FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. MSC – BD, LLC (BD No. 142927), and PAUL J. McINTYRE (CRD No. 1002368), Respondents.	Disciplinary Proceeding No. 2011025679201 Hearing Officer - DMF **EXTENDED HEARING PANEL DECISION** October 2, 2015

The Department of Enforcement did not prove, by a preponderance of the evidence, that Respondents fraudulently misrepresented or omitted material facts in a Private Placement Memorandum, in violation of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, or FINRA Rules 2020 and 2010, or, alternatively, that they negligently misrepresented or omitted material facts from the Private Placement Memorandum, in violation of FINRA Rule 2010. Enforcement also did not prove, by a preponderance of the evidence, that the individual Respondent misused investor funds, in violation of FINRA Rule 2010. Accordingly, all charges in the Complaint are dismissed.

Appearances

Rebecca L. Segrest, Esq., Jennifer M. Sepic, Esq., and David B. Klafter, Esq., for the Department of Enforcement.

Alan M. Wolper, Esq. and Christopher D. Seps, Esq., Ulmer and Berne, LLP, for the Respondents.

DECISION

I. Introduction and Summary

The Department of Enforcement's Complaint charged that Respondents MSC – BD, LLC (the "Firm") and Paul J. McIntyre ("PJM"), who was the owner, CEO and Chief Compliance Officer of the Firm at the relevant time, made fraudulent or negligent misrepresentations and omissions of material facts in a private placement offering of interests in a company formed to purchase, complete, and operate a marina project. The marina was in foreclosure following a prior private offering in which the Firm and PJM had also been involved. Enforcement also charged PJM with improperly returning funds to one investor.

In 2008, the Firm and PJM marketed and sold an unregistered private placement offering of investment notes to accredited investors ("the First Offering"). The purpose of the First Offering was to raise funds for the ongoing development of a marina in Florida. The First Offering notes were secured by a second mortgage on the marina property and by the personal guarantees of four individuals, including the owner of the marina developer (the "Primary Guarantor").

By spring 2009, the bank that held the first mortgage on the marina property had declared its loan in default and the First Offering investors were no longer receiving interest payments on their notes. The bank began foreclosure proceedings, and a trustee representing the First Offering investors' interests filed a cross-claim in those proceedings to enforce the personal guarantees securing the First Offering notes.

PJM, having obtained an appraisal that placed a value on the marina, if completed, far in excess of the development's total indebtedness, worked diligently to find a way to complete construction of the marina for the benefit of the First Offering investors. Initially, he sought construction funding from large potential investors and formulated work-out proposals that he presented to the Primary Guarantor, but in light of the economic circumstances that existed in 2009, he was unable to attract any large investors to the project and the Primary Guarantor rejected his work-out proposals.

PJM then approached the bank that held the first mortgage and negotiated a potential buy-out of the bank's interest that might allow for the completion of the marina project without the participation of the Primary Guarantor and his development company. He also entered into a contract with a construction manager to complete the marina if the buy-out of the bank's interest was successful.

To raise funds to buy out the bank's interest and complete construction of the marina, PJM initiated a second unregistered private placement (the "Second Offering") to offer membership units in a limited liability company (the "Company") to accredited investors. To accomplish that goal, the Second Offering sought to raise a maximum of $13 million from investors. As a part of the Second Offering, the First Offering investors assigned all their rights

to the Company, including their rights under the second mortgage and guarantees securing their notes, in exchange for subordinated interests in the Company.

The Private Placement Memorandum ("PPM") for the Second Offering disclosed numerous circumstances relating to the prior history of the development. It disclosed the bank's first mortgage interest in the marina property, and that the mortgage was in foreclosure. It disclosed the First Offering; the second mortgage held by the First Offering investors; and the risk that the First Offering investors would lose their investments as a result of the bank's foreclosure action. It also disclosed that the First Offering investors would be offered interests in the Company in exchange for assignments of their rights, including their rights against the guarantors, and that, based on those assignments, the Company would pursue litigation against the guarantors of the First Offering notes for the benefit of the Company.

The PPM also contained numerous disclosures regarding PJM's roles relating to the Second Offering. It disclosed that a firm owned by PJM would serve as the manager of the Company in exchange for subordinated interests in the LLC. It disclosed that a registered investment advisor that PJM owned would provide services to the Company and would receive fees of up to 3% of the selling price of the units sold in the Second Offering. It disclosed that the manager owned by PJM might enter into contracts with other affiliated firms to provide other services to the Company. The PPM also disclosed that PJM was serving as the trustee for the trust that had been charged with protecting the rights of the First Offering investors, including pursuing the litigation against the guarantors—rights that the First Offering investors would assign to the Company as part of the Second Offering.

Although the PPM stated that the Second Offering's primary objective was to raise funds to purchase the bank's interest and complete construction of the marina, it also provided that if the Second Offering did not raise sufficient funds to purchase the first mortgage, PJM would have discretion to terminate the Second Offering and return all remaining cash to the investors, except for funds needed to pursue the litigation against the guarantors on behalf of the Company.

Ultimately, the Second Offering did not raise enough money to purchase the first mortgage. In August 2010, in accordance with the terms of the PPM, PJM terminated the Second Offering and returned 45% of their investments to all but one of the investors. The balance of the investors' funds was used to pay expenses of the Company, including attorneys' fees in the litigation against the guarantors. Ultimately, the litigation was unsuccessful because the Primary Guarantor filed for bankruptcy and the other guarantors proved to be uncollectible.

One investor, who was PJM's customer, was treated somewhat differently than the other Second Offering investors. In October 2009, PJM's customer submitted a $25,000 subscription to invest in the Second Offering, but in the following month PJM returned $20,000 of the proposed investment on suitability grounds. In August 2010, when he returned 45% to the other investors, PJM returned the customer's remaining $5,000 Second Offering investment.

Neither the First Offering investors nor the Second Offering investors received any additional returns on their investments. Nevertheless, no investor has made any complaint or filed any claim against Respondents. When a FINRA examiner sought information from Second Offering investors, none responded to his mailings, and only one, who did not express dissatisfaction with his investment, responded to the examiner's telephone messages.

On December 11, 2014, the Department of Enforcement filed a three-cause Complaint initiating this proceeding. In the first cause, Enforcement alleged that Respondents fraudulently misrepresented or failed to disclose material facts in the Second Offering PPM. Specifically, Enforcement asserted that Respondents failed to disclose: (1) their involvement in the marketing and sale of the First Offering; (2) that PJM was receiving compensation from the Company for serving as trustee of the trust that was pursuing the litigation against the guarantors of the First Offering notes; (3) that the main purpose of the Second Offering was to raise funds to pay for the litigation against the guarantors and recoup the losses of the First Offering investors; and (4) the anticipated costs of the litigation against the guarantors. Enforcement charged that Respondents thereby violated Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010. In the second cause, Enforcement alleged, as an alternative to the first cause, that Respondents negligently misrepresented or omitted to disclose the same facts, in violation of FINRA Rule 2010. Finally, in the third cause Enforcement alleged that PJM misused investor funds, in violation of FINRA Rule 2010, by returning the full amount of one investor's Second Offering investment, while refunding only 45% to the other investors.

A hearing on Enforcement's allegations was held in Chicago, Illinois, before an Extended Hearing Panel on July 27 and 28, 2015. The Panel heard testimony from four witnesses, including PJM; GC, an attorney who advised PJM regarding the Second Offering; JL, an individual who prepared an independent due diligence memorandum on the Second Offering that was provided to selling broker-dealers; and a FINRA examiner.[1] The Panel also received numerous documents in evidence, and the Panel considered Joint Stipulations of Fact entered into by the parties, as well as the parties' extensive pre-hearing briefing.

Based on careful consideration of these materials, the Panel concludes:

(1) Enforcement failed to prove that, in light of the extensive disclosures in the PPM, as well as the structure of the Second Offering, a disclosure of Respondents' involvement in the

[1] PJM responded directly to all questions and his answers were consistent with contemporaneous documents offered in evidence. The Panel found him to be a credible witness. GC is an experienced securities attorney who paid his own expenses to the hearing in order to testify before the Panel. His testimony was consistent with PJM's testimony and with the contemporaneous documents in all material respects, and the Panel found him to be a credible witness. JL's involvement in the Second Offering was limited to reviewing documents and preparing an independent due diligence report. While his testimony was credible, it did not add significantly to the other evidence in the record. The FINRA examiner was also a credible witness, but had no personal knowledge of the circumstances relating to the alleged misconduct.

marketing and sale of the First Offering would have been material to reasonable Second Offering investors, or that the failure to make that disclosure caused the PPM to be misleading.

(2) In light of the PPM's disclosures regarding PJM's service as trustee and the PPM's disclosures of numerous other financial benefits to PJM from the Second Offering, Enforcement failed to prove that the fact that PJM would be compensated by the Company for his trustee services which were for the benefit of the Company, would have been material to reasonable Second Offering investors, or that the failure to make that disclosure caused the PPM to be misleading.

(3) The weight of the evidence indicated that the main purpose of the Second Offering was to raise funds to purchase the first mortgage and complete the construction of the marina, as stated in the PPM, and that the pursuit of litigation to enforce the guarantees, which were assets of the Company, was only a secondary goal. Further, because the First Offering investors received only subordinated interests in the Company, the Second Offering investors would have been the primary beneficiaries of any recoveries in the litigation. Under these circumstances, Enforcement did not prove that Respondents failed to disclose the main purpose of the Second Offering, or that they misrepresented or omitted any material facts in that regard.

(4) The pro forma financial statements in the PPM disclosed anticipated legal costs to the Company of $300,000, and Enforcement did not allege or prove that this estimate was unreasonable. And while the PPM did not break out the anticipated costs of the litigation against the guarantors, Enforcement cited no authority requiring such a break-out, and it failed to demonstrate that such a break-out would have been material to reasonable investors in the Second Offering or that the failure to include such a break-out caused the PPM to be misleading.

(5) Insofar as any of the omissions alleged in the Complaint could be considered material, Enforcement failed to prove that Respondents acted with scienter or were negligent in not making the disclosures. The Panel notes that PJM circulated numerous drafts of the PPM for comments and proposed revisions to: (a) three attorneys, including GC, an experienced, independent securities attorney; (b) investors in the First Offering; (c) broker-dealers that PJM hoped would market the Second Offering; and (d) JL, who prepared an independent due diligence report on the Second Offering. PJM received numerous comments and suggested revisions to the PPM, particularly from GC, and adopted the material ones. Enforcement offered no evidence that any of the reviewers suggested that PJM should add any of the disclosures that Enforcement contends were improperly omitted from the PPM. The Panel concludes that PJM acted in good faith in promulgating the PPM without the disclosures Enforcement cited and that, insofar as any material facts were omitted, the omissions were not attributable to intentional, reckless, or negligent conduct by Respondents.

(6) Finally, Enforcement failed to prove that PJM misused investor funds by returning one investor's entire investment in the Second Offering. PJM had authority under the PPM to reject proposed investments in the Second Offering on suitability grounds. Accordingly, his return of $20,000 of the investor's proposed investment on that basis was not improper. PJM

testified credibly that he returned the remaining $5,000 balance in full in August 2010 rather than 45% of the balance because the administrative and accounting costs of retaining 55% of that amount ($2,750) were prohibitive. The Panel finds that he had authority to make such a determination under the terms of the PPM.

Accordingly, all charges in the Complaint will be dismissed.

II. Findings of Fact

A. Respondents

Respondent Firm has been a FINRA member since June 2007. The Firm was previously based in Florida, but is currently headquartered in Oregon. The Firm has two branch offices and 11 registered persons. Until 2011, the Firm was owned by Respondent PJM and operated under another name. The Firm has never been the subject of any regulatory action or any customer complaint. The Firm is subject to FINRA jurisdiction pursuant to Article IV of FINRA's By-Laws.[2]

Respondent PJM first entered the securities industry in 1979. He became registered as an investment company and variable contracts products representative (Series 6) in 1981 and subsequently qualified as a general securities representative (Series 7) and as a general securities principal (Series 24). During the period at issue, PJM owned the Firm and served as its CEO and Chief Compliance Officer. Although PJM no longer owns the Firm, he remains registered with the Firm and serves as its Chief Compliance Officer. PJM has no prior disciplinary record. PJM is subject to FINRA's jurisdiction pursuant to Article V of FINRA's By-Laws.[3]

In addition to his role with the Firm, PJM is, and at the relevant time was, an Investment Advisor through a Registered Investment Advisory firm ("RIA") that he owns.[4] As discussed below, the RIA was involved in the Second Offering, and PJM served in other significant roles, as well.

B. The First Offering

In 2008, Respondents marketed and sold the First Offering, which consisted of "Twelve Percent (12%) Participating Secured Notes" to provide additional funding for the construction of a marina (the "CR Marina") in Florida. The offering was an unregistered private placement and, accordingly, was sold only to accredited investors. The Firm and PJM sold some, but not all, of

[2] Joint Stipulations of Fact ("Stip.") ¶¶ 1-2; Joint Exhibit ("JX")-1; Hearing Transcript ("Tr.") 19, 147.

[3] Stip. ¶¶ 3-5; Complainant's Exhibit ("CX")-1; Tr. 18-19, 145-46.

[4] Stip. ¶ 3; Tr. 20.

the First Offering notes. Some of the notes were purchased by investment funds managed by PJM's RIA.[5]

The First Offering notes were secured by a second mortgage on the CR Marina. A trust (the "CR Trust") was established to act as the mortgagee on behalf of the First Offering investors, and a local attorney was appointed as the trustee (the "CR Trustee"). The notes were also secured by personal guarantees from the Primary Guarantor and three other individuals. The CR Trust empowered the CR Trustee to act for the investors with respect to the guarantees. The First Offering raised approximately $3.1 million from approximately 49 investors.[6]

The initial funding for the CR Marina came from the Primary Guarantor's personal funds and a bank loan to the developer secured by a first mortgage on the CR Marina property. After a portion of the construction had been completed, and subsequent to the sale of the First Offering notes, the bank declared the developer in default on the loan. The Primary Guarantor sought to obtain alternative funding for the project, without success. Interest payments on the First Offering investors' notes ended by the first quarter of 2009.[7]

The bank began proceedings to foreclose its first mortgage on the marina property. In those proceedings, the bank named the CR Trustee as a defendant because of the second mortgage securing the First Offering notes. The CR Trustee, in turn, filed a cross-claim in the foreclosure litigation to enforce the personal guarantees of the Primary Guarantor and the other individuals securing the notes (the "Guarantor Litigation").[8]

PJM still hoped to salvage the First Offering investments. In January 2009, he obtained an appraisal of the CR Marina for the CR Trust. The appraisal stated an "as is" value of $18 million and an "as complete" value of more than $74 million. In contrast, the amount due on the first mortgage loan was less than $9 million. Thus, based on the appraisal, the property was worth more than twice the amount of the first mortgage loan even in its incomplete state, and it would be worth eight times the amount of the first mortgage loan if it were completed. Nevertheless, if the first mortgage was foreclosed, the First Offering investors' second mortgage might be valueless, and recovery in the Guarantor Litigation for the benefit of the First Offering investors was dependent on the guarantors' ability to satisfy the guarantees. Accordingly, PJM

[5] Stip. ¶ 6; Tr. 31-32, 68, 156, 158; JX-85.

[6] Stip. ¶ 6; JX-11; JX-81; JX-82; Respondents' Exhibit ("RX")-7; Tr. 29, 31, 43, 157-61, 164. The Primary Guarantor provided financial statements showing that his net worth of $59 million as of June 2007. A subsequent financial statement, however, showed that his net worth had fallen to $33.5 million as of June 2008. Moreover, his assets were primarily illiquid. Tr. 155; RX-6.

[7] Tr. 34-35, 154, 156-57, 164; JX-13; JX-36; JX-38; RX-44.

[8] Tr. 34-35, 154, 164-66; JX-12; JX-13.

concluded that it would be in the First Offering investors' best interests to complete the marina project.[9]

PJM first sought to work out an arrangement with the Primary Guarantor to complete the marina project, and sought funding in several quarters. The Primary Guarantor, however, ultimately rejected PJM's proposals.[10]

In the meantime, the bank's lawsuit to foreclose the first mortgage on the marina property continued, as did the Guarantor Litigation. The attorney who was serving as the CR Trustee and representing the interests of the First Offering investors in the Guarantor Litigation resigned and was replaced by another local attorney. In June 2009, the First Offering investors selected PJM to succeed that attorney as the CR Trustee.[11]

By summer 2009, PJM concluded that the best way to salvage the First Offering investment was to raise funds to purchase the bank's first mortgage position and complete the project without the participation of the Primary Guarantor. He conveyed his views to the First Offering investors and they agreed with his approach.[12]

C. The Second Offering

Initially, PJM sought funding to purchase the bank's interest from large real estate investors, but in light of the state of the economy at that time and their need to protect their existing investments, none was willing to provide the necessary funding on terms that would preserve and protect the interests of the First Offering investors. After he was unsuccessful in finding a large investor, PJM decided to attempt to raise the funds needed to purchase the bank's interest and complete the project through the Second Offering. For that purpose, he created the Company as the private placement investment vehicle.[13]

Completion of the marina project would be possible only if the Company could obtain ownership of the marina property. To that end, PJM negotiated an agreement with the bank that would allow the Company to purchase the bank's first mortgage position at a discounted price, provided that the transaction was closed by the end of 2009. He also entered into an agreement with a construction manager to oversee completion of the construction of the marina without the involvement of the original developer.[14]

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[9] Tr. 184-88, 201-02; RX-42; JX-13; JX-43.

[10] Tr. 44-50, 188-95; JX-36; JX-37; JX-38; JX-39; RX-43.

[11] Tr. 167-72, 175-76; JX-12; JX-13; RX-41.

[12] Tr. 56-59, 195, 203-04, 208-10; JX-40; JX-43.

[13] Tr. 51-56, 275-77; JX-13.

[14] Tr. 25-26, 62, 195-98, 213-15, 220-21; RX-53; RX-108; JX-6; JX-48; JX-49.

PJM prepared a PPM to solicit investors for the Second Offering.[15] While PJM acknowledged that he had final authority over the content of the PPM, he circulated drafts of the PPM to three attorneys; investors in the First Offering; broker-dealers that he hoped would market the Second Offering; and JL, who prepared an independent due diligence report on the Second Offering for the selling broker-dealers, seeking comments and proposed revisions.[16] GC, a highly experienced securities attorney, was the primary PPM reviewer.[17] GC reviewed numerous drafts of the PPM and provided extensive edits and comments to PJM, nearly all of which PJM adopted.[18] PJM also received comments on the PPM from DM, another experienced attorney, and he had the PPM reviewed by the attorney representing the CR Trust in the Guarantor Litigation. The PPM went through at least 11 drafts before it was finalized.[19]

The finalized PPM, dated September 29, 2009, explained that an investment in the Company was available only to accredited investors, carried a high degree of risk, and should be made only by persons who were able to withstand the total loss of their investment. The PPM stated that the Company intended to acquire, build, and operate a marina, and included numerous disclosures relating to the impediments to accomplishing that goal, including the fact that the Company did not yet own the property, but planned to obtain control of the project by purchasing the bank's note and first mortgage.[20]

The PPM disclosed that the First Offering had occurred, the pending foreclosure litigation initiated by the bank, the second mortgage position held by the First Offering investors, and the risk that the First Offering investors might lose their entire investments if the bank foreclosed its first mortgage. The PPM disclosed that PJM was serving as the CR Trustee, for the benefit of the First Offering investors, and was involved in the foreclosure litigation in that role. The PPM disclosed that the First Offering investors would be given an opportunity to assign their rights to the Company in exchange for interests in the Second Offering, and that, based on preliminary contacts with the First Offering investors, PJM believed they would utilize that opportunity. The PPM disclosed that, assuming the First Offering investors assigned their rights as expected, the Company would be pursuing the Guarantor Litigation and that the outcome of that litigation was uncertain.[21]

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[15] PJM testified he was not acting on behalf of the Firm in preparing the PPM, and his testimony in that regard is supported by evidence that the Company paid the RIA, not the Firm, for PJM's work on the PPM. Tr. 148, 152, 241; JX-24, at 3.

[16] Tr. 23, 240.

[17] Tr. 372-75.

[18] Tr. 23-24, 54, 59-61, 248-49, 255, 260-61; JX-42; JX-47; JX-51; JX-54; JX-56; RX-105.

[19] Tr. 23, 64, 242, 248-55, 267-70; JX-54; JX-55; RX-93; RX-103; RX-105; RX-108; RX-119.

[20] JX-3, at 3, 19.

[21] JX-3, at 3, 8-9, 19.

On advice of GC, PJM created a new entity (the "Manager"), which he owned and controlled, to manage the Company.[22] The PPM identified the Manager, disclosed that PJM was President of the Manager, and gave the Manager very broad authority over the Company.[23] Indeed, the PPM explained that "[t]he Manager has the exclusive authority to manage and control all aspects of the Company's business," and advised potential investors:

> The Company is, and for the foreseeable future will be, dependent upon the services and the financial strength of the Manager. All decisions regarding management of the Company's affairs will be made exclusively by the Manager. Accordingly, the investor should not buy units unless the investors are willing to entrust all aspects of management to the Manager or its successor(s).[24]

The PPM also identified PJM's RIA as an advisor and stated that the Manager had engaged the RIA "to provide administrative, accounting and advisor services to the Company," for which the Company would pay the RIA an administrative fee of up to 3% of the selling price of units sold in the Second Offering.[25] The PPM did not directly refer to the Firm, but it did disclose that the RIA was an affiliate of the Manager and authorized the Manager to employ such additional affiliates "as it deems necessary for the efficient operation of the Company."[26] In fact, the Firm's role in the Second Offering was limited to serving as wholesaler, for which it received a $7,000 fee, and selling, through PJM, an investment in the Second Offering to one customer, as described in more detail below.[27]

The Second Offering did not raise sufficient funds to complete the purchase of the first mortgage from the bank by December 30, 2009. Indeed, by that date the offering had raised only $300,000.[28] Nevertheless, PJM continued the offering, and for that purpose he prepared a revised PPM, dated January 6, 2010. The revised PPM contained the disclosures and warnings that were in the initial PPM, and continued to give PJM plenary authority over the Company's operations, but it differed from the initial PPM in certain respects. Most notably, the amount that the Second Offering was seeking to raise was lowered from $13 million to $7 million. In

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[22] Stip. ¶ 7; Tr. 217; JX-44, at 2.

[23] The PPM acknowledged that the Manager was constrained by its fiduciary responsibilities to the Company when exercising its authority. JX-3, at 29. Enforcement did not allege that PJM breached his fiduciary duties to the Company.

[24] JX-3 at 8, 14, 42.

[25] JX-3, at 8.

[26] JX-3, at 42, 55; Tr. 241.

[27] Tr. 96, 109-10, 148-49; JX-24, at 4.

[28] CX-1; Tr. 275. The PPM disclosed that early investors in the Second Offering would be at greater risk than later investors because the funds they invested would be released immediately to the Company, which would use them to pay expenses, including reimbursing PJM for expenses he had incurred on behalf of the Company. JX-3, at 18.

addition, the prior agreement with the bank to purchase the first mortgage having expired at the end of 2009, the revised PPM stated that the Company "intends to sign an agreement with [the bank] to purchase the First Mortgage and Note from the Bank at a discount or purchase the project at foreclosure." After noting that the 2008 appraisal had placed an "as-is" value of $18 million on the property, the revised PPM stated: "The Company believes that it can gain control of the Project and complete it for approximately $7 million of new investor capital."[29]

Although the Second Offering attracted some additional investors, it did not come close to raising $7 million. In addition to the general economic conditions at the time, the *Deepwater Horizon*, or BP, oil spill occurred beginning in spring 2010. Among its other impacts, the spill severely undercut the demand for marinas on the Gulf Coast of Florida. In August 2010, the Second Offering having raised only $475,000, PJM concluded that it would not be possible to raise enough funds through the Second Offering to purchase the bank's interest.[30]

Both the PPM and the revised PPM provided that if the Second Offering failed to raise sufficient funds to purchase the bank's first mortgage, the Manager, in its discretion, could terminate the offering and return any remaining cash to the investors, except for a legal reserve to pursue the Guarantor Litigation. In accordance with this provision, when he terminated the Second Offering, PJM returned to Second Offering investors 45% of their original investments. The remaining 55% was used to pay costs incurred by the Company. Those costs included $30,000 that PJM charged the Company for his services as the CR Trustee, as well as more than $100,000 in fees paid to PJM's RIA for administrative and accounting support, in accordance with the PPMs. During its existence, the Company also paid legal fees totaling approximately $40,000, of which less than $30,000 was paid to the attorney representing the CR Trust in the Guarantor Litigation.[31]

Although the Second Offering investors generally received a return of 45% of their investments, one investor, EM, received a return of all of his Second Offering investment. EM, a customer of the Firm and PJM, had invested $100,000 in the First Offering. In October 2009, EM sent PJM a subscription agreement for a $25,000 investment in the Second Offering, together with a check for that amount and an assignment of his First Offering rights. PJM initially accepted EM's Second Offering subscription on November 9, 2009, but PJM quickly concluded that, in light of EM's prior investment in the First Offering, which he had assigned to the Company, an additional $25,000 investment in the Second Offering would cause EM to be unduly concentrated in a single investment. PJM therefore sent EM a check dated November 13,

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[29] Stip. ¶¶ 10-11; JX-4; Tr. 27-28.

[30] Tr. 275-78.

[31] Stip. ¶¶ 28-29; Tr. 88, 91-102, 285-88; CX-6; CX-10; CX-12; JX-7; JX-8; JX-23; JX-24; JX-33.

2009, returning $20,000, along with a letter explaining that EM had already been generous with his support for the marina project.[32]

After PJM returned the $20,000, EM retained a Second Offering investment of $5,000. In August 2010, when PJM refunded 45% of the other Second Offering investors' funds, he refunded the entire $5,000 to EM. PJM testified that he did so because if he had retained 55% of EM's $5,000 ($2,750), the accounting and administrative costs to the Company for maintaining such a small account would have been prohibitive. EM was the only Firm customer who invested in the Second Offering.[33]

The litigation against the four guarantors of the First Offering notes concluded unsuccessfully when the Primary Guarantor filed for bankruptcy and the remaining three guarantors proved to be uncollectable.[34] No investor in either the First Offering or the Second Offering has filed any complaint or claim against either PJM or the Firm.[35]

D. The FINRA Examination and Investigation Leading to the Complaint

In August 2011, FINRA began a routine cycle examination of the Firm. In response to pre-exam questions, the Firm indicated that the Second Offering was the only private offering that the Firm had been involved in during the period of the exam. Accordingly, the examiners reviewed the Firm's participation in that offering.[36]

In December 2011, the lead examiner sent a letter to Respondents, pursuant to FINRA Rule 8210, requesting answers to several questions regarding the Second Offering. The following day, PJM responded on behalf of Respondents. Most significantly, in response to a question asking about the "[p]rimary goal for raising capital" in the Second Offering, PJM responded: "The goal was twofold: a) Acquire first mortgage from [the bank] so as to protect

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[32] Tr. 78-80, 114-22, 297-98; JX-21; JX-87; JX-94; JX-95; JX-96. EM did not receive the November 13 check, so the Company placed a stop order on that check and issued EM another check in December 2009, which EM cashed. Tr. 115-16, 122; JX-21. The copy of the letter to EM received in evidence was not a copy of the original, but was printed and given to Enforcement during the investigation. That copy bore the date in 2012 when it was printed, but all parties agreed that the date on the copy received in evidence was erroneous and that, in fact, the letter was sent to EM when the $20,000 was first refunded in November 2009. Tr. 121, 502-03; JX-96.

[33] Tr. 81-82, 114-27, 299-300; JX-21; JX-23; JX-94, JX-96. After FINRA raised a concern that EM had been treated more favorably than the other Second Offering investors, EM elected to reimburse the Company 55% of his original $25,000 subscription. He accomplished that by paying outstanding fees of the attorney representing the CR Trust for the Company's benefit in the Guarantor Litigation. Tr. 126, 128, 302; JX-89; JX-91.

[34] Tr. 129-31.

[35] Tr. 147, 290.

[36] Tr. 134-35.

the capital interests of second mortgage investors; and b) Provide capital to litigate against four guarantors of the second mortgage, primarily [Primary Guarantor], the primary developer."[37]

During the examination, the examiner sent letters to all of the Second Offering investors indicating that FINRA was reviewing the sales of the Second Offering and asking each investor to complete a questionnaire. None of the investors responded to the letters. The examiner then left telephone messages for all the Second Offering investors. Only one investor returned the examiner's call. According to the very brief notes that the examiner made of his conversation with the investor, the investor understood that the funds obtained from the Second Offering would be used to complete the construction of the marina, but would also be used to fund the lawsuit against the guarantors. The examiner's notes do not indicate that the investor had any complaints about the investment.[38] Further, Enforcement offered no evidence that any investor in the First Offering or the Second Offering has ever registered any complaint with the Firm or any regulator, including FINRA, or has ever commenced any arbitration proceeding or lawsuit against Respondents or anyone else regarding their investments in the First Offering or the Second Offering.

In June 2012, FINRA examination staff sent Respondents a report on the examination that had begun in August 2011. The report included an "exception" indicating that the examiners believed that PJM had "failed to provide full and fair disclosure to customers of the [Second Offering]" because (1) the PPM for the Second Offering "failed to include adequate disclosure relating to the intent to use customer monies to fund litigation against the personal guarantors of the [First Offering]"; (2) the PPM "failed to adequately disclose [PJM's] role in the [First Offering]"; (3) PJM "failed to disclose to all investors that one investor … received a 100% refund …"; and (4) "[t]he PPM failed to disclose that [PJM] would be compensated $2,000 per month for duties performed in his role as Trustee for the [First Offering]." The exception also indicated that the examiners believed that PJM had acted outside his authority under the PPM by giving one investor a full refund of the funds he had invested in the Second Offering. The exception asserted that PJM had thereby violated FINRA Rule 2010, but it did not assert that PJM had committed fraud, or that the Firm had committed any violation of FINRA rules. A letter accompanying the report stated that the examination staff had referred the exception to Enforcement "for its review and disposition."[39]

Thereafter, Enforcement conducted its investigation, leading to it filing the Complaint in this proceeding on December 11, 2014. The allegations in the Complaint were similar to those

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[37] Tr. 134-36; JX-8.

[38] Tr. 136, 143; JX-29. The examiner's notes of his conversation with the customer state, "Not disclosed that [EM] received full refund," but they do not indicate that the examiner explained the circumstances of the payments to EM, or that the customer expressed displeasure or concern about the refund to EM. JX-29, at 3.

[39] CX-3 at 1, 5.

set forth in the June 2012 examination report, but Enforcement alleged that the asserted misrepresentations or omissions in the PPM were fraudulent or negligent, and that the Firm, as well as PJM, was responsible for them.

III. Conclusions of Law

A. Enforcement's Charges Against Respondents

The Complaint asserts three causes of action based on Respondents' involvement in the Second Offering. The first cause of the Complaint charges that Respondents made fraudulent misrepresentations or omissions in the PPM and the revised PPM, in violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010. Specifically, the Complaint alleges that "the PPMs do not disclose: (a) the failed [First] Offering was marketed and sold by [the Firm and PJM]; (b) [PJM], who was serving as trustee for the failed [First] Offering while selling the [Second] Offering, was receiving compensation from the [Second] Offering in his capacity as trustee; (c) the main purpose of the [Second] Offering was to pay for litigation against guarantors of the [First] Offering and recoup the losses of investors in the [First] Offering; or (d) the anticipated costs of the litigation."[40] The second cause of the Complaint charges, as an alternative to the first cause, that Respondents negligently made the same alleged misrepresentations or omissions, and thereby violated FINRA Rule 2010.[41]

The third cause of the Complaint alleges that PJM's return of EM's entire $25,000 subscription to the Second Offering was contrary to the Operating Agreement, which was made a part of both PPMs. Specifically, Enforcement relies on a provision of the Operating Agreement stating that "[n]o member shall have priority over any other member as to the return of capital contributions, distributions, or allocations unless otherwise provided in this operating

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[40] Complaint ("Compl.") ¶ 38. Although the Complaint includes the words "for example," suggesting the possibility that Enforcement might have sought to prove additional alleged misrepresentations and omissions, at the final pre-hearing conference Enforcement explained that it was relying only on the alleged misrepresentations and omissions specifically set forth in Paragraph 38, and at the hearing Enforcement limited its case accordingly.

[41] As filed, the second cause of the Complaint alleged that Respondents violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, which prohibit "in the offer of sale of any securities … material misstatements or omissions to obtain money or property," or engaging in "any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser," but the second cause did not specifically allege that Respondents' conduct was negligent. Compl. ¶¶ 42-46. In its pre-hearing submission and its final argument at the hearing, however, Enforcement did not cite Sections 17(a)(2) and 17(a)(3) of the Securities Act or offer any basis for the Panel to conclude that Respondents violated those provisions. Instead, Enforcement argued, with respect to the second cause, that Respondents negligently misrepresented or omitted to disclose material facts and thereby violated Rule 2010. Enforcement's Pre-Hearing Brief, at 24; Tr. 499. Accordingly, the Panel concludes that Enforcement abandoned any reliance on Sections 17(a)(2) and 17(a)(3) of the Securities Act. In any event, the Panel's reasons for concluding that Enforcement failed to prove, by a preponderance of the evidence, that Respondents negligently misrepresented or omitted material facts, in violation of Rule 2010, as set forth below, would also lead it to conclude that Enforcement did not prove that Respondents violated Sections 17(a)(2) or 17(a)(3).

agreement."[42] Enforcement charges that by returning all of EM's subscription, rather than the 45% returned to the other investors, PJM violated this provision, and thereby misused investor funds, in violation of FINRA Rule 2010.

B. Alleged Fraudulent Misrepresentations and Omissions

Section 10(b) of the Exchange Act makes it unlawful "to use or employ, in connection with the purchase or sale of any security … any … deceptive device or contrivance." Rule 10b-5 implements this provision by prohibiting "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." In particular, Rule 10b-5 makes it unlawful to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." FINRA Rule 2020 similarly prohibits any FINRA member or associated person from "effect[ing] any transaction in … any security by means of any … deceptive or other fraudulent device or contrivance."[43] Thus, to prevail on the first charge in the Complaint, Enforcement was required to prove, by a preponderance of the evidence, that: (1) Respondents misrepresented facts in the PPMs or omitted to disclose facts necessary to prevent the PPMs from being misleading; (2) the misrepresented or omitted facts were material to investors in the Second Offering; and (3) Respondents acted with scienter, *i.e.*, they made the misrepresentations either intentionally or recklessly.[44]

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[42] JX-3, at 49; JX-4, at 50; Compl. ¶ 48.

[43] Rule 2010 provides: "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." It is well settled that a violation of another FINRA rule is a violation of FINRA Rule 2010. *See William J. Murphy*, Exchange Act Release No. 69923, 2013 SEC LEXIS 1933, at *26 (July 2, 2013), *aff'd sub nom. Birkelbach v. SEC*, 751 F.3d 472 (11th Cir. 2014) (noting that the violation of another Commission or FINRA rule or regulation constitutes a violation of FINRA Rule 2010).

[44] It was undisputed that any misrepresentations or omissions in the PPM were made in connection with the purchase or sale of securities. Similarly, it was undisputed that the PPMs for the Second Offering were distributed through interstate commerce, as required to establish a violation of Section 10(b) and Rule 10b-5. Stip. ¶¶ 24-25.

In this case, Enforcement focuses on circumstances not disclosed in the PPM and revised PPM. Therefore, it is necessary to first consider whether Enforcement proved that each omitted circumstance was "a material fact necessary in order to make the statements made … not misleading." Further, insofar as an omission was materially misleading, it is necessary to consider whether Enforcement proved that Respondents acted with scienter.[45]

"Whether information is material is dependent upon the significance the reasonable investor would place upon the representation. … A fact is material if there is a substantial likelihood that a reasonable investor would have considered the fact important in making an investment decision, and disclosure of the omitted fact would have significantly altered the total mix of information available."[46] In its pre-hearing submission, Enforcement simply asserted that all of the omissions it cited were "clearly material," without any further explanation.[47] In final argument at the hearing, however, Enforcement counsel attempted to address why the alleged omissions were material.

The first omitted circumstance cited by Enforcement was Respondents' involvement in the First Offering. Respondents do not dispute that the PPMs did not disclose that PJM and the Firm took part in the marketing and sale of the First Offering, but they deny it was a material omission from the PPMs.[48] In closing argument, Enforcement counsel argued that information about Respondents' involvement in the First Offering would have been material to Second Offering investors because the First Offering investors were upset about their losses and had

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[45] Respondents argue that, in any case, they did not "make" any statements or omissions in the PPMs, citing *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S.Ct. 2296 (2011). They contend that, under *Janus*, the responsibility for misrepresentations or omissions in the PPMs lies with the Company, as the issuer of the PPMs. Respondents contend that the Firm had no role whatsoever in the creation of the PPMs, and that even PJM, who admits he had final responsibility for the content of the PPMs, is not responsible for any misrepresentations or omissions under *Janus*. Further, Respondents argue that because PJM's involvement in the preparation of the PPMs was on behalf of his RIA, not the Firm, his actions in that regard are not subject to FINRA disciplinary action.

Because the Extended Hearing Panel finds that Enforcement did not prove that the PPMs misrepresented or omitted any material facts or that, insofar as any material facts were omitted, Respondents acted with scienter, it finds it unnecessary to address these arguments. The Panel notes, however, that the National Adjudicatory Council addressed the significance of *Janus* in FINRA disciplinary proceedings in *Dep't of Enforcement v. Fillet*, No. 2008011762801, 2013 FINRA Discip. LEXIS 26, at *22-29, 37-41 (NAC Oct. 2, 2013), and concluded, *inter alia*, that a respondent can be found to have violated FINRA Rule 2020 even if the respondent did not "make" fraudulent statements. Further, with regard to FINRA's authority to discipline PJM actions taken on behalf of his RIA rather than the Firm, the Panel notes that it is well established that FINRA Rule 2010 applies to all business-related conduct of an associated person.

[46] *Dep't of Enforcement v. Rooney*, No. 2009019042402, 2015 FINRA Discip. LEXIS 19, at *81 (NAC July 23, 2015) (internal quotation marks and citations omitted).

[47] Enforcement's Pre-Hearing Brief, at 18-19. Enforcement quoted a statement by the court in *SEC v. Murphy*, 626 F.2d 633, 653 (9th Cir. 1980) to the effect that "the materiality of information related to financial condition, solvency, and profitability is not subject to serious challenge," but Respondents' involvement in the First Offering does not relate to any of those topics.

[48] Tr. 30, 528.

potential claims against PJM. Enforcement contended that, as a result, Respondents had a financial motive to promote the Second Offering in order to recoup the First Offering investors' losses and avoid those claims. Enforcement asserted that a reasonable investor would have considered this important information in deciding whether to invest in the Second Offering.[49]

Enforcement, however, did not prove that Respondents' involvement in the Second Offering was motivated by complaints from First Offering investors or a desire to avoid potential claims. On the contrary, the only relevant evidence adduced at the hearing was that no investor in the First Offering has ever made any complaint or filed any claim against PJM or the Firm. Further, the PPMs did disclose that the development financed by the First Offering was in bankruptcy; that, as a result, the First Offering investors stood to lose their entire investments; that PJM was serving as the CR Trustee; and that the First Offering investors were being offered, and were expected to accept, an assignment of their First Offering interests for units in the Second Offering, so it would have been clear to a reasonable investor that salvaging the First Offering investors' investments was a goal of PJM in promoting the Second Offering. Further, the PPMs disclosed that PJM and companies he owned stood to benefit financially from the Second Offering in a variety of respects, providing a powerful reason for them to promote the Second Offering.[50] Under these circumstances, Enforcement failed to prove a substantial likelihood that a reasonable investor would have considered information regarding Respondents' involvement in the marketing and sale of the First Offering important in deciding whether to invest in the Second Offering, or that disclosure of that information would have significantly altered the total mix of information available to Second Offering investors. Accordingly, the Panel concludes that Enforcement did not demonstrate that the omission of the information caused the PPMs to be misleading.

The second omitted circumstance cited by Enforcement was PJM's receipt of $2,000 per month from the Second Offering funds for his service as the CR Trustee. In closing argument, Enforcement acknowledged that the PPMs disclosed that PJM was serving as Trustee, but asserted that his receipt of compensation for serving as Trustee provided a financial motive to promote the Second Offering investment that would have been material information for investors.[51]

As Enforcement conceded in its final argument, the PPMs disclosed that PJM was serving as CR Trustee, and the CR Trust provided for payment of $2,000 per month to the CR

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[49] Tr. 482.

[50] In fact, PJM's RIA received more than $100,000 for preparing the PPMs and performing other administrative services. Tr. 344-45; JX-24. If the Second Offering had succeeded, however, PJM stood to reap far greater profits, because the Manager, which he owned, received 10 subordinated units in the Company for its services. JX-3, at 3.

[51] Tr. 483.

Trustee.[52] As a result of the First Offering investors' assignments of their interests to the Company, PJM's service as CR Trustee was for the direct benefit of the Company. Enforcement offered no basis for the Panel to conclude that, absent an express disclosure, reasonable Second Offering investors would have assumed either that PJM was not being compensated for his service as Trustee, or that any compensation was coming from a source other than the Company. Further, as explained above, the PPMs disclosed that PJM and companies he controlled would benefit financially from Second Offering investments in a variety of respects, and, therefore, that he had a strong financial motive to encourage investments in the Second Offering. Under these circumstances, Enforcement failed to prove a substantial likelihood that a reasonable investor would have considered information regarding yet another financial benefit to PJM important in deciding whether to invest in the Second Offering, or that disclosure of that information would have significantly altered the total mix of information available to Second Offering investors.

The third allegedly omitted circumstance cited by Enforcement was that the "main purpose" of the Second Offering was to raise funds for the Guarantor Litigation and recoup the investments of the investors in the First Offering. In support of this allegation, Enforcement relied on PJM's 2011 response to the examiner's question about the "[p]rimary goal for raising capital" in the Second Offering, in which PJM stated that there was a "twofold" goal of protecting the First Offering investors' investments and providing funding to pursue the Guarantor Litigation.[53]

It is undisputed that PJM hoped that the Second Offering would salvage the First Offering investors' investments and provide funds to pursue the Guarantor Litigation. Indeed, that would have been evident to a reasonable investor from the disclosures in the PPMs regarding the pending action by the bank to foreclose its first mortgage, the risk that foreclosure of the first mortgage would cause the First Offering investors to lose their entire investments, the intent to offer the First Offering investors interests in the Company in exchange for assignments of their rights, and the Company's intent to pursue the Guarantor Litigation based on those assignments.

PJM's testimony, however, fully supported by the contemporaneous documents, was that the main purpose of the Second Offering was to raise funds to purchase the bank's interest and complete the marina project, as represented in the PPMs, because he believed that the completed marina project would provide a substantial return to both the First Offering and the Second Offering investors, and, not insignificantly, to himself, in light of the Manager's subordinated interests in the Company. PJM's testimony, again fully supported by contemporaneous documents, was that the Guarantor Litigation was intended primarily as a means to raise additional capital for the marina project, and only secondarily as a fallback to recoup investor

[52] Tr. 482-83, 485.

[53] JX-8, at 1.

funds if the Second Offering failed to raise sufficient funds to purchase the bank's first mortgage interest, as represented in the PPMs.[54]

Further, the structure of the Second Offering ensured that the Second Offering investors, not the First Offering investors, would be the primary beneficiaries of any returns earned by the Company, whether through completion of the marina project or pursuit of the Guarantor Litigation. The parties stipulated that, like the Manager, the First Offering investors received only subordinated units in the Second Offering from their assignments of their First Offering interests. Under the terms of the Second Offering, subordinated units would receive no distributions from the Company whatsoever until the non-subordinated units, *i.e.*, the Second Offering investors, had received back their entire principal investments plus a 9% return. After that, the First Offering investors, like the Manager, would have shared *pro rata* with the Second Offering investors in any additional distributions from the Company.[55] This structure is entirely inconsistent with Enforcement's allegation that the main purpose of the Second Offering was to recoup the First Offering investors' investments through the Guarantor Litigation.

Thus, Enforcement did not prove that the PPMs failed to disclose the main purpose of the Second Offering. And Enforcement did not demonstrate a substantial likelihood that, under the circumstances, a reasonable investor would have considered some further disclosure of PJM's goals important in deciding whether to invest in the Second Offering, or that such an additional disclosure would have significantly altered the total mix of information available to Second Offering investors.

Finally, the fourth alleged omission from the PPMs cited by Enforcement was the anticipated costs of the Guarantor Litigation. The PPMs, however, included *pro forma* financial statements disclosing that the Company expected to incur legal expenses totaling $300,000, and the PPMs disclosed that the Company would be pursuing the Guarantor Litigation, based on the expected assignments of the First Offering investors' rights.[56] Enforcement offered no evidence that the $300,000 figure was unreasonably low, taking into account anticipated litigation costs as well as other likely legal costs. In contrast, PJM testified, without contradiction, that the $300,000 estimate for legal fees was much higher than would ordinarily be expected for an offering such as the Second Offering precisely because it included anticipated litigation costs.[57]

In light of this evidence, Enforcement counsel was forced to argue in closing that the PPMs were misleading because they failed to break out the anticipated litigation costs from the $300,000 total estimated legal costs. Enforcement, however, cited no authority requiring such a break-out, or any reason why such a break-out was required under the circumstances to avoid

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[54] Tr. 231.

[55] Stip. ¶ 8; Tr. 365-66; JX-3, at 9, 40, 50; JX-4, at 9-10, 42, 51.

[56] JX-3, at 13, 19; JX-4, at 13, 19.

[57] Tr. 352-53.

misleading potential investors. Under these circumstances, Enforcement failed to prove a substantial likelihood that a reasonable investor would have considered a break-out of the anticipated costs of the Guarantor Litigation important in deciding whether to invest in the Second Offering, or that such a break-out would have significantly altered the total mix of information available to Second Offering investors.[58]

Accordingly, the Panel concludes that Enforcement failed to prove, by a preponderance of the evidence, that the PPMs misrepresented or failed to disclose material facts. Even assuming, however, that there was some material omission, Enforcement failed to prove that Respondents acted with scienter. Scienter has been defined as the "intent to deceive, manipulate or defraud."[59] Scienter may also be established by a showing that the respondent acted recklessly. In the context of omissions, "reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it. … Under this definition, the danger of misleading buyers must be actually known or so obvious that any reasonable man would be legally bound as knowing, and the omission must derive from something more egregious than even 'white heart/empty head' good faith."[60]

Enforcement offered no evidence whatsoever that PJM intended to omit material information from the PPMs or to mislead Second Offering investors. Similarly, Enforcement failed to prove that the omissions it alleged presented a danger of misleading Second Offering investors that was either known to PJM or was so obvious that he must have been aware of it.

On the contrary, as explained above, before making the PPM available to investors, PJM circulated drafts widely, seeking comments and proposed revisions to improve the document. PJM either made the revisions that were proposed, or made other revisions and re-circulated a draft of the PPM, or reasonably explained why he did not make certain proposed revisions. Significantly, many of those to whom he circulated drafts, including attorneys GC and DM, were aware of the information that Enforcement alleges PJM failed to disclose, yet Enforcement offered no evidence that anyone suggested to PJM that he ought to disclose that information in the PPM.

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[58] In the Complaint, Enforcement alleged that "Respondents duped investors into believing that the majority of invested funds would be used to purchase and develop a marina, when, in fact, Respondents intentionally used the majority of invested funds to pay for litigation against the guarantors of the second mortgage in the [First] Offering." Compl. ¶ 22. In fact, the evidence established that less than $40,000 of the Company's funds were used to pay legal expenses for the Guarantor Litigation. JX-24, at 3-4.

[59] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 (1976).

[60] *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (footnotes, internal quotation marks and citations omitted).

Respondents argued that based on PJM's circulation of the PPM drafts to GC, they were entitled to a "reliance on advice of counsel" defense to Enforcement's fraud charge.[61] Enforcement countered that Respondents' consultations with GC were not sufficient to satisfy the requirements for such a defense.[62] Regardless of whether Respondents satisfied the technical requirements for a defense, however, the Panel concludes that PJM's openness in seeking and responding to comments from attorneys and other knowledgeable reviewers is relevant and probative evidence that weighs heavily against any conclusion that the omissions from the PPMs cited by Enforcement presented a danger of misleading Second Offering investors that was either known to PJM or was so obvious that he must have been aware of it.[63] In contrast, Enforcement presented no evidence from which the Panel could reasonably conclude that PJM acted recklessly.

Accordingly, the Panel concludes that Enforcement failed to prove, by a preponderance of the evidence, that Respondents made fraudulent representations or omissions in connection with the sale of the Second Offering.

C. Enforcement's Alternative Negligence Charge

With respect to its alternative charge in the second cause of the Complaint, Enforcement asserted that it "need not show that [the Firm] or [PJM] acted with scienter, but only that they acted in bad faith or unethically."[64] More specifically, Enforcement argued that if Respondents did not act with scienter, their conduct was at least negligent.

For the reasons set forth above, the Panel concludes that Enforcement did not establish that Respondents misrepresented or omitted any material facts in the PPMs. Further, insofar as the PPMs omitted any material facts, the Panel concludes that for the same reasons Enforcement

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[61] Tr. 533-34.

[62] Enforcement cites the requirements for an advice of counsel defense set forth in *Markowski v. SEC*, 34 F.3d 99, 105 (2d Cir. 1994), which were that the respondent "made complete disclosure to counsel, sought advice as to the legality of his conduct, received advice that his conduct was legal, and relied on that advice in good faith." The advice of counsel defense at issue in *Markowski* did not relate to the issue of scienter, but even assuming the same standards apply, the evidence establishes that in reviewing the PPM, GC was aware of all the circumstances that Enforcement contends should have been disclosed in the PPMs; that PJM sought GC's advice as to whether the PPMs adequately disclosed material information; and that PJM relied in good faith on GC's approval of the PPMs. In that regard, GC testified, credibly, that he would have reviewed every paragraph of the draft PPM; that after his reviews, he was of the opinion that the PPM disclosures were adequate and that the PPM did not contain any misstatements of fact, or omit to state any facts that would cause the PPM to be misleading; and that, although PJM was free to accept his revisions up to a point, if he believed that the PPM was false or misleading, he would have "violently objected" to it, which he did not do. Tr. 393, 395, 417.

[63] *See Howard v. SEC*, 376 F.3d 1136, 1147 (D.C. Cir. 2004) ("reliance on the advice of counsel need not be a formal defense; it is simply evidence of good faith, a relevant consideration in evaluating a defendant's scienter.").

[64] Enforcement's Pre-Hearing Brief, at 23, citing *Calvin David Fox*, Exchange Act Release No. 48731, 2003 SEC LEXIS 2603, at *7 (Oct. 31, 2003), and *Dep't of Enforcement v. Shvarts*, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *13-15 (NAC June 2, 2000).

failed to prove that Respondents acted with scienter, it also failed to prove that Respondents acted negligently.

D. Alleged Misuse of Investor Funds

Enforcement charged that PJM's return of EM's entire proposed $25,000 investment in the Second Offering constituted a misuse of investor funds because it violated a provision of the Operating Agreement included in the PPMs providing that no investor in the Second Offering would receive priority over any other investor as to the return of capital contributions. As described above, EM initially submitted a subscription for a $25,000 investment in the Second Offering. PJM testified, without contradiction, that he concluded that, in light of EM's prior investment in the First Offering, an additional $25,000 investment in the Second Offering would cause EM to be unduly concentrated in a single investment. Therefore, PJM testified, he returned $20,000 just a few days after initially accepting EM's subscription, retaining just $5,000.

The PPM provided: "The Manager may, in its sole discretion, refuse a subscription for Units if the Manager believes that an investor does not meet the applicable investor suitability requirements, the Units are otherwise an unsuitable investment for the investor, or for any other reason."[65] Accordingly, the Panel concludes that PJM's decision to reject $20,000 of EM's proposed $25,000 investment was within his authority.

In final argument, Enforcement counsel acknowledged PJM's authority, but asserted that she had not heard of a situation in which only a part of a proposed investment had been rejected on suitability grounds. But where a suitability concern relates to potential undue concentration, there is nothing improper about permitting a smaller investment that does not raise an undue concentration concern. In any event, the issue in this proceeding is not the suitability of EM's proposed $25,000 Second Offering investment or his ultimate $5,000 investment, but rather whether PJM acted improperly in returning EM's funds. Because the PPM gave PJM broad authority to reject a proposed investment in the Second Offering on suitability grounds, the Panel concludes that his return of $20,000 of EM's proposed investment was authorized, did not amount to a misuse of investor funds, and thus did not violate Rule 2010, as alleged by Enforcement.[66]

There is no question that EM received a preference when, months later, PJM terminated the Second Offering and returned 45% of the other investors' investments, but returned all of EM's remaining $5,000 investment. PJM testified, without contradiction, that he decided to return the entire $5,000 in light of the administrative and accounting costs that would be incurred

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[65] JX-3, at 10.

[66] The PPM provided that the minimum subscription was $25,000, but also provided: "The Manager may waive or lower the minimum purchase requirement for certain investors in its sole discretion." JX-3, at 4, 7; Tr. 117-18.

to maintain an account for EM's remaining investment if he had returned only 45% of the $5,000. Enforcement offered no evidence to the contrary.

The Panel concludes that PJM had authority under the provisions of the PPMs and the Operating Agreement to make that decision. As explained above, the PPMs gave the Manager, which PJM controlled, broad discretion to manage the Company's business. The Operating Agreement, which was a part of the PPMs, provided that "[t]he management of the Company is reserved for the Manager," and that "[t]he Manager is expressly authorized on behalf of the Company to conduct all the business operations of the Company, including, but not limited to … protect and preserve the assets of the Company …."[67] The Panel concludes that PJM's authority extended to returning all of EM's $5,000 investment in the Company under the circumstances presented.

E. Conclusion

For the reasons set forth above, the Panel concludes that Enforcement did not prove, by a preponderance of the evidence, that Respondents fraudulently misrepresented or failed to disclose material facts in connection with the Second Offering, in violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, or FINRA Rules 2020 and 2010; or that Respondents negligently misrepresented or failed to disclose material facts in violation of FINRA Rule 2010; or that Respondent PJM misused investor funds, in violation of FINRA Rule 2010. Accordingly, all charges in the Complaint are dismissed.[68]

IV. Order

The Complaint is hereby DISMISSED.

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David M. FitzGerald
Hearing Officer
For the Extended Hearing Panel

[67] JX-3, at 53-54.

[68] The Extended Hearing Panel considered all of the arguments of the parties. Arguments not specifically discussed herein are rejected or sustained to the extent that they are inconsistent or in accord with this Decision.