHM's unregistered sales violation, the Extended Hearing Panel also ordered disgorgement in the amount of \$78,210.91, which included sales commissions and the monthly retainer fees WHM received. While the Guidelines ask that we consider whether disgorgement is appropriate to remediate misconduct, *see Guidelines*, at 24 n.1, we find that the evidentiary record does not support the Extended Hearing Panel's entire disgorgement amount.

"Disgorgement serves to remedy securities law violations by depriving violators of the fruits of their illegal conduct." *SEC v. Spongetech Delivery Sys., Inc.*, 2015 U.S. Dist. LEXIS 134233, at \*7 (E.D.N.Y. Aug. 3, 2015). While the disgorgement amount need not be precise, it must represent a reasonable approximation of a respondent's unlawful profits, and cannot exceed the amount obtained through the wrongdoing. *See Dratel*, 2016 SEC LEXIS 1035, at \*73. The unlawful conduct in this case was WHM's impermissible unregistered sales of securities. WHM received \$23,230.05 in commissions that were calculated as a percentage of sales transacted in the offerings. We therefore conclude that WHM's sales commissions constitute ill-gotten gains derived from its wrongdoing. On the other hand, LREA paid WHM monthly retainer fees for establishing the LREA OSJ and providing compliance-related services to LREA. As provided in the OSJ Agreement, the monthly retainer fees were to be paid regardless of whether WHM marketed or sold the affiliated private offerings and thus were not directly or indirectly related to WHM's participation in the sales of unregistered securities. Based on this, we cannot conclude that the monthly retainer fees were profits unlawfully derived from WHM's misconduct. Accordingly, we order that WHM disgorge

\$23,230.05, plus prejudgment interest paid to FINRA, which represents a reasonable approximation of WHM's ill-gotten gains.<sup>37</sup>

B. Inadequate Supervision

The Guidelines for supervision violations recommend a fine of \$5,000 to \$73,000, and that we consider independent fines (rather than joint and several) for both the firm and responsible individuals.<sup>38</sup> They also recommend suspending the responsible individual in all supervisory capacities for up to 30 business days, and in egregious cases, suspending the responsible individual in any and all capacities for up to two years or imposing a bar. The Guidelines further ask us to consider principal considerations for this violation, including whether the respondent ignored "red flag" warnings that should have resulted in additional supervisory scrutiny; the nature, extent, size and character of the underlying misconduct; and the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls.<sup>39</sup>

As previously stated, the fact that WHM and Murphy ignored obvious red flags signaling violative conduct weighs towards higher sanctions. Murphy, as the firm's president, was involved in the entire onboarding process of servicing and supervising the LREA OSJ. He was fully aware that Price and Hutton were conducting radio shows and workshops on behalf of LREA and WHM. He pre-approved the LREA scripts and advertising. He also knew, or should have known, that the radio shows and workshops would generate unregistered, non-exempt sales to investors. Murphy, however, failed to effectively supervise the LREA OSJ and registered personnel. The record is devoid of any documented evidence that Murphy periodically inspected the LREA OSJ to detect and deter WHM representatives from extending unregistered offers and sales to the general public in contravention of the securities laws and applicable FINRA rules. Murphy testified that he would visit LREA on occasion but conducted only one formal annual review. Murphy also knew that Price had no securities background before she associated with WHM and Hutton had less than one year of experience with private placements. Yet, WHM and Murphy failed to provide Hutton with any formal supervisory training to ensure Hutton carried out his supervisory responsibilities adequately, and Price was only verbally instructed to never mention any specific securities. Moreover, WHM and Murphy also failed to document reviews of the data tracking reports and client spreadsheets, LREA's websites, podcasts and other associated communications to ensure that no unregistered securities were being offered by general solicitation.

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<sup>37</sup> WHM and Murphy suggest that FINRA's disciplinary system is unfair because the fines we impose are paid to FINRA and are a large revenue source. To the extent that WHM and Murphy are alleging that we have a financial incentive to order a fine, it is not true. We order fines in this case to deter the reoccurrence of this misconduct in the future. Moreover, when we impose fines, the amounts are based on pre-established guidelines and the facts and circumstances of the individual case, not any revenue targets.

<sup>38</sup> *See Guidelines*, at 105.

<sup>39</sup> *Id.*

There are separate guidelines for deficient written supervisory procedures.<sup>40</sup> Those guidelines recommend a fine between \$1,000 and \$37,000 and, in egregious cases, suspending the responsible individual in any or all capacities for up to one year and suspending the firm with respect to any and all activities or functions for up to 30 business days and thereafter until the procedures are amended to conform to the rule requirements.<sup>41</sup> Principal considerations that the Guidelines ask us to consider for deficient WSPs include whether the deficiencies allowed violative conduct to occur or escape detection, and whether the deficiencies made it difficult to determine who was responsible for specific areas of supervision or compliance.<sup>42</sup> WHM's existing WSPs were inadequate to effectively supervise its OSJ at LREA and related sales activities. Murphy was responsible for WHM's WSPs, yet he failed to revise the WSPs to include any procedures to supervise its new business venture with LREA and the issuers. The WSPs did not include LREA or its marketing activities, and the WSPs did not specify who was responsible for ensuring compliance with respect to these omitted activities. These failures led to investors purchasing unregistered securities that were not subject to an exemption from registration, which we find to be egregious.

The Extended Hearing Panel determined that WHM and Murphy's overall supervisory failures were egregious. We agree. WHM and Murphy's disregard of their supervision obligations, including defective WSPs, posed a serious risk to the investing public. Nevertheless, we observe that WHM is relatively a small-sized firm and Murphy served in multiple operational and administrative roles at WHM. *See Guidelines*, at 2-3 (requiring adjudicators to consider a firm's size, number of associated persons, and nature of the firm's business, with a view toward ensuring that the sanctions imposed are remedial and designed to deter future misconduct, but are not punitive). We also note that the supervisory system failures and resulting supervision violations by WHM and Murphy are noticeably intertwined. Therefore, we fine WHM and Murphy, jointly and severally,<sup>43</sup> \$50,000, suspend Murphy from associating with a FINRA member in all capacities for six months, and order that he requalify by examination before he reenters the securities industry in any capacity requiring qualification. The sanctions are consistent with the Guidelines and address the severity of WHM and Murphy's offenses while deterring the occurrence of future misconduct.

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<sup>40</sup> *Id.* at 108.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *See generally Dep't of Enforcement v. Newport Coast Secs. Inc.*, Complaint No. 2012030564701, 2018 FINRA Discip. LEXIS 14, at \*223 (FINRA NAC May 23, 2018) (finding joint and several liability for costs appropriate when multiple parties are found liable for misconduct), *appeal docketed*, SEC Admin. Proc. No. 3-18555 (June 22, 2018).

VI. Conclusion

We affirm the Extended Hearing Panel's findings that WHM violated FINRA Rule 2010 by selling unregistered securities in violation of Section 5 of the Securities Act. For this violation, WHM is fined \$50,000 and ordered to disgorge \$23,230.05, plus prejudgment interest, to FINRA.

WHM and Murphy violated NASD Rule 3010 and FINRA Rule 2010 by failing to establish and maintain a supervisory system, including written supervisory procedures, reasonably designed to ensure compliance with Section 5 of the Securities Act. For this violation, WHM and Murphy are fined \$50,000, jointly and severally, Murphy is suspended from associating with any FINRA member firm in all capacities for six months, and he is required to requalify by examination before he reenters the securities industry in any capacity requiring qualification. Lastly, we affirm the Extended Hearing Panel's order that WHM and Murphy pay, jointly and severally, hearing costs totaling \$15,888.48.<sup>44</sup>

On Behalf of the National Adjudicatory Council,

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Jennifer Piorko Mitchell,  
Vice President and Deputy Corporate Secretary

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<sup>44</sup> Pursuant to FINRA Rule 8320, FINRA will revoke for non-payment the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanctions after seven days' notice in writing.