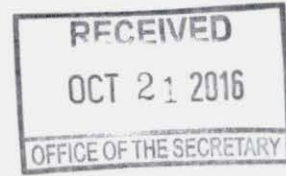


Before the  
SECURITIES AND EXCHANGE COMMISSION

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In the Matter of the Application of :  
 :  
KCD FINANCIAL INC. (CRD No. 127473) :  
 :  
For Review of :  
 :  
FINRA Disciplinary Action :  
 :  
File No. 3-17512 :  
----- X



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**KCD FINANCIAL, INC.'s OPENING BRIEF ON APPEAL**

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## PRELIMINARY STATEMENT

KCD Financial Inc. (“KCD” or the “Firm”) appeals from a decision of FINRA’s National Adjudicatory Council (“NAC”) in a case that, had FINRA’s Department of Enforcement (“Enforcement”) conducted an appropriate investigation, should have never been instituted against the Firm. In its 2013 complaint, Enforcement asserted that KCD violated NASD Rules 3010 and 2010 (by virtue of a violation of Section 5 of the Securities Act of 1933 (“Section 5”)) by offering and selling unregistered securities pursuant to a general solicitation. Enforcement brought its case against KCD based on nothing more than its discovery that two Dallas, Texas area newspapers had published articles about the WRF Distressed Residential Fund 2011 (the “WRF Fund”) during the solicitation period in a private offering for which KCD was the soliciting dealer. Enforcement brought its case without analyzing whether the articles, in fact, constituted a general solicitation, and without investigating whether any of the WRF Fund investors “were actually solicited through the activities which could be viewed as a general solicitation,” which, based on long-standing Securities and Exchange Commission (the “Commission” or “SEC”) guidance, must be shown to find a violation of the rule prohibiting general solicitation.<sup>1</sup>

Had Enforcement conducted an appropriate investigation, it would have found, as KCD demonstrated, that the newspaper articles neither solicited investments in the WRF Fund, nor were they designed to arouse interest in investing in the WRF Fund. Indeed, FINRA’s own examiner admitted that the articles did not include anything to indicate that there were

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<sup>1</sup> R. at 4024 (NAC Decision, dated August 3, 2016, at 26 (quoting an April 6, 2011 letter from Mary Schapiro, then Commission Chairperson, to Darrell E. Issa, Chairman, House Committee on Oversight and Government Reform, at 8) (“Schapiro Letter”)), available at <https://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf>. See also *Interpretive Release on Regulation D*, Exchange Act Rel. No. 33-6455, 48 FR 10045, 10053 (March 10, 1983) (“1983 Regulation D Guidance”) (setting forth a two-pronged test to determine whether an issuer or its agent violated the rules prohibiting general solicitation); *Revisions of Limited Offering Exemptions in Regulation D*, Securities Act Release No. 8828, 2007 SEC LEXIS 1730, \*90 (Aug. 3, 2007) (“2007 Regulation D Guidance”).



opportunities for investors in the WRF Fund.<sup>2</sup> Instead, as the NAC recognized, the articles “informed owners of distressed properties and nonperforming loans that Westmount Realty Finance” had launched a \$10 million fund and that the Fund “was a buyer” in the distressed real estate market.<sup>3</sup>

An investigation by Enforcement would have also revealed that no investors in the WRF fund were solicited through the newspaper articles. IG, who led the WRF Fund sales team for KCD, testified that more than one month before the newspaper articles were published, KCD’s representatives sent emails about the newly launched WRF Fund offering to its pre-existing group of 1,200 accredited investors,<sup>4</sup> and that the Firm sold interests in the WRF Fund only to investors who learned about the offering from those initial emails.<sup>5</sup> LR, KCD’s Chief Compliance Officer (“CCO”), also testified that all of the WRF Fund investors had a pre-existing relationship with the Firm.<sup>6</sup> Despite Enforcement’s failure to present any evidence to contradict IG’s and LR’s testimony, the NAC determined that KCD failed to prove that it (and the issuer) were entitled to rely on an exemption from the registration requirements.<sup>7</sup>

The NAC’s failure to credit KCD’s witnesses’ uncontroverted testimony is especially troubling in light of the NAC’s denial of the Firm’s motion to submit newly discovered evidence – evidence that lends further credence to IG’s and LR’s uncontroverted testimony. The newly discovered evidence relates to the Commission’s staff’s (the “Staff”) investigation of the WRF

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<sup>2</sup> R. at 2192 (Tr. at 274:5-14); R. at 2661-63.

<sup>3</sup> R. at 4023 (NAC Decision at p. 25).

<sup>4</sup> R. at 2397-98 (Hearing Transcript (“Tr.”) at 479:9-480:18).

<sup>5</sup> R. at 2433-34 (Tr. at 515:14-516:3).

<sup>6</sup> R. at 2494-95 (Tr. at 575:22-576:6); R. at 2982 (CX-6 at p. 84)

<sup>7</sup> R. at 4025 (NAC Decision at p. 27).

Fund (along with other WRF offerings).<sup>8</sup> This evidence, which KCD only learned about in January 2016 when discussing indemnification with the issuer, demonstrates that the Staff's investigation included a review of documents and information related to how each of the investors to the WRF Fund were solicited and whether the investors were accredited – the very issues that are at the heart of KCD's witnesses' uncontested testimony. The evidence further indicates that, after conducting its investigation, the Staff determined not to recommend that the Commission bring an enforcement action against the issuer at that time (nor has it at any time since). While KCD understands that, pursuant to Securities Act Release No. 5310, the Staff's decision is not determinative, it is, nonetheless, relevant to the instant action. The Staff's determination not only lends credence to IG's and LR's unrefuted testimony (based on the Staff's review of the investor files), but it also stands in stark contrast to the NAC's erroneous determination that KCD's activities deserved the Sanction Guideline's highest recommended fine for Section 5 violations.

KCD also appeals from the NAC's finding that the Firm failed to supervise the WRF Fund offering. The NAC found that KCD failed to act reasonably after discovering that the newspaper articles had been published because it failed to instruct its representatives to cease its sales of WRF Fund Interests.<sup>9</sup> But the Commission's long-standing guidance allowed for KCD to continue its sales activities after the newspaper articles were published, as long as the investors to the WRF Fund learned about the offering from means other than the newspaper articles. Rather than failing to supervise its representatives, the undisputed evidence in this case shows that KCD implemented procedures that ensured that WRF Fund interests were sold only

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<sup>8</sup> R. at 4031 (NAC Decision at p. 33 n. 48).

<sup>9</sup> R. at 4027 (NAC Decision at p. 29).

to accredited investors with whom the Firm had a prior existing relationship. The NAC also failed to consider that, for the failure to supervise claim, the burden was on Enforcement, not KCD, to show otherwise – a burden Enforcement did not meet.

In the event that the Commission determines that the WRF Fund offering was conducted pursuant to a general solicitation, it should set aside or significantly reduce the excessive fine imposed by the NAC.<sup>10</sup> The \$73,000 fine is commensurate with sanctions that FINRA has imposed on recidivist firms responsible for distributing millions of shares of unregistered securities into the public markets,<sup>11</sup> and bears no relation to the activities at issue in this case,<sup>12</sup> or the sanctions the Commission has imposed for other general solicitation violations.<sup>13</sup> Moreover, even if KCD is found to have violated the letter of the Securities Act, it nonetheless adhered to the spirit of the law by selling the WRF Fund interests only to investors who could fend for themselves.<sup>14</sup> Accordingly, KCD requests that the Commission reduce the sanction to more accurately reflect the *de minimus* (if any) consequences of the purported violation.

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<sup>10</sup> KCD further challenges the Hearing Panel's and the NAC's reliance on the 2015 version of the Sanction Guidelines, which was implemented only after the parties submitted their final post-hearing briefs.

<sup>11</sup> See, e.g., *Midas Securities, LLC, et al*, Admin. Proc. No. 3-14308, 2012 SEC LEXIS 199, \*2, 72-73 (Jan. 20, 2012).

<sup>12</sup> But see R. at 4029-30 (NAC Decision at pp. 31-32) (referring to principal considerations related to distributions). The term "distribution" is not defined in the Securities Act, but refers to "the entire process in a public offering through which a block of securities is dispersed and ultimately comes to rest in the hands of the investing public." *Jacob Wonsover*, 54 SEC 1, 12 & n.25 (1999), *pet. denied*, 205 F.3d 408 (D.C. Cir. 2000) (emphasis added).

<sup>13</sup> *Harry Harootunian, et al*, Admin. Proc. No. 3-8183, 1993 SEC LEXIS 2504, \*7-10 (Sept. 29, 1993); *EMX Corp., et al*, Admin. Proc. No. 3-8185, 1993 SEC LEXIS 2474, \*8 (Sept. 29, 1993); *Robert Testa*, Admin. Proc. No. 3-3184, 1993 SEC LEXIS 2473, \*9 (Sept. 29, 1993); *CGI Capital, Inc.*, Admin. Proc. No. 3-10331, 2000 SEC LEXIS 2081, \*8 (Sept. 29, 2000); *Kenman Corp. et al*, Admin. Proc. No. 3-6505, 1985 LEXIS 1717, \*10-11 (April 19, 1985).

<sup>14</sup> *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-25, 1953 U.S. LEXIS 2688 (1953) ("Since exempt transactions are those as to which 'there is no practical need for [the bill's] application,' the applicability of § 4 (1) should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'") (internal citations omitted).

## PROCEDURAL HISTORY

The Complaint in this action resulted from a 2011 Cycle Examination of KCD.<sup>15</sup> The examination staff referred the case to Enforcement on May 1, 2012, and Enforcement filed its Complaint on November 14, 2013, asserting three separate and unrelated causes of action.<sup>16</sup> KCD entered into an Offer of Settlement on the third cause of action relating to email retention, which was accepted on December 15, 2014.<sup>17</sup> A Hearing on the remaining two causes of action was held on December 16-18, 2014, and the parties filed Post-Hearing Briefs on January 30, 2015. The Hearing Panel issued its Decision on June 16, 2015, finding against KCD on the two causes of action tried at the Hearing.

KCD timely filed its Notice of Appeal to the NAC on July 9, 2015. On January 8, 2016, one business day before the scheduled Oral Argument, KCD filed a Motion to Request a Continuance of Oral Argument and to Introduce Newly Discovered Evidence regarding evidence KCD discovered on the day it filed the Motion.<sup>18</sup> Oral Argument took place as scheduled on January 11, 2016.<sup>19</sup> On January 22, 2016, after Enforcement had filed its Opposition to KCD's Motion, KCD obtained from the issuer additional evidence related to its Motion,<sup>20</sup> which the Firm thereafter attached to its Reply to Enforcement's Opposition.<sup>21</sup> Enforcement opposed what

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<sup>15</sup> R. at 3472. *See also* R. at 944.

<sup>16</sup> This appeal involves the Second Cause of Action. In the First Cause of Action, Enforcement alleged that KCD violated FINRA's communication rule because of purportedly false and misleading advertisements published by three of the Firm's representatives as part of their outside business activities. The Third Cause of Action alleged violations related to KCD's prior email retention system (which was no longer in use at the time of the 2011 Cycle Examination). R. at 1-28.

<sup>17</sup> R. at 1913-18.

<sup>18</sup> R. at 3777-87.

<sup>19</sup> R. at 3789-3887.

<sup>20</sup> R. at 3913-14.

<sup>21</sup> R. at 3917-51.

it referred to as KCD's new motion for additional evidence, and KCD responded.<sup>22</sup> On March 7, 2016, the NAC denied KCD's request to introduce the newly discovered evidence.<sup>23</sup>

The NAC issued its Decision on August 3, 2016, in which it overturned the Hearing Panel's findings for the First Cause of Action, and affirmed the findings for the Second Cause of Action, but slightly modified downward the sanctions imposed for that claim. KCD timely filed its Notice of Appeal with the Commission on August 26, 2016.

### **STATEMENT OF THE FACTS**

The allegations in Enforcement's Second Cause of Action stem from two newspaper articles that were published in Dallas, Texas area newspapers and then posted on the website of Westmount Realty Finance ("WRF") that announced the launch of the WRF Fund, a \$10 million real estate fund to invest in distressed properties.<sup>24</sup> The articles were published during the period in which unregistered interests in the WRF Fund were being privately offered to accredited investors pursuant to an exemption under Rule 506 of Regulation D.<sup>25</sup> KCD was the broker-dealer handling the private offering of the WRF Fund.<sup>26</sup>

#### **I. The Launch of the WRF Fund Offering**

WRF was in the business of raising money for real estate investment projects through either Regulation D private placements,<sup>27</sup> or by getting funding from one or more institutional

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<sup>22</sup> R. at 3953-88.

<sup>23</sup> R. at 3989-90.

<sup>24</sup> R. at 2661-63; R. at 2665-66.

<sup>25</sup> R. at 2743.

<sup>26</sup> R. at 2679.

<sup>27</sup> R. at 2381 (Tr. at 463:3-18).

investors.<sup>28</sup> WRF employed a sales team of FINRA-registered brokers to sell the companies' private offerings. The brokers were registered with FINRA through their association with KCD. IG was the broker in charge of WRF's sales team.

WRF issued the WRF Fund in early 2011 to invest up to \$10 million in the large inventory of foreclosed property that resulted from the 2008 financial crisis.<sup>29</sup> As with WRF's other offerings, KCD's role in the WRF Fund began after IG received the Fund's offering documents from the issuer, which he then forwarded to JL, KCD's then CCO, for review.<sup>30</sup> On March 15, 2011, after conducting his due diligence on the offering, JL signed the Soliciting Dealer Agreement,<sup>31</sup> which signaled to IG and the other KCD representatives that they were approved to begin soliciting interests in the WRF Fund.<sup>32</sup> Within days after receiving the signed Soliciting Dealer Agreement, IG's sales team launched its sales initiative by sending emails to the approximately 1,200 accredited investors with whom IG's team had a prior existing relationship.<sup>33</sup> The emails informed the investors that the WRF Fund was available,<sup>34</sup> and that, if interested, they should contact one of the KCD representatives to request the private placement memorandum, subscription agreement and other offering documents.<sup>35</sup> Thereafter, the

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<sup>28</sup> R. at 2393 (Tr. at 475:5-16); R. at 2438 (Tr. at 520:8-16).

<sup>29</sup> R. at 2479 (JX-27 at p. 7); R. at 2438 (Tr. at 520:8-16); R. at 2394 (Tr. at 476:4-21).

<sup>30</sup> R. at 2395-96 (Tr. at 477:3-478:2).

<sup>31</sup> R. at 2679, 2687.

<sup>32</sup> R. at 2397 (Tr. at 479:9-22); R. at 2687.

<sup>33</sup> R. at 2397 (Tr. at 479:9-22).

<sup>34</sup> R. at 2386-87 (Tr. at 468:18-469:24).

<sup>35</sup> R. at 2398 (Tr. at 480:11-15).

representatives' sales efforts were limited to soliciting purchases from this pre-existing group of accredited investors.<sup>36</sup>

## **II. The Newspaper Articles Regarding the WRF Fund**

On or around April 26, 2011, IG learned from WRF's securities attorney that the Dallas Business Journal had published an article about the WRF Fund.<sup>37</sup> (A similar article had also been published in the Dallas Morning News.)<sup>38</sup> The securities attorney informed IG about his concern that the newspaper article may have been a breach of the prohibition against general solicitation for Rule 506, Regulation D offerings.<sup>39</sup> Unbeknownst to IG at that time, WRF management had also posted the newspaper articles about the WRF Fund on the company's unrestricted website.<sup>40</sup> IG also later learned that the newspaper articles resulted from a press release issued by WRF.<sup>41</sup>

The newspaper articles reported that WRF launched a \$10 million fund to acquire distressed properties, and that WRF was going to partner with operators or firms that specialized in bulk acquisitions of distressed residential assets.<sup>42</sup> The Dallas Business Journal article also reported that the fund "will have a 12-month investment period – and due to the short window for the assets to be purchase and resold, the firm expects to reinvest sales proceeds in additional assets during the period."<sup>43</sup> Neither the Dallas Business Journal nor Dallas Morning News

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<sup>36</sup> R. at 2433-34 (Tr. at 515:14-516:3). IG testified that in addition to their pre-existing customers, in a few instances, his sales team also received calls from people referred to WRF by pre-existing customers. R. at 2404-05 (Tr. at 486:1-487:5).

<sup>37</sup> R. at 2399-400 (Tr. at 481:12-482:15); R. at 2689.

<sup>38</sup> R. at 2661.

<sup>39</sup> R. at 2689.

<sup>40</sup> R. at 2402-03 (Tr. at 484:11-485:9); R. at 2661-63.

<sup>41</sup> R. at 2681.

<sup>42</sup> R. at 2661-64.

<sup>43</sup> R. at 2664.

articles mentioned that WRF was seeking to raise capital to enable the firm to acquire the distressed properties.<sup>44</sup> When questioned, FINRA examiner ET acknowledged that the “12-month investment period” mentioned in the articles referred not to the WRF Fund offering, but to the period in which the WRF Fund would be investing in distressed properties.<sup>45</sup> ET further acknowledged that the newspaper articles did not include anything to indicate that there were opportunities for investors in the WRF Fund.<sup>46</sup>

### III. KCD’s WRF Fund Sales Efforts

Upon learning about the newspaper articles from WRF’s securities attorney, IG called JL and held a conference call with his KCD sales team to instruct the representatives that they should not sell WRF Fund interests to anyone who learned about the offering from the newspaper articles.<sup>47</sup> During the remaining months of the selling period, only one KCD representative, CB, received a call from a potential investor who had learned about the WRF Fund from one of the newspaper articles.<sup>48</sup> CB told the caller that he could not sell him interests in the WRF Fund.<sup>49</sup>

KCD sold interests in the WRF Fund only to the accredited investors who had been offered the securities by email in March 2011 (more than one month before the newspaper articles were published), or to new customers, all of whom were accredited investors, who were introduced to KCD by other investors with whom KCD had a pre-existing relationship.<sup>50</sup>

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<sup>44</sup> R. at 2661-64.

<sup>45</sup> R. at 2191 (Tr. at 273:12-274:4).

<sup>46</sup> R. at 2192 (Tr. at 274:5-14); R. at 2661-63.

<sup>47</sup> R. at 2400-02 (Tr. at 482:16-484:9).

<sup>48</sup> R. at 2681-82; R. at 2403 (Tr. at 485:10-25).

<sup>49</sup> *Id.*

<sup>50</sup> R. at 2433 (Tr. 515:14-516:3); R. at 2435 (Tr. at 517:9-19); R. at 2404-05 (Tr. at 486:1-487:5).



#### IV. FINRA's Investigation of KCD's WRF Fund-Related Activities

FINRA examiner ET testified that he found the Dallas Business Journal and Dallas Morning News articles on the newspapers' websites when he conducted an internet search for the WRF Fund during FINRA's 2011 Cycle Exam.<sup>51</sup> The search was part of his review of KCD's private placement activities. ET also reviewed the Firm's due diligence files on the WRF Fund offering and the WRF Fund Private Placement Memorandum, for which he found no issues.<sup>52</sup> For reasons of suitability, ET also reviewed the files of a sampling of approximately 15 customers who invested in the WRF Fund and determined that the sales were suitable for all the customers he sampled, and he also made no findings regarding suitability.<sup>53</sup> ET admitted that he did not review the customer files to determine whether any of the WRF Fund investors had a pre-existing relationship with KCD.<sup>54</sup> Nor did ET speak with, or request documents from, IG or any of the other KCD representatives who handled the WRF Fund sales.<sup>55</sup> Instead, based only on his discovery of the newspaper articles, ET concluded that KCD had violated the rule prohibiting general solicitation in an unregistered offering.<sup>56</sup>

In a letter dated May 1, 2012, FINRA's examination staff informed KCD that ET's general solicitation finding would be referred to Enforcement.<sup>57</sup> Enforcement brought its charges against KCD in November 2013. Despite the passage of 18 months since it received the

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<sup>51</sup> R. at 2167-68 (Tr. at 249:22-250:3); R. at 2170 (Tr. at 252:3-16).

<sup>52</sup> R. at 2167 (Tr. at 249:6-21); R. at 2170-71 (Tr. at 252:25-253:3).

<sup>53</sup> R. at 2196-97 (Tr. at 278:17-279:6).

<sup>54</sup> R. at 2197-98 (Tr. at 279:7-280:13).

<sup>55</sup> R. at 2184 (Tr. at 266:6-14). JL, the CCO who approved the WRF Fund offering, left the Firm with no notice shortly before FINRA began its examination. R. at 2490 (Tr. at 571:10-25). LR became the new CCO a few weeks before the examination and had no independent knowledge about the WRF Fund offering.

<sup>56</sup> R. at 2181 (Tr. at 263:14-24). *See also* R. at 2167 (Tr. at 251:2-15); R. at 2176 (Tr. at 258:8-20).

<sup>57</sup> R. at 3783.

referral, Enforcement filed its Complaint without conducting any further investigation of KCD's WRF Fund activities to determine whether the WRF Fund investors were accredited and or whether they had a pre-existing relationship with the Firm.<sup>58</sup> Like the examination staff, Enforcement apparently determined that the existence of the newspaper articles alone was a sufficient basis on which to charge a member with a violation of Section 5.

**V. The Commission's Investigation of the WRF Fund**

In January 2016, KCD learned for the first time that in or around March 2013, the Commission instituted an investigation of WRF's successor, Westmount Realty Capital ("WRC"), which included an investigation of the WRF Fund.<sup>59</sup> While KCD had kept WRC apprised of the status of FINRA's Enforcement action as required by the indemnification provision of the WRF Fund Soliciting Dealer Agreement,<sup>60</sup> WRC had not, at any time prior to January 2016, informed KCD about the Commission's investigation of the WRF Fund.<sup>61</sup> Nor is there any public record of the Commission's investigation of WRC or of the WRF Fund.<sup>62</sup>

KCD learned from WRC that, in connection with the Commission's investigation, the Staff asked WRC to preserve all documents related to, among other things, the WRF Fund and KCD.<sup>63</sup> In May 2013, the Staff requested that WRC produce documents and information related to, among other things, the method by which investors were solicited for the WRF Fund and

<sup>58</sup> Over KCD's objections, R. at 269, 435, 455, the Hearing Officer allowed Enforcement to take LR's on-the-record testimony after the Complaint had been filed. R. at 2945. While LR testified in her OTR that she verified that all the investors were accredited and pre-existing, R. at 2980 (CX-6 at p. 38), Enforcement did not seek any documents from KCD following LR's on-the-record testimony.

<sup>59</sup> R. at 3970-72; R. at 3981-83. KCD was aware that the SEC had investigated another WRC offering related to an accounting issue because LR provided an on the record interview for that investigation. The Staff, however, did not ask any questions about, nor even mentioned, the WRF Fund during the course of its interview with LR. R. at 3971 at ¶¶ 4-6.

<sup>60</sup> R. at 2683-85.

<sup>61</sup> R. at 3972 (¶ 12).

<sup>62</sup> See R. at 3612 n.210.

<sup>63</sup> R. at 3924.

other offerings, the number of accredited investors in each offering, and how the sales agents for the offerings typically communicated with potential investors (i.e., calls, emails, face-to-face meetings, etc.).<sup>64</sup> The Staff also conducted a lengthy in-person interview with WRC's staff, and had numerous telephonic follow up interviews with WRC's counsel.<sup>65</sup> In a letter dated August 21, 2014, the Staff informed WRC that it would not recommend that the Commission bring an enforcement action against WRC.<sup>66</sup>

KCD's Motion to introduce the evidence relating to the Commission's investigation was denied without explanation by a subcommittee of the NAC.<sup>67</sup> In its Decision, the NAC indicated that KCD's motion was denied because "[e]ven if the SEC staff investigated the same issue before us, the letter was specifically provided under guidelines that it 'must in no way be construed as indicating that the party has been exonerated or that no action may ultimately result from the staff's investigation of that particular matter.'"<sup>68</sup> To date, the Commission has not brought an enforcement action against WRC or the WRF Fund.

### ARGUMENT

The NAC erred in determining that KCD sold unregistered interests in the WRF Fund in violation of Section 5 and that the Firm failed to supervise the offering. First, the newspaper articles that led to Enforcement's allegations do not constitute a general solicitation – they articles neither offered interests in the WRF Fund nor were they designed to arouse interest in the

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<sup>64</sup> R. at 3932-34.

<sup>65</sup> R. at 3950-51.

<sup>66</sup> R. at 3786.

<sup>67</sup> R. at 3989-92.

<sup>68</sup> R. at 4032 (NAC Decision at p. 34 n.48 (quoting *Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations*, Securities Act Release No. 5310, 1972 SEC LEXIS 238, at \*7 (Sept. 27, 1972))).

WRF Fund offering. Second, KCD did not use the newspaper articles to either offer or sell interests in the WRF Fund. Finally, rather than failing to supervise the WRF Fund offering, as the NAC determined, KCD's supervision of the offering ensured that the securities were sold only to accredited investors who learned about the offering from means other than the newspaper articles, thus entitling the issuer to rely on a Regulation D, Rule 506 exemption. Accordingly, the NAC's decision should be overturned.

But, if the NAC's Decision is sustained, KCD requests that the Commission eliminate or drastically reduce the grossly excessive fine of \$73,000 that has been imposed upon the Firm.<sup>69</sup> The NAC's severe sanction cannot be reconciled with either the Staff's decision to not recommend any enforcement action against WRC – the issuer of the offering – or with the relatively modest sanctions imposed by the Commission and FINRA in cases where respondents have been found to have engaged in a general solicitation.

**I. KCD WAS ENTITLED TO RELY ON AN EXEMPTION FROM THE REGISTRATION REQUIREMENTS FOR THE WRF FUND OFFERING**

In asserting its Section 5 claim against KCD, Enforcement took the position that the only acceptable response the Firm could have after it learned about the publication of the newspaper articles about the WRF Fund was to scrap the entire offering. Enforcement's position is not only contrary to the Commission's long-standing guidance,<sup>70</sup> but, if such a strict interpretation of the rule prohibiting general solicitations were adopted, it could create a chilling effect on capital

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<sup>69</sup> The Hearing Panel and the NAC unfairly relied on the fine recommendations in the Sanction Guidelines that were revised only after the parties submitted their post-hearing briefs, (Sanction Guidelines at 113 (back cover) (indicating the Guidelines were revised in March 2015), which dramatically increased the upper range of the suggested sanctions from \$50,000 to \$73,000.

<sup>70</sup> *1983 Regulation D Guidance*, 48 FR 10045 at 10053; *2007 Regulation D Guidance*, 2007 SEC LEXIS 1730 at \*90; Schapiro Letter at p. 8.

raising in the U.S. market.<sup>71</sup> As KCD has demonstrated throughout these proceedings,<sup>72</sup> the rule prohibiting general solicitation is not inflexible and focuses more on “whether the investors participating in the offering were actually solicited through the activities which could be viewed as a general solicitation” than on the communication involving the solicitation.<sup>73</sup>

In its *Interpretive Release on Regulation D*, the Commission explained that for an issuer or its agent to be found to be in violation of the rule prohibiting general solicitation, the advertisement (or other activity) must meet both prongs of a two-pronged inquiry.<sup>74</sup> The first prong asks: “is the communication in question a general solicitation or general advertisement?” If it is, the second question to be answered is whether the general solicitation or general advertisement was “used by the issuer or by someone on the issuer’s behalf to offer or sell the securities? If either question can be answered in the negative, then the issuer will not be in violation of Rule 502(c).”<sup>75</sup> Here, both parts of the Commission’s two-pronged test can be answered in the negative. First, the newspaper articles did not solicit offers to purchase WRF Fund interests. But, even if the newspaper articles are found that have included an offer, the Firm did not use the articles to offer or sell the WRF Fund interests. Instead, KCD took all necessary steps to insure that the interests were sold only to accredited investors with whom the Firm had a prior existing relationship.<sup>76</sup>

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<sup>71</sup> See *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014* (Oct. 2015) (observing that in recent years the amount of capital raised in Regulation D offerings has far out-paced the amount raised in registered equity offerings), found at <https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf>.

<sup>72</sup> R. at 723 (Respondent’s brief at pp. 1, 28-29).

<sup>73</sup> See Schapiro Letter at p. 8.

<sup>74</sup> See *1983 Regulation D Guidance*, 48 FR 10045 at 10053.

<sup>75</sup> *Id.* at 10053. See also *Dep’t of Enforcement v. Meyers Associates, L.P. et al*, Discip. Proc. No. 2010020954501, 2016 FINRA Discip. LEXIS 29, \*13-14 (April 27, 2016) (recognizing the Commission’s guidance).

<sup>76</sup> *1983 Regulation D Guidance*, 48 FR 10045 at 10053.

**A. The Newspaper Articles Do Not Constitute a General Solicitation**

There is no dispute in this case that WRF issued a press release about the WRF Fund that resulted in articles in the Dallas Morning News and the Dallas Business Journal, or that WRF posted the articles on its unrestricted website.<sup>77</sup> There is also no dispute that this activity occurred during the solicitation period for the WRF Fund offering.<sup>78</sup> KCD, however, challenges the NAC's determination that the articles constituted an offer to sell interests in the WRF Fund.<sup>79</sup>

For the newspaper articles to be considered an offer to the public, it would have to be shown, as it was in the cases of *Gearhart & Otis, Inc.* and *Brian Prendergast*,<sup>80</sup> that the communications had the "purpose of ascertaining [which members of the public] would be willing to accept an offer of securities."<sup>81</sup> The communications in *Gearhart* had that purpose because the broker admitted that he disseminated brochures that discussed the benefits of lithium to approximately 3,000 other securities dealers specifically because of the impending offering of National Lithium Corporation securities that the broker was handling.<sup>82</sup> Similarly, the advertisements and seminars about hedge funds at issue in *Prendergast* were also found to have

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<sup>77</sup> R. at 4015-16 (NAC Decision at pp. 17-18).

<sup>78</sup> R. at 4017 (NAC Decision at p. 19).

<sup>79</sup> See *Remco Sec., Inc.*, 1985 SEC No-Act. LEXIS 2455, at \*2 (Aug. 20, 1985) ("Each case requires an evaluation of the content of the specific press release as well as the circumstances surrounding the actual issuance of such press release in relation to any offering by the affiliates.").

<sup>80</sup> *Gearhart*, 42 S.E.C. 1 (June 2, 1964), *aff'd*, 348 F.2d 798 (D.C. Cir. 1965); *Prendergast*, 55 S.E.C. 289 (Aug. 1, 2001).

<sup>81</sup> *Nonpublic Offering Exemption*, Securities Act Release No. 33-4552, 27 FR 11316 (Nov. 6, 1962), <http://www.sec.gov/rules/final/33-4552.htm> (suggesting that it would be "inconsistent with a claim that the transaction does not involve a public offering" if a general solicitation to an unrelated group of prospective investors had the "purpose of ascertaining who would be willing to accept an offer of securities").

<sup>82</sup> 42 S.E.C. at \*24-25 (finding "that the distribution of the literature concerning lithium was the first step in a campaign to sell National Lithium stock and as such constituted an offer to sell such stock").

served that purpose because the broker stated as much in a letter to existing investors in which he wrote that he would be using the seminars to raise new investment capital for the hedge fund.<sup>83</sup>

Unlike *Gearhart* and *Prendergast*, there is no evidence in this case that even suggests that the purpose of the newspaper articles was to ascertain “who [in the public] would be willing to accept an offer of [WRF Fund] securities.”<sup>84</sup> Indeed, the newspaper articles were not even aimed at investors, but at owners of distressed property from whom the WRF Fund sought to purchase investment properties. The NAC acknowledged as much when it stated that the articles “informed owners of distressed properties and nonperforming loans that Westmount Realty Finance was a buyer in that market.”<sup>85</sup>

The NAC, nevertheless, determined that the newspaper articles also “were designed to arouse interest in the WRF Fund.”<sup>86</sup> To support its finding, the NAC merely listed various statements from the articles without providing any explanation as to how or why the selected statements were indicative of an offer to purchase interests in the WRF Fund or to arouse interest in the Fund.<sup>87</sup> For example, the NAC failed to explain why the description of the WRF Fund as “as a \$10 million real estate fund’ that would ‘acquire bank-owned residential properties and nonperforming, discounted residential loans’” was aimed at potential investors and not at the distressed real estate market.<sup>88</sup> Likewise for the statements “that the issuer was ‘joining with several operators that specialize in bulk acquisition of distressed residential assets,’ and that ‘[i]n

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<sup>83</sup> 55 S.E.C. at 307-08 (finding “that the purpose of the planned seminars was to attract investors to [the hedge fund]” and “there was no reason other than marketing considerations for Prendergast to hold the free seminars”).

<sup>84</sup> *Nonpublic Offering Exemption*, 1933 Act Release No. 33-4552, 27 FR 11316, <http://www.sec.gov/rules/final/33-4552.htm>.

<sup>85</sup> R. at 4023 (NAC Decision at p. 25).

<sup>86</sup> *Id.*

<sup>87</sup> R. at 4022-23 (NAC Decision at pp. 24-25).

<sup>88</sup> R. at 4022 (NAC Decision at p. 24).

just over a year, Westmount has purchased more than 530 distressed residential assets.”<sup>89</sup> Nor did the NAC explain why the use of the word “launched” was a signal that there were opportunities for investors, rather than informing the distressed real estate market that WRF was ready to invest in distressed properties.<sup>90</sup>

While one (and only one) potential investor did contact KCD about WRF Fund interests after reading one of the articles, the NAC admitted that “one investor’s ‘purported understanding’ is ‘not enough’ to show that the articles involved a general solicitation.”<sup>91</sup> That is especially true given KCD’s refusal to sell that reader any interests in the WRF Fund.<sup>92</sup>

Because there is nothing in the articles to indicate that there were opportunities for investors in the WRF Fund,<sup>93</sup> or any evidence that the articles were intended to arouse interest in the WRF Fund, the NAC’s bald reiteration of statements from the newspaper articles is not a sufficient basis to establish that the articles constituted an offer of WRF Fund securities. The Commission should, therefore, overturn the NAC’s Decision and find that there is no basis to find that KCD offered interests in the WRF Fund by way of a general solicitation.

**B. KCD Did Not Use the Newspaper Articles to Offer or Sell WRF Fund Interests**

But even if the Commission finds that the newspaper articles constituted an offer, the Commission’s clear guidance since adopting Regulation D in 1982, instructs that the existence of a public offer is not enough to find a violation of Rule 502(c).<sup>94</sup> As indicated by the second

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<sup>89</sup> R. at 4023 (NAC Decision at p. 25).

<sup>90</sup> *Id.* (NAC Decision at p. 25 n.31).

<sup>91</sup> *Id.* (NAC Decision at p. 25).

<sup>92</sup> R. at 2690.

<sup>93</sup> R. at 2192 (Tr. at 274:5-14); R. at 2661-63.

<sup>94</sup> *1983 Regulation D Guidance*, 48 FR at 10053; *2007 Regulation D Guidance*, 2007 SEC LEXIS 1730 at \*90; Shapiro Letter at p. 8. *Cf. Joseph P. Doxey*, Admin. Proc. No. 3-15619, 2016 SEC LEXIS 1665, \*27-28, 36 (May 5, 2016)  
*cont’d . . .*



prong of the two-pronged inquiry set forth in the *Interpretive Release on Regulation D*, it must also be shown that the issuer or its agent has *used* the offending communication or activity to offer or sell the unregistered securities.<sup>95</sup> The Commission reiterated that guidance in 2007 when it discussed the effect of an issuer's concurrent public and private offerings in the context of general solicitation.<sup>96</sup> The Commission noted that an issuer that offered unregistered securities when a registration statement was in effect would not be in violation of Rule 502(c) if

the prospective private placement investor became interested in the concurrent private placement through some means other than the registration statement that did not involve a general solicitation and otherwise was consistent with Section 4(2), such as through a substantive, pre-existing relationship with the company or direct contact by the company or its agents outside of the public offering effort . . .

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In a 2011 letter to Congress, former Commission Chairperson, Mary Schapiro, stated the same in the context of the media frenzy surrounding a proposed private offering of Facebook by Goldman Sachs. Ms. Schapiro suggested that, despite the intense media scrutiny, had Goldman Sachs gone forward with the offering in the United States, it would not have engaged in a general solicitation if it sold the unregistered securities only to investors who were not solicited by the media attention, but, instead, were the firm's "existing clients or those with whom a pre-existing relationship existed."<sup>98</sup>

While the NAC reluctantly acknowledged that the Commission's guidance *may* be relevant to this matter, it determined that it was of no consequence because KCD failed to prove

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(suggesting that if the respondent can show on remand that it had a prior existing relationship with the investor, there would be no general solicitation violation despite the issuance of press releases regarding issuer).

<sup>95</sup> 1983 *Regulation D Guidance*, 48 FR at 10053.

<sup>96</sup> 2007 *Regulation D Guidance*, 2007 SEC LEXIS 1730 at \*90,

<sup>97</sup> *Id.*

<sup>98</sup> Schapiro Letter at p. 8.

that “none of the persons who purchased interests had seen the newspaper articles,”<sup>99</sup> or that “the investors were all accredited investors or met the sophistication criteria of Rule 506.”<sup>100</sup> The NAC’s ruling was in error. First, KCD presented unrefuted evidence that the investors in the WRF Fund were all accredited and learned about the offering from means other than the newspaper articles.<sup>101</sup> Moreover, the Staff’s determination not to recommend Enforcement action against the issuer after reviewing the WRF Fund lends further credence to IG’s and LR’s uncontroverted testimony.

**1. KCD Provided Uncontested Evidence About Its Offers and Sales of WRF Fund Interests**

KCD presented two witnesses at Hearing who testified under oath and without contradiction, that the investors in the WRF Fund were all accredited and learned about the offering from means other than the newspaper articles.<sup>102</sup> IG testified that, in late March 2011 – more than one month before the newspaper articles were published – KCD’s representatives sent emails to their pre-existing group of 1,200 accredited investors to let them know that interests in the WRF Fund were available and, if interested, they should contact a KCD representative for the offering documents.<sup>103</sup> IG further testified that, throughout the solicitation period of the WRF Fund offering, the representatives’ sales efforts focused only on following up with this group of pre-existing investors who received the initial offering email.<sup>104</sup> Moreover, IG and LR, KCD’s Chief Compliance Officer, testified, again under oath and without contradiction, that

<sup>99</sup> R. at 4025 (NAC Decision at p. 27).

<sup>100</sup> *Id.*

<sup>101</sup> See, e.g., R. at 2433 (Tr. 515:14-516:3); R. 2435 (Tr. at 517:9-19); R. at 2494-95 (Tr. at 575:22-576:6); R. at 2982 (CX-6 at p. 84); R. at 2196-97 (Tr. at 278:17-279:6).

<sup>102</sup> R. at 2433 (Tr. 515:14-516:3); R. 2435 (Tr. at 517:9-19); R. at 2494-95 (Tr. at 575:22-576:6); R. at 2982 (CX-6 at p. 84).

<sup>103</sup> R. at 2387 (Tr. at 469:5-24); R. at 2397-98 (479:23-480:18).

<sup>104</sup> R. at 2433-34 (Tr. at 515:14-516:3).

KCD sold interests in the WRF Fund only to a group of investors with whom the Firm had a prior existing relationship, or to investors who came to the offering through a pre-existing relation.<sup>105</sup> LR testified to the same during her June 2014 on-the-record testimony.<sup>106</sup>

Notably, the NAC made no findings indicating that either IG's or LR's testimony was unreliable or that the witnesses lacked credibility.<sup>107</sup> As such, the NAC had no basis for failing to credit IG's and LR's testimony – testimony that was made under oath,<sup>108</sup> was subject to cross examination,<sup>109</sup> and was not contradicted by any evidence.<sup>110</sup>

Nonetheless, the NAC erroneously rejected IG's and LR's testimony because it found that it was not supported by corroborating evidence.<sup>111</sup> First, FINRA's own examiner corroborated IG's and LR's testimony that the investors in the WRF Fund were all accredited. ET testified that he found that the WRF Fund investments were suitable for the customers he

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<sup>105</sup> R. at 2435 (Tr. at 517:9-19); R. at 2486-87 (Tr. at 567:21-568:8). Certain of the investors were clients of registered investment advisors who were among the group of accredited investors with whom KCD had a pre-existing relationship. R. at 2433-34 (Tr. 515:14-516:3); R. 2435 (Tr. at 517:9-19), or were referred by pre-existing customers. R. at 2404-05 (Tr. at 486:1-487:5).

<sup>106</sup> R. at 2980, 2982 (CX-6 at pp. 36, 38)

<sup>107</sup> *But see Julieann Palmer Martin*, Admin. Proc. No. 3-15613, 2015 SEC LEXIS 880, \*43-44 (March 9, 2015) (making credibility determinations about the witnesses).

<sup>108</sup> *See Edgar B. Alacan*, 57 S.E.C. 715, 730 (July 6, 2004) (accepting witnesses' sworn testimony where no evidence it was false or biased and was not contradicted by the evidence); *Dep't of Enforcement v. Mark H. Love*, 2003 NASD Discip. LEXIS 17, \*17 n.10 (May 19, 2003) (crediting witness' uncontradicted testimony that was made under oath and subject to cross-examination).

<sup>109</sup> *See Love*, 2003 NASD Discip. LEXIS at \*17 n.10.

<sup>110</sup> *See Mark David Anderson*, Admin. Proc. No. 3-9499, 2002 SEC LEXIS 3583, \*56 (April 20, 2002) (crediting Respondent's testimony regarding the alleged wrongdoing that was not contradicted by any evidence in the record); *Raymond L. Dirks*, Admin. Proc. No. 3-6183, 1983 SEC LEXIS 2820, \*10 n.10 (Dec. 19, 1983) (crediting witness' unrefuted testimony); *A.J. White & Co.*, Admin. Proc. No. 3-4390, 1975 SEC LEXIS 2564, \*57 (Jan. 21, 1975) (respondent's unrefuted testimony "must be credited"); *Dep't of Enforcement v. North Woodward Financial Corp.*, Discip. Proc. No. 2011028502101, 2014 FINRA Discip. LEXIS 11, \*58 (May 16, 2014) (accepting witness' uncontroverted testimony); *Dep't of Enforcement v. Jeffrey O. Putterman*, Complaint No. C05960041, 1997 NASD Discip. LEXIS 52, \*25-26 (Oct. 10, 1997) (crediting respondent's uncontroverted testimony and rejecting the NASD's conclusion that respondent's reasoning was "not based on verifiable facts").

<sup>111</sup> R. at 4018-19, 4025 (NAC Decision at pp. 20-21, 27).

reviewed and, therefore, had no findings regarding suitability.<sup>112</sup> And, because the WRF Fund Private Placement Memorandum, which ET also reviewed,<sup>113</sup> specified that the WRF Fund was suitable only for accredited investors,<sup>114</sup> ET's finding that the investments were suitable for KCD's customers means that he determined that the customers were accredited investors.

IG's and LR's testimony was also corroborated by Enforcement's failure to introduce any evidence to contradict their testimony.<sup>115</sup> Once KCD put in evidence that established that it was entitled to an exemption, as it did through the testimony of IG, LR and ET,<sup>116</sup> the burden shifted back to Enforcement to rebut the existence of the exemption.<sup>117</sup> In *James F. Glaza*, the Commission's Division of Enforcement ("Division") similarly failed to put in any evidence to rebut the respondent's claim that it was entitled to rely on an exemption, a claim made, in large measure, through the uncontroverted testimony of the respondent's witnesses.<sup>118</sup> The Division had charged the respondent with selling unregistered securities to more unaccredited investors than allowed under Regulation D in a series of offerings involving approximately 300 investors.<sup>119</sup> While the respondent submitted evidence about the sophistication and accreditation of only four of the investors in the offerings,<sup>120</sup> the Commission nonetheless dismissed the Section 5 claim after crediting the unrefuted testimony of several witnesses who offered

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<sup>112</sup> R. at 2196-97 (Tr. at 278:17-279:6).

<sup>113</sup> R. at 2167, 2170-71 (Tr. at 249:6-21; 252:24-253:3)

<sup>114</sup> R. at 2747, 2750 (JX-27 at 5, 8)

<sup>115</sup> See *James F. Glaza*, Admin. Proc. No. 3-11012, 2005 SEC LEXIS 1798, \*16-17 (July 21, 2005) (dismissing Section 5 claim where the Division of Enforcement failed to introduce evidence to rebut the claimed exemption).

<sup>116</sup> *ACAP Fin. Inc.*, Exchange Act Release No. 70046, 2013 SEC LEXIS 2156, \*29 (July 26, 2013), *aff'd* 783 F.3d 763 (10th Cir. 2015).

<sup>117</sup> See *Glaza*, 2005 SEC LEXIS 1798 at \*17.

<sup>118</sup> *Id.* at \*10-12; \*16-17.

<sup>119</sup> *Id.* at \*8, \*16-17.

<sup>120</sup> *Id.* at \*12.

evidence about the procedures used to ensure that all of the investors in the offerings were accredited.<sup>121</sup> Just as it did in *Glaza*, the Commission should find here that Enforcement's failure to rebut IG's, LR's and ET's testimony was a sufficient basis to establish that KCD was entitled to rely on a Rule 506 exemption from registration.

2. **The Newly Discovered Evidence of the Commission's Investigation Lends Credence to KCD's Evidence**

The newly discovered evidence regarding the Staff's investigation of the WRF Fund lends further credence to IG's, LR's and ET's testimony.<sup>122</sup> The evidence involves the Staff's review of, among other things, documents and information related to the method by which investors were solicited for the WRF Fund and the number of accredited investors in the WRF Fund offering.<sup>123</sup> The Staff's decision to recommend "no action" against WRC suggests that the Staff determined that the WRF Fund investors were accredited and had a pre-existing relationship with KCD or the issuer.<sup>124</sup> Any implication to the contrary suggests that the Staff declined to bring an enforcement action against an issuer that sold unregistered securities in violation of Section 5.

For all of these reasons, the NAC was wrong in finding that KCD had failed to prove that it was entitled to rely on a Rule 506 exemption. There is no evidence that the newspaper articles that resulted from a press release issued by WRF constituted an offer. But, even if they did, the uncontroverted evidence shows that KCD offered and sold interests in the WRF Fund only to accredited investors who learned about the Fund from means other than the newspaper articles. Accordingly, the NAC's Decision to the contrary must be overturned.

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<sup>121</sup> *Id.* at \*10-12; \*16-17.

<sup>122</sup> R. at 3989-90; R. at 4032 (NAC Decision at p. 34 n.48).

<sup>123</sup> R. at 3932-34; R. at 3950-51.

<sup>124</sup> R. at 4032 (NAC Decision at p. 34 n.48).

## II. KCD APPROPRIATELY SUPERVISED THE WRF FUND

KCD also appeals from the NAC's determination that KCD failed to supervise the WRF Fund offering.<sup>125</sup> The NAC erred in finding that KCD failed to respond appropriately to the "red flag" raised by the publication of the newspaper articles.<sup>126</sup> The NAC came to this erroneous conclusion based on an incorrect assumption that (1) the only appropriate response to the "red flag" was for KCD to have instructed its representatives to stop selling WRF Fund interests,<sup>127</sup> and (2) KCD had the power to remove the newspaper articles from WRF's website.<sup>128</sup>

### A. KCD's Supervision of the WRF Fund Offering Ensured that the Firm Did Not Violate Section 5

Consistent with the Commission's long-standing guidance on general solicitations, KCD implemented appropriate supervisory procedures to ensure that the Firm did not use the newspaper articles to either offer or sell interests in the WRF Fund.<sup>129</sup> After learning about the newspaper articles from WRF's securities attorney, IG immediately called JL, KCD's then CCO, to inform him about the situation.<sup>130</sup> IG then held a conference call with the representatives selling WRF Fund interests, during which the representatives were told that

if anyone contacted them interested in the offering, if they did not have a preexisting business relationship with that person, meaning if that person had not invested with them previously in other offerings, the first question they were to

<sup>125</sup> R. at 4026-28 (NAC Decision at pp. 28-30).

<sup>126</sup> R. at 4027 (NAC Decision at p. 29); *see also* R. at 4026 (NAC Decision at p. 28) (citing *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 SEC LEXIS 2843, at \*33 (Dec. 19, 2008) and *La Jolla Capital Corp.*, 54 S.E.C. 275, 285 (1999)). The NAC's reliance on guidance and case law related to the supervision of distributions of unregistered securities is inapposite. *See* R. at 4026 (NAC Decision at p. 28) (citing *Sales of Unregistered Securities by Broker-Dealers*, Securities Act Release No. 5168, 1971 SEC LEXIS 19 (July 7, 1971), as well as cases citing that guidance). This case does not involve any form of a distribution into the public markets.

<sup>127</sup> R. at 4027 (NAC Decision at p. 29)

<sup>128</sup> *Id.*

<sup>129</sup> *See 1983 Regulation D Guidance*, 48 FR 10045 at 10053; *2007 Regulation D Guidance*, 2007 SEC LEXIS 1730 at \*90; Schapiro Letter at p. 8.

<sup>130</sup> R. at 2400-02; R. at 2422-23 (Tr. at 482:13-484:9; 504:7-505:19).

ask is: How did you find out about this? And if the answer was: I read it in an article about it in the paper, whether it was Dallas Business Journal or Daily Morning News, no matter what, then they were to tell that person, I'm sorry, we cannot let you invest in this offering. That was made very clear, crystal clear, to all of the reps at that point.<sup>131</sup>

During the pendency of the WRF Fund offering, only one potential investor contacted KCD after reading one of the newspaper articles.<sup>132</sup> CB, the representative who received the call, informed the potential investor "that he would not be able to invest in the offering because we did not have a pre-existing relationship prior to the offering being sent out."<sup>133</sup> CB told IG about the call,<sup>134</sup> and IG then informed KCD, letting the Firm know that CB declined to even give the potential investor any information about the WRF Fund offering.<sup>135</sup>

The NAC failed to recognize that, for its supervision claim, the burden was on Enforcement to demonstrate that KCD failed to supervise the WRF Fund offering. Enforcement did not meet its burden: it did not show, for example, that KCD allowed the representatives to sell WRF Fund interests to unaccredited investors, nor did it show that KCD sold interests to investors with whom the Firm had no prior relationship.<sup>136</sup> As set forth above, Enforcement could not have presented any such evidence because neither it nor FINRA's examination staff took any steps to investigate KCD's supervisory systems and controls before it brought its claim against the Firm. As such, it was error for the NAC to have found that Enforcement met its burden of proving that KCD failed to reasonably supervise the WRF Fund offering.

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<sup>131</sup> R. at 2401-02 (Tr. at 483:21-484:9).

<sup>132</sup> R. at 2681-82.

<sup>133</sup> R. at 2682.

<sup>134</sup> *Id.*

<sup>135</sup> R. at 2403 (Tr. at 485:10-25).

<sup>136</sup> *Compare Meyers Associates*, 2016 FINRA Discip. LEXIS 29 at \*13-15 (dismissing the Section 5 claim, in part, because the firm successfully implemented procedures to ensure a separation between the purported solicitations and the sales of the offering).

**B. KCD's Inability to Control the Content of WRF's Website Does Not Constitute a Supervisory Failure**

The NAC also found that KCD did not appropriately supervise the offering because IG and LR failed to verify that the newspaper articles were taken down from the WRF Fund website.<sup>137</sup> KCD, however, had no control over WRF's website.<sup>138</sup> IG asked the issuer's IT department to take the articles down in late April 2011 after he learned that they were on WRF's website.<sup>139</sup> He asked again in or around October 2011 after LR, the new CCO, instructed him to get the articles taken down from the website.<sup>140</sup> Neither IG nor LR, however, had the power to require WRF to take it down.<sup>141</sup>

But, whether or not the articles remained on the WRF website is not the determining factor of whether KCD engaged in a general solicitation, or whether it failed to supervise the WRF Fund offering. Even assuming the articles constituted a solicitation, KCD would only have violated the rule prohibiting general solicitation if it had used the articles to offer or sell interests in the WRF Fund.<sup>142</sup> Enforcement did not introduce any evidence to prove that KCD's inability to remove the articles from WRF's website caused the Firm to use the articles to offer or sell WRF Fund interests.

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<sup>137</sup> R. at 4027 (NAC Decision at p. 29).

<sup>138</sup> *Id.*

<sup>139</sup> R. at 2402-03 (Tr. at 484:15-485:9).

<sup>140</sup> R. at 2486 (Tr. at 567:7-20).

<sup>141</sup> The NAC found that LR did not respond reasonably to the newspaper articles on the website given her understanding that they "should not have been on the website during the offering or solicitation stage of a private offering." R. at 4027 (NAC Decision at p. 29). Whether or not LR believed that the articles constituted a solicitation of securities, her belief is not relevant as to whether or not KCD, in fact, engaged in a general solicitation. While LR may have thought the articles should not have been published, she was also aware, through her conversation with IG after she learned about the articles that KCD sold WRF Fund interests only to accredited investors with whom the Firm had a pre-existing relationship. R. at 2784-95 (R. at 575:22-576:6). LR later confirmed IG's representation through a review of the customer files. R. at 2982 (CX-6 at p. 38); R. at 2486-87 (Tr. at 567:21-568:8).

<sup>142</sup> 1983 *Regulation D Guidance*, 48 FR at 10053.



For all of these reasons, Enforcement failed to prove that KCD's supervision of the WRF Fund offering was inappropriate. The NAC's determination to the contrary must, therefore, be overturned.

### **III. THE SANCTIONS IMPOSED ON KCD ARE EXCESSIVE AND PUNITIVE**

If the Commission finds that KCD did engage in some wrongdoing, it should, nonetheless, set aside or significantly reduce the excessive and punitive sanction imposed on the Firm by the NAC.<sup>143</sup> To justify the imposition of the grossly excessive \$73,000 fine, the NAC 1) willfully declined to consider the Staff's determination to take no action against the WRF Fund issuer for the very same activities at issue in this proceeding,<sup>144</sup> and (2) incorrectly treated the activities herein as if they involved an unlawful distribution of unregistered, low-priced securities into the public marketplace, rather than as a general solicitation of a private offering.<sup>145</sup> The Commission should correct the NAC's errors and impose a sanction that is commensurate with sanctions imposed on other respondents found to have violated the rule prohibiting general solicitation.

#### **A. The Commission Should Consider its Staff's Review of the WRF Fund Offering in Making a Sanctions Determination**

Unlike the NAC, the Commission should consider the Staff's determination in 2014 to not recommend any action against the WRF Fund issuer after it conducted a review of the

<sup>143</sup> See *ACAP Fin., Inc.*, 783 F.3d 763, 768 (10th Cir. April 3, 2015) ("By statute, the SEC must set aside or reduce any FINRA sanction that is 'not necessary or appropriate in furtherance of the purposes of [the act] or is excessive or oppressive.'" (quoting 15 U.S.C. § 78s(e)(2))).

<sup>144</sup> R. at 4031 (NAC Decision at p. 33, 33 n.48).

<sup>145</sup> R. at 4029-30 (NAC Decision at pp. 31-32 ("KCD did not implement reasonable procedures to ensure that it did not participate in an unregistered distribution.") (citing a Principle Consideration No. 4 to Section 5 claims, which relates to unlawful distributions)); R. at 4026 (NAC Decision at p. 28) (citing authority related to unlawful distributions).

activities at issue herein when it makes its sanction determination.<sup>146</sup> The Staff made its “no action” determination after it conducted a review of documents and information related to how investors to the WRF Fund were solicited, and whether those investors were accredited.<sup>147</sup> Even if the Commission cannot conclude from the Staff’s decision that the Staff did not find any wrongdoing in the WRF Fund offering,<sup>148</sup> any such wrongdoing was, apparently, not serious enough to warrant taking any action against the WRF Fund issuer – the entity that filed the Form D indicating that it was entitled to rely on a Rule 506 exemption.<sup>149</sup> The NAC’s determination to impose the highest recommended fine under the Sanction Guidelines against KCD simply cannot be reconciled with the Staff’s decision to not recommend any action against the issuer for the exact same activities.<sup>150</sup>

**B. The NAC’s Sanction Reflects an Unlawful Distribution Rather Than a General Solicitation**

The NAC’s excessive and punitive fine bears no relationship to any alleged wrongdoing in this action, or to sanctions imposed by the Commission on respondents found to have violated

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<sup>146</sup> R. at 3783, 3923-51.

<sup>147</sup> R. at 3932-34; R. at 3950-51 (¶ 6).

<sup>148</sup> R. at 4032 (NAC Decision at p. 34 n.48)

<sup>149</sup> R. at 2672, 2677.

<sup>150</sup> KCD also challenges the Hearing Panel’s and the NAC’s reliance on Sanction Guidelines that did not go into effect until after the parties submitted their Post-Hearing Briefs. At all times during these proceedings, the parties relied on Sanction Guidelines that recommended fines in the range of \$2,500 to \$50,000 for violations of Section 5. *See, e.g.*, R. at 3351 (Count II sanctions argument in Enforcement’s post-hearing brief). The Hearing Panel and the NAC, however, fashioned the sanction for the Section 5 claim based on Guidelines that were revised in March 2015, *see* Sanction Guidelines at p. 113 (back cover), two months after the parties filed their Post-Hearing Briefs. *See* R. at 3319; R. at 3399. The revised Guidelines raised the high end of the sanctions range from \$50,000 to \$73,000. *Compare* R. at 3351 to Sanction Guidelines, p. 24.

KCD recognizes that the Guidelines specifically state that they become “effective as of the date of publication, and apply to all disciplinary matters, including pending matters.” Sanction Guidelines at p. 8. KCD, however, questions the fairness of characterizing the instant case as being a “pending” matter when the new Guidelines went into effect. All of the proceedings had long been concluded by March 2015, and the only thing that was pending was the Hearing Panel’s Decision. Accordingly, if the Commission determines that sanctions are warranted in this action, the Firm urges the Commission to impose a fine based on the Sanction Guidelines that were in effect when the case was actually pending, and not the Guidelines that went into effect as the parties waited for the Hearing Panel to complete its Decision.

Rule 502(c)'s prohibition against general solicitation.<sup>151</sup> The NAC justified its \$73,000 fine by relying not on authority related to general solicitations, but on authority related to the distinct Section 5 violation involving the unlawful distributions of unregistered securities.<sup>152</sup> Indeed, the fine imposed on KCD is commensurate with the \$80,000 fine imposed on a recidivist firm responsible for distributing millions of shares of low-priced, unregistered securities into the public markets.<sup>153</sup>

The Commission and FINRA target firms that engage in unlawful distributions, like the firm in *Midas Securities, LLC*, because of the grave impact the distributions can have on the general public.<sup>154</sup> These unlawful distributions typically involve substantial amounts of little known securities – often “microcap” companies, , *i.e.*, those characterized by thin capitalization, low share prices, limited public information and little or no analyst coverage – that “appear in the trading markets within a fairly short period of time and without the benefit of registration under the Securities Act of 1933.”<sup>155</sup> Once in the market, the shares are available to any investor, no matter the level of sophistication or financial means – in other words, the type of investors that require the protections afforded by the Securities Act.<sup>156</sup>

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<sup>151</sup> See, e.g., *Harry Harootunian*, 1993 SEC LEXIS 2504 at \*7-10 (in an offer of settlement, imposing a sanction against a broker-deal that conducted a general solicitation of a censure and an agreement to refrain from any future violations of Section 5); *CGI Capital, Inc.*, Admin. Proc. No. 3-10331, 2000 SEC LEXIS 2081, \*5-6 (Sept. 29, 2000) (in an offer of settlement, imposing a \$25,000 fine against a broker-deal that conducted a general solicitation).

<sup>152</sup> R. at 4029-30 (NAC Decision at pp. 31-32); R. at 4026 (NAC Decision at p. 28). See also *Jacob Wonsover*, 54 SEC at 12 & n.25 (observing that the term “distribution” is not defined in the Securities Act, but refers to “the entire process in a public offering through which a block of securities is dispersed and ultimately comes to rest in the hands of the investing public” (emphasis added)).

<sup>153</sup> *Midas Securities, LLC, et al*, 2012 SEC LEXIS 199 at \*2, 72-73.

<sup>154</sup> See, e.g. “Broker-Dealer Controls Regarding Customer Sales of Microcap Securities,” *National Exam Program Risk Alert*, By the Office of Compliance Inspections and Examinations (Oct. 14, 2014), found at <https://www.sec.gov/about/offices/ocie/broker-dealer-controls-microcap-securities.pdf>.

<sup>155</sup> *Distribution By Broker-Dealers of Unregistered Securities*, Securities Act Rel. 6721, 1962 SEC LEXIS 74, \*4 (Feb. 2, 1962).

<sup>156</sup> See *Ralston Purina*, 346 U.S. at 124-25.

This case does not involve activities that had the kind of public impact found in an unlawful distribution. Even if the Commission finds that KCD sold WRF Fund interests to investors with whom it did not have a pre-existing relationship, the FINRA examiner found that the securities were sold only to investors for whom they were suitable.<sup>157</sup> Moreover, the WRF Fund sales were not conducted in the public markets, but privately through subscription agreements entered into between the investor and the issuer, with the WRF Fund investors receiving the benefit of detailed information about the offering that was set forth in the offering's Private Placement Memorandum.<sup>158</sup>

The Commission appears to have recognized that general solicitations have much less of an impact on the public than do unlawful distributions based on the relatively modest sanctions imposed on firms found to have violated the rule prohibiting general solicitations.<sup>159</sup> For example, in a series of cases brought against the issuer, the issuer's director and a broker-dealer, all of which were involved in an unregistered offering that was conducted through a general solicitation, the Commission accepted offers of settlement from each that were limited to a censure (in the case of the broker-dealer) and an agreement by each party to "permanently cease and desist from committing or causing any violation of, and committing or causing any future violation of, Section 5 of the Securities Act."<sup>160</sup> In addition, in *CGI Capital, Inc.*, in which a broker-dealer was found to have engaged in a general solicitation, the Commission accepted an offer of settlement of a censure, an agreement not to commit further violations of Section 5 and a

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<sup>157</sup> R. at 2196-97 (Tr. at 278:17-279:6).

<sup>158</sup> R. at 2473.

<sup>159</sup> See, e.g., *CGI Capital, Inc.*, 2000 SEC LEXIS 2081 at \*8; *Kenman Corp. et al*, Admin. Proc. No. 3-6505, 1985 LEXIS 1717, \*10-11 (April 19, 1985).

<sup>160</sup> See *Harry Harootunian, et al*, 1993 SEC LEXIS 2504 at \*10; *EMX Corp., et al*, Admin. Proc. No. 3-8185, 1993 SEC LEXIS 2474, \*8 (Sept. 29, 1993); *Robert Testa*, Admin. Proc. No. 3-3184, 1993 SEC LEXIS 2473, \*9 (Sept. 29, 1993).

information regarding the Commission's investigation of the WRF Fund. KCD had no independent access to the information about the Staff's investigation because the Commission has never released any publicly available information indicating that it investigated the issuer or the WRF Fund.<sup>167</sup>

KCD also demonstrated to the NAC that the newly discovered evidence was material to KCD's defense. The evidence indicates that the Commission sought and received documents and information from WRC related to, among other things, the broker-dealers that sold its securities, how investors to the WRF Fund were solicited and whether the investors to the WRF Fund were accredited – the very issues that are at the center of this action. The evidence also indicates that the Staff informed the issuer that it did “not intend to recommend any enforcement action by the Commission at this time.”<sup>168</sup> As argued above this evidence is relevant to the instant matter because it (1) lends further credence to IG's and LR's uncontroverted testimony that all investors to the WRF Fund were accredited and had a pre-existing relationship with KCD; and (2) stands in stark contrast to the NAC's determination that KCD's WRF Fund activities merit a severe sanction when the Staff determined that the WRF Fund activities did not even warrant bringing an enforcement action.

For these reasons, the Commission should overturn the NAC's denial of KCD's motion and consider the materials related to the staff's investigation when making its Decision in this appeal.

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<sup>167</sup> R. at 3612 (KCD's brief to the NAC at p. 39, 39 n.210).

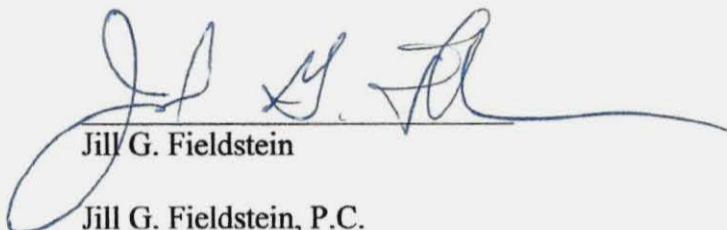
<sup>168</sup> R. at 3783 at. KCD understands that, pursuant to Securities Act Release No. 5310, the Staff's decision is not determinative.

**CONCLUSION**

For all of the foregoing reasons, KCD hereby requests that the Commission find in favor of KCD and overturn the NAC's findings in this case. In the alternative, KCD requests that, if the NAC sustains the NAC's ruling, it set aside or drastically reduce the excessive fine imposed on the Firm to reflect that KCD adhered to the spirit of the Securities Act by preventing unaccredited and unsophisticated investors from purchasing interests in the WRF Fund.

October 19, 2015

Respectfully Submitted,

A handwritten signature in blue ink, appearing to read "Jill G. Fieldstein", is written over a horizontal line. The signature is fluid and cursive.

Jill G. Fieldstein

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Before the  
SECURITIES AND EXCHANGE COMMISSION

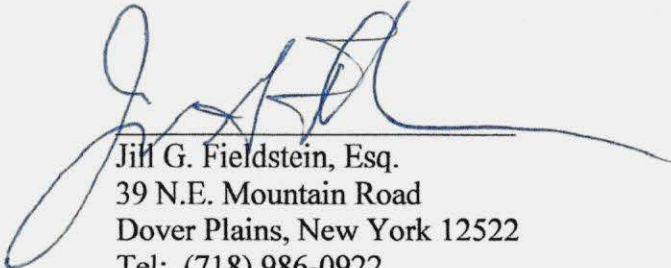
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In the Matter of the Application of :  
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KCD FINANCIAL INC. (CRD No. 127473) :  
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For Review of :  
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FINRA Disciplinary Action :  
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File No. 3-17512 :  
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**CERTIFICATION OF WORD COUNT**

I, JILL G. FIELDSTEIN, hereby declare and certify, under the penalty of perjury, that the following is true and correct:

1. I am over 21 years of age and am a resident of the state of New York. I am competent to make this declaration regarding the length of KCD Financial Inc.'s Opening Brief on Appeal, dated October 19, 2016 ("Opening Brief") in accordance with Rule 450(d) of the Commission's Rules of Practice (September 2016 ed.).
2. The Opening Brief complies with the length limitation for opening briefs as set forth in Rule 450(c) because it contains less than 14,000 words.
3. According to the word count of the word-processing system used to prepare the Opening Brief, the Opening Brief includes 10,771 words, exclusive of the table of contents and table of authorities.

October 19, 2016

  
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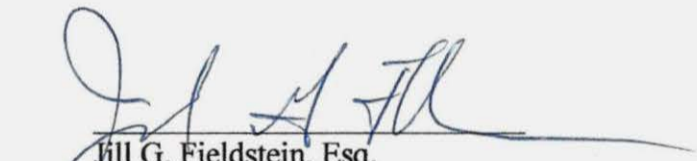
Before the  
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In the Matter of the Application of :  
KCD FINANCIAL INC. (CRD No. 127473) :  
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FINRA Disciplinary Action :  
File No. 3-17512 :  
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**CERTIFICATE OF SERVICE**

I hereby certify that on this 19th day of October 2016, I sent by Overnight Mail an original and three copies of the KCD Financial Inc.'s OPENING BRIEF ON APPEAL and CERTIFICATION OF WORD COUNT to The Office of the Secretary, Securities and Exchange Commission, 100 F Street, N.E., Room 10915, Washington, D.C. 20549-1090.

On this 19th day of October 2016, I also sent a copy of the OPENING BRIEF ON APPEAL and CERTIFICATION OF WORD COUNT by Overnight Mail to Michael Garawski, Esq., Office of General Counsel, FINRA, 1735 K Street, N.W., Washington, D.C. 20006. I also sent a courtesy copy of the foregoing to Mr. Garawski by email to michael.garawski@finra.org.

  
Jill G. Fieldstein, Esq.  
*Counsel for KCD Financial Inc.*