

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS**

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

KCD FINANCIAL, INC.
(CRD No. 127473),

Respondent.

Disciplinary Proceeding
No. 2011025851501

Hearing Officer—LOM

HEARING PANEL DECISION

June 16, 2015

Respondent violated NASD Rule 2210 and FINRA Rule 2010 by permitting registered representatives in two offices to use false and misleading advertising as a marketing tool for their securities business. For this misconduct, Respondent is censured and fined \$40,000.

Respondent also violated NASD Rule 3010 and FINRA Rule 2010 by failing to reasonably supervise registered representatives who offered and sold unregistered securities that were not exempt from registration. For this misconduct, Respondent is censured and fined \$75,000. Respondent also is ordered to pay costs.

Appearances

Seema Chawla, Esq., Kansas City, Missouri, Dean M. Jeske, Esq. and Mark A. Koerner, Esq., Chicago, Illinois, representing the Department of Enforcement.

Jill G. Fieldstein, Esq., Blauvelt, New York, representing Respondent.

I. INTRODUCTION

The Department of Enforcement (“Enforcement”) for the Financial Industry Regulatory Authority (“FINRA”), a self-regulatory organization for the securities industry, brought this

disciplinary proceeding against Respondent, KCD Financial, Inc. (“KCD” or “Respondent” or the “Firm”), a FINRA member firm.¹

In its Complaint, Enforcement alleges two causes of action.²

The First Cause of Action. The First Cause of Action charges that the Firm violated NASD Rule 2210, the Rule regarding firm communications with the public, and FINRA Rule 2010 regarding ethical conduct. According to the Complaint, a registered representative in the Firm’s Palm Beach Gardens, Florida branch and two other registered representatives in the Firm’s Sun City, Arizona office separately ran what was sometimes referred to as a CD-finder or CD-locator service. The representatives regularly advertised FDIC-insured certificates of deposit (“CDs”) at a rate of return that was far above the market rate.

The Hearing Panel finds that the advertisements were false and misleading in at least two important ways. *First*, no FDIC-insured CDs existed at the advertised rate of return, but the advertisements made it seem that such CDs existed. *Second*, the representatives used the advertisements as a marketing tool to entice potential customers into their offices in order to sell securities and other financial products to them. However, the advertisements did not mention securities.

The remaining issue is whether the Rule governing broker-dealers’ communications with the public, NASD Rule 2210, applies in this case. The Firm argues that it was not responsible for supervising the advertisements because the CD-finder service was an approved separate outside business activity.

The Hearing Panel rejects the Firm’s argument. The CD advertisements are member communications with the public and fall within the scope of NASD Rule 2210.

The CD advertisements were not separate and apart from the representatives’ securities business, but, rather, were a marketing tool for their securities business. The purported CD-finder service had no independent purpose and was unsustainable as a separate business because the representatives did not charge a fee for the service. The representatives only made money when they sold securities or other financial products instead of or in addition to a CD.

¹ FINRA is responsible for regulatory oversight of securities firms and associated persons who do business with the public. It was formed in July 2007 by the consolidation of NASD and the regulatory arm of the New York Stock Exchange. FINRA is developing a new “Consolidated Rulebook” of FINRA Rules that includes NASD Rules. The first phase of the new Consolidated Rulebook became effective on December 15, 2008. See FINRA Regulatory Notice 08-57 (Oct. 2008), <http://www.finra.org/industry/notices/08-57>. The applicable Conduct Rules are those that existed when the conduct at issue occurred. FINRA’s Rules (including NASD Rules) are available at www.finra.org/industry/finra-rules. References here to FINRA include references to NASD.

² As originally filed, the Complaint also contained a Third Cause of Action relating to the supervision, review, and retention of email. However, the Parties reached a settlement regarding the charges in that Cause of Action, and it is no longer at issue.

Furthermore, because the representatives used the same telephone number, address, and business identity for the CD-finder service as they used for their securities business, no meaningful distinction was drawn between the CD-finder service and the securities business the representatives did through KCD. From the customers' perspective, the CDs and securities were offered and sold by the same person from the same office as part of the same business.

Finally, the Firm was aware of, or at least turned a blind eye to, the nature and function of the advertising. It conducted an initial review of the Florida office advertising, and acknowledged at the time of that review that the CD advertising could result in securities transactions. The Firm also knew that the purpose of the Arizona CD-finder service was to generate "goodwill" and potential customers for the representatives' other businesses, including their securities business through KCD.

The Second Cause of Action. The Second Cause of Action charges that the Firm violated NASD Rule 3010, concerning supervisory responsibilities, and FINRA Rule 2010, by failing to supervise appropriately the activities of KCD's registered representatives at a Dallas, Texas office, and permitting the representatives to offer and sell unregistered securities that were not exempt from registration. The securities were for an investment fund that was to use the proceeds of the offering to invest in distressed real estate.

The securities were purportedly entitled to an exemption from registration under Rule 506 of Regulation D of the Securities and Exchange Commission ("SEC"). That exemption is available only if there is no general solicitation of the public. Whether the securities were entitled to the exemption became an issue because of two news articles published in local Dallas newspapers discussing the offering and the investment fund's prospects. One of the articles was also posted on the website of the Dallas office for at least six months, while the representatives continued to offer and sell the unregistered securities.

The Firm argues that the news articles were not a general solicitation, and that, in any event, the Firm sufficiently corrected any problem by instructing its registered representatives not to sell the securities to anyone who had learned of the offering because of one of the news articles. The Firm asserts that it limited sales to pre-existing customers.

The Hearing Panel rejects both of the Firm's arguments. The news articles, which were widely distributed, constituted a general solicitation. Indeed, at least one person sought to purchase the security as a result of seeing the news article, confirming that the article was viewed by the general public as a solicitation for buyers. In fact, KCD was on notice that the securities attorney who had worked on the offering was concerned that there had been a breach of the rules relating to registration and exemption.

Selling only to pre-existing customers was not a cure for the violation. Once the unregistered securities were the subject of a general solicitation, they were not entitled to an

exemption from registration. Without an exemption, the unregistered securities could not be offered or sold.

Accordingly, the Hearing Panel finds that the Firm committed the violations alleged in the Complaint and imposes sanctions, as discussed below.

II. BACKGROUND

A. The Proceeding

The hearing took place for three days on December 16-18, 2014.³ The Parties filed post-hearing briefs on January 30, 2015.⁴

B. How This Proceeding Arose

This proceeding combines examinations initially conducted by different FINRA offices. FINRA's Florida District Office conducted a "cause" examination of KCD registered representative EW, in Palm Beach Gardens, Florida after receiving a regulatory tip that he was running advertisements for CDs at above-market rates. The tip suggested that the advertisements could be used to prey on seniors. The staff conducted an unannounced on-site visit. EW explained his CD-finder service to the staff. The staff then referred sample advertisements to the Advertising Regulation Department. After studying the samples, the Advertising Regulation Department had concerns that the advertisements were misleading.⁵

FINRA's Chicago District Office was at the same time conducting a "cycle" examination of KCD, and it had identified similar problems with other advertisements. The Florida inquiry into EW's advertising was then referred to the Chicago District Office so that it could be consolidated with the cycle examination.⁶

³ References to the hearing transcript are cited here as "Hearing Tr.," with a parenthetical for the last name of the witness whose testimony is cited and the page number of the transcript. Thus, testimony of a FINRA examiner is cited "Hearing Tr. (Foye) 59."

The following people testified at the hearing: Peter Foye ("Foye"), a FINRA principal examiner; David Wegner ("Wegner"), a FINRA examination manager; Kimberly Flanders ("Flanders"), a FINRA principal investigator in the Advertising Regulation Department; Eugene Teh ("Teh"), a FINRA principal examiner; Jeff Allen Katz ("Katz"), the owner of the Sun Cities Financial Group, who was registered with KCD at the time of the events at issue; Linda Bradle ("Bradle"), a former Chief Compliance Officer with KCD; Isaac D. Gregory ("Gregory"), who was responsible for supervising FINRA registered salespeople at the Dallas office affiliated with KCD; and Lori Lee Rastall ("Rastall"), KCD's current Chief Compliance Officer and FINOP.

⁴ The briefs were entitled as follows: The Department Of Enforcement's Post-Hearing Brief ("Enf. PH Br."); and KCD Financial, Inc.'s Post-Hearing Brief ("KCD PH Br.").

⁵ Hearing Tr. (Foye) 56-68; JX-10.

⁶ Hearing Tr. (Foye) 71-72.

The cycle examination focused on KCD's Sun City, Arizona office in part because of a customer complaint. The customer complained that she had responded to a CD advertisement, but when she went to the Sun City office she felt pressured to buy something different. She ultimately purchased a fixed annuity.⁷

While on-site at the Sun City, Arizona office, a FINRA examiner saw an advertisement in the Firm's branch office files that caught her attention because it had the word "guarantee" on it. It also advertised an interest rate that was in the 3% to 4% range, which seemed high.⁸ FINRA staff then researched the current market rate for CDs and found that the market rate was closer to 1% than to 3%.⁹

FINRA staff considered the advertisements to be member communications covered by NASD Rule 2210 (even though the advertisements do not mention securities or KCD) because the purpose, at least in part, was to offer securities through KCD. The advertisements were the first step in marketing securities through KCD.¹⁰ The First Cause of Action covers both the Florida and the Arizona advertisements.

The cycle examination of KCD uncovered a separate problem that is the subject of the Second Cause of Action. That problem had to do with the Firm's due diligence in connection with the private placement of securities by the Firm's Dallas, Texas office. The private placement offering was for an investment fund sponsored by an affiliate of the KCD Dallas office. The offering relied on an exemption from registration pursuant to Rule 506 of the SEC's Regulation D. The staff discovered, however, that articles had been published in two local Dallas newspapers that discussed the launch of the fund and how the fund intended to invest in distressed real estate. One article also was posted on the website for the Dallas office and its affiliates. The staff considered the articles to constitute a general solicitation for investors in the fund, which meant that the exemption did not apply and therefore the securities could not be offered or sold without registration.¹¹

⁷ Hearing Tr. (Wegner) 103-08.

⁸ Hearing Tr. (Wegner) 106-07; JX-6.

⁹ Hearing Tr. (Wegner) 107-09.

¹⁰ Hearing Tr. (Flanders) 223-34; JX-1, at 13. In 2008, FINRA staff had investigated the CD-locator service offered by the Sun City, Arizona office but had taken no action. The owner of the Sun City office believed that this inaction by FINRA staff constituted recognition that FINRA had no jurisdiction over the service because it was not a securities product. Hearing Tr. (Katz) 318-19, 322-27.

¹¹ Hearing Tr. (Teh) 246-60; JX-1, at 2-4; JX-3, at 4-5; JX-12.

III. FINDINGS

A. Respondent And Jurisdiction

KCD was formed in 2003 as a new broker-dealer.¹² Its home office is in Wisconsin.¹³ FINRA has jurisdiction over KCD for purposes of this FINRA disciplinary proceeding pursuant to Art. IV, Sec. 6 of FINRA's By-Laws.

During the period when the conduct at issue occurred, from January 2009 to April 2012, the Hearing Panel finds that the Firm suffered through a period of stress and management disruption. The Firm was put up for sale in 2008. While waiting to close the sale, two of the Firm's officers left the organization, and, in the fall of 2008, it had a temporary Chief Compliance Officer ("CCO") for a few weeks. However, the Firm's then-Chief Executive Officer ("CEO") and president was in failing health, and the purchase transaction did not close. In mid-January 2009, the temporary CCO, Linda Bradle, returned, and she and her husband, who ran the trading desk, helped the ailing CEO run the company for about two years.¹⁴ Ownership did eventually transfer to new management in April 2011. At some point, Bradle was replaced by a new CCO, Jeff Larson. However, he left abruptly in late August 2011 for a position at a different broker-dealer. There was no transition. He resigned and the next day he was gone. A woman who had been his part-time assistant for approximately six months, Lori Rastall, became the CCO in September 2011. She had never been a CCO before and had just received her Series 24 Principal's license. She stepped into the position shortly before FINRA staff began a cycle examination in October 2011.¹⁵

The Hearing Panel believes that this turmoil and lack of continuity contributed to the Firm's failure to exercise appropriate oversight over its representatives' activities and its failure to acknowledge its responsibilities when FINRA staff expressed concerns in the course of the examinations giving rise to this proceeding.

B. The CD-Finder Service

(1) Palm Beach Gardens, Florida

EW ran a one-man shop in Palm Beach Gardens, Florida under the name Principal First. It was a branch office of KCD. EW used the same business name to advertise CDs.¹⁶ A third of EW's business was a securities business, selling REITs (Real Estate Investment Trusts).

¹² Hearing Tr. (Bradle) 394.

¹³ Hearing Tr. (Teh) 246.

¹⁴ Hearing Tr. (Bradle) 394-96.

¹⁵ Hearing Tr. (Rastall) 542-44, 569-71, 591; Hearing Tr. (Bradle) 394-96.

¹⁶ Hearing Tr. (Foye) 58-59. At one point the name of the business was Principal First Trust. Hearing Tr. (Foye) 59.

Another third of his business involved fixed annuities, and the CDs represented the last third.¹⁷ According to EW, he placed over \$16.5 million in assets into CDs from 2007 through October 2010.¹⁸

KCD treated EW's business in CDs, which EW called a CD-finder service, as an approved outside business activity involving a non-securities product. KCD conducted an initial review of EW's CD advertisement, but after that it never reviewed any of his CD advertising.¹⁹

EW explained in an on-the-record interview ("OTR") how his so-called CD-finder service worked. He would conduct an internet search for high yielding CDs, which were returning 1% to 2%. Then he would add percentage points to that rate and advertise a CD at a higher annual rate of 5.6%. He would place ads for the above-market-rate CDs in the local Palm Beach County newspaper on a regular basis, generally every Tuesday and Thursday. This was his practice from 2007 forward.²⁰

The advertisements made it appear that Principal First was offering to sell FDIC-insured CDs with a rate of return that far outstripped the current bank CD rate. However, no such FDIC-insured CD existed.²¹ Some of the advertisements reflected how extraordinarily high the advertised rate of return was in the excited tone of the language used. For example, one of the advertisements bore a large headline saying "Hottest CD in Town."²² That headline clearly implied that such a CD existed, even though it did not.

The advertisements provided a telephone number for interested persons to call to learn more about acquiring the advertised CD. That was the same telephone number used for EW's securities business. EW would require a person responding to the CD advertisement to come into the office for an in-person meeting. He used the same address for all his businesses, including his business as a KCD branch office.²³

At the in-person meeting, EW would collect the potential customer's name, address, net worth, liquid net worth, investment objective, risk tolerance, and the like. He not only talked about the advertised CD but also about other financial products, including securities offered through KCD. He sold securities through KCD to some customers who responded to the high-yielding CD advertisements.²⁴ When FINRA staff investigated EW's activities in 2012, the staff

¹⁷ Hearing Tr. (Foye) 66.

¹⁸ RX-23, at 8.

¹⁹ Hearing Tr. (Foye) 78; RX-23.

²⁰ Hearing Tr. (Foye) 60-61; CX-4.

²¹ Hearing Tr. (Foye) 68-70.

²² Hearing Tr. (Flanders) 200-01; JX-10.

²³ Hearing Tr. (Foye) 62-64, 96-98; CX-4. The customers purchased REITs which are securities.

²⁴ Hearing Tr. (Foye) 62-64; CX-4.

discovered that a majority of the customers interviewed who had purchased securities from EW had established their relationship with him through his CD advertising.²⁵

If a customer insisted on buying a CD at the advertised rate, EW would find the highest interest rate bank CD, generally in the range of 1% to 2% during the relevant period. Then, to achieve the advertised yield, he would make up the rate difference out of his own pocket by writing a check for the difference to the customer or to the bank for the benefit of the customer.²⁶ At least some customers who purchased a CD told FINRA staff in the course of the investigation that, when they made the purchase, EW explained that he would be paying a portion of the interest rate himself.²⁷ The advertisements did not disclose this information, however.

EW testified in an OTR that the purpose of the CD advertisements was to meet new customers and generate new business for the other financial products he sold, including his securities business through KCD.²⁸ He earned no income from his CD-finder service because he did not charge customers for the service and he had no arrangements with the banks selling the underlying CDs to pay him a commission for any business he directed to them.²⁹

FINRA staff who reviewed the CD advertisements were concerned that the purpose of the advertisements was, at least in part, to generate sales of securities. If so, the advertisements should have disclosed that securities might be offered through KCD.³⁰ The advertisements did not, however, include KCD's name or mention securities.³¹ FINRA staff found no advertising by EW of his securities business as a registered representative of KCD.³²

Some of the CD advertisements included a small print statement saying, "Promotional incentive may be included to obtain yield." However, the staff did not view that statement as sufficient to cure the false and misleading nature of the advertisement. FINRA staff concluded that the advertisement created the overall impression that there was a CD in existence offering a certain rate of interest without explaining what was meant by a "promotional incentive" or who was providing the "promotional incentive."³³

The Hearing Panel finds that the Principal First advertisements were false and misleading. They advertised an instrument that did not exist—an FDIC-insured CD with an

²⁵ Hearing Tr. (Foye) 80.

²⁶ Hearing Tr. (Foye) 64-65, 82-83.

²⁷ Hearing Tr. (Foye) 82-83.

²⁸ Hearing Tr. (Foye) 61-62, 66.

²⁹ Hearing Tr. (Foye) 66.

³⁰ Hearing Tr. (Flanders) 202.

³¹ Hearing Tr. (Foye) 85-86.

³² Hearing Tr. (Foye) 98.

³³ Hearing Tr. (Flanders) 204; JX-10.

investment rate more than twice the market rate. The advertisements failed to explain that the registered representative planned to make up the difference between the market rate and the rate advertised.

The fact that, after a customer insisted on buying a CD as advertised, EW may have revealed that he would be paying some of the interest on the CD out of his own pocket does not alter the false and misleading nature of the advertisement.³⁴ Nor did the small print disclosure concerning a “promotional incentive” cure the problem. The small print was too insignificant within the context of the advertisement as a whole, and the words were too cryptic, to counteract the overall impression conveyed by the advertisement.³⁵

The Hearing Panel further finds that the advertisements were false and misleading because they did not reveal their true purpose. The so-called CD-finder service was no more than a marketing tool for the other businesses operated under the Principal First name, including the securities business EW conducted as a KCD branch office. As EW operated it, the so-called CD-finder service had no value whatsoever as an independent business. It was neither intended nor structured to generate a penny of revenue.

The Hearing Panel rejects the Firm’s assertion that the advertisements had nothing to do with it. Although the Firm claimed to FINRA staff that it was unaware of EW’s CD-finder service,³⁶ that claim is contradicted by the fact that it conducted an initial review of the advertising in substantially the same false and misleading form as the later advertisements that

³⁴ Hearing Tr. (Foye) 89-90. The disclosure that EW was making up the difference between the advertised rate and the true rate of an existing CD actually added to the misleading nature of the advertising. A customer might think that the disclosure showed that EW was honest, because he was attempting to live up to the promise in the advertisement, as opposed to focusing on the fact that the advertisement promised something EW could not deliver. Furthermore, learning that EW would be paying some of the promised return on the CD out of his own pocket could play a role in persuading customers to buy other financial products from him, including securities, out of a misplaced sense of trust or reciprocity.

³⁵ As an examiner testified, “[T]he confusing disclosure can’t cure false and misleading statements and claims ... in the communications.” Hearing Tr. (Flanders) 205.

³⁶ Hearing Tr. (Foye) 65-66.

gave rise to the FINRA staff's concerns.³⁷ Moreover, when KCD initially reviewed EW's CD advertising, KCD knew that EW did not derive any income from the CD-finder service.³⁸ That put the Firm on notice that the advertising was being used to promote EW's other revenue-raising businesses, including his securities business. The fact that the staff located no other advertising by EW for his securities business bolsters the conclusion that the CD advertising was integrated with EW's securities business. To the extent that EW sold securities through KCD to customers who first met EW because of the CD advertising, KCD benefited from the false and misleading advertising. In these circumstances, the advertisements were the Firm's communications, as it had reason to know, and it should have taken steps to comply with FINRA Rule 2210 regarding Firm communications with the public.

At best, the Firm turned a blind eye to the true nature and function of EW's activities in connection with his CD-finder service. It abdicated its responsibilities for its communications with the public.

(2) Sun City, Arizona

During the relevant period, KCD sold securities through a Sun City, Arizona office doing business under the name of Sun Cities Financial Group ("Sun Cities Financial"). The Sun City office offered securities products, including mutual funds and REITs, as well as CDs and fixed insurance products such as fixed annuities. There were two registered representatives in the Sun City office, Jeff Katz and LP. Katz was and is the owner of Sun Cities Financial. Sun Cities Financial has other offices in the Phoenix area but the other offices do not do any securities business and do not have any registered representatives.³⁹

Sun Cities Financial ran advertisements on a regular basis (each Sunday, Tuesday, and Thursday) for high-yield CDs at above-market rates, similar to the advertisements that EW ran in Florida. The Sun Cities Financial advertisements listed the Sun City office as one of the offices

³⁷ RX-23, at 2, 6.

³⁸ RX-23, at 5. In its regulatory responses, the Firm was somewhat hazy on what it knew and when. It tried to draw a distinction between "current management" and "former management," saying that "current management" was unaware of EW's advertising but that "former management" had reviewed a marketing piece in 2007 that was "substantively similar" to advertisements provided to FINRA in 2009. The Firm further explained that not only did it review the advertising but it discussed the nature of the activity with EW at some unspecified point in time. The Firm wrote to FINRA staff that "former management" had concluded that the CD-finder service was an outside business activity that needed no further review, and "current management" had relied on "former management's" conclusion when it decided it did not need to approve or disapprove of the advertising. At some unspecified point, the Firm also knew that EW did not sell existing CDs but, rather, in at least some instances, packaged CDs together with a promotional incentive to achieve the advertised interest rate. RX-23, at 2-3.

Whether under former or current management, the Firm was still the Firm. Its knowledge and responsibility continued even if management changed.

³⁹ Hearing Tr. (Katz) 301-05; Hearing Tr. (Wegner) 104-06, 109-10, 175-76. Currently, Sun Cities Financial does no securities business at any office. It sells only fixed annuities and life insurance. Hearing Tr. (Katz) 301.

to be contacted to learn about the CDs. In his testimony, Katz referred to the advertisements as a CD-locator service.⁴⁰

The Sun Cities Financial CD advertisements contained small print disclosures relating to the hybrid nature of the offered product—part annual rate, part bonus. Witnesses discussed a typical advertisement as an example. It disclosed in small print that the advertised interest rate was composed of a 1.06% annual percentage yield and a 1.96% interest bonus.⁴¹ But, as one witness testified, the print was so small that it was nearly impossible to read.⁴²

The Hearing Panel finds that the physical contrast between the small print disclosing the bonus and the large type advertising the false, above-market rate made the small print insufficient to correct the misimpression created by the advertisement—the misimpression that there was an existing high-yield CD when there was no such CD. Moreover, even if the small print could be read, the Hearing Panel finds that the disclosure was too cryptic to inform the reader that there was, in reality, no CD at the rate advertised. The small print did not inform the reader who was offering the bonus, why it was offered, or how it would work.

The CD-locator service run by Sun Cities Financial worked much the same way as the CD-finder service run in Florida. LP testified in his OTR that he would arrange an in-person meeting at his office when a prospective customer telephoned in response to a CD advertisement. He would ask about his or her financial situation, needs, and objectives. Then he would move into discussing products.⁴³ Katz confirmed in his testimony at the hearing that no one could open a CD over the telephone. Rather, interested persons had to come into the office and fill out paperwork.⁴⁴

At the Sun City office, the other products that might be discussed included securities.⁴⁵ The CD advertisements contained no disclosures relating to securities or KCD, but they did refer the viewer to the Sun Cities Financial Group website. The website had securities broker-dealer disclosures on it.⁴⁶ The Hearing Panel finds the reference to the Sun Cities Financial website an insufficient disclosure of the connection between the advertising and possible securities transactions through KCD. At the same time, this reference to the website establishes the connection between the CD advertisements and the KCD representatives' securities business.

⁴⁰ Hearing Tr. (Katz) 302-03, 385; JX-6. Katz testified that the Sun City office did not itself sell CDs, but rather “located” CDs for clients, which the clients could then purchase or “open,” dealing directly with a bank. Hearing Tr. (Katz) 317-18.

⁴¹ Hearing Tr. (Wegner) 158-59; Hearing Tr. (Flanders) 210-14; JX-6.

⁴² Hearing Tr. (Katz) 307, 354-56; JX-6.

⁴³ Hearing Tr. (Wegner) 115-16; CX-1, CX-2.

⁴⁴ Hearing Tr. (Katz) 341.

⁴⁵ Hearing Tr. (Katz) 333, 388-89; JX-8.

⁴⁶ Hearing Tr. (Wegner) 190; JX-6.

The purpose of the Sun Cities Financial CD advertisements was to get customers to come to a Sun Cities Financial office, enabling its representatives to establish and develop a relationship with the customers. Sun Cities Financial did not charge customers for the so-called CD-locator service, and its representatives did not earn any money when a customer decided to purchase a CD identified for the customer by Sun Cities Financial. The only way any Sun Cities Financial representative made money is if the representative could sell products other than CDs, including securities.⁴⁷ In his testimony, Katz described the service as a way of generating leads for other products, not by itself as a means to generate income.⁴⁸

In March 2009, Katz provided to KCD, and KCD provided to FINRA staff in response to prior regulatory inquiries, a description of Sun Cities Financial's CD-locator service. KCD described the CD advertising in its response to FINRA staff as marketing for other financial products.⁴⁹ KCD also expressly linked the CD marketing to potential securities transactions. Its then CCO, Linda Bradle, wrote to FINRA staff that after a client was satisfied with the CD service, "Mr. Katz may subsequently sell securities...."⁵⁰

At the hearing, Katz testified that he provided the CD-finder service to seniors who were unable to locate the CDs on the internet for themselves.⁵¹ He told the former CCO of KCD, Bradle, that the CD-locator service was done for goodwill.⁵² She testified at the hearing that she understood that the CD-locator service was done to cultivate goodwill, and that she knew that Katz was not earning a commission for that service.⁵³

If a customer purchased a CD at the advertised rate, Katz would make up the difference between the high advertised rate and the market rate by writing a check to the customer for the difference or writing a check to the bank.⁵⁴ KCD's former CCO understood that Katz used a "marketing" budget to make the bonus payments on CDs.⁵⁵

When asked whether he advertised other products in addition to CDs, Katz responded that Sun Cities Financial also advertised fixed annuities, a non-securities product.⁵⁶ He did not say that Sun Cities Financial ever advertised its securities business.

⁴⁷ Hearing Tr. (Wegner) 114-15, 126; Hearing Tr. (Katz) 302, 334, 338-41; Hearing Tr. (Bradle) 406-07.

⁴⁸ Hearing Tr. (Katz) 388.

⁴⁹ RX-6, at 2-4.

⁵⁰ *Id.*, at 5.

⁵¹ Hearing Tr. (Katz) 302-03.

⁵² Hearing Tr. (Bradle) 406.

⁵³ Hearing Tr. (Bradle) 411.

⁵⁴ Hearing Tr. (Katz) 310; Hearing Tr. (Wegner) 112-13; Hearing Tr. (Flanders) 207-08, 211.

⁵⁵ Hearing Tr. (Bradle) 407.

⁵⁶ Hearing Tr. (Katz) 311-13; JX-6.

It is significant that Katz did not mention any securities business advertising. That means that LP, the other registered representative at the Sun City office, who was one of the top producers at KCD, developed his substantial securities business from the customer base generated by the non-securities advertising, the CD and fixed annuity advertising. During the relevant period, LP was KCD's fourth highest producer or commission-earning registered representative, and the Sun City branch was a high producing branch of KCD.⁵⁷

It is also significant that Katz told the former CCO, Bradle, that he operated the CD-locator service to generate goodwill. This should have signaled to the CCO the connection between the CD advertising and Katz's other businesses, including the Sun City office's securities business. Furthermore, Katz testified that every twelve months he updated the outside business activity form for KCD, and when he did so, if he was offering bonus CD's at the time he informed KCD that he was doing that. He claimed that he made KCD aware of everything he was doing at the time.⁵⁸ If so, then KCD was informed that Katz was using the advertisements for the so-called CD-locator service to draw in potential customers for his other businesses, including his securities business through KCD.

Indeed, a May 5, 2009 letter from Bradle to Katz, copied to the then-president of KCD, shows that KCD understood the connection between the CD-advertising and potential securities sales. The letter was written in connection with KCD's determination to lift a cease-and-desist instruction that the Firm had imposed in response to regulatory inquiries prior to the examinations that led to this proceeding. The Firm's cease-and-desist order had prohibited Katz from engaging in activities related to his CD-locator service. Bradle's letter lifting the cease-and-desist order refers to the potential that a customer might decide to use the proceeds from a maturing CD in a securities transaction. In the letter, Bradle wrote, "[W]e believe there will [be] clients wishing to use CD proceeds to fund a security transaction..."⁵⁹ She reiterated at the conclusion that the letter was intended to "support your activities as it relates to the use of CD proceeds in the event there is a securities transaction involved."⁶⁰

In his hearing testimony, however, Katz attempted to minimize the connection between the CD advertising and the securities business at the Sun City office. He testified that it was rare that a customer who responded to a CD or annuity advertisement would have any interest in a security. He claimed that he did not initiate a discussion of a securities purchase with such customers because they were interested in safety of their investment.⁶¹

⁵⁷ Hearing Tr. (Wegner) 104-05.

⁵⁸ Hearing Tr. (Katz) 386-87.

⁵⁹ RX-18, at 1.

⁶⁰ *Id.*

⁶¹ Hearing Tr. (Katz) 313-14.

Katz's testimony in this regard was not credible because it was inconsistent with a summary of 2011 securities purchases that was prepared under his supervision to give to FINRA. That summary showed that at least 25 customers who purchased securities from the Sun City Financial representatives in 2011 had also bought CDs at some point (not necessarily in 2011, but before). Some of the securities customers had purchased multiple CDs over the course of years. Four customers who bought securities in 2011 also bought a CD the same day.⁶² Katz's testimony also was inconsistent with the fact that LP was one of KCD's highest producers in terms of commission earnings on securities transactions.

Katz's testimony also was not credible because it became apparent at the hearing that he had previously concealed the truth in response to regulatory inquiries. FINRA had asked KCD, pursuant to Rule 8210, whether Sun Cities Financial had ever advertised a CD with a higher yield than the CD was actually paying. With knowledge that his response would be conveyed to the regulators, Katz told KCD the answer was no. But the answer was actually yes. He had placed advertisements for CDs at a rate that was a combination of the highest rate possible plus a bonus that he would pay.⁶³

Katz attempted to explain away his failure to provide the whole truth in response to FINRA's prior investigative inquiries. He said that he did not understand the question posed by FINRA staff to encompass the advertisements that combined the highest rate CD with an additional bonus.⁶⁴ The Hearing Panel finds his testimony on this point was evasive and not credible.

Katz also attempted to minimize the amount of securities business done in the Sun City office, testifying that its securities business was "very miniscule compared to our insurance business and CD business."⁶⁵ That testimony is not consistent with other evidence. LP was one of KCD's top producers, which meant that the securities business at the Sun City office was more than "miniscule." Furthermore, KCD's own summary exhibit showed that during the period from 2009 through 2012, the Sun City office had 199 securities transactions. During that same period, the Sun City office had 1867 annuity sales and 617 CD transactions. However, the

⁶² Hearing Tr. (Wegner) 118-24; JX-8. See also Hearing Tr. (Katz) 344-47.

⁶³ Hearing Tr. (Katz) 359-64; CX-4; RX-6. Katz described a different kind of "bonus CD" to KCD. He told KCD's CCO that sometimes CD market rates changed between the time of running an advertisement and the time that a customer came into the office to obtain the CD at the advertised rate. In such a situation, he would make up the difference with a "bonus." Hearing Tr. (Bradle) 406-07.

⁶⁴ Hearing Tr. (Katz) 362-64.

⁶⁵ Hearing Tr. (Katz) 330.

CD transactions generated no revenue. The revenue-generating transactions (annuities plus securities) in the office totaled 2066. Thus, securities transactions comprised approximately 9.6% of the total number of revenue generating transactions at the Sun City office.⁶⁶

In sum, the Hearing Panel finds that the CD-locator service operated by Sun Cities Financial had no independent business purpose. It was a marketing tool to lure people into the office, where they might buy other financial products, including, in the case of the Sun City office, securities offered through KCD. The Hearing Panel further finds that the operation of the CD-locator service was integrated with all the businesses operated at the Sun City office, including the securities business, and that KCD understood that the CD-locator service was connected to potential securities transactions, if not at the time a customer responded to a CD advertisement then later, when a CD originally purchased in response to the advertising matured. To the extent that the CD advertisements led to securities transactions, KCD also made money and thereby benefited.⁶⁷

C. The Sale Of Unregistered Securities

(1) KCD's Sales Of Private Placement Offerings In Dallas

KCD was the broker-dealer through which a Dallas, Texas real estate investment enterprise called Realty Capital Partners (“RCP”) offered and sold interests in real estate development projects. RCP put together real estate investments and employed a sales team of registered representatives to sell interests in those investments. The investments were done as unregistered offerings pursuant to SEC Rule 506 of Regulation D.

In late 2010, pursuant to a joint venture with another entity, RCP employees went to work for the joint venture, which was called Westmount Realty Finance (“WRF”). The KCD broker-dealer business was done under the same name as the joint venture, WRF. Isaac Gregory, senior vice president of capital markets at WRF, was responsible for overseeing the registered salespeople affiliated with KCD, first at RCP and then at WRF.⁶⁸ He testified that while he was with RCP he was involved in 30 to 40 unregistered offerings representing about \$150 million in private equity.⁶⁹

Gregory testified that the salespeople were a “captive” salesforce who did no business other than for RCP (and then WRF). He said that KCD had no experience with such a “captive”

⁶⁶ RX-52. Respondent compared the 199 securities transactions to all the transactions at *all* the Sun Cities Financial offices, including CD transactions, to minimize the proportion of the business attributable to securities transactions. Hearing Tr. (Katz) 330-32. Katz acknowledged the figures in RX-52 and confirmed that no money was made on CD sales. He further acknowledged that money *was* made on securities sales. Hearing Tr. (Katz) 366-70.

⁶⁷ Hearing Tr. (Katz) 367.

⁶⁸ Hearing Tr. (Gregory) 459-66, 474, 499.

⁶⁹ Hearing Tr. (Gregory) 472.

salesforce prior to 2008 but that the then-owner and Linda Bradle spent three days in Dallas to develop a way of doing business together.⁷⁰

In general, an entity called Westmount Realty Capital, LLC (“Westmount Realty”) would find a real estate deal, conduct due diligence and screen the investment from the issuer side. Then RCP (later WRF) would handle the preparation of the sales documents and put together a package to submit to KCD. KCD would then review the material and sign off on a soliciting dealer agreement. That would be the broker-dealer approval required before launching the offering.⁷¹ As investors subscribed to the offering, Gregory would review the documents and send them to KCD for approval and verification that the investors were accredited investors eligible to participate.⁷²

Gregory testified that he was familiar with SEC Rule 506, Regulation D, and the form required to be filed when using a Rule 506 exemption from registration. He said that a solicitation to the general public could not be made and that only accredited investors (and/or a maximum of 35 unaccredited investors) could be permitted as investors.⁷³

(2) WRF Fund Private Placement

After the joint venture was set up and the salesforce transferred to WRF, Westmount Realty put together a private placement for an investment fund known as the WRF Distressed Residential Fund 2011, LLC (“WRF Fund”). The Private Placement Memorandum (PPM”) for the offering disclosed that the WRF Fund would be managed by Westmount Realty Finance LLC (“Westmount Finance”), through an affiliate. Westmount Finance was the sponsor for the WRF Fund.⁷⁴

KCD’s CCO at the time, Jeff Larson, approved the deal by signing the soliciting dealer agreement on March 15, 2011, and within two to three business days the salesforce began contacting their existing customer base about it.⁷⁵ They sold interests quickly thereafter.⁷⁶

The soliciting dealer agreement and the PPM for the WRF Fund private placement specified that up to \$10 million of securities would be sold.⁷⁷ KCD, as the selling broker-dealer

⁷⁰ Hearing Tr. (Gregory) 466-67.

⁷¹ Hearing Tr. (Gregory) 467-69.

⁷² Hearing Tr. (Gregory) 469-70.

⁷³ Hearing Tr. (Gregory) 472-73.

⁷⁴ JX-27, at 1, 7; Hearing Tr. (Teh) 247-49, 252; JX-27. A Form D was filed with the SEC for the WRF Fund offering, indicating its reliance on Rule 506 of Regulation D. JX-15.

⁷⁵ Hearing Tr. (Gregory) 475-80; JX-16.

⁷⁶ Hearing Tr. (Gregory) 487.

⁷⁷ JX-16, at 1; JX-27, at 1.

for the offering, would receive fees that included a 4% commission and a 1% non-accountable due diligence and marketing allowance. KCD was also entitled to a share of the Carried Interest distributions payable to the manager of the offering.⁷⁸

(3) The News Articles Raising General Solicitation Issue

In late April 2011, the securities attorney who had worked on the PPM for the WRF Fund offering called Gregory with concerns about a newspaper article the attorney had seen in the Dallas Business Journal. The attorney was concerned about the effect of the article on the representation in the PPM that the securities were sold pursuant to the Regulation D exemption from registration.⁷⁹

The article was one of two articles that appeared in local Dallas newspapers. Each article discussed the launch of the WRF Fund and quoted Westmount Realty's Chief Investment Officer as saying that "[W]e continue to see a steady stream of buying opportunities."⁸⁰ The articles used information supplied in a press release Westmount Realty had issued.⁸¹

Based on the securities attorney's reaction to the news article, Gregory believed that the article was a breach of the rules against general solicitation for a private placement. Gregory then called Larson, the KCD CCO, and told him there had been a breach of the rules.⁸²

The Hearing Panel finds it highly significant that KCD was informed that the securities attorney who had worked on the PPM for the WRF Fund offering thought there had been a breach of the rules. The attorney was knowledgeable and familiar with the particular offering. His concerns were not idle speculation.

The Hearing Panel also finds it significant that there was no testimony to indicate that Gregory or anyone at KCD called the securities attorney or any other attorney to ask for advice on how to deal with the problem. By avoiding speaking to legal counsel, they avoided being told to stop offering and selling the securities.

Instead, without benefit of legal counsel, Gregory and Larson developed their own plan and implemented it. They informed the salesforce that the WRF Fund could only be sold to investors who had invested with them before, and not to anyone who had learned of the offering through one of the news articles. Salespeople were to ask a caller who had not previously

⁷⁸ JX-27, at 1.

⁷⁹ Hearing Tr. (Gregory) 481-82, 499-503.

⁸⁰ JX-12; JX-13; Hearing Tr. (Teh) 249-52; Hearing Tr. (Gregory) 491-508.

⁸¹ Hearing Tr. (Teh) 257.

⁸² Hearing Tr. (Gregory) 481-82, 491-92.

invested with them how the caller found out about the offering. If the caller said through the news article, then the salesperson was to decline to allow the caller to invest.⁸³

Later, Gregory learned that one of the news articles also had been posted on the website for the WRF affiliates, including the KCD broker-dealer business. He called technology staff and asked them to take it down. He knew that the securities attorney had been especially concerned that the article should not appear on the website.⁸⁴

Still later, Gregory learned that, despite his instruction, the article had remained posted on the WRF website until it was discovered by FINRA staff in October 2011, approximately six months after he instructed that it be taken down.⁸⁵ At least one person called a registered representative at WRF expressing an interest in the offering as a result of seeing one of the news articles.⁸⁶ Gregory notified KCD of this incident.⁸⁷

(4) FINRA Staff Discovery Of Unregistered Securities Sales

In the cycle examination commenced in October 2011, FINRA staff examined the efficacy of KCD's due diligence in connection with its top three selling private placement offerings. The staff investigated the information publicly available that might not be in the PPMs and compared that information to KCD's files.

The WRF Fund offering was one of the three top selling private placements the staff examined. The staff discovered the news articles relating to the WRF Fund offering. The article was still posted on the WRF website. KCD's then-CCO, Lori Rastall, instructed Gregory to take the article down from the website. He believed that she had concluded it was a general solicitation, and she testified at her OTR that she thought it was a general solicitation.⁸⁸ However, she did not instruct that KCD representatives stop offering and selling the securities. Nor did she do any other follow-up.⁸⁹ This was the first time that she had dealt with any private placement offerings or exemptions from registration under Regulation D as a CCO.⁹⁰

The Hearing Panel finds that neither Gregory nor Rastall did anything meaningful to remove the news article from the WRF website, even though both were aware that the posting on the website was a general solicitation that made it improper for KCD's registered representatives

⁸³ Hearing Tr. (Gregory) 482-84, 505, 509-13, 515-17.

⁸⁴ Hearing Tr. (Gregory) 484-85, 505-07.

⁸⁵ Hearing Tr. (Gregory) 506-08; Hearing Tr. (Teh) 256, 272, 274-75.

⁸⁶ Hearing Tr. (Gregory) 513-14.

⁸⁷ Hearing Tr. (Gregory) 485.

⁸⁸ Hearing Tr. (Gregory) 514-15; Hearing Tr. (Rastall) 568, 579.

⁸⁹ Hearing Tr. (Rastall) 567, 574, 577-78.

⁹⁰ Hearing Tr. (Rastall) 569-70.

to continue offering the unregistered securities. The problematic news article remained posted on the WRF website for months.

IV. CONCLUSIONS

A. Advertisements In Violation Of Member Communications Rule

FINRA Rule 2210 concerning member communications with the public sets a general standard applicable to all member communications with the public. It requires that such communications be “based on principles of fair dealing and good faith,” and that they “be fair and balanced.” It further requires that such a communication should not omit any material fact if, “in light of the context of the material presented,” the omission would cause the communication to be misleading. The Rule also specifies that no member “may make any false, exaggerated, unwarranted, promissory or misleading statement in any communication.” It prohibits a member from publishing, circulating or distributing any communication that the member “knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.” These requirements apply to registered representatives in the same manner as members by virtue of what is now FINRA Rule 140.

The SEC has summarized, “[The member communication Rule] prohibits a member from making any false, exaggerated, unwarranted, or misleading statements in its communications with the public. Public communications must be based upon principles of fair dealing and good faith, must provide a sound basis for evaluating the facts discussed, and must not omit material facts or qualifications that would cause a communication to be misleading in light of this context.”⁹¹

As discussed above, the Hearing Panel finds that the CD-finder advertisements were false and misleading. Without a doubt, the advertisements did not comply with the high standards set forth in Rule 2210.

If the representatives who were responsible for creating and running the advertisements were the respondents here, they would be found to have violated the Rule even though the advertisements concerned CDs and not securities. The case relied upon by Enforcement, *Robert L. Wallace*,⁹² establishes that communications do not have to be about securities in order to be subject to the Rule concerning member communications with the public. The respondent in *Wallace* was found to have violated the Rule by running false and misleading advertisements relating to viatical settlements. The SEC sustained NASD’s finding of a violation of the communications Rule without determining whether viatical settlements were securities, declaring

⁹¹ *Phillipe N. Keyes*, Exchange Act Release No. 54723, 2006 SEC LEXIS 2631, at *12 (Nov. 8, 2006).

⁹² *Robert L. Wallace*, Exchange Act Release No. 40654, 1998 SEC LEXIS 2437 (1998).

that the Rule governs *all* member communications with the public, not just those involving securities.⁹³

However, it is the Firm that is the Respondent in this case, not the representatives. The issue remains whether the advertisements constituted the Firm's communications with the public, as well as the representatives' communications. The Firm argues that the advertisements were not its communications but, rather, were the representatives' communications in connection with an approved outside business activity.⁹⁴

The Hearing Panel rejects the Firm's argument. The Panel concludes that, in the circumstances of this case, the CD advertisements did constitute the Firm's communications with the public.

First, the essential purpose of the CD-finder service and advertisements was not to promote CDs but to promote the registered representatives' other businesses, including the sale of securities through KCD.⁹⁵ The CD-finder service was not actually a sustainable, independent outside business activity. Rather, it was a marketing tool that the representatives in Palm Beach Gardens, Florida and Sun City, Arizona used to promote their actual income-producing businesses—including sales of securities through KCD. Moreover, there was no evidence that the Florida and Arizona offices advertised their securities business, so their securities business depended upon the customer base developed from the CD advertising.

Second, from the perspective of the customers who inquired about the CDs, the CD-finder service was intertwined with the securities business through KCD: the CD advertisements were run under the same business name as the securities business; when customers responded to the CD advertisements, they called the same telephone number used for the securities business; and customers met the registered representatives at the same offices from which the representatives conducted their securities business.

Third, many of the people who purchased CDs also actually purchased securities. To the extent that they did, KCD benefited from the CD advertising. At least with respect to the Arizona office, the benefit must have been substantial, since it was one of the Firm's highest-producing offices.

Fourth, KCD was aware of the connection between the CD advertising and potential securities transactions and discussed it in correspondence with Katz and with FINRA staff.

⁹³ *Id.* at *13.

⁹⁴ Hearing Tr. (Rastall) 548-58; JX-2; KCD PH Br. 3-6, 12-18.

⁹⁵ *Similarly, see Sheen Financial Resources, Inc.*, Exchange Act Release No. 35477, 1995 SEC LEXIS 613, at *9 (Mar. 13, 1995) (rejecting argument that advertisements for radio program were for separate and distinct business from securities business, because essential purpose of radio program was to sell securities through the broker-dealer firm).

Fifth, KCD did to some extent involve itself in overseeing the CD advertising. It reviewed EW's advertisements when he joined the Firm. It instructed Katz to cease and desist running the advertisements for a period of time in response to earlier FINRA staff inquiries, prior to the examinations that gave rise to this proceeding.

Accordingly, the Firm violated the member communication Rule, FINRA Rule 2210. In so doing, it also violated the ethics Rule FINRA Rule 2010.⁹⁶

B. Sales Of Non-Exempt Unregistered Securities

Section 5(a) of the Securities Act of 1933 prohibits the sale of an unregistered security unless there is an applicable exemption,⁹⁷ and Section 5(c) prohibits the offer of an unregistered security without an exemption.⁹⁸ Thus, an unregistered security may be neither offered nor sold unless it is covered by an exemption. "The party claiming the exemption must show that it is met not only with respect to each purchaser, but also with respect to each offeree."⁹⁹

Exemptions are affirmative defenses that must be established by the person or entity claiming the exemption.¹⁰⁰ Registration exemptions "are construed strictly to promote full disclosure of information for the protection of the investing public."¹⁰¹ Evidence in support of an

⁹⁶ Violations of law and FINRA Rules have long been held inconsistent with the standards of ethical conduct required by NASD Rule 2110 and FINRA Rule 2010. *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 182 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966); *Alvin W. Gebhart*, Exchange Act Release No. 53136, 2006 SEC LEXIS 93, at *54 n.75 (Jan. 18, 2006), *rev'd and remanded in part on other grounds sub nom. Gebhart v. SEC*, 2007 U.S. App. LEXIS 27183 (9th Cir. Nov. 21, 2007); *Richard F. Kresge*, Exchange Act Release. No. 55988, 2007 SEC LEXIS 1407, at *42 (June 29, 2007).

⁹⁷ 15 U.S.C. § 77e (a). No one in this case has disputed that the interest in the WRF Fund that was offered and sold was a security or that it was offered and sold in interstate commerce, so that Section 5 applies here.

⁹⁸ 15 U.S.C. § 77e (c).

⁹⁹ *SEC v. Stratocomm Corp.*, 2 F. Supp. 3d 240, 264 (N.D. N.Y. Feb. 19, 2014) (quotation and citation omitted).

¹⁰⁰ *See, e.g., SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 ("Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable."); *Zacharias v. SEC*, 569 F.3d 458, 464 (D.C. Cir. 2009) (citing *Ralston Purina*, 346 U.S. at 126), *aff'g in relevant part, John A. Carley*, Exchange Act Release No. 57246, 2008 SEC Lexis 222 (Jan. 31, 2008), *Swenson v. Engelstad*, 626 F.2d 421, 425 (5th Cir. 1980); *Rodney R. Schoemann*, Securities Act Release No. 9076, 2009 SEC LEXIS 3939 (Oct. 23, 2009), *aff'd*, 398 F. App'x 603 (D.C. Cir. 2010) (unpublished).

The SEC has made plain that once Enforcement has established a *prima facie* case of selling unregistered securities, the burden shifts to the respondent in a disciplinary proceeding to establish that an exemption applied. *See ACAP Financial, Inc.*, Exchange Act Release No. 70046, 2013 SEC LEXIS 2156 (July 26, 2013).

¹⁰¹ *SEC v. Cavanagh*, 445 F.3d 105, 115 (2d Cir. 2006); *see also SEC v. Murphy*, 626 F.2d 633, 641 (9th Cir. 1980) (same).

exemption must be explicit, exact, and not built on conclusory statements.¹⁰² The SEC has stated that a broker “ha[s] a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act and should be reasonably certain such an exemption is available.”¹⁰³

In this case, KCD had no reasonable basis for thinking that the WRF Fund offering was exempt from registration. The news articles constituted a general solicitation, and at least one person understood it as a solicitation and made an inquiry as a result of seeing one of the articles. Furthermore, KCD was informed that the securities attorney who worked on the offering documents thought that the news articles had created a breach of the applicable requirements. That was more than a red flag; it was a red stop sign. But KCD ignored the stop sign, and continued to offer and sell securities in the WRF Fund offering.

KCD’s cure for the violation of the registration requirements also had no reasonable basis. There is no safe harbor in the statute or Regulation D for sales of unregistered non-exempt securities to pre-existing customers after a general solicitation has been made. KCD had no authority for its continued offer and sale of the unregistered securities in the face of the clear requirement that it stop.

The violation of the registration requirements is serious. “The registration requirements are the heart of” the Securities Act.¹⁰⁴ Their purpose is to “protect investors by promoting full disclosure of information thought necessary to informed investment decisions.”¹⁰⁵ Section 5 imposes strict liability on those who offer or sell unregistered securities.¹⁰⁶ *Scienter* (intent to deceive) is not a requirement.¹⁰⁷

NASD Rule 3010, as it was in effect at the time of the misconduct, required KCD to establish, maintain, and implement a system of supervision that was reasonably designed to achieve compliance with applicable securities laws and regulations. Final responsibility for supervision rests on the Firm. The Firm’s failure to stop the unlawful distribution of

¹⁰² *Ronald G. Sorrell*, 1981 SEC LEXIS 1467, at *5 n.8 (1981) (quoting *Lively v. Hirschfeld*, 440 F.2d 631, 633 (10th Cir. 1971)), *aff’d*, 679 F.2d 1323 (9th Cir. 1982).

¹⁰³ *Midas Securities, LLC*, Exchange Act Release No. 66200, 2012 SEC LEXIS 199, at *33 and n.43 (Jan. 20, 2012).

¹⁰⁴ *Pinter v. Dahl*, 486 U.S. 622, 638 and n.14 (1988).

¹⁰⁵ *Midas Sec.*, 2012 SEC LEXIS 199, at *26 (citing *Ralston Purina*, 346 U.S. at 124 (1953) and *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)) “Registration is the central mechanism the framers of the securities acts chose for the protection of investors.” *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591, 605 and n.6 (5th Cir. 1975) (Wisdom, J.), *vacated and remanded on other grounds*, 426 U.S. 944 (1976).

¹⁰⁶ *SEC v. Calvo*, 378 F.3d 1211, 1215 (11th Cir. 2004); *Cavanagh*, 445 F.3d at 115; *Stratocomm Corp.*, 2 F. Supp. 3d at 263-64.

¹⁰⁷ *Midas Sec.*, 2012 SEC LEXIS 199, *27 and n.34.

unregistered securities in the face of a clear duty to do so was an abject failure of the Firm's supervisory and compliance systems. The Firm's failure even to follow-up on the instruction to remove the news article from the WRF website further demonstrated its lack of an adequate supervisory system. These supervisory failures constitute a violation of Rule 3010.

The violation of NASD Rule 3010 is also inconsistent with the "high standards of commercial honor and just and equitable principles of trade" required by FINRA Rule 2010.¹⁰⁸

V. SANCTIONS

Adjudicators in FINRA disciplinary proceedings look to FINRA's Sanction Guidelines ("Guidelines") in considering the appropriate sanction for a violation.¹⁰⁹ The Guidelines contain recommendations for sanctions for many specific violations, depending on the circumstances and any mitigating or aggravating factors. The Guidelines also contain General Principles and overarching Principal Considerations that are applicable in all cases.¹¹⁰ The Guidelines are intended to be applied with attention to the regulatory mission of FINRA—to protect investors and strengthen market integrity.¹¹¹ They are intended to be remedial and to deter the respondent and others from similar misconduct in the future.¹¹²

Ultimately, however, adjudicators must do what they believe is right in the circumstances of the particular case. The Guidelines "do not prescribe fixed sanctions."¹¹³ They are "not intended to be absolute."¹¹⁴

A. CD Advertising In Violation Of Firm Communications Rule

Breaches of NASD Rule 2210 may involve a late filing with FINRA regulation staff, a failure to file, or the use of a false or misleading communication that fails to comply with the standards set forth in the Rule. A late filing may be subject to a fine of \$1,000 to \$15,000. A failure to file may be subject to a fine of \$1,000 to \$22,000. A failure to comply with the substantive standards set forth in the Rule or an inadvertent use of misleading communications may be subject to a fine of \$1,000 to \$29,000. In egregious cases, a firm may be suspended with respect to any and all activities or functions for up to a year and thereafter subject to a "pre-use" filing requirement to gain permission for a proposed communication with the public.¹¹⁵

¹⁰⁸ *Midas Sec.*, 2012 SEC LEXIS 199, at *46 n.63.

¹⁰⁹ FINRA Sanction Guidelines (2015) ("Guidelines"), <http://www.finra.org/industry/sanction-guidelines>.

¹¹⁰ Guidelines at 2-7.

¹¹¹ Guidelines at 1, Overview.

¹¹² Guidelines at 2, General Principle 1.

¹¹³ Guidelines at 1, Overview.

¹¹⁴ *Id.* and at 3.

¹¹⁵ Guidelines at 78-79.

In this case, the CD advertising was false and misleading, and the advertisements were widely circulated in the representatives' local communities.¹¹⁶ The representatives purposefully created the false and misleading advertisements and used them to support their securities business. Although the Firm knew the connection between the advertising and the representatives' securities business through KCD,¹¹⁷ and although the Firm benefited from the advertising to the extent that the representatives conducted securities transactions for customers who initially inquired about CDs,¹¹⁸ the Firm treated the advertising as though it had no responsibility for it. It abdicated its responsibility for oversight, and it did so in connection with two different offices in different parts of the country. As a result, the false and misleading advertisements were permitted to circulate repeatedly, each week, for more than three years, from January 2009 to April 2012.¹¹⁹ The Firm has never accepted its responsibility for this misconduct but has suggested, instead, that FINRA staff previously approved the way it handled the CD-finder service as an outside business activity.¹²⁰ In these circumstances, the violation cannot be characterized as inadvertent or isolated or aberrant.¹²¹ These are all aggravating circumstances.

There are no mitigating circumstances. The Hearing Panel has noted, however, that the lack of continuity in management contributed to its misunderstanding of its obligations. While this is not mitigating, that lack of continuity and accompanying turmoil bear on the likelihood of future misconduct under current management. The Hearing Panel does not presume that going forward under current management the Firm will likely engage in similar misconduct.

The Hearing Panel censures the Firm and imposes a total fine of \$40,000 for the advertising violation. Although, in total, this amount exceeds the range set forth in the Guidelines, the Hearing Panel believes that a fine of \$20,000 for the false and misleading advertisements circulated by each office (one in Florida, the other in Arizona) is appropriately remedial.

¹¹⁶ Guidelines at 79. Whether violative communications with the public were circulated widely is a Principal Consideration in determining sanctions for this particular kind of violation.

¹¹⁷ Principal Consideration 13 focuses on whether a respondent's misconduct was the result of an intentional or reckless act. In this case, KCD acted recklessly, if not intentionally. Guidelines at 7.

¹¹⁸ Principal Consideration 17 focuses on whether the misconduct resulted in potential monetary gain to the respondent. Guidelines at 7.

¹¹⁹ Principal Considerations 8 and 9 focus on whether there was a pattern of misconduct and whether the misconduct occurred over an extended period of time. Guidelines at 6. Principal Consideration 18 focuses on the number, size, and character of the transactions at issue. Here, many false and misleading advertisements were permitted to circulate to the public as a result of KCD's failure to fulfill its responsibilities. Guidelines at 7.

¹²⁰ Principal Consideration 2 concerns whether the respondent has accepted responsibility for the misconduct prior to regulatory detection and intervention. Guidelines at 6.

¹²¹ Principal Consideration 16 concerns whether the record supports the conclusion that the misconduct at issue was aberrant. Guidelines at 7.

B. Distribution Of Non-Exempt Unregistered Securities

The recommended fine for selling non-exempt unregistered securities ranges from \$2,500 to \$73,000. In egregious cases, adjudicators may consider suspending a firm with respect to any or all activities or functions for up to 30 business days or until procedural deficiencies are remedied.¹²²

There are a number of Principal Considerations that apply to this particular type of violation. One of them is of paramount importance here: whether the respondent disregarded “red flags” suggesting the presence of an unregistered distribution.¹²³

In this case, KCD disregarded a red flag that could not be ignored. The call from the securities attorney who worked on the WRF Fund offering expressing concern about the news article notified KCD of the general solicitation and of the loss of the exemption from registration.¹²⁴ KCD’s response—to continue offering and selling the securities—was not an appropriate response. The Firm’s attempt to cure the violation by selling only to pre-existing customers did not cure the violation. KCD’s misconduct was an egregious violation.

Additional Principal Considerations applicable in connection with all cases confirm that stringent sanctions are warranted. The misconduct was the result of an intentional act. Gregory and the then-CCO, Larson developed a plan for continuing to offer and sell the unregistered securities even though they knew that the rules regarding the basis for claimed exemption had been breached.¹²⁵ The Firm failed to develop and implement controls related to the misconduct and did not even make certain that the news article posted on the WRF website was removed.¹²⁶ The misconduct resulted in monetary gain to the Firm.¹²⁷

Even though the violation was egregious, the Hearing Panel does not impose a suspension. The Panel believes that the remedial purposes of disciplinary sanctions can be served by censuring the Firm and imposing a substantial fine of \$75,000. The Hearing Panel chooses a figure that slightly exceeds the top end of the Sanction Guideline range even though KCD’s violation was egregious and could warrant an even greater sanction. Current management then has the opportunity going forward to improve the Firm’s compliance function, cognizant of the importance of doing so.

¹²² Guidelines, at 24.

¹²³ *Id.*

¹²⁴ The Principal Considerations applicable in all cases include a concern whether the respondent demonstrated reasonable reliance on competent legal advice. Guidelines at 6, Principal Consideration 7. Here the Firm not only did not rely on advice of counsel but acted contrary to counsel’s express concerns.

¹²⁵ Guidelines at 7, Principal Consideration 13.

¹²⁶ Guidelines at 6, Principal Consideration 5.

¹²⁷ Guidelines at 7, Principal Consideration 17.

VI. ORDER

For violating NASD Rule 2210 regarding member communications with the public and FINRA Rule 2010 regarding ethical conduct, as alleged in the First Cause of Action, KCD Financial, Inc. is censured and fined \$40,000.

For violating NASD Rule 3010 and FINRA Rule 2010 by unlawfully selling non-exempt unregistered securities, KCD Financial, Inc. is censured and fined \$75,000.

The Firm is also ordered to pay costs, which amount to \$5556.48, including a \$750 administrative fee and the cost of the transcript.¹²⁸ The fines and assessed costs shall be due on a date set by FINRA, but not sooner than thirty days after this decision becomes FINRA's final disciplinary action in this proceeding.

Lucinda O. McConathy
Hearing Officer
For the Hearing Panel

¹²⁸ The Hearing Panel has considered and rejects without discussion any other arguments made by the Parties that are inconsistent with this decision.