INITIAL DECISION RELEASE NO. 1130
ADMINISTRATIVE PROCEEDING
FILE NO. 3-17551

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of MED-X, INC.	INITIAL DECISION May 8, 2017

APPEARANCES: Kevin P. O'Rourke, Joshua E. Braunstein, and Nancy L. Singer for the Division of Enforcement, Securities and Exchange Commission

James F. Moyle, Moyle LLC, for Med-X, Inc.

BEFORE: Jason S. Patil, Administrative Law Judge

Summary

Respondent Med-X, Inc., concedes that it failed to file a required report on time and that, as a result, it unknowingly sold shares of its exempt offering while not in compliance with Regulation A's rules. However, it argues that these errors were committed inadvertently due to its counsel's misinterpretation of those rules, and that the balance of equities favors vacating the Securities and Exchange Commission's temporary suspension of Med-X's Regulation A exemption. This initial decision does just that.

Procedural Background

On September 16, 2016, the Commission issued an order temporarily suspending the exemption of Med-X under Regulation A, pursuant to Section 3(b) of the Securities Act of 1933 and Rule 258(a), 17 C.F.R. § 230.258(a). Med-X requested a hearing on the temporary suspension, as was its right under Rule 258(b)(2), 17 C.F.R. § 230.258(b)(2). The hearing was held on January 10 and 25, 2017. The Division of Enforcement called two witnesses: Cesar Sebastian Gomez Abero, chief of the Division of Corporation Finance's Office of Small Business Policy (OSBP), and Christopher Reilly of the Division of Economic and Risk Analysis. Med-X called three witnesses: (1) its expert, Gerald Laporte, who was OSBP's head from 2002 until July 2013; (2) Mark Richardson, Med-X's general counsel; and (3) Matthew Mills, Med-X's founder, chairman, president, and COO. The parties filed their post-hearing briefs on March 21, 2017, and their responsive briefs on April 7.

Findings of Fact and Legal Background

I base the following findings of fact on the entire record and the demeanor of the witnesses who testified at the hearing, applying preponderance of the evidence as the standard of proof. *See Steadman v. SEC*, 450 U.S. 91, 100-04 (1981). Insofar as the witnesses—particularly Gomez and Laporte—offered legal opinions, I do not rely on that testimony. *See Robert D. Potts, CPA*, Securities Exchange Act of 1934 Release No. 39126, 1997 WL 690519, at *10 & n.56 (Sept. 24, 1997). All arguments and proposed findings that are inconsistent with this decision are rejected.

Med-X

Med-X was formed in February 2014 for three cannabis-related business purposes: (1) publishing www.marijuanatimes.org and generating revenue from selling advertisements; (2) selling the natural insecticide Nature-Cide® to cannabis cultivators; and (3) developing supplements made from cannabis oil. Div. Ex. 1 at DIV22; Tr. 285-86.[1] Only one Med-X officer or director, Jennifer Mills, takes a salary from the company, and that salary is less than $50,000. Tr. 286.

Regulation A and Regulation A+[2]

In Section 3(b)(1) of the Securities Act, Congress authorized the Commission to exempt small-dollar-amount offerings of securities from Section 5, which prohibits the sale of securities for which no registration statement is in effect. 15 U.S.C. §§ 77c(b)(1), 77e. The Commission may exempt classes of securities for which it finds that "enforcement . . . with respect to such securities is not necessary in the public interest and for the protection of investors." *Id.* § 77c(b)(1). Beginning in the 1930s, the Commission and the Federal Trade Commission issued rules under this authority, which were codified as Regulation A in 1936. Amendment to Rules of Practice, Securities Act Release No. 632, 1936 WL 30900 (Jan. 21, 1936). Before this century, the statutory cap on Regulation A offerings was last raised in 1980 to $5 million. Small Business Investment Incentive Act of 1980, Pub. L. 96-477, tit. 3, § 301, 94 Stat. 2275 (1980). In 2012—perhaps recognizing that Regulation A had been rendered obsolete by inflation, *see* Tr. 16 ("Regulation A had not been widely utilized."); Tr. 161-62—Congress passed the Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (codified in scattered sections of 15 U.S.C.), to modernize the exemption for small issuances. The JOBS Act required the Commission to update and expand Regulation A to cover offerings of up to $50 million within a twelve-month period, with the goal of "increas[ing] American job creation and economic growth

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[1] Citations to the hearing transcript are noted as "Tr. __." Citations to the Division's exhibits and Respondent's exhibits are noted as "Div. Ex. __" and "Resp. Ex. __," respectively. Citations to the Division's post-hearing filings are noted as "Div. Br." and "Div. Reply." Citations to Respondent's post-hearing filings are noted as "Resp. Br." and "Resp. Reply." Citations to a document's Bates number omit any preceding zeros.

[2] The Commission continues to refer the exemption as "Regulation A," while practitioners call the amendments "Regulation A+." This decision uses the latter at times to refer to the amendments and Med-X's offering.

by improving access to the public capital markets for emerging growth companies." JOBS Act preamble; *see id.* § 401 (codified at 15 U.S.C. § 77c(b)(2)-(5)).

The Commission adopted rules implementing the JOBS Act in March 2015. *See* Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21806, 21806, 21925 (Apr. 20, 2015) (to be codified at 17 C.F.R. pt. 230). The new rules—known as "Regulation A+"—provide for two tiers of offerings. Med-X's offering was made under tier 2, which governs offerings of up to $50 million in a twelve-month period. 17 C.F.R. § 230.251(a)(2). In addition to having a higher annual cap, tier 2 offerings have certain benefits, including preemption of state securities laws and disclosure obligations. *See id.* § 230.256; *see also* 15 U.S.C. § 77r(a), (b)(3). But in exchange for these benefits, issuers taking advantage of the tier 2 exemption must satisfy more federal disclosure requirements than those using tier 1. *Compare* 17 C.F.R. § 230.257(a), *with id.* § 230.257(b). After qualification of the offering statement, tier 2 issuers are required to file annual reports, with audited financial statements, and semi-annual reports. *Id.* §§ 230.251(d)(2), .257(b)(1), (3).

Med-X's Regulation A+ Offering

Beginning in 2014, Med-X used the private placement exemption under Regulation D, 17 C.F.R. § 230.500 *et seq.*, to raise capital and commence research and development activities. Tr. 246-47, 287-88. For that offering, Med-X had to verify the accredited status of each investor by reviewing tax returns, credit reports, or financial statements, or by obtaining third-party verification from the investor's accountant, securities broker, or advisor. 17 C.F.R. § 230.506(c)(2)(ii); *see* Tr. 247-48. In addition, shares sold pursuant to Regulation D cannot easily be re-sold, depriving investors of liquidity. *See* 17 C.F.R. § 230.500(d) ("Regulation D provides an exemption only for the transaction in which the securities are offered or sold by the issuer, not for the securities themselves."); Tr. 296-97. Med-X's Regulation D offering raised only $1.1 million over eighteen months. Tr. 247.

In August 2015, Med-X filed an offering statement on Form 1-A, seeking to qualify a tier 2 offering of $15 million of common stock on a continuous basis under Regulation A+. Div. Ex. 1. Med-X pursued the Regulation A+ offering to raise capital more quickly by accessing a larger pool of prospective investors. Tr. 288-89. The offering was intended for "sophisticated investors only," and no sale could be made to an investor if the aggregate purchase price paid was more than 10% of the greater of the investor's annual income or net worth, not including the value of the investor's primary residence. Div. Ex. 1 at DIV10, DIV60. The offering statement included Med-X's audited financial statements as of December 31, 2014, and unaudited financial statements as of June 30, 2015. *Id.* at DIV66-83. Page one of the offering circular contains a four-page summary of risk factors and a more detailed seven-page section on the offering's substantial risks. *Id.* at DIV14-19, DIV29-42. Corporation Finance had one comment on the offering statement, which led to Med-X amending it in October 2015. Div. Exs. 2-3. Per Med-X's request, Corporation Finance qualified the offering on November 3, 2015. Div. Exs. 4-5.

Med-X did not commence selling immediately because several amendments were required by the broker-dealer that Med-X had engaged to provide compliance-related services, including review of all subscription documents; Richardson, who had prepared the filings, explained that Med-X "wanted to make sure that the offering statement was absolutely correct."

Tr. 249-54, 290. Similarly, Mills testified that Med-X delayed selling shares so that it could establish "back end housekeeping to make sure that we were really following all regulatory issues," including completion of "multiple post-qualifications, to get re-qualified for those fees" and "the portal" that were associated with the broker-dealer. Tr. 290-91. Because the offering was Med-X's first that was not limited to accredited investors, management paid attention to "the process of bringing, especially, nonaccredited investors to the plate." Tr. 290; *see* Tr. 287-89. Med-X filed three post-qualification amendments to its offering statement before February 8, 2016, when the first sales were recorded. Resp. Exs. B-D; *see* Tr. 146; Div. Exs. 15, 20. The last of the substantive amendments was qualified on January 29, 2016. *See* Tr. 253-54. Med-X filed an additional amendment in February 2016 and a supplement in July 2016 to extend the offering's sales termination date. Resp. Ex. E at ii; Resp. Ex. F at 3; *see* Div. Ex. 20. The Division has not alleged that the offering statement, as amended and supplemented, was deficient in any way.

Because Med-X's fiscal year ends December 31, its 2015 annual report was due April 30, 2016. Div. Ex. 11 at DIV244; Div. Ex. 21 at DIV580 (Form 1-K General Instructions A(2)); *see* 17 C.F.R. §§ 230.257(b)(1), 239.91. Med-X's officers relied fully on Richardson to ensure the deadlines were met. Tr. 258, 260, 292. While reviewing filings in 2016, OSBP discovered that Med-X had missed its deadline and had not yet filed its annual report. Tr. 34-35. On August 30, 2016, Corporation Finance mailed a letter to Med-X notifying the company of its noncompliance and informing it that "the Commission may, without further notice, issue an order temporarily suspending" the exemption. Resp. Ex. G-1 at MX2; *see* Tr. 47. Med-X received the letter on Friday, September 2, 2016, and its CFO forwarded it to Richardson to "review and call us ASAP!" Resp. Ex. G-1 at MX1; Tr. 255-56. Richardson was "[i]ncredibly upset" at missing his first filing deadline in thirty-eight years of practice. Tr. 257. Mills, recognizing that the delinquent filing was a serious problem, instructed Richardson to get "all hands on deck" to complete the report and "immediately respond back to the SEC, immediately, don't waste any time." Tr. 292-93.

On Tuesday, September 6, 2016, after the Labor Day holiday, Richardson left a voicemail with Tim Henseler of Corporation Finance to explain the error—he thought that the annual report would not be due until 2017 (for fiscal year 2016) because the last post-qualification amendment was not qualified until 2016—and report that Med-X would file its Form 1-K "within the next couple of weeks":

> I just want to reassure you that we will be filing our 1-K and our 1-S within the next couple of weeks to be completely caught up on Med-X. I was going off the date of the last post-effective amendment so I didn't—I didn't realize we had an annual report due on April 30th. But I acknowledge your correspondence and we're going to take care of it. If you have any questions you can call me at the law office . . . . Thank you, Tim. Appreciate it.

Resp. Ex. G-3; *see* Tr. 92, 257, 267, 281-82. Richardson and Med-X did not receive a return call. Tr. 282. Med-X had already begun working on its semiannual report for the first half of 2016, which the Commission estimated would require 187.43 hours to complete, and it immediately began working on its 2015 annual report as well, which the Commission estimated

would require approximately 600 hours to complete. Tr. 257-58; 80 Fed. Reg. at 21889-90; 17 C.F.R. §§ 239.91-.92.

Two-and-a-half weeks after Corporation Finance mailed the letter to Med-X, on Friday, September 16, 2016, the Commission temporarily suspended Med-X's exemption on the basis of the delinquent annual report. Div. Exs. 9-9A; *see* 17 C.F.R. § 230.258(a). The order was published online by the Commission on the same day. https://www.sec.gov/litigation/admin/adminarchive/adminarc2016.shtml; *see, e.g.*, Stephen M. Quinlivan, *SEC Suspends Regulation A+ Offering*, Lexology (Sept. 16, 2016), http://www.lexology.com/library/detail.aspx?g=3cc36051-1d7c-410d-917c-e4967f962562 (reporting on temporary suspension). But the records of the Office of the Secretary indicate that Med-X did not receive the mailed copy of the suspension order until September 22, 2016.

After Richardson attempted to contact Corporation Finance, Med-X "circled wagons, went right to work . . . with the CFO, [its] accounting firm," and "[e]verybody" to complete the 2015 annual report and the 2016 semiannual report. Tr. 293; *see* Tr. 258 ("We worked night and day for two weeks."). Med-X filed its reports after the close of the EDGAR database on Monday, September 19, 2016, so the reports received date stamps of September 20. Div. Exs. 11-12; Tr. 81, 258. Med-X did not disclose Corporation Finance's August 30, 2016, letter in its reports; nor did it disclose the temporary suspension. *See* Div. Exs. 11-12. Although the temporary suspension order was posted on the Commission's website on September 16, there is no evidence that Med-X received notice of it until after Med-X had filed its reports. *See* Form 1-U at *2. Med-X later disclosed the temporary suspension order and the present administrative proceeding in a current report. *Id.*

Med-X sold shares of the offering while its annual report was delinquent. *See* Div. Exs. 15, 17. Corporation Finance learned this from the annual report. Tr. 48-50, 83-86. As summarized by Reilly, approximately $240,000—roughly 28% of all money invested during Med-X's Regulation A+ offering—was invested after April 30, 2016, and 145 of the 150 post-April 30 investors were investing in Med-X for the first time. Tr. 146-150; Div. Ex. 17; *see* Div. Ex. 15. The overwhelming majority of these shares were sold before Med-X was aware that it was delinquent. *See* Div. Ex. 15.

The parties, however, dispute whether Med-X sold shares after the Commission temporarily suspended Med-X's exemption. Division Exhibit 15, a spreadsheet of Med-X's sales data that the Division compiled from data provided by Med-X, contains eight entries bearing the date September 27, 2016. *Id.*; *see* Tr. 144-45. Med-X contends that that the "Date" column represents the date a sale was cleared, not the date of sale. *See* Resp. Reply Br. at 21-23. Neither Reilly nor any other Division witness explained what the "Date" column represents. Values in that column suggest that Med-X is correct that the sales took place at some indeterminate prior time. Each "Date" entry also includes a time. For the eight trades dated September 27, 2016, the time is the same: 11:13 a.m. PDT. Div. Ex. 15. In addition, the distribution of dates suggests periodic clearance of sales that had happened earlier; before the eight Tuesday, September 27 trades, there were eight Friday, September 16 trades at 12:13 p.m. PDT, nine Friday, September 9 trades at 11:40 a.m. PDT, and so forth. *Id.* It is plausible that the sales listed with a certain date occurred in between that date and the last date that sales were cleared, in which case the eight September 27 trades occurred after September 16, if not on

September 27. The parties' stipulation as to the approximate number of shares sold between May 1, 2016, and September 20, 2016, also might suggest that at least some sales occurred after the entry of the Commission's order—or the end date may have simply been derived from the date on which Med-X's reports were accepted for filing. But these are merely suppositions; the Division did not establish with any certainty that any shares were sold after September 16, 2016.

Med-X's offering was suspended after raising only $872,968 of the $15 million it sought. Div. Ex. 17. The temporary suspension makes it extremely difficult for Med-X to raise capital. Tr. 295. Before the suspension, Med-X was well positioned to expand its business and compete in the market arising from California's legalization of marijuana through the passage of Proposition 64, but due to the suspension it is losing ground to competitors. Tr. 295-96. If the suspension is made permanent, even assuming a waiver can be obtained as to Regulation D, Tr. 136-39, resort to that exemption would create liquidity issues and "will definitely slow [Med-X] down," Tr. 297. Mills testified that Med-X will have to "stop operations," "save all the capital," and "file and get the company public." Tr. 296-97. If Med-X cannot timely re-enter the capital-raising process under Regulation A+, it may not survive. Tr. 296. Thus, a permanent suspension for this late filing would potentially be catastrophic for the company and its investors. Tr. 225-26, 296.

Conclusions of Law

The Power to Suspend Exemptions

Until 1953, the Commission did not include any rules on suspending exemptions under Regulation A. *See* J. William Hicks, 7 Exempted Transactions Under the Securities Act of 1933 § 6:96, n.2 (2017). Rule 223, adopted in 1953, established the procedure for suspension of Regulation A exemptions that was essentially identical to that found in modern Rule 258. *See* Regulation A: General Exemption, 18 Fed. Reg. 1434, 1436-37 (Mar. 13, 1953) (to be codified at 17 C.F.R. pt. 230). *Compare* 17 C.F.R. § 230.223 (Supp. 1953), *with* 17 C.F.R. § 230.258. In adopting Rule 223, it was "the Commission's hope that this provision will be invoked only in those rare cases where persons employing the rule refuse to comply with the spirit of the regulation." Regulation A: General Exemption, 18 Fed. Reg. at 1434. In 1956, the Commission replaced Rule 223 with Rule 261, which is also similar to current Rule 258. *See* Regulation A: General Exemptions, 21 Fed. Reg. 5739, 5742 (Aug. 1, 1956) (to be codified at 17 C.F.R. pt. 230); *compare* 17 C.F.R. § 230.261 (Supp. 1956), *with* 17 C.F.R. § 230.258.

Rule 258, adopted in 2015, allows the Commission to temporarily suspend a Regulation A exemption on any of six bases. 17 C.F.R. § 230.258(a) (adopted as part of Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. at 21900). Once an issuer is notified of the temporary suspension, it may request a hearing, but if it does not, the temporary suspension automatically becomes permanent thirty days after it was entered. *Id.* § 230.258(b), (c). If a hearing is held, "the Commission will . . . either vacate the order or enter an order permanently suspending the exemption." *Id.* Paragraph (d) elaborates on permanent suspensions:

> The Commission *may*, at any time after notice of and opportunity for hearing, enter an order permanently suspending the exemption

> for any reason upon which it could have entered a temporary suspension order under paragraph (a) of this section. Any such order shall remain in effect until vacated by the Commission.

Id. § 230.258(d) (emphasis added); *cf.* 17 C.F.R. § 230.223(c) (1953) (using identical language); 17 C.F.R. § 230.261(c) (same).

Discretion Under Rule 258

The parties disagree on the scope of the Commission's discretion under paragraphs (c) and (d) of Rule 258. Med-X contends that nothing in Regulation A "*requires* a permanent suspension of the exemption" under Rule 258, "without consideration of ameliorating facts and circumstances." Resp. Br. at 18 (emphasis in original). It points to the word "may" in paragraph (d) as the textual basis for the Commission's discretion. *See id.* at 22. By contrast, the Division argues that "may" relates only to the grounds the Commission is permitted to consider in determining whether to make a temporary suspension permanent; that is, the Division's reading of the rule allows the Commission to consider any conduct that *could have* led to the temporary suspension, not just the conduct alleged in the OIP. Div. Br. at 25 n.20. However, in contrasting Regulation A with Section 8(d) of the Securities Act, the Division acknowledges that the former "committed to the Commission's *discretion* whether to impose a permanent suspension or vacate the temporary suspension." *Id.* at 31 (emphasis added); *see also* Tr. 77-79 (Division expert: "The rules contemplate that through this proceeding, then the determination will be made whether to vacate the temporary order or to make it permanent.").

Because the report Med-X delinquently filed has been required only since the 2015 amendments to Regulation A, there is no binding precedent on the specific question. Thus, both parties look elsewhere for guidance. In arguing for broad discretion, Med-X relies on several cases involving the requirement of Regulation A that an issuer file a Form 2-A semi-annually, documenting sales under the exemption and the use of proceeds therefrom. In many cases under that regime, the Commission vacated temporary suspensions after the issuer filed the past-due reports. *See, e.g.*, *Red Lane Calcareous Sinter Co.*, Securities Act Release No. 4337, 1961 WL 61566, at *1 (Mar. 6, 1961) (after late report was filed, "Commission concluded that it was appropriate in the public interest to lift the suspension order"); *Champion Ventures, Inc.*, Securities Act Release No. 4316, 1961 WL 61545, at *1 (Jan. 13, 1961) (suspension vacated after missing report filed, despite respondent's "fail[ure] to cooperate with the Commission by its failure to respond to letters from the Commission"); *Simplex Precast Indus., Inc.*, Securities Act Release No. 3850, 1957 WL 7748, at *1 (Oct. 22, 1957) (noting that "failure to file the report was due entirely to inadvertence"); *see also William Baxter*, Securities Act Release No. 4783, 1965 WL 87562, at *1-2 (June 4, 1965) (concluding that it was "not . . . necessary to make [a] temporary suspension permanent" despite the issuer's "fail[ure] to file a report within the time required by Rule 260, despite repeated requests from our staff that it do so" where, among other things, there were no allegations that the offering circular and the late report were deficient and Corporation Finance had not requested a permanent suspension). As the Division points out, Form 2-A was very different than the annual report Med-X filed late. Div. Reply at 8-10. Nonetheless, these cases indicate that the Commission routinely forgave reporting failures once the issuer regained compliance; and more importantly, indicate some measure of discretion.

Further, even beyond the context of failures to file Form 2-A, the Commission has indicated that it has discretion in deciding whether to make a temporary suspension under Regulation A permanent or to vacate the suspension. In *Illowata Oil Co.*, the temporary suspension was based in part on "untrue and misleading statements of material facts" in the offering documents. Securities Act Release No. 3999, 1958 WL 55565, at *1 (Dec. 4, 1958). The company amended its documents after receiving notice of the temporary order and requested that the suspension be lifted, subject to further revisions "in a form satisfactory to the Division [of Corporation Finance]." *Id.* at *3. Corporation Finance objected, arguing that "Regulation A makes no provision for filing amendments" after a suspension is imposed, and that "this is not a case for the exercise of [the Commission's] discretion to consider such amendments because Illowata did not use adequate care in preparing its original filing." *Id.* The Commission disagreed, holding that it could consider post-suspension amendments in "an appropriate case," drawing an analogy to its practice in Section 8(d) stop order cases. *Id.* However, because "[t]he opportunity to amend cannot . . . be permitted to impair the required standards of careful and honest filings under the Regulation . . . , before we will consider such amendments in any case, there must be a clear showing of a good faith and of other mitigating circumstances in connection with the deficiencies." *Id.* Ultimately, after making supplemental findings, the Commission issued a permanent suspension, but nonetheless reiterated this standard. *See Illowata Oil Co.*, Securities Act Release No. 4127, 1959 WL 59459, at *2-3 (Aug. 10, 1959).

In the present matter against Med-X, the Division points to other lines of Commission and circuit court precedent, which it argues render null any discretion the Commission might have because "Regulation A is a privilege which demands that issuers comply strictly with the regulation." Div. Br. at 28-29 (quoting *Mut. Emps. Trademart, Inc.*, Securities Act Release No. 4478, 1962 WL 68472, at *5 (Apr. 17, 1962)). However, the cases cited by the Division involve conduct that is materially distinguishable from that of Med-X. Each of the cases involved false or misleading statements in the issuers' offering documents or other fraud. *See SEC v. Cavanaugh*, 445 F.3d 105, 107, 115-16 (2d Cir. 2006) (pump-and-dump scheme); *Tabby's Int'l, Inc. v. SEC*, 479 F.2d 1080, 1083 (5th Cir. 1973) (declining to vacate suspension where offering was "permeated with fraud," but recognizing ability to do so in cases "involv[ing] far less serious noncompliance"); *Robert Mfg. Corp.*, Securities Act Release No. 5489, 1974 WL 161998, at *1 (Apr. 30, 1974) (offering circular materially deficient because it was not amended to disclose that respondent "no longer had any of the machinery, equipment, and inventory spoken of therein," and incompletely disclosed relationship between respondent and underwriter; respondent did not object to permanent suspension); *Am. Television & Radio Co.*, Securities Act Release No. 4355, 1961 WL 61056, at *1 (Apr. 18, 1961) (offering circular contained "untrue and misleading statements of material facts"); *Mut. Emps. Trademart, Inc.*, 1962 WL 68472, at *2-5 (finding two misleading statements and two failures to disclose in offering documents and finding "no reason to grant to the issuer another opportunity to conform prior to issuance of a suspension order" "[w]here a filing presents serious questions on its face and indicates at the least an indifferent attitude towards the requirements of the Regulation"). Moreover, *Illowata Oil* shows that even in the case of misleading statements, the Commission considers itself to have some discretion to allow amendments and vacate temporary suspensions in an appropriate case.

The text of Rule 258 and the weight of authority under its predecessor reasonably suggest that the Commission has discretion to vacate a temporary suspension even if an issuer does not

or cannot contest its legal validity. However, Rule 258 does not provide guidance on how to exercise that discretion. *Illowata Oil* is almost sixty years old and has not been cited in a Commission opinion since 1987. *See Teletest Corp.*, Securities Act Release No. 6717, 1987 WL 756078, at *2 n.8 (June 4, 1987). More recently, in discussing its "decision to impose any remedial sanction," the Commission noted its "broad discretion," stating that a remedy must merely have a "reasonable relation" to the record and the violation at issue. *KPMG Peat Marwick LLP*, Exchange Act Release No. 43862, 2001 WL 47245, at *24 (Jan. 19, 2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002). In performing such an analysis, the Commission "traditionally ha[s] balanced a variety of mitigating and aggravating circumstances, such as the harm caused by the violations, the seriousness of the violations, the extent of the wrongdoer's unjust enrichment, and the wrongdoer's disciplinary record." *Id.*

KPMG involved the showing required for a cease-and-desist order under Section 21C of the Exchange Act. *See id.* at *19. That section, like Rule 258, does not mandate what the Commission is to consider, beyond the fact of the violation, in levying a sanction. *See* 15 U.S.C. § 78u-3(a). It therefore provides evidence as to what the Commission may consider in exercising its Rule 258 discretion. Generally, the factors listed in *KPMG* align with the factors discussed in *Gateway International Holdings, Inc.*, Exchange Act Release No. 53907, 2006 WL 1506286, at *4 (May 31, 2006), and *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981), the cases setting forth the standards for registration revocations and industry bars, respectively, which Med-X argues should be applied here. Resp. Br. at 32-36. They also align with factors the Commission considered in suspension proceedings under Regulation A. *See, e.g.*, *Automata Int'l, Inc.*, Securities Act Release No. 4719, 1964 WL 66909, at *2 (Sept. 4, 1964) (vacating temporary suspension for inaccuracies in Form 2-A in part because there was "no allegation or evidence that the issuer failed to exercise due diligence in selecting the underwriter or was otherwise guilty or any wrongdoing or misconduct"); *Inspiration Lead Co., Inc.*, Securities Act Release No. 4076, 1959 WL 59540, at *5 (May 7, 1959) (permanent suspension issued in light of "serious and extensive" deficiencies relating to "matters of the utmost importance to prospective investors"); *supra* at 7 (cases vacating temporary suspensions after issuer's cooperation led to compliance); *cf. Axum, Inc.*, Securities Act Release No. 8736, 2006 WL 2504448, at *1 (Aug. 30, 2006) ("find[ing] that it is in the public interest," based on the underlying admitted facts, to permanently suspend Axum's Regulation A exemption as part of settlement).

At their core, these tests attempt to balance the equities as they affect the Commission's mission of protecting investors, maintaining efficient markets, and facilitating capital formation, the last of which was the primary emphasis of the JOBS Act. *See Gateway Int'l Holdings, Inc.*, 2006 WL 1506286, at *4 (framing the sanctions question as "turn[ing] on the effect on the investing public, including both current and prospective investors, of the issuer's violations, on the one hand, and the . . . sanctions, on the other hand"). The nonexclusive factors the Commission listed in *Gateway*, for example, were the seriousness of the violation and whether it was isolated or repeated, the degree of culpability, efforts to remedy the violation and ensure future compliance, and the credibility of assurances against future violations. *Id.* A similar approach makes sense in this proceeding.

The Division argues that the standard should be stricter than *Gateway*'s standard for registration revocations, because registration is the default method of selling securities under the

Securities Act, whereas an exemption is a "privilege." Div. Br. at 28. Rule 257's reporting requirements are indeed an important tool for the protection of investors. But the Division's argument misconstrues the nature of the exemption. As previously noted, the purpose of the JOBS Act was to "improv[e] access to the public capital markets for emerging growth companies," because the registration process is cost prohibitive for smaller issuers. JOBS Act preamble. Regulation A+ therefore "facilitate[d] smaller companies' access to capital," and gave investors "more investment choices." *SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital*, SEC Press Rel. 2015-49 (Mar. 25, 2015), https://www.sec.gov/news/pressrelease/2015-49.html. As such, the exemption is not so much a privilege as simply another way for companies to raise capital. Therefore, it is appropriate to apply the *Gateway* factors to this proceeding.

The Division also argues that Rule 260 demonstrates how seriously the Commission takes the reporting requirements. Div. Br. at 21-23. Rule 260 defines which types of compliance failures will "result in the loss of the exemption from the requirements of Section 5 of the Securities Act for any offer or sale to a particular individual or entity" and which will not. 17 C.F.R. § 230.260(a). A failure to comply with the rule prohibiting sales while an issuer is not current on its reports is "deemed to be significant to the offering as a whole," and thus can result in the loss of the exemption. *Id.* §§ 230.260(a)(2), .251(d)(3)(i)(F). It is unclear, however, what role Rule 260 plays in this matter, other than that it "provides no relief or protection from a proceeding under Rule 258." *Id.* § 230.260(c). Notably, Rule 260 refers to the "loss" of the exemption, whereas Rule 258 refers to its "suspension." So, while the stern language regarding significant deviations in the 2015 adopting release indicates the importance of the reporting requirements, 80 Fed. Reg. at 21854, 21885, it does not follow that noncompliance requires permanent suspension.

Analysis

Based on the following factors pertinent to the equitable determination of whether to vacate or make permanent Med-X's temporary suspension, I find that on balance, Med-X merits a favorable exercise of discretion and the suspension should be vacated.

Acceptance of Responsibility. Med-X has consistently and fully accepted responsibility for its violation. *See* Resp. Exs. G-3; Tr. 281-82, 293-94. Mills, the principal officer of the company, was humble and remorseful in his testimony. *See* Tr. 293-94.

Scienter. Med-X did not intend to miss its filing deadline or sell shares while it was delinquent. On the contrary, it relied on a seasoned legal practitioner with thirty-eight years of experience in corporate and securities law who had never missed an SEC filing to be responsible for its SEC filings. From the instant Richardson and Med-X's officers and directors were aware of the missed deadline, they exerted all available effort in ensuring the report was made accurately and as quickly as possible. In the absence of Commission precedent or staff guidance discussing the effect of multiple pre-sale "qualifications" of amended offering statements on the timing of reporting obligations, Med-X relied on Richardson's interpretation. The Division characterizes Richardson's mistake as "illogical," but under the circumstances, given the staff's use of the word "qualified," Tr. 279-80, Richardson's interpretation at the time (though technically incorrect as a matter of law) that the timing would be based on the qualified offering

under which Med-X sold shares, as opposed to prior offering statements under which no sales were ever made, was reasonable. In observing Richardson's testimony on this point, his sincerity and thought process in reaching the inaccurate interpretation were genuine, and his remorse at the mistake was palpable. *See* Tr. 256-68. The Division's argument that Med-X is "bound by" its "lawyer-agent" and its observation that Richardson "was one of the Founders" who "capitalized the company through his no-charge legal work" (Div. Reply at 6)—much in the same way virtually all of its founders did, by working without salaries—does not make its reliance on him any less extenuating.

Investor Harm. Notwithstanding the inadvertent five month delay in providing the audited annual report, all investors received the primary offering document before making the decision to invest. And with respect to the information in the delayed report, the Division fails to identify any facts that would materially alter or change the financial landscape presented in the offering circular: this is an early-stage company with virtually no revenues that is encumbered by ongoing expenses. *See* Resp. Ex. E at 39. The Division's main witness, Gomez, testified that investors who bought shares without the annual report on file made their decision without the benefit of updated financials. Tr. 51. But he was not asked to identify information in the annual report that he believed would be important to potential investors. In addition, Med-X voluntarily turned over all shareholder information to the Commission. Tr. 144-45. Yet the Division presented no evidence of any investor complaints or any indication that investors would have acted differently had the annual report been timely filed.

The Division contends that three items in the annual report would have been material to investors' decisions to purchase Med-X shares after April 30, 2016. According to the Division, one purportedly material item was the $40,000 that Med-X lent to an affiliate, which was repaid. Div. Br. at 10. However, contrary to the intimation of the Division that investors lacked this information, the offering circular every investor received stated that "[o]n April 14, 2015, the Company loaned Pacific Shore Holdings, Inc. $ 40,000 as a short-term non-interest bearing loan to be repaid in sixty days. The loan was repaid in full on May 29, 2015." Resp. Ex. E at F-13.

Second, the Division claims that Med-X's failure to issue an annual report on April 30, 2016, deprived investors of notice that Med-X borrowed $50,000 from an affiliated entity in *June* 2016 and planned to repay it in *September* 2016. Div. Br. at 10. However, if Med-X had filed its report by the deadline, this loan—which had yet not occurred—would not have been in it.

Third, the Division notes that investors were not advised that Med-X's revenue declined from $360 in 2014 to $200 in 2015, and its net loss increased from $16,135 in 2014 to $402,227 in 2015. Div. Br. at 10; *see* Div. Ex. 11 at DIV274. The offering circular that every investor received reported no sales in the first half of 2015, expenses of $138,304 and a loss of that amount as a result. Resp. Ex. E at F-17. It also stated that "costs exceed revenue because we do not have sales" and that Med-X "cannot assure when or if revenue will exceed operating costs." *Id.* at 38. The offering circular stated that Med-X's "capital needs have primarily been met from the private placement of our common stock"; and advised investors that it "will have additional capital requirements during 2015 and 2016" and does "not expect to be able to satisfy [its] cash requirements through online sales, and therefore [it] will attempt to raise additional capital through the sale of our common stock." *Id.* at 39. Med-X also advised investors that it was

"incurring operating deficits that are expected to continue for the foreseeable future." *Id.* Thus, the 150 investors that the Division argues were harmed expected no sales or revenue in 2015. Given the lack of expected revenue in 2015, the loss in the second half of that year (which was unreported) is consistent with the loss for the first half of that year. *See id.* at F-17. The disclosures in the annual report, though belated, do not establish that investors suffered any material harm in light of substantially similar disclosures each was armed with by the offering circular.

Prompt Remediation. Med-X filed the delinquent report eleven business days after receiving notice of the deficiency. Med-X was otherwise diligent in complying with all rules and requirements. Its initial offering statement was so thorough it received only one comment from Corporation Finance, which was promptly addressed, before being qualified. While Med-X could have immediately offered and sold shares, it waited to do so until the last of three post-qualification amendments (addressing changes to the distribution plan) were qualified. Med-X was already working on the required semiannual report when it received notice of the late annual report. It filed the semiannual report ahead of schedule.

Public Interest. The Division asserts that permanently suspending Med-X "would reassure smaller issuers and investors" and that "permitting Med-X to avoid the consequences of its admitted failures would chill compliance" by small issuers. Div. Reply at 5. However, Med-X has already suffered considerably on account of its mistake—its offering was frozen upon raising only 6% of the potential capital authorized by its Regulation A+ offering, and has remained in stasis for the better part of a year. Stated differently, it was frozen out of the opportunity to access more than $14 million of an authorized $15 million that it could have raised to grow its business. There is a public interest in helping small companies such as Med-X raise capital under the exemption, and not chilling its use by establishing a rule that a single filing error accompanied by the sale of stock could result in a permanent suspension and disqualification from other exemptions. *See* Tr. 171, 192; Resp. Ex. I ¶ 11. The public interest would also be served by calibrating a penalty to a violation, and avoiding an overly harsh penalty that could irreparably harm not only the company, but also several hundred current shareholders. *See* Tr. 193-94; *see also* Tr. 185-87. As Laporte observed, discretion "should be exercised to protect not only *potential* investors . . . , but also *actual* investors in Med-X, who could be significantly harmed if there is a permanent suspension for an untimely filing." Resp. Ex. I ¶ 13.

Based on these circumstances, permanently suspending Med-X may chill use of the exemption for small offerings by the growing companies it was designed to help. It is quite likely that companies would not use tier 2 for small offerings if accidental noncompliance with its reporting provisions results in permanent suspension and "bad actor" disqualification. *See* 17 C.F.R. §§ 230.262(a), .506(d); *see also* Tr. 192, 225-26; Resp. Ex. I ¶ 13. As Laporte testified, if "a single inadvertent failure to file a required report results in a suspension of the exemption, people just won't use it, because it's like a gotcha rule, and . . . the Commission isn't usually in the business of issuing gotcha rules for smaller companies." Tr. 192. Of 140 issuers that filed for a Regulation A+ offering, only 81 offerings seeking $1.5 billion have been qualified since 2015; only $190 million has been raised.[3] An even-handed, equitable application of the

[3] For this proposition, I take official notice of the following information made publicly available by the SEC: Anzhela Knyazeva, *Regulation A+: What Do We Know So Far?* 1 (Nov.

exemption—which protects investors as well as encouraging issuers—may well advance its intended purpose of encouraging capital formation.

Here, a permanent suspension would harm all investors who have provided capital to the company, which far outweighs the harm of disclosure deficiencies that have since been rectified. *See* Tr. 171, 193-94, 296-97; Resp. Ex. I ¶ 13; *see also e-Smart Techs., Inc.*, Initial Decision Release No. 272, 2005 SEC LEXIS 253, at *23 (ALJ Feb. 3, 2005) ("The effect of any suspension, as with revocation, would be to harm investors unfairly, rather than to serve any deterrent or remedial function now that the company has filed, albeit untimely, all its delinquent reports."), *finality order*, Exchange Act Release No. 51309 (Mar. 3, 2005).

Bootstrapping. The Division argues that "the record shows further illegal sales *after* the imposition of the temporary suspension order and *after* Med-X made its late filing." Div. Reply at 3; *see id.* at 5 n.2. The Division contends that Med-X should be permanently suspended because it sold shares during the five-month period that the annual report was unknowingly delinquent. However, since Med-X did not know that the report was delinquent, it had no knowledge that its sale of shares resulted in a potential violation of Section 5. The amount of shares sold in the brief period between which Med-X became aware of the delinquency and corrected it was minute. Although the Division also contends that Med-X sold shares after it received notice of the temporary suspension, the Division did not prove that to be fact.

Similarly, the Division argues that Med-X failed to disclose the temporary suspension in its late-filed annual report. *See* Div. Br. at 35-36. However, at the time the annual report was filed on September 19, 2016, Med-X had not received the mailed copy of the temporary suspension order (although the order would have been available on the Commission's website).

Past Misconduct. The Division argues that cease-and-desist orders entered in California and Pennsylvania against Mills and Pacific Shore Holdings (of which Mills is chairman, CEO, and president, Div. Ex. 1 at DIV46), as well as Mills' testimony about the orders, weigh in favor of permanent suspension. The Pennsylvania matter (which Mills and Pacific Shore Holdings settled for $5,000 without admitting or denying the allegations) dealt with an episode of cold-calling committed by unidentified representatives of Pacific Shore Holdings. Div. Ex. 22. The California case pertained to the offer or sale of securities not qualified under California law, which may have stemmed from the same episode. Div. Ex. 23; Tr. 316. Mills is named as a respondent in those cases and Pacific Shore Holdings continues to be affiliated with Med-X. However, the conduct occurred almost six years ago and involved violations dissimilar from Med-X's missed reporting deadline. Although Med-X also sold shares while not in compliance with securities regulations, it did so unknowingly. Further, both proceedings were disclosed in Med-X's offering circular. Resp. Ex. E at 25.

The Division's characterization of Mills' testimony about these incidents as "plainly inconsistent," Div. Br. at 37, is inaccurate. Mills initially testified that he suspected his brother-

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2016), https://www.sec.gov/files/Knyazeva_RegulationA%20.pdf; and SEC, Government-Business Forum on Small Business Capital Formation, at 17:58-18:41 (Nov. 17, 2016), https://www.sec.gov/video/webcast-archive-player.shtml?document_id=gbforum111716 (remarks of Keith F. Higgins, then-Director of Corporation Finance).

in-law, who also worked for Pacific Shore Holdings, was behind the cold-calling. Tr. 315-16, 325-26. His subsequent testimony made clear that it was a suspicion, not a certainty, that his brother-in-law was involved because his name was contained in some of the administrative documents. Tr. 325, 332. However, Mills testified that he was permitted very little discovery in those proceedings, so he could not be sure who the cold-caller was. Tr. 323 ("We asked for information about this . . . . It wasn't given to us. We didn't know who it was. Quite frankly, it could have been anybody."); Tr. 327 ("We don't have any information . . . . Somebody said something. We've never been given facts on it."). Watching him testify, I did not interpret this testimony as a lack of candor; rather, Mills came across as someone trying to remember events occurring between four and six years ago, the details of which he may never have known completely. What Mills was certain of is that he does not condone cold-calling, and that his brother-in-law was fired because of the incident. Tr. 332-33.

* * *

Based on this record, Med-X inadvertently failed to meet its reporting requirements because of a mistake by learned counsel. Upon being advised of that erroneous interpretation, the company embarked on a commendable effort to successfully and expeditiously correct the deficiency. Though reporting requirements exist to provide current and potential investors with important information, the record reflects that investors were not significantly harmed and that a permanent suspension would not only adversely impact Med-X investors, but would unreasonably chill the use of Regulation A to raise capital. As such, the temporary suspension of Med-X's exemption will be lifted.

Record Certification

Pursuant to 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the corrected record index issued by the Commission's Office of the Secretary on April 26, 2017.

Order

Based on the findings and conclusions set forth above, the temporary suspension of Med-X, Inc.'s Regulation A exemption is VACATED and this administrative proceeding is DISMISSED.

This initial decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that rule, a party may file a petition for review of this initial decision within twenty-one days after service of the initial decision. A party may also file a motion to correct a manifest error of fact within ten days of the initial decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then a party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The initial decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct a manifest error of fact or the Commission determines on its own initiative to review the initial

decision as to a party. If any of these events occur, the initial decision shall not become final as to that party.

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Jason S. Patil
Administrative Law Judge