UNITED STATES OF AMERICA

Before the

SECURITIES AND EXCHANGE COMMISSION

In the Matter of the Application of mPHASE TECHNOLOGIES, INC. For Review of Action taken by FINRA	ADMINISTRATIVE PROCEEDING File No. 3-15130

REPLY BRIEF IN SUPPORT OF APPLICATION OF mPHASE TECHNOLOGIES, INC. FOR REVIEW OF ACTION TAKEN BY FINRA

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FINRA's Brief in Opposition to the Application for Review ("FINRA's Opposition Brief") argues that Section 19(f) of the Securities Exchange Act of 1934 ("Exchange Act") governs the review of this case. *See* 15 U.S.C. § 78s(f). But, this assumes that FINRA had the authority to act under Rule 6490, ignoring the Respondents' argument that FINRA's deficiency determination exceeded the scope of its authority under that rule.

Whether FINRA misinterpreted and misapplied Rule 6490 – and thus improperly denied Respondent's application – is a gateway issue that must be decided before the Commission performs any review. In deciding whether FINRA acted within the scope of its authority, the Commission must first look at the enabling statute and SEC Rule, the FINRA rule, legislative history, and principles of statutory construction and interpretation. Under the correct analysis, FINRA's interpretation of Rule 6490 was improper. Because FINRA's interpretation and application of Rule 6490 was improper, its deficiency determination should be reversed.

While FINRA argues that it did not consider as evidence the allegations of the complaint in *SEC v. Packetport.com, et al.*, 2007 WL 911900 (D. Conn. March 21, 2007), or the substantive findings of the cease-and-desist proceeding, *see Packet Port*, 2007 SEC Lexis 2472, at *1, this argument is the height of sophistry since they are part of the record submitted by it on this appeal. FINRA argues that Respondent waived this argument (FINRA's Opposition Br., 20-21 n.22), but the fact is that mPhase had no way of knowing that FINRA relied upon the complaint during the underlying proceedings until it filed the record on appeal with the Commission. Thus, this appeal was Respondent's first opportunity to object to FINRA's improper use of the complaint. Moreover, FINRA's arguments concerning the cease-and-desist proceeding have no merit. FINRA improperly considered the substantive findings, and Respondents properly objected to FINRA's use of the findings in the proceedings below.

Furthermore, FINRA misunderstands that the Commission attempted, but failed, to bar or place conditions on the ability of Ronald Durando and Gustave Dotoli to serve as officers and directors in the *Packetport.com* litigation, which was dismissed with prejudice. As a result, the Commission is prevented from doing so now, which the Commission would do by affirming the deficiency determination.

Lastly, FINRA's attempt to analogize the denial of a Rule 10b-17 request to a membership denial is misplaced. Membership denials maintain the status quo. As demonstrated by this case, a deficiency determination punishes the company's shareholders by preventing them from voting on company actions that other corporations are entitled to engage in. In this case, it also punishes Durando and Dotoli, who have served the Respondent and its shareholders responsibly, complied with the federal securities laws, and posed no threat to investors. Thus, the deficiency determination was a punishment, and because FINRA's basis was the settlement of the *Packetport.com* litigation, the Commission's affirmation would violate the five-year statute of limitations.

II. REPLY ARGUMENT

A. FINRA's Interpretation And Application of Rule 6490 And Its Denial Of Respondent's Application Exceeded The Scope Of FINRA's Authority.

1. Whether FINRA misinterpreted and misapplied Rule 6490 – and thus improperly denied Respondent's application – is a gateway issue that must be decided before the Commission performs any review.

The main issue on appeal is whether FINRA's interpretation and application of Rule 6490 – which it used to deny Respondent's Rule 10b-17 application to engage in a reverse stock split – exceeded FINRA's grant of authority. Respondent's argument that FINRA's interpretation and application of Rule 6490 exceeded its authority is set forth in its opening brief and is based on the enabling statute, the rule itself, its legislative history, and principles of

statutory construction and interpretation. All of these indicate that the rule is ministerial in nature and provides FINRA with no authority to deny a corporation the right to engage in a corporate related action, unless the documentation submitted in support of its Rule 10b-17 application is deficient. Op. Br. 9-13 & n.10.

FINRA has failed to respond to these arguments. Instead, FINRA attempts to cloud the issue by citing Section 19(f) of the Exchange Act, and the multi-prong test that the Commission uses to perform Section 19(f) reviews. However, there is an initial gateway issue that must be decided *before* the Commission performs any review to determine whether FINRA's decision is based on facts, is in accordance with its own rules, and is consistent with the purposes of the Exchange Act. First, the Commission must determine whether FINRA's interpretation and application of the rule exceeds the authority conferred under Section 10(b) of the Exchange Act and Rule 10b-17 promulgated thereunder.[1]

FINRA cites *Tassaway, Inc.*, 45 S.E.C. 706, 709 (1975) in insisting that this appeal is confined to a Section 19(f) review. FINRA's Opposition Br., 12. The decision in *Tassaway*, however, was decided in March 1975, several months before the Congress amended the Exchange Act. According to the D.C. Circuit Court of Appeals, as "made clear" by the 1975

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[1] Rule 10b-17, pursuant to which Rule 6490 was promulgated, provides that it shall constitute a "manipulative or deceptive device or contrivance" to fail to give notice of certain matters to FINRA, including pending, adjudicated, or settled regulatory actions or investigations related to an issuer or its officers or directors, when seeking to engage in certain types of corporate action. *See* 17 C.F.R. § 240.10b-17. Thus, it is clear that the authority conferred upon FINRA under Rule 10b-17 is merely to review and process documentation related to an announcement for Rule 10b-17 actions or other company related actions, as Rule 6490(a) itself states. It does not permit FINRA to make independent discretionary determinations.

FINRA argues that Rule 6490 bears no relation to Rule 10b-17, citing the Approval Release. *See* FINRA's Opposition Br., 24 n.24. FINRA is wrong. All the Approval Release says is that FINRA's proposal "was consistent with the Act ... *including* Section 15A(b)(6) ... and Section 15A(b)(5)." 75 FED.REG. 39603, at 3906 (July 10, 2010) ("Approval Release") (*citing* 15 U.S.C. 78 o -3(b)(5) & 15 U.S.C. 78 o -3(b)(6)) (emphasis added). It does not say it was promulgated under Section 15A(b)(6) or Section 15A(b)(5). Indeed, it could not, because it was plainly promulgated under Section 10(b) and Rule 10b-17.

amendments, the Commission may "fully revisit" FINRA decisions, and can "completely reject or modify" FINRA decisions as it deems appropriate. *National Ass'n of Secs. Dealers. Inc. v. SEC*, 431 F.3d 803, 806-807 (D.C. Cir. 2005), *rehearing en banc denied* (2006) ("*NASD v. SEC*"). Because a decision by FINRA essentially supplants action by the Commission, and because FINRA's authority is entirely derivative from the SEC, the "authority it exercises ultimately belongs to the SEC, and the legal views of the self-regulatory organization must yield to the Commission's view of the law." *Id. See also Fiero v. FINRA*, 600 F.3d 569, 574-79 (2d Cir. 2011) (analyzing whether FINRA's actions in that case conformed to the authority granted under the Exchange Act and any corresponding SEC and/or SRO rule).

Accordingly, the basis of FINRA's argument that the Commission should first look to Section 19(f) before deciding whether FINRA's interpretation and application is proper is simply wrong. The Commission must instead first determine whether FINRA had the authority to do what it did or whether it misinterpreted and misapplied Rule 6490.

2. In deciding whether FINRA acted within the scope of its authority, a reviewing body must look at the enabling statute and SEC Rule, the FINRA rule, legislative history, and principles of statutory construction and interpretation.

Court cases discussing what legal principles are violated when FINRA acts beyond its authority appear to be relatively few, but a recent case from the Second Circuit Court of Appeals is instructive. In *Fiero v. FINRA*, 600 F.3d at 569, a panel consisting of, *inter alia*, Chief Judge Winter and former Chief Judge Walker considered whether FINRA acted outside of its authority in pursuing a court action to collect a disciplinary fine that it previously imposed on a former member. FINRA made two arguments to support its claim that it acted within its authority: (1) the Exchange Act and (2) a 1990 rule that it filed – without notice and comment –

under an exception to the 1975 amendments that allows FINRA to create its own "housekeeping" rules, with minimal oversight by the Commission (the "1990 Rule"). *Id.* at 574.

Writing for the Court, Chief Judge Winter looked first to the Exchange Act to see whether FINRA acted within its grant of authority, and found none. The Court noted that there was no express statutory authority for FINRA to bring a judicial action to enforce fines in the statutory provisions relied on by FINRA; that there was not any evidence of Congressional intent to authorize enforcement and collection of fines in surrounding provisions of the Exchange Act; and that there were other provisions within the Exchange Act that weighed heavily against FINRA's argument. *Id.* at 575-76. The Court then rejected FINRA's second argument, since the 1990 Rule affected "substantive rights," as opposed to being merely a housekeeping rule. According to the Court, since the 1990 Rule affected "substantive rights," it would be invalid because FINRA was required to promulgate the rule under the procedures established by the Exchange Act. *Id.* at 577-78. Those procedures include submitting a proposed rule to the Commission, the Commission allowing interested parties an opportunity to comment, and FINRA and the Commission addressing those comments in an approval release. *Id.* at 578 (*citing* 15 U.S.C. 78s(b) & n.11 (*citing* S. Rep. No. 94-75 (1975)).

Thus, *Fiero* instructs that when determining whether FINRA has acted within the proper scope of its authority, the reviewing body must look first to the enabling statute. Additional sources of authority include the text of FINRA's rule as well as the rule's legislative history, which consists of the proposal and approval releases. The decisions in *Fiero* and *NASD v. SEC* also demonstrate how principles of statutory construction and interpretation must also apply to and guide the analysis.

3. Under the correct analysis, FINRA's interpretation of Rule 6490 was improper.

As Respondent carefully stated in its Opening Brief, FINRA's interpretation of Rule 6490 exceeded its authority and is improper. Op. Br. 9-13 & n.10. In light of the relevant Exchange Act provisions, SEC Rules, legislative history and legal concerns, such as due process and federalism, Rule 6490 should be viewed as a ministerial rule requiring FINRA to ensure that issuers seeking to perform corporate actions disclose all necessary material information. Indeed, that is the very touchstone of Section 10(b) and Rule 10b-17. Under subsection (d)(3)(3), FINRA can deny a request if the issuer or associated persons were the subject of a pending, adjudicated, or settled securities investigation or action, but failed to disclose that fact in its application *and* FINRA has "actual knowledge" of that fact.

FINRA fails to respond to this. Instead, it argues that it meets the Section 19(f) standard of review, because it has acted in accordance with its own interpretation of its own rule. Rule 6490, however, was not written to further Section 19(f), but to implement SEC Rule 10b-17. FINRA cites a block quote from the Approval Release as evidence that the changes to Rule 6490 were intended to transform FINRA's role in processing Rule 10b-17 applications from a ministerial function to one where FINRA is able to exercise judgment about an issuer based on past conduct. FINRA's Opposition Br., 15. FINRA's use of this block quote, however, is misleading, and Respondent urges the Commission to read that quote in context.

Read together with the preceding and following paragraphs,[2] that portion of the Approval Release addresses a Commentator's concern that if an issuer is delinquent in Exchange

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[2] Specifically, FINRA's block quote is taken from a paragraph that begins with "In response to this commentator ...." The Commission should first read the preceding paragraph, beginning with the sentence that begins with, "As noted above ..." The Commission should continue reading to the end of the following paragraph (continued...)

Act filings, the issuer's application to perform a Rule 10b-17 or other corporate action will automatically be denied under Rule 6490(d)(3)(1). *See* Approval Release, at 39606. FINRA responded that delinquency will not automatically disqualify the issuer since its staff has the discretion to conduct a review of the issuer, upon the issuer's request, and can "seek additional information or documentation"[3] that would satisfy the delinquency. *Id.* In other words, if an issuer has a legitimate reason to be delinquent in its Exchange Act filings – like annual 10-K and quarterly 10-Q statements – the issuer can notify FINRA, and FINRA can ask for further documents to determine whether the information that would otherwise be public is sufficient to allow further processing. According to the Commission, this latter solution "furthers FINRA's goal to assure that documents supporting a request to process a Company-Related Action are complete and correct and that [FINRA's] facilities are not misused in furtherance of fraudulent or manipulative practices." *Id.* If anything, the block quote that FINRA cites on page 15 of its brief – when read in context – supports Respondent's reading of Rule 6490, specifically, that the rule is ministerial in nature, and is intended to ensure that documents supporting a request for company related actions are complete and correct. Since the documentation submitted by Respondent was complete and correct, FINRA had no basis for its deficiency determination.

4. Any ambiguity should be resolved in Respondent's favor.

FINRA also argues that Rule 6490 must be given its plan meaning, without reference to other sources, and cites a Supreme Court holding that the statutory text "should be

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(continued...)

that begins with the sentence, "The Commission believes ..." and ends with the sentence, "The Commission notes." *See* Approval Release, at 39606.

[3] Notably, these exact words – "and seek additional information or documentation" – are deleted from FINRA's block quote. *Compare* Approval Release, at 39606 with FINRA's Opposition Br., 15.

determined by looking to the particular language of the rule, in addition to the design of the rule as a whole." FINRA's Opposition Br. 17 (*citing K Mart Corp. v. Cartier*, 486 U.S. 281, 8 S. Ct. 1811 (1988)). Yet, FINRA again misses the gateway issue, i.e. – whether the text is clear. Indeed, Circuit Courts that have followed the *K Mart* holding first ask whether the language at issue is clear. *See, e.g. Alabama Power Co. v. U.S. EPA*, 40 F.3d 450, 454 (D.C. Cir. 1994); *Conoco, Inc. v. Skinner*, 970 F.2d 1206, 1216 (3d Cir. 1993); *Illinois EPA v. U.S. EPA*, 947 F.2d 283, 289 (7th Cir. 1991). If the text was unclear, the Courts undertook a *Chevron* analysis of the text, the text of surrounding provisions, and legislative history to decipher the statute's meaning, all the while constrained by principles of statutory interpretation, and legal and constitutional concerns, such as due process. *See id.* (*applying Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43, 104 S. Ct. 2778 (1984)).

Since FINRA conceded in its brief that the words of Rule 6490 were not clear by relying on the Approval Release, cited above, and the text of the next subsection, (d)(3)(4), to support its reading of the words "actual knowledge" in (d)(3)(3), *see* FINRA's Opposition Br., 16-17, FINRA's plain meaning argument is fatuous. Indeed, subsection (d)(3)(4) states that FINRA can deny a request if FINRA is told by an authority that the issuer is involved in a securities fraud investigation or action or "FINRA otherwise has actual knowledge" of that securities fraud investigation or action. If anything, subsection (d)(3)(4) makes clear that FINRA's "actual knowledge" must be obtained by FINRA independent of any source, in particular, the issuer.

Thus, one way to harmonize subsections (d)(3)(3) and (d)(3)(4) – and to harmonize subsection (d)(3)(3) with the Exchange Act, SEC Rules, history and legal concerns, such as federalism and due process – is to read (d)(3)(1), (d)(3)(2), and (d)(3)(3) *together*. By

doing so, under subsection (d)(3)(3), FINRA can deny a request if the issuer or associated persons were the subject of a pending, adjudicated, or settled securities investigation or action, but failed to disclose that fact in its application *and* FINRA has "actual knowledge" of that fact. Such a construction of the Rule is reasonable and addresses the concerns outlined in Respondent's opening brief. Moreover, when a statute or rule is ambiguous, the rule of lenity – which is applicable to Section 10(b) and the rules promulgated thereunder, because Section 32 of the Exchange Act makes willful violations criminal – counsels that the statute or rule be construed in favor of the defendant, or the Respondent in this case. *See generally U.S. v. O'Hagan*, 521 U.S. 642, 679, 1178 S. Ct. 2199 (1997) (Scalia, J.) (concurring in part and dissenting in part).

5. Because FINRA's interpretation and application of Rule 6490 was improper, its deficiency determination should be reversed.

Furthermore, Respondent's reading of FINRA Rule 6490 is consistent with the way in which the FINRA examiner responsible for the intake of Respondent's application dealt with Respondent and handled the application – *up to the point* where FINRA denied the application. Specifically, a careful review of the record shows that Respondent filed its initial application and disclosed that its two officers, Durando and Dotoli, settled charges with the SEC for alleged violations Section 5 of the Securities Act and Section 13(d) and 16(a) of the Exchange Act. *See* FINRA 00055-57, 00065-68, 00075-76. Subsequent to Respondent's disclosure, and pursuant to subsection (d)(3)(1), the FINRA examiner requested further information material to Respondent's stock split, and Respondent eventually satisfied these further requests. FINRA 000299-305; *see also* FINRA 000165-169, 000171-176, 000241-243, 000245-248, 000249-252, 000257-261, 000263-267, 000269-273, 000277-282. Respondent was current with its Exchange Act filings, satisfying subsection (d)(3)(2). *See id.* The record

indicates that the examiner also attempted to determine if there was an active investigation involving mPhase, pursuant to subsection (d)(3)(4), but the examiner did not learn of any such investigation. *See* FINRA 000283, 000285.

Notably, once Respondent submitted all information material to the stock split, the examiner's supervisor asked the examiner whether Respondent was "up front" about Durando and Dotoli's settled charges with the SEC. FINRA 000283 ("3. Was the issuer up front about the SEC case or did you identify that in your review?"). At this point, the examiner should have explained that mPhase was in fact "up front" about and disclosed the settled charges, *see* FINRA 00055-57, 00064-67, 00075-76, and it should have been determined that Respondent satisfied subsection (d)(3)(3). The record, however, is unclear as to what the examiner actually told his supervisor.[4] That said, after Respondent submitted all information material to the stock split, counsel for Respondent contacted the examiner and asked for a status update. FINRA 000293-298 ("Could you please give me an update on whether you have all of the information you need from mPhase"). The examiner responded that "[a]t this time there is no additional documentation needed." FINRA 000299. The examiner further explained that the settled charges were being considered by FINRA, *but* he further acknowledged "the issuer's full disclosure of the regulatory actions as cited in the Issuer's 10k filed with the SEC." *Id.* Thereafter, FINRA improperly considered the settled charges and improperly determined that Respondent's application was "deficient," despite this "full disclosure." As demonstrated above,

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[4] Specifically, the examiner responded to his supervisor's question about whether Respondent was "up front" about the settled SEC charges by stating that the examiner would answer in writing, and place that answer in the FINRA Review Form. However, the last version of the FINRA Review Form contained in the record has no such answer. *Compare* FINRA 000283 & 000285 ("Thanks Katie ... I will add answers to the outstanding questions to the review form for items #1-4") with FINRA000288. The fact that FINRA's handling of Respondent's application is so non-transparent is yet another reason why FINRA's interpretation would violate due process. *See* Op. Br. n. 7.

FINRA relied on an improper interpretation of Rule 6490. Accordingly, FINRA's determination that Respondent's application to perform a reverse stock split should be reversed.

B. By Improperly Considering Evidence, FINRA Failed to Comply With Its Own Rules And The Deficiency Determination Should Also Be Reversed On This Basis.

FINRA argues that it did not consider as evidence the allegations of the complaint or the substantive findings of the cease-and-desist proceeding in the *Packetport.com* litigation. Alternatively, FINRA argues that since it may consider settled charges when evaluating membership disqualification applications, FINRA may consider such charges under Rule 6490, as well. FINRA also argues that because mPhase did not object to FINRA's consideration of this evidence in the underlying proceedings, Respondent waived this argument. Respondent addresses each of these counterarguments below.

1. FINRA's counterargument that it was allowed to consider the consent decree, the cease-and-desist order, and the complaint – because those documents exist in fact – is deceptive and misleading.

As an initial matter, all of FINRA's counterarguments about improper evidence are misleading because, throughout the remainder of their arguments, they continue to rely on the broad interpretation of the words "actual knowledge" in subsection (d)(3)(3). Based on that interpretation, FINRA insists that it may rely on the consent decree, cease-and-desist order, and complaint *because these documents exist in fact*. *See* FINRA's Opposition Br., 18-32. As set forth in Respondent's opening brief and above, under subsection (d)(3)(3), FINRA can deny a request if the issuer or associated persons were the subject of a pending, adjudicated, or settled securities investigation or action, but failed to disclose that fact in its application *and* FINRA has "actual knowledge" of that fact. Because Respondent disclosed that Durando and Dotoli settled prior charges with the SEC, FINRA's denial was improper. Additionally, FINRA's

denial was improper because FINRA considered the consent decree, cease-and-desist order, and complaint in the *Packetport.com* litigation.

2. Because FINRA improperly took notice of the complaint filed in the *Packetport.com* litigation, the deficiency determination should also be reversed on this basis.

While FINRA denies that it considered as evidence the allegations of the complaint in the *Packetport.com* litigation, this argument is the height of sophistry since the complaint is part of the record submitted by FINRA in this appeal.[5] FINRA's Opposition Br., 23. FINRA then states that, *even if* the initial deficiency determination was based on the Examiner's review of the complaint, the Commission can only review the "final decision" from the underlying proceedings, which is the UPC Subcommittee's decision. FINRA then prays that the Commission not infer that the UPC Subcommittee considered the complaint.

These arguments are tortured and laughable. The examiner admitted that he looked at the complaint, he highlighted the complaint, and the examiner specifically told his supervisor that he was including the complaint in the file. *See* FINRA 000288-289 (examiner's investigative summary), FINRA 000007-000009 (examiner's screen shots of portions of the complaint that he highlighted, in particular, paragraph 10), FINRA 000287 (the examiner telling his supervisor, "Also the screen shots are now attached to the case for your reference"). Moreover, because the initial deficiency determination was based on the complaint, there is simply no way to verify to what extent that inclusion may have affected the UPC Subcommittee's decision. Worse, there is no way to verify that the UPC Subcommittee did not

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[5] While FINRA denies the fact that the initial deficiency determination and the UPC Subcommittee's decision are based on the complaint, by making this ridiculous argument, FINRA concedes that mPhase had no way of knowing that FINRA looked at the complaint, since FINRA never indicated to mPhase that it looked at the complaint.

itself look into the file, and review and factor the complaint into its decision. Instead, FINRA's inclusion of the highlighted complaint in the record and its denial, when read carefully, should be considered an admission that it improperly took judicial notice of the *Packetport.com* complaint, but failed to provide mPhase notice and an opportunity to object pursuant to FINRA Rule 9145(b). As a result, FINRA has actually failed to meet its standard of review on appeal.[6]

3. Because FINRA improperly considered the findings of fact in the consent decree and cease-and-desist order, the deficiency determination should also be reversed on this basis.

As set forth in Respondent's opening brief, the consent decree and cease-and-desist order expressly state that the facts contained therein were "not binding on any other person or entity in this or any other proceeding." Op. Br., 15-16. Accordingly, FINRA was prohibited from considering the findings of fact contained in the consent decree and cease-and-desist order, and FINRA's consideration of those facts is yet another grounds for reversing the deficiency determination. *Id.* According to FINRA, this argument lacks legal support.[7] As set forth in Respondent's opening brief, the "not binding" language was the result of a negotiated settlement and exchange of mutual, bilateral promises by the Division of Enforcement, on the one hand, and Durando and Dotoli, on the other. Apparently, FINRA believes that the entire law of contract is inapplicable to agreements made by the Commission.[8]

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[6] Moreover, if FINRA had notified Respondent that it was considering the complaint in the *Packetport.com* litigation, Respondent would have made the same argument it made in its Opening Brief, i.e. – the complaint cannot and should not be considered because it was dismissed with prejudice. Op. Br., 14, 16-17.

[7] Notably, FINRA failed to respond to Respondent's argument that by allowing FINRA to use non-binding findings of fact, the Division would find it much harder to settle with defendants and persons under investigation. Op. Br., 16 n.8.

[8] FINRA's position may also be inaccurate. For example, it is also in direct conflict with the arguments being made by Judge Rakoff over the Division's use of "neither admit nor deny" settlements. As Judge Rakoff points out, when the Division allows a party to settle charges, but includes findings of fact that are "not binding on any other person or entity in this or any other proceeding," such language prohibits private plaintiffs from relying on (continued...)

FINRA alternatively argues that it did not consider the findings of fact in the consent decree and cease-and-desist order, but merely considered the fact that Durando and Dotoli entered into a settlement of "serious" charges. *See* FINRA's Opposition Br. 22, 19. Respondent notes that, first, this is a distinction without merit. FINRA offers no legal support that it may base a deficiency determination on the mere fact that an issuer settled a case, which the issuer has fully disclosed. FINRA cites three decisions where a reviewing body determined that securities violations were "serious," even though the facts of those decisions make them inapposite to this case. Specifically, a district court in *Falstaff* and Judge Murray in *Cosmetic Center* and *Lorsin* made nuanced, detailed findings to determine whether the facts underlying securities violations supported an injunction, a Section 12(j) sanction, and a cease-and-desist order, respectively. *See SEC v. Flagstaff Brewing Corp.*, 629 F.2d 62, 76-77, 77-80 (D.C. Cir. 1980); *Cosmetic Ctr., Inc.*, 2007 SEC LEXIS 871, *32-46 (Apr. 30, 2007)[9]; *Lorsin, Inc.*, 2004 SEC LEXIS 961, *32-38 (May 11, 2004). They did not consider the mere fact that those parties settled charges for non-scienter based securities violations to be "serious" violations of the federal securities laws.

Lastly, FINRA argues that since it may consider settled charges when evaluating a request for FINRA membership or membership continuance, FINRA may consider settled charges under Rule 6490, as well. Respondent first notes that, under the relevant Exchange Act

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(continued...)

those facts and bringing, *inter alia*, a follow-on private Rule 10b-5 action. *See SEC v. Citigroup Global Markets, Inc.*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011) ("*Citigroup I*"); *SEC v. Citigroup Global Mkts. Inc.*, 673 F.3d 158 (2d Cir. 2012) ("*Citigroup II*").

[9] Notably, FINRA claims *Cosmetic Center* stands for the proposition that settling charges for Section 13 and Section 16 violations amounts to a "serious" violation of the federal securities laws. Judge Murray, however, specifically did not consider the Division's allegations supporting their Section 13 and Section 16 charges in *Cosmetic Center*. 2007 SEC LEXIS 871, *30 n.24.

provision, FINRA may deny an individual or firm's membership application if FINRA determines that such association would be inconsistent with the public interest and the protection of investors. 15 U.S.C. § 78o-3(g)(2) (providing that FINRA "may . . . deny membership to any registered broker or dealer, and bar from becoming associated with a member any person, who is subject to a statutory disqualification"). In contrast, Section 10(b) and Rule 10b-17 are not membership rules, but notice rules. Thus, under Rule 6490, FINRA must have "actual knowledge," derived independently from the issuer, that the issuer was previously found liable or guilty of securities fraud, or settled a securities fraud investigation or action, but failed to disclose that fact in its application. As set forth above, this is a limiting principle, specific to Rule 6490, that should preclude any analogy between membership determinations and Rule 10b-17's notice requirement.

FINRA relies on three other cases in support of its argument. Yet, these cases are so factually distinct from the instant case that they should be disregarded. Notably, in *Weiss*, the Commission sustained a denial of a member application due to the applicant's having been statutorily barred in Connecticut, as well as numerous prior complaints. That bar resulted from the applicant entering into a settlement that contained the following provision:

> This Consent Order shall not preclude additional proceedings by the Commissioner against Weiss for acts or omissions not specifically addressed in this Consent Order or for acts and/or omissions that do not arise from the facts or transactions addressed herein ...

See Eric J. Weiss, 2013 SEC LEXIS 2380, * 7-8 (Mar. 19, 2013); *In The Matter of: Eric John Weiss*, Consent Order, *available at*: http://www.ct.gov/dob/cwp/view.asp?a=2246&q=442056.

In contrast, and as set forth above, the settlement entered into by Durando and Dotoli is "not binding on any other person or entity in this or any other proceeding."[10]

4. FINRA's waiver argument has no merit.

Buried in footnotes 22 and 23, FINRA asserts that in the proceedings below, Respondent waived its objection to FINRA's consideration of the allegations in the *Packetport.com* complaint and the findings in the consent decree and cease-and-desist order. FINRA's Opposition Br., 20-21 n.22 & n.23. As set forth above, the waiver argument simply does not apply to the complaint, since mPhase only learned that FINRA relied on the complaint through the record in this appeal. Additionally, FINRA mischaracterizes Respondent's objection to the consent decree in the proceedings below.

The quotes relied on by FINRA with respect to the consent decree merely evidence that Respondents acknowledged that FINRA was relying on its own interpretation of Rule 6490 to consider prior settled charges. As Respondents made clear, however, "[i]t is the company's belief that the existence of the Consent Decree should not *per se* constitute a 'deficiency' under its current notification to FINRA of the above corporate action." FINRA 000331. mPhase further argued that, to the extent FINRA considered the consent decree, FINRA should also weigh the fact that the settled charges were technical, non-scienter based securities violations, *not* securities fraud. FINRA 000330-332, 000341-342. In doing so, Respondent objected to the way FINRA considered the underlying factual findings, and any inferences that FINRA may have been drawing from them. *See id.*

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[10] In *Emerson*, the Commission sustained a denial of a member application where the disqualifying event was a felony DUI conviction. *See generally Timothy H. Emerson Jr.*, 2009 SEC LEXIS 2417 (July 17, 2009). In *Asensio*, the Commission sustained a denial of a member application because of the member's refusal to answer questions in an On the Record meeting concerning suspicion that the company's reports contained misleading facts and omitted material information. *See generally Ansensio & Co., Inc.*, 2012 SEC LEXIS 3954 (Dec. 20, 2012).

Furthermore, the cases relied on by FINRA in support of its waiver argument are inapposite. In *Nortel*, a plaintiff's lawyer sought to modify his attorney fee award based upon an amendment to the federal securities laws. *See In re Nortel Networks Corp. Secs. Lit.*, 539 F.3d 129, 132 (2d. Cir. 2008). The Second Circuit refused to hear this argument, because the lawyer failed to raise it *at all* before the district court. *Id.* ("Having reviewed Milberg's filings and oral presentation to the district court regarding this issue, we conclude that Milberg has waived this argument by failing to present it below"). Here, and as set forth above, Respondent objected to FINRA's consideration of the consent decree from the very moment it learned of this fact.

In *Amsel*, a NASD hearing panel determined that a securities trader engaged in a scheme that conferred benefits on favored clients to the detriment of his firm and other customers. *See generally Mayer A. Amsel*, 52 S.E.C. 761 (1996). On appeal to the Commission, Amsel argued that the decision should be reversed because one of the members on his hearing panel was biased against him. *Id.* at 766. In rejecting Amsel's argument, the Commission first noted that Amsel could have, but failed, to object to the panel member *before the NASD decision was issued. Id.* at 767. Thus, the actual basis of the Commission's decision was the inference that, by failing to object to the panel member, Amsel calculated that the panel member might have found him not liable. The Commission concluded Amsel's miscalculation was not a proper basis for reversal, stating that "a respondent cannot be permitted to gamble on one course of action and, upon an unfavorable decision, to try another course of action." *Id.* Here, Respondent did not know that the Examiner looked at the complaint in *Packetport.com* and Respondent objected to FINRA's using the consent decree from the very moment it learned of this fact. Moreover, Respondent has always asserted that FINRA is punishing mPhase for its officers' past conduct, and that such course of action by FINRA is improper.

C. FINRA's Refusal To Admit It Acted Beyond Its Authority By Punishing mPhase For The Past Conduct Of Its Officers Is Further Reason Why The Commission Should Reverse The Deficiency Determination.

Respondent's remaining arguments are interrelated: that FINRA's actions in this case are inconsistent with the purposes behind the federal securities laws, that the Commission's affirmation of FINRA's deficiency determination would amount to a *de facto* and improper officer and director bar, and that the basis for FINRA's denial is time barred. Respondent addresses each of FINRA's counterarguments below.

1. FINRA mischaracterizes the purpose of the Exchange Act and its actions in this case run contrary to the Exchange Act's purposes.

FINRA insists that its denial advances only one of the three purposes behind the federal securities laws: investor protection. FINRA fails to acknowledge, however, that the interest in investor protection is to be balanced against two other interests identified by Congress: the need for companies to raise capital and the need for fair, orderly, and efficient markets. *See, e.g.*, Exchange Act § 3(f), 15 U.S.C. § 78c(f); Exchange Act § 23(a)(2), 15 U.S.C. § 78w(a)(2); Exchange Act § 11A, 15 U.S.C. § 78k-1; *see also* L. Loss, J. Seligman, T. Paredes, SECURITIES REGULATION § 6-C-4 (2012) (the Commission's statutory mission is "to protect investors, promote fair and orderly markets and facilitate capital formation"). Thus, the Supreme Court has read the federal securities laws as foremost promoting a philosophy of full disclosure, and *not* being a merit-based regime. *See SEC v. Zandford*, 535 U.S. 813, 819, 122 S.Ct. 1899 (2002) (citing cases and discussing how Section 10(b) and the Exchange Act, in general, were written to promote a philosophy of full disclosure surrounding the purchase or sale of securities on national exchanges). Such disclosure ensures that all three interests are advanced in proportionate measure. *See id.*

Here, Respondent fully disclosed that two of its managing officers settled an action with the SEC for conduct that occurred more than 10 years ago. FINRA 00055-57, 00065-68, 00075-76. Respondent further provided FINRA with documentation and assurances that, since the settlement, they have served, and will continue to serve, the company and its shareholders responsibly; that they have complied, and will continue to comply, with the federal securities laws; and that they pose no threat to investors. FINRA 000328-332, 000341-342. Curiously, FINRA has failed to address Respondent's forthrightness in the application about the past violations of its officers, as well as the company's subsequent assurances. By ignoring this evidence – and insisting, however strenuously, that its expertise as a securities regulator justifies its broad sweeping powers in the interest of protecting investors – the Commission should view FINRA's responses to these last arguments skeptically. FINRA improperly denied Respondent's application based on past conduct. It now attempts to defend its actions because it does not want to admit that it overstepped its authority, and hence limit its decision-making powers in the future. The Commission reviews FINRA determinations for precisely this reason. *See NASD v. SEC*, 431 F.3d at 806-807 (*quoting* S. Rep. No. 94-75, at 23 (1975)) ("Care should be exercised, lest the use of phrases such as 'partnership' and 'cooperative regulation' lead to the impression that the industry and the government fulfill the same function in the regulatory framework or that they enjoy the same order of authority or deserve the same degree of deference"). Accordingly, FINRA's deficiency determination should be reversed.

2. FINRA misunderstands that when the *Packetport.com* litigation concluded, the Commission was foreclosed from barring Durando and Dotoli, and that, as a result, the Commission is prevented from effectively doing so now by affirming the deficiency determination.

According to FINRA, when Durando and Dotoli entered into the consent decree, they settled charges based on past securities violations. *See* FINRA's Opposition Br. 25-27 &

n.25. FINRA further argues that the Commission should not apply principles of collateral estoppel to the decision of the DOP and UPC Subcommittee because the deficiency determination was based on a concern that Durando and Dotoli might commit future securities violations. *See id.*, n.25. FINRA misunderstands the nature of SEC enforcement actions. As the Commission is aware, when the Division of Enforcement seeks to hold issuers, and their officers and directors liable for securities violations or securities fraud, they either pursue concurrent causes of actions seeking officer or director bars, or they seek them after a judgment or settlement. As explained in Respondent's opening brief, the *Packetport.com* litigation was dismissed with prejudice, and the Commission ultimately settled charges for technical securities violations – *not* scienter-based fraud. Op. Br. 9-12, 18-22. Thus, the Commission was foreclosed from seeking an officer and director bar or conditioning the service as officers and directors by Durando and Dotoli. Op. Br. 18-22 (relying on, *inter alia*, Sections 8A(f) & 20(b) of the Securities Act and Sections 21(d)(2) & 21C(f) of the Exchange Act).

Here, the deficiency determination was improperly based on Durando and Dotoli's involvement in the *Packetport.com* litigation and their entering into a consent decree for securities violations. This was the only basis for the DOP and UPC Subcommittee's decision. *See* FINRA 000312-314, 000401-404. As set forth above, Respondent disclosed the consent decree and gave FINRA ample evidence that, since the *Packetport.com* litigation concluded, Durando and Dotoli have served mPhase and its shareholders responsibly, complied with the securities laws, and posed no threat to investors. FINRA 00055-57, 00065-68, 00075-76, 000328-332, 000341-342. Neither the DOP nor the UPC Subcommittee addressed Respondent's disclosure or this subsequent history. *Compare id.* with FINRA 000312-314, 000401-404. Thus, because the deficiency determination was based on the *Packetport.com* litigation and consent

decree, the Commission is collaterally estopped from effecting a *de facto* officer and director bar, which it would do by affirming the deficiency determination.

3. Despite FINRA's protests, the deficiency determination is a punishment that can only become final if the Commission affirms in this proceeding, but the basis of that determination – the facts underlying the *Packetport.com* litigation and consent decree – occurred well past the five-year statute of limitations.

First, FINRA's attempt to analogize the denial of a Rule 10b-17 request to a membership or membership continuation denial is misplaced. The cases on which FINRA relies make clear that the applicants seeking membership or membership continuance had been previously barred by FINRA, the SEC, or state securities regulators. *See* cases discussed in Section II.B.3., *supra*. Denying their membership or membership continuation denial was – as FINRA notes – maintaining the status quo. FINRA's Opposition Br., 30. In contrast, when the *Packetport.com* litigation was dismissed with prejudice, the parties subsequently entered into the consent decree for technical, non-scienter based securities violations with the SEC allowing Durando and Dotoli to continue working as managing officers at publicly traded companies. As set forth above, since that time, Durando and Dotoli have served mPhase and its shareholders responsibly, complied with the federal securities laws, and posed no threat to investors. Moreover, mPhase's shareholders approved of Durando and Dotoli's leadership. A deficiency determination punishes the company's shareholders by preventing them from voting on company actions that other corporations are entitled to engage in.[11] The deficiency determination therefore punishes mPhase for the past conduct of its officers.

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[11] It should be noted that FINRA has failed to demonstrate any risk whatsoever to either mPhase's 23,000 shareholders if mPhase engaged in the reverse stock split and Messrs. Durando and Dotoli continued in their present positions as Directors and Officers of the company. Moreover, New Jersey state corporate law properly governs a reverse stock split by mPhase and is designed to protect investors by requiring shareholder approval for the type of reverse split that mPhase submitted to FINRA under Rule 6490. A formal proxy on Schedule 14 would need to be (continued...)

Furthermore, and as set forth in Respondent's opening brief, because FINRA based the deficiency determination on the *Packetport.com* litigation and consent decree, the determination was based on facts that occurred well past the five-year statute of limitations. Op. Br., 22-25. FINRA attempts to confuse the issue by stating that FINRA – as opposed to the Commission – is not subject to Section 2462. FINRA's Opposition Br., 28-29. Yet the deficiency determination can only become final if the Commission affirms in this proceeding. However, the Commission is clearly bound by Section 2462. As set forth in Respondent's opening brief, any attempt to escape the reach of Section 2462 by pointing to the separation of FINRA as a non-governmental agency from the Commission is unfairly placing form over substance. Moreover, FINRA's powers are derivative from the Commission. *See generally NASD v. SEC*, 431 F.3d at 803; *Fiero*, 600 F.3d at 569. In sum, the five year statute of limitations precludes the Commission's affirmation of the deficiency determination.

(continued...)

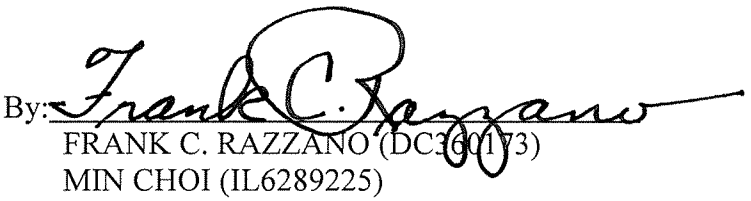
submitted to shareholders with full and fair disclosure pursuant to the Exchange Act. It should further be noted that the shareholders of mPhase reelected as Directors of the company Messrs. Durando and Dotoli at an Annual Meeting of Shareholders held on August 27th of 2008. The shareholders elected such individuals after full and fair disclosure of the consent decree, which occurred in October of 2007, in a Proxy that was in compliance with the Exchange Act. *See* FINRA000101; *see generally* FINRA000094-000118. In addition, mPhase disclosed the consent decree in periodic 10Q and 10K filings since the occurrence of the consent decree was entered into. FINRA should not be given the authority not to disenfranchise such shareholders of the right to vote on the reverse stock split. *See also* Op. Br., 20 n.10.

III. CONCLUSION

For all of the foregoing reasons, we respectfully request that the Commission reverse the decision of the DOP, UPCC Subcommittee, and FINRA in favor of Respondents.

Dated: April 24, 2013

Respectfully submitted,

By: 

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