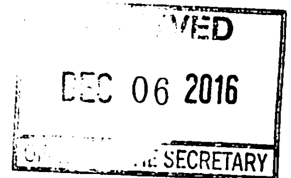

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Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of the Application of

KCD FINANCIAL INC. (CRD No. 127473)

For Review of

FINRA Disciplinary Action

File No. 3-17512

KCD FINANCIAL, INC.'s REPLY BRIEF ON APPEAL

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December 5, 2016

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PRELIMINARY STATEMENT

In its Opposition Brief, FINRA did not deny that its Department of Enforcement ("Enforcement") failed to conduct any investigation before it accused KCD Financial Inc. ("KCD" or the "Firm") of selling interests in the WRF Distressed Residential Fund 2011 (the "WRF Fund") without an exemption from the registration requirements. FINRA did not deny that Enforcement failed to investigate whether any of the investors in the WRF Fund were actually solicited through the newspaper articles, or whether the Firm had appropriately limited its sales to investors who learned about the private offering through means other than the newspaper articles.[1] FINRA also did not deny that KCD offered uncontroverted evidence at Hearing demonstrating that the Firm offered interests in the WRF Fund only to its pre-existing group of 1,200 accredited investors,[2] and sold those interests only to investors who learned about the offering from those initial emails.[3] Nor did FINRA deny that once KCD put in evidence that established that it was entitled to an exemption, the burden shifted back to Enforcement to rebut the existence of the exemption,[4] a burden Enforcement failed to meet. As such, it was error for the National Adjudicatory Council (the "NAC") to have ruled against KCD, and FINRA's

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[1] *See* 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 (stating that "the proper analysis of whether a general solicitation occurred focused on whether the investors participating in the offering were actually solicited through the activities which could be viewed as a general solicitation or if, for example, the investors were existing clients or those with whom a pre-existing relationship existed"). *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").

[2] Record ("R.") at 2397-98 (Hearing Transcript ("Tr.") at 479:9-480:18).

[3] R. at 2433-34 (Tr. at 515:14-516:3); R. at 2494-95 (Tr. at 575:22-576:6); R. at 2982 (CX-6 at p. 84).

[4] *See 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).

Opposition Brief fails to state a basis for sustaining the NAC Decision that KCD sold unregistered securities in violation of Section 5 of the Securities Act of 1933 ("Section 5").

With respect to the supervision claim under NASD Rule 3010, FINRA declined to acknowledge that Enforcement failed to meet its burden of proof because it did not – and could not – demonstrate that, because of supervisory lapses, KCD allowed its representatives to sell WRF Fund interests to investors who were solicited through the newspaper articles, or who were not accredited, or who the Firm or the issuer had no prior relationship. Instead, FINRA adheres to NAC's flawed rationale that KCD failed to supervise the offering solely because it did not cease the offering after the newspaper articles were published. The NAC's rationale for its supervision claim, however, is not separate and distinct from its determination that KCD violated Section 5, but simply uses different terminology to find again that KCD continued selling interests in the WRF Fund after the publication of the newspaper articles purportedly deprived the issuer of an available registration exemption. FINRA offered no basis in its Opposition Brief as to why such a duplicative finding should be sustained.[5]

FINRA made only a half-hearted attempt to address KCD's arguments with respect to its motion to introduce newly discovered evidence, arguing only that the evidence is irrelevant because it involves a different regulator and a different party. However, the regulator is the Commission – the very regulator that promulgated the rules that are at issue in this proceeding.[6] And the party is not a stranger to this case, but the issuer of the WRF Fund on whose behalf

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[5] *See Ahmed Gadelkareem*, 2016 FINRA Discip. LEXIS 9, *1 (May 2, 2016) ("Because the gravamen of the claimed violations of both provisions arises from the same ... conduct, the violations are 'duplicative' rather than ... separate and additional infraction[s]' and are properly set forth in a single claim.") (quoting *Midwestern Securities Corporation*, Admin. Proc. File No. 3-3276, 1973 SEC LEXIS 3504, *31 (Nov. 7, 1973) (dismissing a claim as duplicative)).

[6] Indeed, FINRA does not even have the authority to bring a claim under the Securities Act, but can only assert that KCD violated FINRA Rule 2010 *by virtue* of a purported violation of the Securities Act. FINRA brought its claim even though there has been no prior finding that KCD or the issuer, in fact, violated the Securities Act.

KCD offered and sold the unregistered securities,[7] the entity that issued the press release that caused the newspaper articles to be written,[8] the entity that posted the newspaper articles to its website,[9] the entity that filed a Form D indicating that it was entitled to rely on a Rule 506 exemption from registration,[10] and the entity whose securities attorney's statement about a purported breach has been invoked throughout these proceedings.[11] It is nonsensical to argue that the Commission's review of the WRF Fund offering is irrelevant to these proceedings when the actions of the issuer and KCD were so inextricably intertwined with respect to the WRF Fund offering.

Finally, FINRA invoked the exploitation of elderly investors as a purported justification for the draconian fine the NAC imposed on KCD.[12] Even though FINRA acknowledged that Enforcement did not allege any customer harm or introduce any evidence of customer harm,[13] or even suggest that the WRF Fund was unsuitable for any of the investors,[14] it nonetheless deemed it appropriate to suggest that KCD's actions had some impact on the most vulnerable of investors. Such an irresponsible argument should not be condoned.

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[7] R. at 2679 (Soliciting Dealer Agreement between the WRF Fund and KCD).

[8] R. at 4015 (NAC Decision at p. 17).

[9] R. at 4017 (NAC Decision at p. 19).

[10] R. at 2677 (Form D signed by the WRF Fund CEO).

[11] R. at 4016-17 (NAC Decision at pp. 18-19).

[12] Opposition Brief at p. 40.

[13] Opposition Brief at pp. 38-39.

[14] Opposition Brief at pp. 30-31.

ARGUMENT

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

Despite the Commission's guidance to the contrary, FINRA continues to argue that the publication of the newspaper articles alone was a sufficient basis to deprive the WRF Fund issuer (and KCD) of its ability to rely on a Rule 506 exemption from the registration requirements.[15] But SEC guidance establishes that even if the newspapers articles constitute an "activity that could be viewed as a general solicitation," an exemption may still be available if, like here, the participants in the private offering were not solicited by means of the general solicitation.[16]

A. The Publication of the Newspaper Articles Alone Did Not Constitute a Breach of the Rule Prohibiting General Solicitation

In its Opposition Brief, FINRA improperly characterized as "post-breach efforts" KCD's offer and sales of the WRF Fund interests only to those investors who learned about the offering from means other than the newspaper articles.[17] FINRA's argument is based on the flawed premise that the publication of the newspaper articles alone constituted a breach of Rule 502(c)'s prohibition on general solicitations. But, as set forth in KCD's Opening Brief,[18] the Commission's long-standing guidance provides that, even where there have been activities that could be viewed as a general solicitation, there may be no violation of the rule prohibiting

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[15] Opposition Brief at pp. 20-25.

[16] Schapiro Letter at p. 8. *See also* 1983 Regulation D Guidance, 48 FR at 10053; 2007 Regulation D Guidance, 2007 SEC LEXIS 1730 at *90.

[17] Opposition Brief at pp. 20-25.

[18] Opening Brief at pp. 13-14, 17-18.

general solicitation if the investors in a private placement learned about the offering from means other than the general solicitation.[19]

Shortly after Regulation D was adopted, the Commission issued guidance that specifically stated that to find an issuer or its agent to be in violation of Rule 502(c), it would have to be shown not only that a communication was a general solicitation or general advertisement, but also that the communication was used to offer or sell the unregistered offering.[20] The Commission stated that if one of those two things was not present, there would be no violation.[21] In 2007, the Commission reviewed the scope of the ban on general solicitation in the context of a concurrent private and public offering, and similarly to its 1983 guidance, provided that the determination as to whether a registration statement would affect the availability of an exemption for the private offering should be based on an analysis of whether the issuer used the registration statement to attract investors to the private offering.[22] The Commission observed that, if the investors were solicited by means other than the registration statement, then the private offering would retain its ability to rely on a registration exemption.[23] In a 2011 letter to Congress, former Commission Chairperson Mary Schapiro provided further guidance on the scope of the ban on general solicitations, this time in the context of a proposed

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[19] 1983 Regulation D Guidance, 48 FR at 10053; 2007 Regulation D Guidance, 2007 SEC LEXIS 1730 at *90; Schapiro Letter at p. 8.

[20] 1983 Regulation D Guidance, 48 FR at 10053

[21] *Id.*

[22] 2007 Regulation D Guidance, 2007 SEC LEXIS 1730 at *90. FINRA argues that "[n]othing in the 2007 Regulation D Guidance suggests that it was intended to apply outside the narrow context of concurrent registered and private offerings." Opposition Brief at p. 23. But the Commission's 2007 guidance relies on the same logic it used in its 1983 Interpretative Release, focusing not on the communication itself, but whether the communication was actually used to offer or sell the unregistered securities. Moreover, Chairperson Schapiro explicitly referred to the 2007 guidance in the context of privately offering shares of Facebook when such offerings had been so widely publicized by the media. *See* Schapiro. As such, there is no indication that the Commission intended to limit its reasoning in its 2007guidance to only the narrow context of concurrent public and private offerings.

[23] *Id.*

private offering of Facebook shares in light of the media frenzy over the securities.[24] Schapiro noted that Goldman Sachs would not have been automatically foreclosed from engaging in a private offering of Facebook shares even though the publicity about the shares could be described as a general solicitation. Referring to the Commission's 2007 guidance, Schapiro stated that "the proper analysis of whether a general solicitation occurred focused on whether the investors participating in the offering were actually solicited through the activities which could be viewed as a general solicitation or if, for example, the investors were existing clients or those with whom a pre-existing relationship existed."[25]

In accordance with the Commission's guidance, KCD did not automatically violate Rule 502(c) upon the publication of the newspaper articles about the WRF Fund, even if the Commission concludes that those articles did constitute "activities which could be viewed as a general solicitation."[26] KCD's violation would have occurred had the Firm used the articles to offer or sell the WRF Fund interests, which it did not. As set forth in KCD's Opening Brief, the undisputed evidence introduced by KCD at Hearing showed that the investors to the WRF Fund were solicited by means other than the newspaper articles – that is, through the emails that KCD representatives sent to its pre-existing group of 1,200

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[24] Schapiro Letter at p. 8.

[25] *Id.* FINRA argued in its Opposition Brief that the Facebook example is not pertinent to the instant matter because, FINRA alleges, Goldman Sachs was not the "prime movers of the media coverage that could have been viewed as a general solicitation," whereas the WRF Fund issuer's actions were responsible for the publication of the newspaper articles. FINRA offers no support for its contention that a general solicitation caused by a third party should be treated differently than one conducted by the issuer or its agent. Indeed, the Commission's 2007 guidance relates to registration statements that are entirely within the control of the issuer, yet the Commission's guidance indicated that the publication of the registration statement alone was not a sufficient basis on which to find a violation of the ban on general solicitations.

[26] *Id.* As set forth in KCD's Opening Brief, the Firm maintains that the newspaper articles do not constitute an offer to purchase interests in the WRF Fund, nor were they intended to condition the market for the sale of those securities. *See* Opening Brief at pp. 15-17.

accredited investors approximately one month before the newspaper articles were published.[27] Accordingly, the NAC erred in sustaining the Hearing Panel's determination that the Firm violated Rule 502(c) and thus, that it was not entitled to rely on a Rule 506 exemption from the registration requirements.

B. <u>KCD Proved that It Was Entitled to Rely on the Registration Exemption Available Under Rule 506 of Regulation D</u>

As set forth in KCD's Opening Brief, the Firm presented uncontroverted evidence at Hearing indicating 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,[28] and that the Firm sold interests in the WRF Fund only to investors who learned about the offering from those initial emails.[29] In its Opposition Brief, FINRA notably did not address the fact that Enforcement failed to offer any evidence to contradict the evidence presented by KCD at Hearing.[30] Nor did FINRA dispute that, once KCD put in evidence to establish that it was entitled to an exemption, the burden shifted back to Enforcement to rebut the existence of that exemption,[31] a burden Enforcement did not meet. Instead, FINRA attempts to discredit KCD's witnesses in contravention of the NAC's Decision, which made no findings indicating that KCD's witnesses were unreliable or lacked credibility.[32] In support of its contentions, FINRA cites to precedent that does not, in fact, contradict any of KCD's arguments.

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[27] Opening Brief at pp. 17-22.

[28] R. at 2397-98 (Hearing Transcript ("Tr.") at 479:9-480:18).

[29] R. at 2433-34 (Tr. at 515:14-516:3); R. at 2494-95 (Tr. at 575:22-576:6); R. at 2982 (CX-6 at p. 84).

[30] Opening Brief at p. 21.

[31] Opening Brief at p. 21 (citing *Glaza*, 2005 SEC LEXIS 1798 at *16-17).

[32] Opposition Brief at p. 20 (citing *Julieann Palmer Martin*, Admin. Proc. No. 3-15613, 2015 SEC LEXIS 880, *43-44 (March 9, 2015) (making credibility determinations about the witnesses)).

1. KCD's Witnesses' Testimony Was Credible and Reliable

FINRA's assertion that LR's testimony deserves no weight because she provided FINRA's staff with false information about the status of the newspaper articles on Westmount Realty Finance's ("Westmount") website is without basis.[33] LR neither misled FINRA, nor did she attempt to mislead FINRA. LR testified truthfully at Hearing that when KCD stated in its response to FINRA's examination report that the newspaper articles had been taken down from Westmount's website, she assumed the articles had been removed, but that she had not actually checked to see if they had been removed.[34] Moreover, Enforcement brought this action based only on the fact that KCD continued the WRF Fund offering after the publication of the newspaper articles in April 2011,[35] which was six months before LR even learned that the articles existed.[36] It is, therefore, irrelevant to these proceedings whether or not the newspaper articles had been removed from Westmount's website in October 2011 after LR first learned about articles from the FINRA examiner.

LR also did not mislead FINRA about monitoring Westmount's website, as the NAC found and FINRA argues.[37] KCD stated in its response to FINRA's examination report that it was "now check[ing] the website periodically to ensure no improper articles are posted on the site."[38] KCD submitted its examination response in March 2012, which was after the WRF Fund offering had ended. The Firm's statement was prospective and did not state or imply that it

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[33] Opposition Brief at p. 26.

[34] R. at 2496-97 (Tr. at 577:11-578:22). *See also* R. at 2486 (Tr. at 567:7-20).

[35] R. at 1-28 (Complaint at p. 5); R. at 2187-88 (Tr. at 269:2-270:10 (indicating that KCD had already violated the rule prohibiting general solicitation once the articles were published)).

[36] LR became KCD's Chief Compliance Officer in late September 2011, only a few weeks before the 2011 Cycle examination began. R. at 2190 (Tr. at 272:4-7).

[37] R. at 4027, 4030 (NAC Decision at pp. 29, 32); Opposition Brief at pp. 26, 37-38.

[38] R. at 2597.

was checking the site to see if Westmount had, in fact, taken the WRF Fund-related newspaper articles down. Nor did LR state otherwise in her testimony.[39]

FINRA's attempt to discredit IG's testimony is equally unavailing.[40] FINRA argues that IG's reliability is questionable based on nothing more than his recollection at Hearing that the issuer's securities attorney told him the newspaper articles "could be a breach" rather than that the attorney had "made us aware of the breach of general solicitation," as he had written in a letter written closer to the events.[41] FINRA fails to explain how this minor difference – assuming it is a difference – is sufficient to tarnish IG's reliability as a witness. Indeed, whether, after seeing the newspaper articles, the securities attorney stated that it was a breach or that it could be a breach does not change the fact that the attorney's client – that is, the issuer – did not thereafter cease the offering, nor did it refrain from submitting a Form D to the Commission indicating that it was entitled to rely on a Rule 506 exemption.[42]

FINRA further argues that IG's testimony is "undermined" by the fact that, in its examination response, KCD did not "take the position that interests had been sold only to pre-existing customers."[43] But, KCD did not take *any* position about sales or investors in its examination response because the examination staff's findings related only to the publication of the newspaper article,[44] and KCD merely addressed the examination staff's findings.[45] As examiner ET testified, it was his determination that the violation occurred once the newspaper

[39] Opposition Brief at p. 26.

[40] Opposition Brief at pp. 27-28.

[41] Opposition Brief at 27.

[42] It is possible that the securities attorney, after further review of the matter, determined that there newspaper articles alone did not constitute a breach of the rule prohibiting general solicitation.

[43] Opposition Brief at p. 27.

[44] R. at 2582-83.

[45] R. at 2597.

articles were published and,[46] as reflected in the examination staff's findings and the subsequent Complaint filed by Enforcement, facts about the investors to the WRF Fund were irrelevant to Enforcement's determination to bring charges against KCD.[47]

Finally, regardless of the publication of the newspaper articles, FINRA suggests that, based on IG's testimony, KCD may have engaged in a general solicitation because "one of the WRF Fund investors could have been a 'new client' of one of the investment advisors" who were among the investors with whom KCD had a prior existing relationship.[48] But, such a new investor would not automatically deprive the issuer (or KCD) of its ability to rely on a registration exemption. As the Commission noted in its Final Rule amending the definition of accredited investor (among other things), "if an offering is structured so that only persons with whom the issuer and its agents have had a prior relationship are solicited, the fact that one potential investor with whom there is no such prior relationship is called may not necessarily result in a general solicitation."[49]

2. FINRA's Examiner's Review of the WRF Fund Investors

Remarkably, in its efforts to undermine KCD's evidence, FINRA was willing in its Opposition Brief to further diminish the little bit of investigation of the WRF Fund offering that its staff actually conducted.[50] FINRA asserted that the testimony of examiner ET did not, as KCD argued,[51] corroborate IG's and LR's testimony that the WRF Fund investors were all

[46] R. at 2187-88 (Tr. at 269:2-270:10.

[47] R. at 2582-83; R. at 1-28 (Complaint at p. 5).

[48] Opposition Brief at 28.

[49] *Regulation D*, Securities Act Release No. 33-6825, 1989 SEC LEXIS 520, *8 (March 15, 1989).

[50] Opposition Brief at p. 30-31.

[51] Opening Brief at pp. 20-21 ("ET testified that he found that the WRF Fund investments were suitable for the customers he reviewed and, therefore, had no findings regarding suitability." (R. at 2196-97 (Tr. at 278:17-279:6))).

accredited because he stated only "that he 'didn't have any findings in [the] review' concerning suitability, and that he found 'nothing unsuitable'" in his review of the WRF Fund investors.[52] FINRA further argues that ET was not specifically asked if the investors were accredited.[53] But, as KCD set forth in its Opening Brief, ET testified that he reviewed the WRF Fund Private Placement Memorandum as part of his investigation.[54] The Private Placement Memorandum specifically states that the WRF Fund was suitable only for accredited investors.[55] FINRA fails to explain how ET's failure to find any issues related to suitability is any different that ET's failure to find any issues related to the sale of WRF Fund interests to non-accredited investors.

3. KCD's Uncontroverted Evidence Provided Sufficient Proof that the Firm Could Rely on a Registration Exemption

In its Opposition Brief, FINRA did not challenge that *James F. Glaza* stands for the proposition that once KCD put in evidence that established that it was entitled to an exemption, the burden shifted back to Enforcement to rebut the existence of the exemption.[56] FINRA argues only that KCD did not provide sufficient proof. Notably, in the cases that FINRA cites to support its contention,[57] the opposing party, unlike Enforcement, introduced evidence that successfully rebutted the evidence introduced by the party seeking to prove that the exemption was available.

In *V. F. Minton Sec., Inc.*, the respondent claimed that in a stock offering that was admittedly fraudulent, it did not violate the registration requirements because it was not an

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[52] Opposition Brief at p. 30.

[53] Opposition Brief at p. 30.

[54] Opening Brief at p. 21 (citing R.at 2167, 2170-71 (Tr. at 249:6-21; 252:24-253:3).

[55] Opening Brief at p. 21 (citing R. at 2747, 2750 (JX-27 at 5, 8)).

[56] Opposition Brief at p. 30 n.13. *See also* Opening Brief at p. 21 (citing *Glaza*, 2005 SEC LEXIS 1798 at *17).

[57] Opposition Brief at pp. 28, 30.

underwriter and, therefore, could rely on an exemption under Rule 144(k).[58] The adjudicator found that the letter the respondent offered as evidence was insufficient to prove it was entitled to an exemption,[59] but further noted that evidence presented by the Commission specifically established that it was impossible for the respondent to have met the conditions necessary for the exemption.[60]

In *Dale Dwight Schwartzenhauer*, the respondent presented evidence indicating that he sold the shares on behalf of non-controlling investors to support his contention that he was entitled to rely on a registration exemption.[61] The NAC (or its predecessor) and the Commission found otherwise, citing to evidence introduced by FINRA (then NASD) indicating that the respondent acted as an underwriter and, therefore, was not entitled to rely on a registration exemption.[62]

In *SEC v. Credit First Fund, LP*, the court found that the defendant failed to submit sufficient evidence about the nature the offerees and the investors in a private offering to prove the defendant was entitled to rely on a registration exemption.[63] But the court also cited to evidence that Commission introduced that rebutted the defendant's contentions.[64]

Unlike the prior three cases relied on by FINRA, *Lively v. Hirschfeld*, involved a private action in which certain shareholders sought to rescind shares because they were sold in violation

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[58] 51 S.E.C. 346, 351-52 (1993).

[59] *Id.* at 352.

[60] *Id.* at 351-52 (indicating that the Commission showed that the stock in question had been issued approximately two years before the sale and, therefore, "it was impossible for the rule's three-year holding requirement to have been met").

[61] 50 S.E.C. at 1155, 1158 (1982).

[62] *Id.* at 1156-57, 1158.

[63] No. CV05-8741, 2006 U.S. Dist. LEXIS 96697, *39, *45-46 (C.D. Cal. Feb. 13, 2006).

[64] *Id. at* *38-39, *44-45 n. 26, *45-46 (introducing evidence of buying investor lead lists and cold calling investors).

of Section 5.[65] In *Lively*, the plaintiffs contended, and the court found, that they did not meet the sophistication standards required for the issuer to have relied on a registration exemption. The defendant-issuer did not put in sufficient evidence to refute the evidence established by the plaintiffs.[66]

Mark v. FSC Sec. Corp., also involved a private action in which the plaintiffs sought to rescind their securities that were sold in violation of Section 5.[67] The plaintiffs presented evidence at trial indicating that the issuer engaged in a wide ranging sales effort that included 10-20 different broker dealers and the offer of at least 447 private placement memoranda to prospective investors, all suggesting a public rather than a private offering.[68] Like *Lively*, the defendant-issuer failed to submit sufficient evidence to contradict the plaintiff's evidence.[69]

FINRA offered no explanation as to why, in this case, Enforcement was relieved of its responsibility to put in any evidence to rebut the evidence offered by KCD or, indeed, to have even investigated the Firm's purported Section 5 violation prior to filing the Complaint in this action. Enforcement made no efforts to establish any facts about how KCD handled the WRF Fund offering and, therefore, did not – and could not – offer any evidence to rebut the evidence offered by KCD at Hearing. In addition, the NAC made no findings indicating that KCD's witnesses, who testified under oath and were subject to cross examination, were either unreliable

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[65] 440 F.2d 631, 631 (10th Cir. 1971).

[66] *Id.* at 633.

[67] 870 F.2d 331 (6th Cir. 1989).

[68] *Id.* at 334.

[69] *Id.* at 335-37.

or lacked credibility.[70] Accordingly, it was error for the NAC to have determined that KCD failed to prove that it was entitled to rely on a registration exemption.

II. ENFORCEMENT DID NOT MEET ITS BURDEN OF PROVING THAT KCD FAILED TO SUPERVISE THE WRF FUND OFFERING

In its Opposition Brief, FINRA dismissed the arguments set forth in KCD's Opening Brief regarding the failure to supervise claim and, instead, focused on rehashing the NAC's Decision on the issue.[71] But, the NAC's Decision was flawed. It did not present any reasoning that was separate or distinct from its determination that KCD violated Section 5. The NAC merely used different terms to find the same thing – that is, that KCD violated Section 5 by continuing to offer and sell interests in the WRF Fund after the newspaper articles were published, and KCD failed to supervise because it continued to offer and sell WRF Fund interests after the newspaper articles were published. For this reason, the NAC's Decision on the supervision claim should be overturned as being duplicative of its Section 5 determination.[72]

The NAC's Decision should also be overturned because Enforcement failed to meet its burden of proving that KCD failed to supervise the WRF Offering. To have stated a supervision claim, Enforcement was required to prove that, because of KCD's purported supervisory failures, the Firm allowed its representatives to sell WRF Fund interests to unaccredited investors, or to investors with whom the Firm had no prior relationship, or to investors who were solicited

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[70] *But see Julieann Palmer Martin*, 2015 SEC LEXIS 880 at *43-44 (making credibility determinations about the witnesses).

[71] Opposition Brief at pp. 31-35.

[72] *See Ahmed Gadelkareem*, 2016 FINRA Discip. LEXIS 9 at *1 ("Because the gravamen of the claimed violations of both provisions arises from the same . . . conduct, the violations are 'duplicative' rather than ... separate and additional infraction[s]' and are properly set forth in a single claim.") (quoting *Midwestern Securities Corporation*, 1973 SEC LEXIS 3504 at *31 (dismissing a claim as duplicative)).

through the newspaper articles.[73] Citing its arguments in the Opposition Brief regarding the Section 5 claim, FINRA asserts that "KCD did not even take sufficient supervisory steps to ensure that WRF Fund interests were sold only to accredited investors who learned about the offering from means other than the general solicitation claim."[74] FINRA did not acknowledge that, unlike the Section 5 claim, the burden rested with Enforcement to establish those things, and that it failed to offer any such evidence. Instead, FINRA focuses only on the fact that LR testified that she did not confirm whether or not the WRF Fund investors had seen the newspaper articles about the WRF Fund.[75] But, it is irrelevant whether or not the investors had seen the articles; the issue is whether the investors learned about the offering from means other than the newspaper articles.[76] Here, the undisputed evidence shows that the WRF Fund investors learned about the offering from the emails that KCD's representatives sent approximately one month before the articles were published, or from an investment advisor who had received such an email.[77] As such, Enforcement did not – and could not – meet its burden of proving that KCD, by virtue of its purported supervisory failures, sold interests in the WRF Fund to any investor that did not have a prior existing relationship with the firm, or was unaccredited, or had learned

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[73] Opening Brief at 23-25. *See also Haley Securities, Inc.*, Discip. Proc. No. 2009020642101, at pp. 2-3 (AWC Jan. 31, 2013) (indicating that Enforcement's supervision claim was based on facts demonstrating that the firm sold securities to 17 new customers who were solicited before the firm had pre-screened the customers or documented "the creation of a substantial pre-existing relationship prior to the offer"), found at http://disciplinaryactions.finra.org/Search/ViewDocument/33053; *Rainmaker Securities, LLC.*, Discip. Proc. 2013035059001 (AWC July 15, 2015) (setting forth specific facts indicating the firm failed to supervise (as well as violated Section 5) by offering and selling securities to investors with whom the firm did not have an established relationship), found at http://disciplinaryactions.finra.org/Search/ViewDocument/63214.

[74] Opposition Brief at p. 34.

[75] Opposition Brief at pp. 34-35.

[76] Schapiro Letter at p. 8; 2007 Regulation D Guidance, 2007 SEC LEXIS 1730 at *90.

[77] R. at 2435 (Tr. at 517:9-19); R. at 2486-87 (Tr. at 567:21-568:8); R. at 2433-34 (Tr. 515:14-516:3); R. 2435 (Tr. at 517:9-19); R. at 2404-05 (Tr. at 486:1-487:5).

about the offering from the newspaper articles. For this additional reason, the NAC's supervision Decision should be overturned.

III. THE HARSH SANCTION IMPOSED ON KCD WAS UNJUSTIFIED

In an effort to justify the excessive sanctions the NAC imposed on KCD, FINRA inappropriately suggests in its Opposition Brief that KCD not only attempted to mislead FINRA, but is also a repeat offender threatening elderly investors with risky, illiquid securities. As set forth above, KCD did not intend to mislead FINRA when it stated in its examination response that the newspaper articles had been taken down from the issuer's website. As LR truthfully testified, that statement was based on a mistaken assumption that the issuer took the articles down after KCD requested that it do so. In characterizing LR's statement as "misleading," the NAC and FINRA failed to consider that the newspaper articles were posted on the issuer's *unrestricted* website, a fact that has been made clear in these proceedings,[78] and, therefore, KCD knew when it made the statement to FINRA that the examination staff had every ability to determine whether or not the newspaper articles, in fact, remained on the website. KCD could not have intended to mislead FINRA about information that was so easily contradicted.

Nor did KCD mislead FINRA about its new procedures for checking the issuer's website. As set forth above, KCD made that statement in March 2012, after the WRF Fund offering had ended. KCD's intention was to review the issuer's website for subsequent offerings "to ensure no improper articles are posted on the site."[79] Moreover, KCD's statement did not represent that the Firm would check the website to determine whether the WRF Fund articles had been taken

[78] NAC Decision at p. 22.

[79] R. at 2597.

down, nor did LR testify to the contrary.[80] As such, it was error for the NAC to have found that KCD's comments were misleading, and the NAC should not have used these statements as justification for imposing such a harsh and excessive fine on the Firm.

It was further error for the NAC and FINRA to suggest that KCD's misstatement in the examination report "was a harbinger of future additional misconduct"[81] where there has been no allegation or facts that even hint at any purported misconduct by the Firm other than what was alleged in the instant action.[82] FINRA's suggestion of future wrongdoing is especially troubling in light of Enforcement's objection to LR's attempt to testify about the results of FINRA's 2013 cycle examination of KCD, which, if the Hearing Officer had allowed LR to continue, would have indicated that exam resulted in only a handful of findings, none of which were referred to Enforcement.[83] Under all standards of justice, it was improper for the NAC to base its sanction determination, in any part, on the *potentiality* that KCD might engage in future misconduct. Indeed, based on the NAC's flawed reasoning, every firm and every representative would be subject to increased sanctions in an Enforcement action.

It was also inappropriate for FINRA to argue that imposing a fine at the top of the Sanction Guidelines was an important step in protecting investors, "including the elderly, from fraud and abuse in highly risky, illiquid offerings."[84] Enforcement did not allege, and no adjudicator found, that any investor was harmed in this case, let alone that any unsophisticated

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[80] Opposition Brief at p. 26.

[81] Opposition Brief at p. 37 (referring to the NAC Decision at p. 32 (stating the purportedly misleading statements "do not suggest that future misconduct is unlikely").

[82] Indeed, the NAC had already determined that KCD's purported wrongdoing asserted in the First Cause of Action was not, in fact, violative of any FINRA rule and had overturned the Hearing Panel's decision stating otherwise. *See* NAC Decision at 16.

[83] R. at 2464 (Tr. at 545:7-21).

[84] Opposition Brief at 40.

elderly investors were harmed. Nor did Enforcement allege, or any adjudicator find, that the WRF Fund offering involved any fraud or abuse. FINRA was wrong to suggest otherwise. While KCD acknowledges that the rule prohibiting general solicitation is intended to shield investors who need of the protections of the registration requirements from private offerings, there is no support for FINRA's suggestion that all violations of Section 5 should be treated harshly simply because an unsophisticated investor may have been exposed to a private offering.[85] Indeed, as KCD demonstrated in its Opening Brief, the Commission has seen fit to impose sanctions on the low end of the scale in numerous actions involving Section 5 violations where, like here, there was no actual investor harm.[86]

Neither the NAC nor FINRA provided a justifiable basis for the imposition of a fine at the highest end of the Sanction Guidelines. Should the Commission affirm all or part of the NAC's Decision, KCD requests that the Commission modify the sanction so that the fine imposed on the Firm is commensurate with the lack of any actual harm and the lack of recidivist conduct.

IV. THE COMMISSION SHOULD CONSIDER KCD'S NEWLY DISCOVERED EVIDENCE

Contrary to the NAC's determination and FINRA's argument in its Opposition Brief, the evidence regarding the Commission's investigation of Westmount Realty Capital ("WRC"), Westmount's successor, is highly relevant to these proceedings. FINRA offered no explanation as to why the fact that a different regulator – that is, the Commission – investigated the WRF Fund offering makes the newly discovered evidence irrelevant. And, while FINRA correctly

[85] If that were the case, it seems unlikely that the Commission would have adopted Rule 506(c), which have the potential of exposing all manner of unsophisticated investors to private offerings.

[86] Opening Brief at pp. 29-30.

noted that the Commission investigated another party,[87] that other party is the issuer of the WRF Fund and, as this instant proceeding has made clear, the actions of KCD and the issuer are inextricably intertwined. There is no dispute that it was the issuer's press release that is at the heart of the alleged general solicitation for which the Hearing Panel and the NAC found KCD to be liable.[88] There is also no dispute that KCD offered and sold interests in the WRF Fund on behalf of the issuer.[89] Moreover, the ability to rely on an exemption rests, first and foremost, with the issuer.[90] As such, with respect to the claimed general solicitation, there simply is no distinction between KCD's actions and that of the issuer. Accordingly, it is very much relevant to these proceedings that the Commission's staff reviewed the issuer's WRF Fund activities (among other things) and determined not to recommend any enforcement action.

KCD acknowledges that the Commission's staff's decision not to recommend Enforcement action against WRC was not determinative.[91] But, as KCD set forth in its Opening Brief, even if the Commission cannot conclude from the staff's termination of the investigation that it did not find any wrongdoing in the WRF Fund offering, the staff's decision not to recommend any action indicates that whatever wrongdoing the issuer may have committed, it was not serious enough to take any immediate action.[92] The NAC's determination to impose the highest recommended fine under the Sanction Guidelines against KCD simply cannot be

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[87] Opposition Brief at p. 42.

[88] R. at 4015 (NAC Decision at p. 17).

[89] R. at 2679.

[90] 17 C.F.R. § 230.506(a) ("Offers and sales of securities by an *issuer* that satisfy the conditions in paragraph (b) or (c) of this section shall be deemed to be transactions not involving any public offering within the meaning of section 4(a)(2) of the Act.") (emphasis added).

[91] Opposition Brief at p. 42 (citing to *Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations*, Securities Act Release No. 5310 , 1972 SEC LEXIS 238, *7 (Sept. 27, 1972)).

[92] Opening Brief at p. 27. To KCD's knowledge, as of the date of this filing, the Commission has not taken any action against WRC as it relates to the WRF Fund (or for any other reason).

reconciled with the Commission's staff's decision to not recommend any action against the issuer for the same activities. The evidence of the Commission's staff investigation, therefore, is very relevant to KCD's contention that the sanctions the NAC imposed on the Firm are excessive and should be withdrawn or considerably reduced.

The newly discovered evidence is also relevant because it further corroborates IG's and LR's testimony.[93] The evidence involves the Commission's staff's review of, among other things, documents and information related to the method by which investors were solicited for the WRF Fund and accreditation status of the investors in the WRF Fund offering.[94] As KCD argued in its Opening Brief, the Commission's staff's decision to recommend "no action" against WRC suggests that they had no findings that the WRF fund was improperly sold. 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.

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[93] See Opening Brief at p. 22.

[94] R. at 3932-34; R. at 3950-51.

Before the
SECURITIES AND EXCHANGE COMMISSION

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

CERTIFICATION OF WORD COUNT

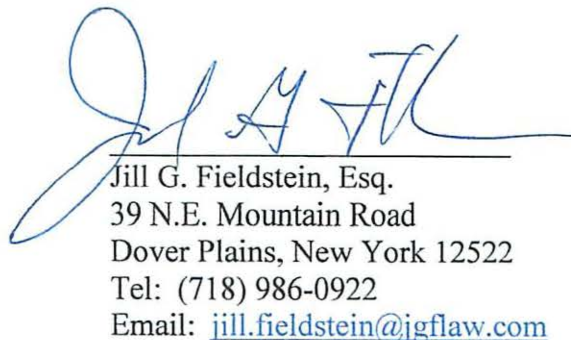
I, JILL G. FIELDSTEIN, hereby declare and certify, under the penalty of perjury, that the following is true and correct:

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 Reply Brief on Appeal, dated December 5, 2016 ("Reply Brief") in accordance with Rule 450(d) of the Commission's Rules of Practice (September 2016 ed.).

2. The Reply Brief complies with the length limitation for reply briefs as set forth in Rule 450(c) because it contains less than 7,000 words.

3. According to the word count of the word-processing system used to prepare the Reply Brief, the Reply Brief includes 6,669 words, exclusive of the table of contents, table of authorities and exhibits.

December 5, 2016



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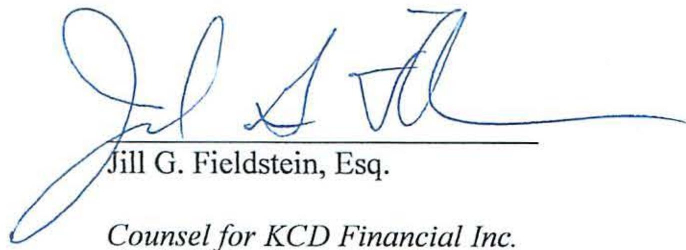
Before the
SECURITIES AND EXCHANGE COMMISSION

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

CERTIFICATE OF SERVICE

I hereby certify that on this 5th day of December 2016, I sent by Express Mail an original and three copies of the KCD Financial Inc.'s REPLY 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. I also sent a copy of the foregoing to the Office of the Secretary by facsimile to (703) 813-9793.

On this 5th day of December 2016, I also sent a copy of the OPENING BRIEF ON APPEAL and CERTIFICATION OF WORD COUNT by Express Mail to Michael Garawski, Esq., Office of General Counsel, FINRA, 1735 K Street, N.W., Washington, D.C. 20006. I also sent a copy of the foregoing to Mr. Garawski by facsimile to (202) 728-8264, and by email to michael.garawski@finra.org.



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