

BEFORE THE NATIONAL ADJUDICATORY COUNCIL
FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of

Department of Enforcement,

Complainant,

vs.

CapWest Securities, Inc.
Lakewood, CO,

Respondent.

DECISION

Complaint No. 2007010158001

Dated: February 25, 2013

Respondent violated the content standards that apply to FINRA member communications with the public and failed to supervise effectively the use of advertisements and sales literature. Held, findings affirmed and sanctions modified in part.

Appearances

For the Complainant: Leo F. Orenstein, Esq., Gary M. Lisker, Esq., Gregory R. Firehock, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: H. Thomas Fehn, Esq.

Decision

The Review Subcommittee of the National Adjudicatory Council (“NAC”) called this matter for review solely to examine the sanctions that the Hearing Panel imposed upon CapWest Securities, Inc. (“CapWest”), for violating the content standards that apply to FINRA member communications with the public. We have determined to modify, in part, these sanctions. Specifically, we find excessive the fine imposed upon CapWest for violating NASD Rules 2210 and 2110, and we reduce this fine to a level that we conclude is consistent with the remedial objectives of the FINRA Sanction Guidelines.

I. Procedural History

This matter stems from a FINRA Advertising Regulation Department (“Advertising Regulation”) “sweep” or review of member advertising. Specifically, Advertising Regulation reviewed the communications of members concerning certain tax-deferred exchanges under Section 1031 of the Internal Revenue Code in which an investor exchanges an interest in real

property for a tenancy-in-common (“TIC”), real-property interest that generally constitutes a security for purposes of the federal securities laws and FINRA rules. *See* discussion *infra* Part II.B. After scrutinizing the advertisements and sales literature that CapWest used during the review period – October 1, 2006, to March 31, 2007 – Advertising Regulation referred the firm to FINRA’s Department of Enforcement (“Enforcement”) for possible disciplinary action.

On March 4, 2010, Enforcement filed a two-cause complaint alleging that CapWest violated FINRA rules in connection with its promotion of Section 1031 exchanges and securitized TIC interests. The first cause of action alleged that CapWest promoted Section 1031 exchanges and TIC investments through 166 advertisements and sales literature items that violated the content standards that apply to all FINRA member public communications, in violation of NASD Rules 2210 and 2110.¹ The second cause of action alleged that CapWest failed to implement effectively its supervisory system for the approval, prior to use by the firm’s registered representatives, of the advertisements and sales literature and thus failed to supervise the firm’s activities, in violation of NASD Rules 3010 and 2110.

On December 19, 2011, after holding a one-day hearing, the Hearing Panel issued its written decision finding CapWest liable for the misconduct alleged in the complaint.² For its use of deficient public communications, the Hearing Panel censured CapWest and fined the firm \$150,000. The Hearing Panel fined the firm an additional \$25,000 for its supervisory failures.

Neither CapWest nor Enforcement appealed the Hearing Panel’s decision to the NAC. On February 3, 2012, however, the Review Subcommittee of the NAC, invoking its authority under FINRA Rule 9312, called this matter for review to examine further the sanctions that the Hearing Panel imposed upon CapWest for its use of the advertisements and sales literature that violated NASD Rules 2210 and 2110.³ The NAC subcommittee empanelled to consider this

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

² At the hearing, Enforcement presented its evidence through a single witness, the Advertising Regulation investigator who reviewed the communications that CapWest submitted to FINRA in response to the sweep of Section 1031 and TIC-related advertising. CapWest’s evidence was limited to the testimony of Dale Hall (“Hall”), who became president and chief executive officer of the firm in January 2008.

³ FINRA Rule 9312(a) permits the Review Subcommittee of the NAC to call for review any Hearing Panel decision issued pursuant to FINRA Rule 9268. If the Review Subcommittee determines to call a case for review, it must notify the parties of the findings, conclusions, or sanctions with respect to which the Review Subcommittee determined that a call for review was necessary. FINRA Rule 9312(c). In this case, the Review Subcommittee limited its call for review to the sanctions that the Hearing Panel imposed upon CapWest for violating NASD Rules 2210 and 2110, as alleged in the first cause of Enforcement’s complaint. We therefore summarily affirm the Hearing Panel’s findings and sanctions that were not addressed in the notice of review, and which we conclude are appropriate and supported by the record. *See id.*

[Footnote continued on next page]

matter heard oral arguments after the parties filed briefs on the issue of the appropriate sanctions to impose for CapWest's advertising violations.

II. Facts

A. The Firm

CapWest became a FINRA member in 1992. Headquartered in Lakewood, Colorado, CapWest operated more than 30 branch offices and employed 45 registered representatives when Enforcement commenced disciplinary proceedings against the firm. On September 23, 2011, FINRA cancelled CapWest's membership because the firm failed to pay regulatory fees to FINRA.

B. Section 1031 Exchanges and TIC Interests

Section 1031 of the Internal Revenue Code permits an investor to defer paying capital gains tax due on the sale of real estate held for productive use in a trade or business or for investment by exchanging it for "like-kind" property of equal or greater value. 26 U.S.C. § 1031(a)(1); *NASD Notice to Members 05-18*, 2005 NASD LEXIS 25, at *10 (Mar. 2005). To help investors find properties suitable for Section 1031 tax-deferred exchanges, sponsors offer co-ownership of income-producing or rental real estate to pools of investors in the form of TIC interests in which each tenant holds a fractional undivided interest in real property.⁴ *NASD Notice to Members 05-18*, 2005 NASD LEXIS 25, at *6.

TIC interests generally constitute investment contracts and securities under the federal securities laws when offered or sold with other integral contractual arrangements.⁵ *Id.* In a typical securitized TIC transaction, the tenants in common each invest in an undivided fractional interest in rental real property and pool their assets and share in the risks and rewards of their enterprise, while obtaining profits derived mostly from the efforts of others through contracts

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We nevertheless address these issues here to provide the parties with a final FINRA decision that addresses all aspects of the case.

⁴ Section 1031 does not permit tax-deferred exchanges of partnership interests. 26 U.S.C. § 1031(a)(2); *NASD Notice to Members 05-18*, 2005 NASD LEXIS 25, at *3. To qualify for tax deferral under Section 1031, an investor must ensure that the TIC interest received in an exchange is an interest in real estate and not a partnership interest. *See NASD Notice to Members 05-18*, 2005 NASD LEXIS 25, at *3; *see generally* Rev. Proc. 02-22, 2002 IRB LEXIS 122 (Apr. 8, 2002) (discussing the 15 conditions under which the Internal Revenue Service will consider a request for a ruling that an undivided fractional interest in real property is eligible for tax-free exchange under Section 1031).

⁵ TIC ownership of real property alone does not generally lead to the creation of a security. *Id.*

concerning the management, operation, and leasing of the acquired property.⁶ *Id.* Sponsors typically offer securities-based TIC interests as Regulation D private placement offerings exempt from registration under the Securities Act of 1933. *Id.* at *17-18.

The sale of TIC interests, given the potential for their use in Section 1031 tax-deferred exchanges of real property, grew dramatically during the early part of the last decade. *Id.* at *4. TIC interests, however, are generally illiquid investments for which no secondary market exists and subsequent sales may occur at a significant discount to the net asset value of the undivided interest in real property. *Id.* at *10. Moreover, the fees and expenses associated with a TIC interest have the potential to outweigh any tax benefits associated with a Section 1031 TIC exchange.⁷ *Id.* at *11.

C. CapWest's Promotion of Section 1031 Exchanges and TIC Interests

From October 1, 2006, to March 31, 2007, CapWest and certain of its registered representatives used 268 advertisements and sales literature items to communicate with the public about Section 1031 tax-deferred exchanges of real estate and TIC ownership. These communications included seminar invitations, flyers, slides, and handouts, newspaper and magazine advertisements, newsletters, brochures, form letters, radio scripts, website materials, and postcards. They ranged in their size and dimension from small, partial-page advertisements to multiple-paged sales literature. The advertising included promotions that prominently displayed the name of CapWest and certain of its registered representatives within the advertising, as well as sales materials that conspicuously identified real-estate companies owned by these CapWest registered representatives and referenced CapWest solely as the broker-dealer through which any securities would be offered.⁸

The 166 communications spotlighted in this case, which were duplicative and repetitive in their nature, possessed several marked characteristics, assertions, and claims about the use and utility of Section 1031 exchanges and the potential investment appeal of TIC ownership. For instance, the advertising commonly portrayed Section 1031 exchanges as a method to “unlock trapped equity” in real estate and as a way to “sell your income properties and defer paying capital gains tax now.” The sales materials also depicted TIC ownership as a “savvy way to handle a 1031 tax-deferred exchange” and as a “popular choice among real estate investors seeking replacement property” for use in a Section 1031 exchange of real estate. “Whether looking to defer capital gains tax, diversify, consolidate real estate holdings, increase the

⁶ In addition to managing and operating the acquired property, TIC sponsors ordinarily structure the TIC interest and negotiate the sale price and the loan for the acquired property. *Id.*

⁷ TIC products are often structured with high up-front fees and expenses paid to the sponsor and broker-dealers. *Id.*

⁸ NASD Rule 2210(d)(2)(C)(iii) requires that a FINRA member's advertisements and sales literature, if it includes the name of any non-member, “reflect which products or services are being offered by the member.”

leverage on an investment, or even relocate a particular investment to another market,” CapWest asserted in a representative advertisement, “this may be achieved through a 1031 Exchange into a [TIC] investment.” “1031 [e]xchanges might just be the best kept secret in the Internal Revenue Code,” some advertisements maintained, providing “the ability to capture profit, reinvest capital and allow equity to grow without dilution due to taxes.”

Other aspects of the advertising at issue here focused upon the potential income, tax benefits, and investment growth associated with TIC ownership. “Under this ownership structure,” illustrative advertisements and sales literature claimed, “the investor may own an undivided fractional interest in an entire property” acquired in a Section 1031 exchange, while sharing in their “portion” of the “net income” or “monthly cash flow,” the “tax shelter” or “tax benefits” of income property ownership, and the “appreciation” or “potential growth” associated with the TIC property. TIC interests, CapWest and its registered representatives commonly emphasized, are “management-free,” “passive income investments” in “large investment-grade” properties, where real estate professionals bear the burden of “management headaches,” “stress,” and “tenant problems,” and investors enjoy the benefit of “a monthly cash flow,” a “steady income,” and “peace of mind.”

A few of CapWest’s communications contained projections of future earnings. One announcement promoted a variety of “alternative investments,” including Section 1031 exchanges and TIC interests, and stated: “Investments may yield 10% or higher!” Several others claimed that TIC interests “typically” generate “cash flow,” “cash-on-cash flow,” “cash-on-cash returns,” or “income” ranging anywhere from six percent to greater than 10 percent annually.⁹

D. CapWest’s Supervision of TIC-Related Advertisements and Sale Literature

During the review period, CapWest’s written supervisory procedures required the firm’s registered representatives to submit proposed advertisements and sales literature to the firm’s compliance department and to obtain written, principal approval of those materials prior to use. To request this review and approval of advertisements and sales literature, CapWest utilized a form that the registered representatives were required to complete and submit. After a principal of the firm approved the advertisement or sales literature, the principal attached the submittal form to the sales material and placed the materials in the firm’s files. CapWest principals approved for use all 166 advertisements and sales literature pieces that are at issue in this case.¹⁰

⁹ Although not defined in any of CapWest’s advertising, the Advertising Regulation investigator who testified at the hearing stated, without contradiction, that “cash-on-cash flow” or “cash-on-cash return” generally refers to the pre-tax cash flow generated by a TIC-related property divided by the property’s cost.

¹⁰ These principals included CapWest’s then president and chief compliance officer, Debra White, compliance officers Greg Schindorff and Pamela Schneithorst, and compliance coordinator Traci Horan.

III. Discussion

We affirm the Hearing Panel's findings of liability.

A. CapWest Violated the Content Standards that Apply to Public Communications by Member Firms

NASD Rule 2210 generally governs FINRA member communications with the public and includes certain content standards that apply to all member communications, as well as standards that apply specifically to advertisements and sales literature.¹¹ *See* NASD Rule 2210(d). The Hearing Panel found that CapWest's advertisements and sales literature failed to uphold these standards, in violation of NASD Rules 2210 and 2110.¹² We affirm the Hearing Panel's findings.

1. CapWest Communications Were Not Fair and Balanced

The content standards that apply to all communications with the public require that FINRA members base their public communications, including advertisements and sales literature, on principles of fair dealing and good faith, ensure that their communications are fair and balanced, and provide within their communications a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service discussed. *See* NASD Rule 2210(d)(1)(A). As the Hearing Panel concluded, many advertisements and sales literature items used by CapWest and its registered representatives during the review period did not meet these requirements.

First, CapWest's advertisements and sales literature routinely referenced Section 1031 exchanges (and their potential use to defer capital gains tax due on the sale of real estate) without providing an explanation of how these exchanges work or a recognition of the requirements and restrictions set forth in the Internal Revenue Code that allow tax-deferral when acquiring TIC ownership. Given the importance of that tax treatment, and the need to determine whether a particular TIC offering will qualify as a like-kind exchange of real property under Section 1031,

¹¹ Under NASD Rule 2210, the phrase "communications with the public" is defined to include the terms "advertisement" and "sales literature." NASD Rule 2210(a). Advertisement generally refers to a communication made available to the public through media such as radio, television, newspapers, magazines, billboards, and websites. *See* NASD Rule 2210(a)(1). Sales literature generally refers to communications made to a more targeted audience, which do not meet the definition of an advertisement, including circulars, research reports, market letters, form letters, seminar texts, and telemarketing scripts. *See* NASD Rule 2210(a)(2).

¹² On March 29, 2012, the SEC approved new FINRA rules governing communications with the public, which became effective February 4, 2013. *See generally* *FINRA Regulatory Notice 12-29*, 2012 FINRA LEXIS 36 (June 2012). New FINRA Rule 2210 encompasses, subject to certain changes, the provisions of current NASD Rule 2210 and certain interpretive materials. *Id.* at *6. New FINRA Rule 2210 does not alter, in any material manner, any of the content standards applied in this case. *Id.* at *40.

it was incumbent upon CapWest to consistently provide some sense of these factors to the public.¹³ See *NASD Notice to Members 05-18*, 2005 NASD LEXIS 25, at *3-5 (discussing generally the tax status of Section 1031 exchanges and the importance placed upon verifying the tax treatment of TIC interests). CapWest, however, far more often than not, failed to provide the investing public with a sound basis for evaluating Section 1031 exchanges.¹⁴ See *Dep't of Enforcement v. Beloyan*, Complaint No. 2005001988201, 2011 FINRA Discip. LEXIS 44, at *21-22 (FINRA NAC Dec. 20, 2011) (finding that certain emails did not provide a sound basis for evaluating an investment where they did not provide any support or explanation for the investment, omitted negative facts, and made no risk disclosures).

Second, CapWest's advertisements and sales literature frequently discussed the possible income, tax benefits, and investment growth associated with securitized TIC property. The "goal" of TIC ownership, from the perspective given by one piece of sales literature, "is to buy [real property], gain a monthly income and tax benefits, and eventually sell at a profit." In most instances where these purported benefits of TIC ownership were discussed, however, CapWest failed to disclose, where it would have been appropriate to do so, that TIC-investment income is not guaranteed; the potential for loss of the investor's principal exists; upfront fees and expenses associated with certain TIC offerings may impact investor returns and outweigh any perceived tax benefits; TIC interests are generally illiquid investments; an investor's ability to recognize any investment appreciation may be limited; and the value of the real estate underlying a TIC security may fluctuate based upon economic and environmental factors.¹⁵ CapWest thus failed

¹³ CapWest itself identified some of the restrictions that apply to Section 1031 exchanges in certain sales literature pieces that were not considered to have violated the standards set forth in NASD Rule 2210(d)(1)(A). For example, in a few lengthier sales literature items, CapWest disclosed that Section 1031 of the Internal Revenue Code requires that replacement property purchased in an exchange be of equal or greater value to the relinquished property, that the properties exchanged must be held for productive use in a trade or business or for investment, that the investor must reinvest all of the exchange equity into the replacement property, that he also must meet certain property identification and exchange deadlines, and that the Internal Revenue Service requires that specific pre-conditions be met before the purchase of a TIC interest will be recognized as an exchange of "like-kind" property under Section 1031.

¹⁴ Advertising Regulation identified 127 CapWest communications that did not contain an adequate discussion of the features and Internal Revenue Code restrictions associated with Section 1031 exchanges of real property.

¹⁵ Although CapWest provided some general risk disclosures in certain of these communications, these disclosures proved inadequate. See *Dep't of Enforcement v. Hedge Fund Capital Partners, LLC*, Complaint No. 2006004122402, 2012 FINRA Discip. LEXIS 42, at *15 (FINRA NAC May 1, 2012) ("While some of the materials contained general disclaimers and statements regarding risk, and referred to other documents for more specific disclosures, the materials did not present a fair and balanced assessment of the investments they were touting."). Substantive risk disclosures appeared in few of the firm's advertisements and sales literature concerning TIC interests.

to consistently provide a fair and balanced presentation of the investment potential and risks linked with TIC ownership of real property.¹⁶ See *Jay Michael Fertman*, 51 S.E.C. 943, 950 (1994) (holding that FINRA rules require that a member's public communications "disclose in a balanced way the risks and rewards of the touted investment"); see also *Philippe N. Keyes*, Exchange Act Rel. No. 54723, 2006 SEC LEXIS 2631, at *12-13 (Nov. 8, 2006) (stating that it was undisputed that respondent violated NASD Rule 2210 where he promoted certain notes as having "solid growth" and "reliable income" and failed to disclose that the notes were illiquid and carried a high risk of default); *Excel Fin., Inc.*, 53 S.E.C. 303, 311-12 (1997) (holding that sales literature that failed to explain an investment's speculative nature – including tax consequences, the lack of liquidity, and the potential for fluctuations in value – were misleading and violated FINRA advertising rules).

Lastly, CapWest often highlighted the "management-free" traits of TIC ownership in its advertisements and sales literature. For example, a widely circulated advertisement promoting TIC investments that appeared in magazines and bar association bulletins in central California stated, "I used to manage my real estate property . . . and now I manage my mailbox." These representations, however, should have been, but were not, balanced with statements concerning certain restraints accompanying TIC ownership. See *Pac. On-Line Trading & Secs., Inc.*, 56 S.E.C. 1111, 1119 (2003) ("[T]he advertising highlighted the benefits of online securities trading but failed to provide essential risk disclosures regarding such trading."). These could include the investor's loss of day-to-day control over management decisions, the constraints of voting by other tenants in common regarding significant issues that can result in substantial expenses affecting the investment – such as votes to initiate renovations, repairs, or upgrades of the associated property – and the potentially significant, related fees that come with professional management of the TIC property.

2. CapWest's Communications Contained Improper Performance Projections

NASD Rule 2210 also includes content standards that prohibit member firms from using any public communication that predicts or projects performance or makes any exaggerated or unwarranted claim or forecast concerning prospective investment results.¹⁷ See NASD Rule 2210(d)(1)(D). Several CapWest advertisements and sales literature pieces violated these standards.

For instance, one CapWest registered representative stated assuredly in a newsletter for her real estate company that "TICS are popular because they are simpler to acquire than many types of properties . . . , can be conservative and straight-forward, and the returns are generally predicted and estimated." "No management, no fuss, no tenant problems – simply a return on

¹⁶ Advertising Regulation identified 127 CapWest communications that failed to present a balanced discussion of the investment potential and hazards associated with TIC securities.

¹⁷ FINRA rules permit hypothetical illustrations of mathematical principles, provided they do not predict or project the performance of an investment or investment strategy. See NASD Rule 2210(d)(1)(D).

the investment,” this sales literature claimed. Indeed, as one illustrative newsletter asserted, “TICs typically . . . generate cash-on-cash flow from 6% to 9%.” Another registered representative sent a postcard to potential investors that claimed that “[i]nvestments may yield 10% or higher.” Finally, one notable advertisement stated that TIC interests are popular with potential investors who want “effortless cash flow.”

CapWest’s unwarranted promises of successful TIC investing, the use of forward-looking statements concerning “typical” TIC investment performance, and claims of “effortless cash flow” all clearly violated NASD Rule 2210 proscriptions against exaggerated performance predictions and unwarranted performance claims and forecasts.¹⁸ See *Hedge Fund Capital Partners*, 2012 FINRA Discip. LEXIS 42, at *16 (finding respondent made unwarranted claims and forecasts where institutional sales materials claimed “compound average annual return[s] of 16%-18% net of fees,” “15% compounded returns net of fees,” and the goal of “long-term returns of 30 percent”) (quotations omitted).

3. CapWest’s Communications Exaggerated TIC Investment Protections

NASD Rule 2210 further prohibits a member firm from making “any false, exaggerated, or unwarranted or misleading statement or claim in any communication,” and proscribes the publication, circulation, or distribution of any communication the firm “knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.” See NASD Rule 2210(d)(1)(B). Within the context of the presentations in which they appear, several advertisements and sales literature pieces used by CapWest and its registered representatives gratuitously implied that regulation and oversight of TIC offerings by the SEC, FINRA, and others provide a degree of additional investor protection that increases the likelihood of a successful investment.

For example, references to the regulation of TIC securities stated that “[t]he securities industry is overseen by the SEC . . . and [FINRA] . . . and is highly regulated.” In this context, CapWest claimed in two seminar handouts that “[t]he SEC advocates full disclosure, and the sponsors as well as the securities dealers . . . must follow many rules to be in compliance and to guide them in straightforward practices that reflect ethics and disclosure.” “Added scrutiny on several layers and full disclosure are an added benefit for investors” and “more regulations and more paperwork” are a “positive,” this sales literature asserted. “The real goal to all of this [regulation],” another newsletter stated, “is to make the sales and offerings and their regulations as secure as possible for investors.” “Certainly, because the TIC industry is popular and large amounts of funds are being infused into the sponsored properties,” the newsletter added, “additional scrutiny is good.”¹⁹

¹⁸ Advertising Regulation identified 13 communications that fall within this category of violations.

¹⁹ In certain of these sales literature items, CapWest added that the “securities industry” conducts “extensive due diligence” of TIC offerings that provides an additional level of protection to investors.

The foregoing statements and claims misled investors and exaggerated the degree of oversight and safety afforded to investors in TIC securities.²⁰ *Cf. Pac. On-Line Trading*, 56 S.E.C. at 1120 (finding that “[i]mplying NASD endorsement” of an investment violates FINRA rules); NASD Rule 2210 Interpretive Material (“IM”) 2210-4 (stating that a member may not imply that FINRA “or any other regulatory organization endorses, indemnifies, or guarantees the member’s business practices, selling methods, the class or type of securities offered, or any specific security”).

4. CapWest Improperly Used Customer Testimonials

The content standards that apply to member advertisements and sales literature require that a member disclose certain information when they utilize customer testimonials in their communications. *See* NASD Rule 2210(d)(2)(A). An advertisement or sales literature that provides any testimonial concerning a member’s investment advice or performance or the products it offers must disclose, prominently, that the testimonial may not be representative of the experience of other customers, that there is no guarantee of future performance or success, and whether the member paid more than a nominal sum for the testimonial. *Id.* In one postcard, a CapWest registered representative included three testimonials obtained from apparent customers without disclosing that the testimonials may not be representative of the experience of other clients and did not guarantee any future performance or success.

* * *

In sum, CapWest and certain registered representatives of the firm used 166 advertisements and sales literature pieces that abrogated, in one or more ways, the content standards that apply to FINRA member communications with the public. We therefore affirm the Hearing Panel’s findings that CapWest violated NASD Rules 2210 and 2110.²¹

B. CapWest Failed to Implement Its Supervisory System Effectively

NASD Rule 3010 requires each member firm to establish and maintain a reasonably designed system, including written procedures, to supervise the activities of its registered representatives, principals, and associated persons and achieve compliance with the federal securities laws and FINRA rules. *See* NASD Rules 3010(a), (b)(1). A member’s failure to supervise the activities of its personnel is a violation NASD Rule 3010. *Dep’t of Enforcement v. Pellegrino*, Complaint No. C3B050012, 2008 FINRA Discip. LEXIS 10, at *47 (FINRA NAC Jan. 4, 2008), *aff’d*, Exchange Act Rel. No. 59125, 2008 SEC LEXIS 2843 (Dec. 19, 2008).

²⁰ Our review of the record found seven pieces of advertising and sales literature that violated NASD Rule 2210 in this manner.

²¹ NASD Rule 2110 requires FINRA members, in the conduct of their business, to observe high standards of commercial honor and just and equitable principles of trade. A violation of another FINRA rule constitutes a violation of NASD Rule 2110. *Stephen J. Gluckman*, 54 S.E.C. 175, 185 (1999).

The adequacy of CapWest's supervisory system, including the firm's written supervisory procedures, is not at issue in this case. As Enforcement acknowledged, CapWest reasonably designed its supervisory system to ensure compliance with FINRA rules concerning member communications with the public. The firm's written supervisory procedures, during the relevant period, required the firm's registered representatives to submit for principal review and approval all advertisements and sales literature that they intended to use.²²

As the Hearing Panel found, however, CapWest failed to implement effectively its supervisory system. CapWest admits that principals of the firm reviewed and approved all 166 flawed communications that in this case violated the content standards drawn in NASD Rule 2210. Still, evidence introduced at the hearing below proved that CapWest did not provide these principals, or the firm's registered representatives, with adequate training and guidance concerning these standards. *See Richard F. Kresge*, Exchange Act Rel. No. 55988, 2007 SEC LEXIS 1407, at *35 (June 29, 2007) ("Members should determine that supervisors understand and can effectively conduct their requisite responsibilities."); *see also* NASD Rule 3010(a)(6) (stating that FINRA members must undertake "[r]easonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities").

Final responsibility for proper supervision of a member's business rests with the member, and this supervision must be reasonable based on the particular facts of each case. *See* NASD Rule 3010(a); *see also* *Christopher J. Benz*, 52 S.E.C. 1280, 1284 (1997) ("The standard of 'reasonableness' is determined based on the particular circumstances of each case."), *aff'd*, 168 F.3d 478 (3d Cir. 1998). The evidence here established that CapWest failed to effectively and reasonably implement its supervisory system.²³ *See Robert E. Strong*, Exchange Act Rel. No. 57426, 2008 SEC LEXIS 467, at *29 (Mar. 4, 2008) ("[T]he evidence establishes that Strong's unreasonable inaction effectively nullified the supervisory system related to the Firm's compliance with Rule 2711."). The result was that the firm's communications promoting Sections 1031 exchanges and TIC investments during the review period violated NASD Rule

²² NASD Rule 2210 requires a registered principal of a firm to approve prior to use any advertisement or item of sales literature. *See* NASD Rule 2210(b)(1).

²³ CapWest took a number of actions to improve its supervision of Section 1031 and TIC-related promotions after Advertising Regulation issued its July 2007 findings, but prior to the commencement of these disciplinary proceedings. *See infra* Part IV.A. n.26. Such after-the-fact efforts to improve CapWest's supervision of the firm's communications with the public, however, do not excuse its lack of supervision of these communications during the period of October 1, 2006, to March 31, 2007. *See John B. Busacca, III*, Exchange Act Rel. No. 63312, 2010 SEC LEXIS 3787, at *43 (Nov. 12, 2010) ("Reasonable supervision . . . required Busacca . . . to address known deficiencies promptly . . . not only after regulatory action had commenced."); *Kresge*, 2007 SEC LEXIS 1407, at *37 ("Kresge's [remedial] actions occurred months after the misconduct at issue already had transpired and after [FINRA] began its investigation.").

2210. *See Pellegrino*, 2008 FINRA Discip. LEXIS 10, at *71 (“While [respondent] implemented a variety of supervisory actions, those actions, whether viewed individually or collectively, failed to directly address the problems that were causing voluminous amounts of unsuitable recommendations and misleading sales presentations.”).

We thus affirm the Hearing Panel’s findings that CapWest violated NASD Rules 3010 and 2110.

IV. Sanctions

A. Supervisory Violations

We address the sanction that the Hearing Panel imposed upon CapWest for the firm’s supervisory violations first. For violating NASD Rules 3010 and 2110, the Hearing Panel fined CapWest \$25,000. We affirm this sanction.

For a failure to supervise, the FINRA Sanction Guidelines (“Guidelines”) recommend a fine of \$5,000 to \$50,000.²⁴ In determining the proper remedial sanctions, the Guidelines for a failure to supervise recommend that adjudicators consider two principal considerations that are relevant here: 1) the quality and degree of the implementation of the firm’s supervisory procedures and controls; and 2) the nature, extent, and character of the underlying misconduct.²⁵

As Enforcement acknowledged, CapWest reasonably designed the firm’s supervisory procedures and controls. The Hearing Panel concluded, however, the firm failed to effectively implement these procedures and controls. Hall testified, tellingly, that CapWest’s principals were unaware of “what the rules were” concerning NASD Rule 2210 content standards, and the evidence showed that the firm’s personnel received inadequate training and guidance concerning how to apply these standards to the firm’s communications with the public.²⁶ The result was that

²⁴ *FINRA Sanction Guidelines*, 103 (2011), <http://www.finra.org/web/groups/industry/@ip/@enf/@sg/documents/industry/p011038.pdf> [hereinafter *Guidelines*]. In cases involving egregious misconduct, the Guidelines for a failure to supervise recommend that FINRA adjudicators consider limiting or suspending the firm with respect to any or all activities or functions for up to two years or an expulsion of the firm. *Id.* Because CapWest is no longer in business and FINRA has cancelled the firm’s membership, we conclude that these elements of the Guidelines for supervisory violations are inapplicable here.

²⁵ *Id.* The Guidelines also recommend a third principal consideration – whether the respondent ignored “red flag” warnings that should have resulted in additional supervisory scrutiny. *Id.* Enforcement did not allege, and we find no evidence to conclude, that CapWest principals in this case ignored any red flags indicating misconduct by the firm’s registered representatives. We conclude instead that CapWest’s supervisory failures in this instance were systemic in their nature.

²⁶ At the hearing, Hall testified concerning a number of corrective actions that CapWest undertook after the firm received Advertising Regulation’s initial findings in July 2007,

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firm principals approved for use, over a six-month period, various flawed advertisements and sales literature pieces that failed to provide a fair and balanced picture of the benefits, limitations, restrictions, and risks associated with Section 1031 exchanges and TIC investments.

Under these facts, we agree with the Hearing Panel's conclusion that a \$25,000 fine serves the public interest by encouraging future compliance with the rules at issue here by CapWest and others in the securities industry with similar responsibilities. *See Strong*, 2008 SEC LEXIS 467, at *48 ("Strong's supervisory failures reflect a troubling inattention to the responsibilities given to him by . . . management and the [p]rocedures.").

B. NASD Rule 2210 Content Standards Violations

The Guidelines for a failure to comply with NASD Rule 2210 content standards and the inadvertent use of misleading communications with the public recommend a fine of \$1,000 to \$20,000.²⁷ In cases involving the intentional or reckless use of misleading public communications, the Guidelines recommend a fine of \$10,000 to \$100,000.²⁸ A principal consideration in this context is whether CapWest circulated widely the violative communications with the public.²⁹

The Hearing Panel, applying aspects of the foregoing Guidelines and the Principal Considerations that apply to all sanctions determinations, censured CapWest and fined the firm \$150,000 for violating NASD Rule 2210 content standards. Although we affirm the Hearing Panel's decision to censure the firm,³⁰ we disagree with the Hearing Panel's application of the Guidelines and conclude that the fine it imposed upon the firm in this case was excessive. We therefore modify this monetary component of the Hearing Panel's sanctions.

[cont'd]
including efforts to amend the firm's supervisory controls, provide more robust supervision of the firm's promotional activities, and hire new, experienced compliance personnel. These corrective actions, however, are not mitigating for purposes of sanctions. *See, e.g., Dennis Todd Lloyd Gordon*, Exchange Act Rel. No. 57655, 2008 SEC LEXIS 819, at *68 (Apr. 11, 2008) ("Remedial action taken after the initiation of an examination has little mitigative value.").

²⁷ *Guidelines*, at 79.

²⁸ *Id.* at 80. As with the Guidelines for a failure to supervise, the Guidelines for violations of NASD Rule 2210 recommend that FINRA adjudicators consider limiting or suspending the firm with respect to any or all activities or functions for up to two years or an expulsion of the firm. *Id.* at 79-80. As we discuss above, we conclude that these elements of the Guidelines are inapplicable in this case.

²⁹ *Id.* at 79.

³⁰ *See id.* at 9 (Technical Matters); *see also NASD Notice to Members 99-91*, 1999 NASD LEXIS 121 (Nov. 1999) (discussing FINRA's censure policy).

First, the specific Guidelines for failures to comply with NASD Rule 2210 standards and the use of misleading public communications explicitly require that adjudicators consider the inadvertent, reckless, or intentional character of the subject communications.³¹ *See Dep't of Enforcement v. Jordan*, Complaint No. 2005001919501, 2009 FINRA Discip. LEXIS 15, at *43-44 (FINRA NAC Aug. 21, 2009) (“These Guidelines demonstrate that . . . state of mind is a factor in determining appropriate sanctions.”). Although the Hearing Panel imposed a monetary sanction that exceeded by \$50,000 the highest recommended fine for the intentional or reckless use of misleading communications, the Hearing Panel’s decision does not discuss, and makes no findings concerning, whether the use of the 166 problematic communications at issue in this case was of a negligent, reckless, or intentional nature.³² This constitutes clear error.³³

Undeniably, Enforcement conceded that only a few of the 166 advertisements and sales literature pieces that violated NASD Rule 2210 – namely those communications that contained unwarranted performance projections or exaggerated the extent of regulatory and industry oversight of TIC investments – were properly characterized as reckless communications. Rather, as Enforcement admits, most of the problematic communications that confront us here appear to have been inadvertent in character. We find that these facts warrant a moderation of the fine imposed by the Hearing Panel. *Cf. Beloyan*, 2011 FINRA Discip. LEXIS 44, at *49-51 (fining respondents within the range recommended for inadvertent misleading communications where, although some of their communications were reckless, respondents “exhibited repeated negligence when they sent their clients abbreviated emails that provided little detail or background about the stocks they recommended for purchase”).

Second, the Hearing Panel found that the number of advertisements and sales literature pieces that violated NASD Rule 2210 was an aggravating factor and supported imposing the monetary sanction it imposed upon CapWest.³⁴ In this respect, the Hearing Panel decision suggests that CapWest engaged in a “pattern of misconduct” through which the firm sought to

³¹ *See Guidelines*, at 79-80. Recklessness is defined as “an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the [respondent] or so obvious that the [respondent] must have been aware of it.” *Gregory O. Trautman*, Exchange Act Rel. No. 61167, 2009 SEC LEXIS 4173, at *61 (Dec. 15, 2009) (*quoting Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 704 (7th Cir. 2008)).

³² Indeed, the Hearing Panel’s decision makes no mention of the Sanction Guidelines that apply to the intentional or reckless use of communications that violate NASD Rule 2210 standards.

³³ We recognize that the recommended ranges of sanctions in the Sanction Guidelines are not absolute and adjudicators may impose sanctions above or otherwise outside of a recommended range. *See Guidelines*, at 3 (General Principles Applicable to All Sanction Determinations). Adjudicators, however, must identify the basis for the sanctions they impose and consider all appropriate aggravating and mitigating factors in determining remedial sanctions in each case. *Id.*

³⁴ *See Guidelines*, at 6 (Principal Considerations in Determining Sanctions, No. 8).

widely tout TIC interests as investments with “little or no risks.” We conclude, however, that the Hearing Panel’s decision in this respect provides an unduly broad-brushed and unmerited impression of the firm’s misconduct. *See Dep’t of Enforcement v. Bukovcik*, Complaint No. C8A050055, 2007 NASD Discip. LEXIS 21, at *13 (NASD NAC July 25, 2007) (“We thus do not consider the number of documents that Bukovcik signed or the period over which he signed customer documents for purposes of assessing sanctions, as suggested by other parts of the Guidelines.”).

As an initial matter, although CapWest approved for use 166 advertisements and sale literature items that violated NASD Rule 2210 content standards, the Hearing Panel failed to consider the duplicative and repetitive character of these communications, both in their presentation and substance. For example, one newsletter, used by a single registered representative, appears in the record 73 times and accounts for nearly 44% of the violations that exist here. There were no substantive changes to the newsletter over time and the registered representative periodically updated the newsletter to reflect only changes in the TIC properties available in local real estate markets. In another example, a magazine advertisement that appeared in certain real-estate publications is included as a violative communication 17 times. The 166 communications we have reviewed here are not, as Enforcement would have us believe, each “unique.”

Additionally, the Hearing Panel’s decision implied a concerted campaign by CapWest to promote Section 1031 exchanges and TIC investments. CapWest, however, approved the 166 advertisements at issue here for use by relatively few of the firm’s total number of registered representatives, with three registered representatives in particular accounting for the vast majority of problematic communications. Use and abuse of Section 1031 and TIC-related advertising does not therefore appear to have been widespread within the firm.³⁵

Finally, the Hearing Panel’s decision to consider the number of violative communications as an aggravating factor fails to account, fittingly, for the systemic nature of CapWest’s

³⁵ The Guidelines caution adjudicators to consider, among other factors, whether the respondent’s misconduct resulted directly or indirectly in injury to the investing public or resulted in the potential for the respondent’s monetary gain. *See Guidelines*, at 6-7 (Principal Considerations in Determining Sanctions, Nos. 11, 17). We conclude that these factors provide little or no grounds for aggravating sanctions in this case. Although the record established that CapWest registered representatives sold TIC interests totaling approximately \$36.9 million during the review period, it is also clear that registered representatives not affiliated with or connected to the TIC-related communications that are before us sold most of these interests. Moreover, there is no direct evidence that establishes that the sale of these TIC interests resulted in any harm to customers. *See, e.g., Dep’t of Enforcement v. Pac. On-Line Trading & Secs., Inc.*, Complaint No. C10000037, 2002 NASD Discip. LEXIS 19, at *34 (NASD NAC Nov. 27, 2002) (“We also considered that there was no showing of demonstrable harm or injury to the investing public from the Respondents’ misconduct.”), *aff’d*, 56 S.E.C. 1111. Finally, the record is silent as to the extent of the firm’s business these TIC sales constituted or to which the firm profited from these sales.

misconduct.³⁶ We recognize that, “depending on the facts and circumstances of a case . . . multiple violations [of FINRA rules] may be treated individually such that a sanction is imposed for each violation.”³⁷ But this is not such an occasion. As the Hearing Panel recognized, “CapWest approved the [flawed] communications while essentially ignoring its own supervisory procedures designed to achieve compliance with the applicable advertising rules that, in turn, are designed to protect the investing public.”³⁸ A unitary sanction for all of the firm’s FINRA rule violations therefore would have been appropriate. *See Hedge Fund Capital Partners*, 2012 FINRA Discip. LEXIS 42, at *97 (affirming a unitary sanction where respondents’ misconduct related to FINRA’s advertising rules, registration violations, books and records failures all resulted “from the broad and systemic supervisory failures at the Firm”). Instead, the Hearing Panel divorced the heavy sanctions that it imposed, and any supporting analysis, for CapWest’s NASD Rule 2210 violations from the sanctions that it imposed upon the firm for its failure to supervise the use of Section 1031 and TIC-investment advertisements and sales literature. The results, we conclude, were incongruous.

The Review Subcommittee did not call the sanction that the Hearing Panel imposed for CapWest’s supervisory violations for review, and we find it inappropriate under the circumstances to impose a unitary sanction at this stage of these proceedings. We nevertheless find that it is fitting, given the facts present here and the posture with which this matter presents itself to the NAC, to impose a fine for CapWest’s violations of NASD Rule 2210 that is consubstantial with the fine imposed for the firm’s supervisory violations.³⁹ Consequently, we impose a \$25,000 fine upon CapWest for the firm’s use of 166 communications with the public that violated the content standards contained within NASD Rule 2210.

Although we impose a lesser fine, we recognize that CapWest and certain of its registered representatives widely circulated many of the communications that failed to abide by content

³⁶ *See Guidelines*, at 4 (General Principles Applicable to All Sanction Determinations, No. 4) (“[I]t may be appropriate to aggregate similar violations if . . . the violations resulted from a single systemic problem or cause that has been corrected.”).

³⁷ *Id.*

³⁸ Having concluded that CapWest’s violations of NASD Rule 2210 derived from the firm’s supervisory failures, we find ourselves perplexed by the Hearing Panel’s decision to not order a pre-use filing requirement whereby FINRA staff would express whether they have “no objection” to CapWest’s proposed communications for a defined period. *See id.* at 79-80. Imposing pre-use filing requirements in this case would have served to ensure that CapWest had indeed remediated the systemic problems that confronted the firm prior to its taking corrective actions. Because CapWest is no longer in business, however, the issue is now moot.

³⁹ *See Guidelines*, at 3 (General Principles Applicable to All Sanction Determinations, No. 3) (“To address the misconduct effectively in any given case, Adjudicators may design sanctions other than those specified in these guidelines.”).

standards that serve an important role in protecting investors.⁴⁰ This finding, however, is tempered by the fact that the target audience for the advertisements and sales literature generally comprised accredited investors that already owned income-producing real estate and the accountants and others financial professionals who advise them.⁴¹

In sum, we conclude that a censure and \$25,000 fine for CapWest's advertising violations represent sanctions best tailored to remediate the totality of the misconduct at issue.⁴² Rather than unduly emphasize the perceived breadth of CapWest's misconduct, we place greater emphasis on the source, content, and context of CapWest's problematic advertising concerning Section 1031 exchanges and TIC investments. *See Pac. On-Line Trading*, 2002 NASD Discip. LEXIS 19, at *33 (“[Respondent] did not understand the implications of the language he included . . . [and] did not seem to fully appreciate his responsibility . . . to ensure that communications with the public were balanced, and not misleading.”); *cf.* IM-2210-1(1) (“Members must ensure that statements are not misleading within the context in which they are made.”); IM-2210-1(2) (“Members must consider the nature of their audience to which the communications will be directed.”). In this respect, we agree with Enforcement that the small number of communications that contained unwarranted performance projections and made misleading assurances based on purported regulatory review and oversight of TIC offerings were egregious. We nevertheless find that a majority of the communications that violated NASD Rule 2210 in this case, while serious, were more benign in their nature. CapWest's communications were generally generic, outwardly designed to promote conventional awareness of the benefits and opportunities associated with Section 1031 exchanges and TIC interests, and they did not promote investments in any particular securities offerings. Many of CapWest's communications mentioned TIC interests in a passing fashion, and only then in the context of Section 1031 exchanges and the potential for their use as replacement properties in transactions that permit the deferral of capital gains tax. To the extent that certain advertisements and sales literature mentioned any income, tax benefits, and appreciation that accompany TIC ownership, most only did so in the context of highlighting the fractional undivided nature of that interest, not in any

⁴⁰ *Id.* at 79. We have also considered that the firm's misconduct would not have stopped absent FINRA staff's sweep of this area. *See id.* at 6 (Principal Considerations in Determining Sanctions, No. 9).

⁴¹ *See id.* at 7 (Principal Considerations in Determining Sanctions, No. 19) (“The level of sophistication of the injured or affected customer.”). Under Rules 505 and 506 of Regulation D, an issuer may sell its securities to “accredited investors” that meet certain financial criteria. *See* 17 C.F.R. §§ 230.502(e), 230.505-.506. For individuals, these criteria generally include a net worth of at least \$1 million at the time of the purchase or income exceeding \$200,000 in each of the two most recent years and a reasonable expectation of the same level of income in the current year. *See* 17 C.F.R. § 230.501(a).

⁴² *See Guidelines*, at 3 (General Principles Applicable to All Sanctions Determinations, No. 3) (“Adjudicators should tailor sanctions to respond to the misconduct at issue.”); *see also Dep't of Enforcement v. Kresge*, Complaint No. CMS030182, 2008 FINRA Discip. LEXIS 46, at *36 n.32 (FINRA NAC Oct. 9, 2008) (“Whether a sanction is punitive or remedial . . . depends on the facts or circumstances of the case.”).

apparently deliberate and determined effort to tout TIC interests as “risk-free” investments to an unsuitable, unsuspecting public. *See Beloyan*, 2011 FINRA Discip. LEXIS 44, at *54 (“[T]he record does not support the conclusion that [respondents] were deliberately trying to mislead their customers.”).

V. Conclusion

We affirm the Hearing Panel’s findings that CapWest used 166 flawed communications that violated, in at least one way, the content standards that apply to the public communications of FINRA members, in violation of NASD Rules 2210 and 2110. We also affirm the Hearing Panel’s findings that the firm failed to supervise the use of these communications, in violation of NASD Rules 3010 and 2110. For these supervisory failures, we affirm the Hearing Panel’s decision to fine the firm \$25,000. We modify, in part, the sanctions imposed by the Hearing Panel for this firm’s use of flawed advertisements and sales literature. For these violations, we censure the firm and fine it an additional \$25,000. We also affirm hearing costs in the amount of \$2,867.75.⁴³

On Behalf of the National Adjudicatory Council,

Marcia E. Asquith, Senior Vice President and
Corporate Secretary

⁴³ We also have considered and reject without discussion all other arguments advanced by the parties.

Pursuant to FINRA Rule 8320, the registration of any member who fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days’ notice in writing, will summarily be revoked for non-payment.