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UNITED STATES OF AMERICA
BEFORE THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

In the Matter of the Application of

SCOTTSDALE CAPITAL ADVISORS CORPORATION, JOHN J. HURRY, TIMOTHY B. DIBLASI, AND D. MICHAEL CRUZ

For Review of Disciplinary Action Taken by FINRA

3-18612

OPENING BRIEF FOR APPEAL OF D. MICHAEL CRUZ AND SCOTTSDALE CAPITAL ADVISORS

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Petitioners D. Michael Cruz ("Mr. Cruz") and Scottsdale Capital Advisors ("SCA") appeal the decision of the National Adjudicatory Counsel ("NAC") dated July 20, 2018 in FINRA Complaint No. 2014041724601. The NAC found that Mr. Cruz and SCA violated NASD Rule 3010 and FINRA Rule 2010 for failing to adequately supervise SCA's microcap liquidation business. The NAC imposed a fine of $250,000 on SCA, related, in part, to these violations, a fine of $50,000 on Mr. Cruz, and a two-year all-capacities suspension on Mr. Cruz. For the reasons discussed herein, the Commission should reverse the NAC's decision.

Mr. Cruz joined SCA in 2008 and served as SCA's President from January 2014 until January 2015 (except for approximately six weeks in early 2014). Mr. Cruz served as the firm's Chief Legal Counsel. Mr. Cruz has worked in the securities industry for 20 years and has held the Series 7 and 24 licenses. Before joining SCA, Mr. Cruz served as an officer in the United States Marine Corps and worked for the NASD as well as several large broker-dealers, including Countrywide, Wells Fargo, and Citigroup.

A basic factual overview of this matter and a description of other relevant parties was set forth in Petitioner Hurry's Motion to Stay Sanctions and Incorporated Memorandum of Points and Authorities in Support, filed on July 23, 2018. For purposes efficiency, not all of those facts are not repeated here.

I. EXECUTIVE SUMMARY

Section 5 of the Securities Act of 1933 ("Securities Act") prohibits the sale of unregistered securities absent an exemption. Mr. Cruz oversaw SCA's process for conducting due diligence to determine whether such exemptions applied. The NAC concluded that he did not reasonably supervise that process, and that SCA improperly permitted the sale of stock for three issuers.

The essential premise underlying the NAC's decision is that, between December 2013 and June 2014 (the "Relevant Period"), Mr. Cruz oversaw a due diligence process that consisted of gathering documents without any critical analysis. Uncontested facts demonstrate otherwise. Mr. Cruz conducted a final and additional review of deposits that came through CSCT. SCA rejected a total of approximately 46% of all deposits proposed by CSCT.[1] Faced with the unmistakable take-away that such a high rejection rate is irreconcilable with an argument that Mr. Cruz did not critically review stock deposits, the NAC summarily deemed that information "not reliable" because there was "no identification of the source of the numbers contained in [the table]" and "no explanation concerning how" it was created.[2] That statement is false. SCA's current President, Henry Diekmann testified that he compiled the information from SCA's books and records.[3] Enforcement even consented to that information's admission into evidence.[4] Neither Enforcement nor the Hearing Panel asked any questions about those figures.[5] The lengths to which the NAC has gone to invent patently false reasons for ignoring otherwise compelling information is indicative of the extraordinary bias that has infected this proceeding.

To understand the breadth and depth of Mr. Cruz's good faith supervisory efforts, it is helpful to note several undisputed facts regarding Mr. Cruz's role at the firm. Mr. Cruz wrote the firm's standalone Rule 144 Manual,[6] which, as detailed below, provides thorough guidance on each of the elements of Rule 144, as well as each of the alleged "red flags" highlighted in FINRA Regulatory Notice 09-05.[7] He also developed SCA's due diligence questionnaire, a document

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[1] RX-40 at 2 (FINRA 009256).
[2] NAC Decision at 74 n.160 (FINRA 10904).
[3] Tr. 1872:13-19 (FINRA 004214).
[4] Tr. 1874:1–2 (FINRA 004216).
[5] *See* Tr. 1868:20–1874:3, 1910:21–1911:19 (FINRA 004210-4214, 004252-4253).
[6] Tr. 582:6–23 (FINRA 002921).
[7] *See Infra* Sections VI.C and VIII.

that, like the Rule 144 Manual, guided SCA representatives in gathering all material information bearing on Rule 144 compliance.[8] Under his leadership, SCA devised and implemented a beneficial ownership declaration—a means of confirming the beneficial ownership of securities on deposit, using a format that FinCEN later recommended to financial institutions to identify the beneficial owners of their legal entity customers for anti-money laundering purposes.[9]

Under Mr. Cruz's leadership, SCA employed a dedicated Rule 144 review team, comprising approximately one-third of SCA's total staff,[10] many of whom were lawyers.[11] As SCA began taking deposits from customers of foreign financial institutions ("FFIs") that were, in turn, customers of CSCT, Mr. Cruz, an experienced lawyer, securities industry veteran, and former NASD examiner, voluntarily added himself to the review process so as to provide an additional set of eyes before approving those deposits, which resulted in rejecting nearly half of the deposits from CSCT.[12]

These are the hallmarks of rigorous and effective supervision.

In an effort to impugn Mr. Cruz's thoughtful and responsible supervision of a complex process, FINRA focused on five deposits for three issuers that it contends violated Section 5. This constituted a tiny sliver of the deposits from the Relevant Period. For example, SCA earned only $38,000 in revenue from the subject sales, representing 0.03% of the firm's revenue during the

[8] Tr. 593:3–23 (FINRA 002932).
[9] Tr. 217:5–12 (FINRA 002555); *see infra* note 25 and accompanying text; *see also* 81 Fed. Reg. at 29,398.
[10] Tr. 1954:11–13, 22–24 (FINRA 004296); Tr. 2251:17–2252:4, 2313:11–22 (FINRA 004594–95, 004656); *see* CX-9 at 2, 3 (FINRA 005384, 005385).
[11] Tr. 1953:11–25, 1954:11–13 (FINRA 004295, 004296).
[12] Tr. 251:14–20 (FINRA 002589); Tr. 558:2–559:20 (FINRA 002897–98); Tr. 694:8–14 (FINRA 003033).

Relevant Period.[13] This is far from a sufficient basis on which to make sweeping judgments about Mr. Cruz's supervision of SCA's liquidation business.

II. STANDARD OF REVIEW

When a broker-dealer appeals the disciplinary findings of a self-regulatory organization ("SRO"), the Commission conducts an independent review of the record. *In re Lane & Lane*, Exchange Act Rel. No.74269,2015 WL 627346, at *5 (S.E.C. Feb. 13, 2015); *In re Cespedes*, Exchange Act Rel. No. 59404, 2009 WL 367026, at *6 (S.E.C. Feb. 13, 2009). The Commission must overturn the SRO's decision if a preponderance of the evidence does not support its findings. *Id.* Even if the Commission affirms the factual findings of the SRO, it may reduce or cancel the sanctions as it sees fit. 15 U.S.C. § 78s(e)(2).

III. OVERVIEW OF SECTION 5 AND EXEMPTIONS FROM REGISTRATION

Section 5 of the Securities Act prohibits the sale of unregistered securities absent an exemption from registration. 15 U.S.C. § 77e. Two exemptions apply here: Rule 144 and § 4(a)(4) of the Securities Act.

A. Overview of Rule 144

Rule 144 ties to Section 4(a)(1) of the Securities Act, which exempts from registration securities transactions by persons other than an underwriter, issuer or dealer. An "underwriter" is "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security." *Id.* § 77b(a)(11). A "distribution" is generally

[13] RX-40 at 1 (FINRA 009255); Tr. 1871:13–24 (FINRA 004213).

understood to refer to the sale of a block of securities to the public. J. William Hicks, *Resales of Restricted Securities* § 3:32 (2018 ed.).

Rule 144 affords the seller of unregistered securities a "safe harbor" from being deemed an "underwriter" when certain objective criteria are met. 17 C.F.R. § 230.144 preliminary note; *Revisions to Rules 144 and 145*, 72 Fed. Reg. 71,546, 71,549 (Dec. 17, 2007). Rule 144 provides that a seller who is not an affiliate of an issuer[14] may sell restricted shares after holding them for (1) six months, if the issuer is subject to, and has complied with, certain reporting requirements; or (2) one year, if the issuer is not subject to those requirements. 17 C.F.R. § 230.144(b)(1), (c)–(d).

For purposes of this case, Rule 144 applied if: (1) the seller held the stock for at least one year, inclusive of permissible tacking; (2) the seller was not an affiliate of the issuer, which includes not owning more than 10% of the issuer's stock; and (3) the issuer was not a shell company.

The holding period for Rule 144 begins when the person "is deemed to have paid for the securities and thereby assumed the full risk of economic loss with respect to them." *Resales of Restricted and Other Securities*, Securities Act Release No. 6099, 17 SEC Docket 1422, 1429 (Aug. 2, 1979). Shares acquired via a conversion (e.g., the conversion of a promissory note) are "deemed to have been acquired" when the money is loaned, that is, "at the same time as the securities surrendered for conversion or exchange, *even if the securities surrendered were not convertible or exchangeable by their terms*." 17 C.F.R. § 230.144(d)(3)(ii) (emphasis added). The

[14] An affiliate of an issuer is "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." 17 C.F.R. § 230.144(a)(1). Affiliates are subject to special requirements when selling unregistered securities pursuant to Rule 144. *Id.* § 230.144(b)(2), (c)–(i). Owners of at least 10% of an issuer's equity are presumed to be affiliates. Hicks, *Resales of Restricted Securities* § 4:38.

amendment of securities to permit conversion does not affect the holding period as long as the holder did not supply additional cash consideration. *Id.* § 230.144(d)(3)(ii) note, (d)(3)(x) note 1. Additionally, a purchaser of securities is permitted to "tack" his holding period to that of the previous owner if the prior holder is unaffiliated with the issuer. *Resale of Restricted Securities*, 55 Fed. Reg. 17,933, 17,941 (Apr. 30, 1990); *see also* Hicks, *Resales* § 4:103.

Even if the objective criteria of Rule 144 are satisfied, the safe harbor will not apply if the transaction is part of a "plan or scheme to evade" Section 5's registration requirements. 17 C.F.R. § 230.144 preliminary note.

B. Overview of the Section 4(a)(4) Exemption

Section 4(a)(4) applies to unsolicited brokers' transactions if, among other things, the broker "[a]fter reasonable inquiry is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that the transaction is a part of a distribution of securities of the issuer." 17 C.F.R. § 230.144(g).

Consistent with the standard of reasonableness enshrined in the Rule, "[t]he amount of inquiry called for necessarily varies with the circumstances of particular cases." *Wonsover v. SEC*, 205 F.3d 408, 415 (D.C. Cir. 2000) (quoting *Distribution by Broker-Dealers of Unregistered Securities*, Securities Act Release No. 4445 (Feb. 2, 1962)). As Petitioners' expert, former FINRA General Counsel for Regulation Marc Menchel,[15] explained, facts not probative of a distribution, such as minor discrepancies in deal documents, have no bearing on the broker's duty.[16] *See ACAP*

[15] Mr. Menchel served as FINRA's General Counsel for Regulation from May 2002 through June 2012. RX-38 at 1 (FINRA 009233). He held this position when FINRA issued Regulatory Notice 09-05, which provides guidance to broker-dealers on Section 5. Tr. 2504:18–2506:22 (FINRA 004901–03).

[16] *See* Tr. 2428:23–2429:8, 2431:25–2432:7, 2522:3–10 (FINRA 004825–26, 004828–29, 004919).

Fin., Inc., Exchange Act Release No. 70046, 2013 WL 3864512, at *2 (July 26, 2013) (describing a broker's duty to "detect any warning signs indicating the possibility of an unlawful distribution").

The broker's exemption applies independently of Rule 144, meaning the exemption shields a broker from Section 5 liability even when the sale itself does not satisfy Rule 144. J. William Hicks, *Exempted Transactions Under the Securities Act of 1933*, at § 13:14 (2018 ed.).

IV. MR. CRUZ CREATED EXTENSIVE POLICIES AND CONTROLS TO ENSURE COMPLIANCE WITH SECTION 5

A. SCA's Rule 144 Manual Addressed in Detail All Pertinent Aspects of Rule 144

In order to guide SCA's deposit review team, Mr. Cruz created an extensive Rule 144 Manual that specified how to conduct stock deposit reviews, incorporated relevant regulatory guidance, and even included summary charts for ease of reference.[17] SCA's Rule 144 Manual addresses in depth each topic relevant to Rule 144 transactions: beneficial ownership, affiliate status, shell status, convertible debt securities, holding periods, public information, and legal opinions, among others. The Rule 144 Manual provides legal background on Rule 144, and Section 1.2 explains each of the diligence steps required by SCA's Deposited Securities Checklist—a form that is "specifically tailored to follow the elements required under Rule 144."[18] The manual also distills the Rule 144 requirements into a simple and easy-to-understand table.[19]

Several of the manual's sections specifically address determining affiliate status and beneficial ownership, which are the critical issues in this case.[20] The manual emphasizes the need to determine the identity of the individual with the economic interest in the stock, *i.e.*, the beneficial

[17] *See generally* CX-185 (FINRA 006891–6914).
[18] CX-185 at 3–4 (FINRA 006893–94) (quoting *Distribution by Broker-Dealers of Unregistered Securities*, Securities Act Release No. 4445 (Feb. 2, 1962)); *id.* at 5–10 (FINRA 006895–6900).
[19] CX-185 at 21 (FINRA 006911).
[20] Tr. 582:3–595:19 (FINRA 002921–34).

owner. For instance, Section 1.2.2 supplies detailed guidance on ascertaining the beneficial ownership of securities.[21] Appendix D includes further direction in the boxes titled "Client Name" and "Dep/Tot. Ownership," which require the name of the ultimate beneficial owner of securities and assessment of his or her total shareholdings.[22]

In addition, SCA's AML policies include a red flag directed specifically at misuse of so-called "nominees."[23]

B. Mr. Cruz Drove The Creation Of A Beneficial Ownership Declaration

Mr. Cruz was the driving force behind the creation of SCA's beneficial ownership declaration, an important component of the stock deposit review process. The form specifically addresses the possibility that a company may have nominee officers and directors by demanding an unambiguous declaration that: (1) "Beneficial Owner is the exclusive beneficial owner of the Security"; and (2) "No other person or entity whatsoever has any right, title, or interest, legal equitable, contingent or otherwise, in or to the Security."[24] Answering these questions would pierce through the use of nominees because, by definition, nominees do not have the economic interest in the deposited securities.

The wisdom and effectiveness of this approach was subsequently confirmed by the U.S. government in May 2016, when FinCEN published a final rule endorsing the use of such beneficial ownership declarations.[25] In permitting customer self-reporting of beneficial ownership, FinCEN

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[21] CX-185 at 6–7 (FINRA 006896–97).
[22] CX-186 at 1 (FINRA 006915).
[23] CX-184 at 25 (FINRA 006881) (§ 10.3.2 lists as a red flag evidence that "[t]he customer appears to be acting as an agent for an undisclosed principal, but declines or is reluctant, without legitimate commercial reasons, to provide information or is otherwise evasive regarding that person or entity").
[24] *E.g.*, RX-1 at 11 (FINRA 008421).
[25] Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,398 (May 11, 2016) (to be codified at 31 C.F.R. pts. 1010, 1020, 1023, 1024, and 1026). The standard

cited two considerations: "the customer is generally the best source of this information," and "there is generally no other source of beneficial ownership information available to covered financial institutions, aside from the legal entity itself."[26] If the use of such a form is good enough for the federal agency tasked with combatting money laundering and terrorist financing, it should be sufficient for FINRA's purposes.

The NAC downplayed the effectiveness of the beneficial ownership declarations because they were not witnessed or notarized. Mr. Cruz and SCA were forward thinking in developing such declarations. Neither FINRA nor the SEC had even suggested this type of approach. Indeed, the subsequent FinCEN rule did not require a signature under penalty of perjury. Having the declarations witnessed or notarized may be constructive suggestions, but not having thought to take those additional steps, when there was no regulatory guidance or requirement to do so, does not equate to unreasonableness. This is especially true given that after the lengthy investigation and litigation, FINRA has yet to adduce any evidence whatsoever that the individuals identified on the declarations were not the actual beneficial owners. The Commission should not indulge FINRA's speculative theories.

C. SCA Would Not Accept Deposits Totaling, Across the Firm, More Than 9.9% Of the Outstanding Stock

To address the risk that a person might secretly try to split up his stock holding across multiple corporate accounts and shield his actual identity on account forms, Mr. Cruz had SCA implement a policy prior to the Relevant Period whereby SCA would not accept deposits of more

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certification form appended to the FinCEN rule obligates the natural person opening a new account on behalf of a legal entity to provide certain identification information in a form that concludes with a written and signed affirmation—not under penalty of perjury—that the person completing the application "hereby certif[ies], to the best of [his] knowledge, that the information provided above is complete and correct." *Id.* at 29,454–57.

[26] *Id.* at 29,407.

than 9.9% of any issuer's outstanding stock, aggregated across all of SCA's customers.[27] That served to further reduce the risk a person could exceed the 10% presumptive affiliate threshold if he lied in all of SCA's diligence materials.

In light of these significant structures and processes that Mr. Cruz implemented, the unmistakable conclusion is that, at a minimum, Mr. Cruz reasonably fulfilled his supervisory obligations with respect to SCA's microcap liquidation business.

V. OVERVIEW OF THE SUBJECT TRANSACTIONS

A. NHPI: Neuro-Hitech Inc.

NHPI traded on the OTC Pink market.[28] Since its formation in 1996, the company has been engaged principally in the business of developing and marketing specialty pharmaceuticals, including a drug that completed a Phase II FDA clinical trial.[29] The company subsequently expanded its business line to include oil-and-gas exploration.[30]

The NHPI transaction began with a convertible note from NHPI to Thomas Collins for $10,000 dated May 1, 2012 for consulting services.[31] The existence of the note was reflected in NHPI's publicly filed financial statements.[32] The conversion price was $0.0001.[33] The note was

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[27] Tr. At 733:20-23 (FINRA 003072)
[28] RX-1 at 41 (FINRA 008451).
[29] RX-1 at 20–21 (FINRA 008430-31); *accord Huperzine A in Alzheimer's Disease*, ClinicalTrials.gov, https://clinicaltrials.gov/ct2/show/ NCT00083590?term=neurohitech&rank=1 (last updated Feb. 19, 2008). The Commission can take notice of this fact as this is a source whose accuracy cannot reasonably be questioned. *See* 17 C.F.R. § 201.323.
[30] RX-1 at 21 (FINRA 008431); *see* Tr. 609:3–610:9 (FINRA 002948-49).
[31] RX-1 at 106 (FINRA 008516).
[32] RX-1 at 120, 122 (FINRA 008530, 008532).
[33] *Id.*

due on July 1, 2012, and NHPI defaulted.[34] Thus, as of July 1, 2012, Mr. Collins had the legal right to obtain up to 100 million shares of NHPI.[35]

In September 2013, Mr. Collins sought to obtain liquidity in his interest in NHPI by obtaining $50,000 convertible loans from three entities: Sky Walker, Inc., Ireland Offshore Securities, and Swiss National Securities.[36] Each of those entities used the same form documents and agreed to the same terms of the loan.[37] The loan documentation packages included pledge agreements whereby Mr. Collins pledged 20 million shares of NHPI as collateral for each of the three loans.[38] The conversion price was $0.0025 per share,[39] which was a discount to the prevailing trading price of between $0.025 and $0.035 per share,[40] as is typical in convertible loans.[41] Mr. Collins then converted 90% of his note with NHPI into stock.[42] When Mr. Collins subsequently defaulted on his loans from Sky Walker, Ireland Offshore, and Swiss National, 60 million of his shares were transferred to those entities (20 million shares to each).[43] The 60 million shares, in the aggregate, amounted to less than 10% of NHPI's issued and outstanding stock.[44]

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[34] RX-1 at 106, 107 (FINRA 008516, 008517).
[35] *See* RX-1 at 106 (FINRA 008516).
[36] RX-1 at 32, 112, 190 (FINRA 008442, 008522, 008600).
[37] *See* RX-1 at 32, 112, 190 (FINRA 008442, 008522, 008600).
[38] RX-1 at 113–16, 191–94 (FINRA 008523–26, 008601–04).
[39] *See* RX-1 at 113, 191 (FINRA 008523, 008601).
[40] These historical price figures, and all others cited in this brief, derive from data published on OTCMarkets.com. *Rocky Mountain Power Co.*, Exchange Act Release No. 40648, 1998 WL 774744, at *5 n.13 (Nov. 9, 1998) (taking official notice of OTC stock prices). NHPI's trading price was $0.035 around September 1, 2013 and $0.025–$0.03 around November 15, 2013.
[41] Tr. 486:18–487:2, 487:10–18, 21–24 (FINRA 002824–25); *see* Tr. 2401:20–2402:18, 2528:7–21 (FINRA 004798–99, 004925).
[42] RX-1 at 107–09 (FINRA 008517–19). Had Mr. Collins converted 100% of his note, he would have owned more than 10% of NHPI's outstanding stock and therefore would have been a presumptive affiliate of NHPI. *See* RX-1 at 1, 4 (FINRA 008411, 008414). As is both common and logical, holders of convertible notes often structure their transactions to avoid subjecting themselves to the burdens associated with affiliate status. Tr. 328:2–9, 14–16 (FINRA 002666); Tr. 2501:7–16, 2503:3–16 (FINRA 004898, 004900).
[43] RX-1 at 33, 117, 195 (FINRA 008443, 008527, 008605).
[44] *See* RX-1 at 43 (FINRA 008453) (listing 981,408,909 shares issued and outstanding).

Although the transfer of the pledged securities occurred in November 2013,[45] the form note satisfaction agreement that Mr. Collins used with each entity listed an incorrect date—instead of November 16, 2013, the date on the form was September 16, 2013.[46] Other contemporaneous documentation reflects that the transfer of shares to the three entities occurred in November, thereby confirming that the reference to September in the note satisfaction agreement was no more than a typographical error.[47] The securities were deposited at SCA several months later, between February and April 2014.[48]

B. VPLM: VoIP-Pal.com, Inc.

VPLM provides Voice-over-Internet-Protocol ("VoIP") services and holds a portfolio of VoIP patent applications.[49] The company was in the developmental stage during the Relevant Period, with its shares trading on the OTC Pink market.[50] It currently trades on the OTCQB.[51]

VPLM and Locksmith Financial, a company owned by VPLM's former CEO Richard Kipping, made an oral loan agreement that had been drawn to $58,636 as of July 2012. The oral

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[45] RX-1 at 34 (FINRA 008444); RX-115 (FINRA 009419); Tr. 1847:1–1848:1 (FINRA 004189–90).
[46] RX-1 at 33, 117, 195 (FINRA 008443, 008527, 008605).
[47] *See* RX-1 at 34 (FINRA 008444); RX-115 (FINRA 009419). SCA staff consistently testified that the September date appeared to be a simple typographical error: the parties assuredly intended to write November 16, 2013, eight days after the maturity date and one day after Mr. Collins formally exercised his right of conversion under the Collins note. RX-1 at 26 (FINRA 008436); Tr. 366:5–7 (FINRA 002704); Tr. 949:18–21, 957:1–18, 973:17–24 (FINRA 003288, 003296, 003312); Tr. 1836:14–25, 1838:1–22 (FINRA 004178, 004180). Moreover, as Mr. Diekmann explained, the fact that the September date appears in each agreement supports the notion that it was a typo that the parties innocently reproduced, given that the agreements had identical terms. Tr. 1837:4–7 (FINRA 004179).
[48] RX-1 at 2, 79, 159 (FINRA 008412, 008489, 008569).
[49] RX-2 at 189 (FINRA 008827).
[50] RX-2 at 40–42, 60 (FINRA 008678–80, 008698).
[51] *VPLM: VoIP-Pal.com, Inc.*, OTCMarkets, https://www.otcmarkets.com/stock/VPLM/quote. The Commission may take official notice of VPLM's current trading price and exchange status. *See supra* note 40.

agreement existed as of July 2012 and was subsequently memorialized in writing in August 2013.[52] That debt is reflected in VPLM's public financial statements and in bank records and payment schedules that SCA obtained as part of its due diligence to verify the validity of the debt.[53] On the same date that VPLM and Locksmith memorialized the more-than-one-year-old, disclosed debt obligation, the parties also executed a debt settlement agreement whereby Locksmith received 29,318,000 shares of VPLM in exchange for extinguishing the debt.[54] On August 23, 2013, Locksmith sold those shares to VHB International, whose beneficial owner was Victor Hugo Bretel, for $0.008186 per share.[55] At the time, VPLM was trading around $0.072 per share.[56] After receiving 9,318,000 shares for VHB through CSCT, SCA approved the deposit for sale on February 10, 2014.[57]

C. ORFG: Orofino Gold Corp.

ORFG traded on the OTC Pink market during the Relevant Period.[58] Upon its formation in 2005, ORFG was engaged in the automotive-cleaning-and-detailing business, but it entered the mining industry in 2009.[59] During 2014, ORFG was classified as "current information" on the OTC Pink market, signifying that it had recently published financial reports.[60]

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[52] RX-2 at 26–27, 28 (FINRA 008664–65, 008666). Although the loan agreement dates the oral arrangement to August 1, 2012, all other supporting documentation confirms that the loans referenced in the debt settlement agreement commenced in July 2010 and ceased in July 2012, producing the outstanding balance reflected in the written agreement. *See infra* VIII.B.
[53] RX-2 at 40–42, 43–45, 46–59 (FINRA 008678–80, 008681–83, 008684–97).
[54] RX-2 at 26–32 (FINRA 008664–70).
[55] RX-2 at 33 (FINRA 008671).
[56] *See supra* note 40.
[57] RX-2 at 2 (FINRA 008640).
[58] RX-3 at 60 (FINRA 008987). Since the Relevant Period, the company has changed its name to Bakken Energy Corp.
[59] CX-298 at 3 (FINRA 008136).
[60] RX-3 at 60 (FINRA 008987).

The ORFG stock at issue originated from a $600,000 convertible note between Casey Forward and ORFG dated September 1, 2012.[61] The note was due in June 2013 and the conversion option—which authorized Mr. Forward to convert the debt at $0.0025 per share—expired in September 2013.[62] In January 2014, Mr. Forward assigned a $50,000 portion of his note to Anything Media in exchange for 20,000 Preferred B shares of Anything Technologies Media, Inc., and ORFG agreed to modify the terms of the note to provide for a lower interest rate and a right of conversion at: (i) a 55% discount from the lowest trade price in the 120 days preceding exercise of that right; or (ii) a mutually agreeable price.[63]

In April 2014, Anything Media exercised its conversion option as to a $9,000 portion of the note and sold the resulting 15 million shares of ORFG for $0.005 per share—a discount to the prevailing market price of $0.026 per share[64]—to Media Central of Belize ("Media Central Belize").[65] The agreement between Anything Media and Media Central Belize was dated April 16, 2014.[66] Shortly after finalizing the terms of the agreement to sell the stock, Anything Media converted its loan into stock on April 22, 2014 and delivered the ORFG stock to Media Central Belize, which then deposited 13,280,000 shares at SCA via CSCT.[67]

VI. MR. CRUZ'S SUPPOSED SUPERVISORY FAILINGS

The NAC gave two reasons for concluding that Mr. Cruz should not have approved the five deposits. First, Mr. Cruz "failed to analyze" whether the original instruments were securities

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[61] RX-3 at 36–41 (FINRA 008962–67).
[62] RX-3 at 36, 38 (FINRA 008962, 008964).
[63] RX-3 at 42, 49 (FINRA 008968, 8975); *see also* RX-3 at 46–48 (FINRA 008972–74).
[64] *See supra* note 40.
[65] RX-3 at 55, 56–58 (FINRA 008982, 008983–85).
[66] RX-3 at 56–58 (FINRA 008983–85).
[67] RX-3 at 55 (FINRA 008982).

capable of tacking for purposes of the Rule 144 holding period.[68] Second, Mr. Cruz "failed to investigate" alleged red flags associated with the deposits.[69] Neither reason withstands scrutiny.

A. Enforcement Presented No Evidence to Rebut the Presumption that the Notes Are Securities

In another example of how the NAC has invented uncharged, post-hoc theories to salvage Enforcement's failed case, the NAC imposed liability on Mr. Cruz for not "rais[ing] the question" of whether the NHPI, VPLM, and ORFG notes were securities.[70] In making this flawed conclusion, the NAC ignored the reality that pursuant to Supreme Court precedent, notes are mandatorily presumed by law to be securities. *Reves v. Ernst & Young,* 494 U.S. 56 at 65 (1990). Thus, as to whether the deposits traced to securities, *Reves* presumptively answered that question in the affirmative.

Indeed, this self-evident conclusion is so obvious that not even Enforcement raised the issue with respect to NHPI and ORGF.[71] Thus, the NAC held Mr. Cruz liable for unreasonable supervision because he—like FINRA's multitude of lawyers who investigated and prosecuted the case—did not question the presumption mandated by our nation's highest court. Even then, FINRA refuses to acknowledge that Mr. Cruz testified, without contradiction, to his opinion that the NHPI, VPLM, and ORFG debt obligations were securities capable of tacking.[72]

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[68] NAC Decision at 87 (FINRA 010917)
[69] *Id.*
[70] NAC Decision at 88 (FINRA 010918).
[71] *See*, FINRA Complaint (FINRA 000001); FINRA Pre-Hearing Brief (FINRA 001621), FINRA Post-Hearing Brief (FINRA 009453).
[72] *See* Tr. 133:14–19 (FINRA 002471); Tr. 325:11–326:14, 364:10–20, 367:1–18, 370:3–5, 431:15–433:19, 471:6–472:8 (FINRA 002663–64, 002702, 002705, 002708, 002769–71, 002809–10); Tr. 506:13–508:2, 518:12–15, 618:9–14, 639:17–640:11, 641:13–642:25 (FINRA 002845–47, 002857, 002957, 002978–79, 002980–81).

Enforcement had feebly raised the question with respect to VPLM by contending that oral lines of credit do not qualify as securities.[73] It well established, however, that the existence of a written agreement is not prerequisite to being a security. *Canadian Imperial Bank of Commerce Trust Co. v. Fingland*, 615 F.2d 465, 466-67 & n.5 (7th Cir. 1980). Settled federal case law is also clear that an instrument designed to raise money for general business use or to finance capital investments, *including investment-driven loans related to lines of credit*, are securities. *See Singer v. Livoli*, 741 F. Supp. 1040, 1049-50 (S.D.N.Y. 1990); *Griffin v. Jones*, 975 F. Supp. 2d 711, 721-23 (W.D. Ky. 2013); *Sias v. Herzog*, No. 04-3832 (JNE/JSM), 2006 WL 2418950, at *11-13 (D. Minn. Aug. 21, 2006). Thus, Enforcement's suggestion that an oral line of credit cannot be a security is not legally accurate.

Moreover, simply stating a belief that the VPLM note was not a security is not nearly sufficient to overcome the strong mandatory *Reves* presumption. Actual evidence, not mere supposition, would have been required, but there was none. "[T]he presumption that all notes are securities" means that the party arguing that a particular note is not a security "would ultimately 'bear the burden of proof' on that issue at trial." *SEC v. Thompson*, 732 F.3d 1151, 1161–62 (10th Cir. 2013). "[T]he mere introduction of some evidence suggesting that a note is not a security" is not enough to discharge this burden. *Stoiber v. SEC*, 161 F.3d 745, 749 n.7 (D.C. Cir. 1998). Accordingly, when the party asserting that a note is not a security fails to present *any* evidence or argument rebutting the *Reves* presumption, that presumption remains intact and the opposing party is entitled to judgment in its favor. *See, e.g.*, *Officer v. Duran*, No. 12 C 10195, 2014 WL 5439782,

[73] Complaint ¶ 115 (FINRA 000084); DOE Pre-Hearing Br. at 27 & n.76 (FINRA 001653); Tr. 28 (FINRA 002366); Tr. 430–33 (FINRA 002768-71); Tr. 639–40 (FINRA 002978-79); Tr. 1710–18 (FINRA 004051-59); Tr. 1860–61 (FINRA 004202-03); Tr. 2145–46 (FINRA 004487); Tr. 2667 (FINRA 005064); Tr. 2789 (FINRA 005186); DOE Post-Hearing Br. at 24, 27–28, 41–42 (FINRA 009538, 009541-42, 009555-56).

at *4 (N.D. Ill. Oct. 27, 2014) (finding that a note was a security where defendant "put forth no evidence or argument to rebut [the *Reves*] presumption").

With respect to NHPI and ORFG, it is a legal impossibility to overcome the mandatory *Reves* presumption because Enforcement never even contended that those notes were not securities. With respect to VPLM, Enforcement did no more than make a suggestion based upon a flawed understanding of the law. Enforcement adduced no documents or witness testimony to contradict the mandatory presumption that the note was a security,

The NAC's decision is irreconcilable with *Reves* and bedrock principles of evidence. It must be reversed.

B. The NAC's Analysis Was Wrong

In any event, FINRA's substantive analysis was also incorrect. Under *Reves*, notes intended "to raise money for the general use of a business enterprise or to finance substantial investments" are securities. *Reves*, 494 U.S. at 66. The notes at issue here all appear on their face, and in supporting records, to fit this category.[74]

The NAC held that the NHPI note was not a security because the individual noteholder presumably was not motivated by the profit to be generated from the note.[75] But *Reves* plainly explains that, "by 'profit' in the context of notes, we mean 'a valuable return on an investment,' which undoubtedly includes interest." 494 U.S. at 68 n.4. The NHPI and ORFG notes provided for interest and therefore represented profit for purposes of *Reves*.[76] Moreover, the conversion

[74] *See* RX-1 at 106, 122 (FINRA 008516, 008532); RX-3 at 36–41, 60 (FINRA 008962–67, 008986). The same is true of the VPLM line of credit. *See* RX-2 at 26–27, 44–45 (FINRA 008664–65, 008682–83).
[75] NAC Decision at 69 (FINRA 010899).
[76] RX-1 at 106 (FINRA 008516); RX-3 at 36 (FINRA 008962). Again, the same is true of the VPLM line of credit. RX-2 at 26 (FINRA 008664).

feature of the notes[77]—an aspect the NAC did not address—further supports their characterization as securities. *See SEC v. Constantin*, 939 F. Supp. 2d 288, 304 (S.D.N.Y. 2013) ("[W]hen a convertible note is acquired ostensibly for investment purposes, the note should be considered a security."); *Carlucci v. Han*, 886 F. Supp. 2d 497, 513 (E.D. Va. 2012) (a convertible feature "militates in favor of finding . . . notes securities"); *Leemon v. Burns*, 175 F. Supp. 2d 551, 559 (S.D.N.Y. 2001) (a note's convertibility into common stock "is a strong factor for holding that the [n]ote is a security").

The NAC's substantive analysis regarding VPLM's status is also lacking. The NAC simply and summarily concluded that the VPLM line of credit had certain unnamed "hallmarks" of a debt financing arrangement to fund the business, that the verbal nature of the note "suggests" that it is not a security, and that the note "lacked a connection to the general investing public."[78] Tellingly, the NAC does not cite to a single piece of evidence to support these vague and conclusory statements—there is simply nothing to contradict SCA's or Mr. Cruz's reasonable understanding that the VPLM note qualified as a security.[79] Without evidence, the NAC cannot overcome the *Reves* presumption that the VPLM note is a security. *Duran*, 2014 WL 5439782, at *4.

C. The NAC's Red Flag Analysis is Wrong

1. The NAC Ignored the Context of the Deposits

The NAC imposed liability on Mr. Cruz for "fail[ing] to investigate a parade of red flags" associated with the deposits.[80] The NAC made specific reference to five purported red flags that,

[77] RX-1 at 106 (FINRA 008516); RX-3 at 38 (FINRA 008964).
[78] NAC Decision at 70 (FINRA 010900).
[79] *Id.*
[80] NAC Decision at 88 (FINRA 010918).

in its judgment, received inadequate treatment.[81] The NAC's analysis ignores the fundamental principle that "red flags" are context-specific, turning on the facts presented as well as the broker-dealer's knowledge and experience with the issues presented.[82] Mr. Cruz, along with Mr. Diekmann, testified at length as to why, based upon their extensive experience in the microcap industry, the types of things that Enforcement had seized upon were, in context, not suspicious or indicative of an illegal distribution.[83]

Given the nature of microcap companies, which often are small, struggling operations that are resource constrained, their paperwork on various transactions and agreements generally is not as sophisticated or detailed as it might otherwise be for larger companies. It is through this prism that the Commission should evaluate the supposed "red flags."

Moreover, "red flags" are relevant for Rule 144 compliance only to the extent that they are probative of a distribution.[84] *See, e.g.*, *ACAP Fin.*, 2013 WL 3864512, at *2 (broker's duty is to "detect any warning signs indicating the possibility of an unlawful distribution"); 17 C.F.R. §230.144(g)(4) (broker's inquiry is directed to "circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that the transaction is part of a distribution of securities of the issuer"). As described below, most of the supposed

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[81] *Id.*

[82] *See Donald J. Anthony, Jr.*, SEC Release No. 745, 2015 WL 779516, at *82–84 (ALJ Feb. 25, 2015) (defining "red flag" and assessing whether particular circumstances constituted "red flags"); *Dep't of Enforcement v. SWS Fin. Servs., Inc.*, 2015 WL 5782976, at *15–16 (FINRA OHO Aug. 13, 2015) (rejecting the contention that certain facts constituted red flags in light of the respondents' explanations, which were based on respondents' industry experience and knowledge of the relevant parties); *Dep't of Enforcement v. Jennings*, 2013 WL 2146654, at *19–20 (FINRA OHO Mar. 4, 2013) (finding insufficient evidence that particular facts amounted to red flags under the circumstances).

[83] *See, e.g.,* 87 Tr. 299:12-22 (FINRA 002637); Tr. 1013:10-24 (Day 4) (Diekmann) (FINRA 003352); Tr. 1893:3-4 (FINRA 004181); see, e.g., 15 U.S.C. § 77q(a)(2).

[84] *See* RX-38 at 3–11 (FINRA 009235–43); Tr. 2428:20–2429:8, 2431:25–2432:7, 2434:21–2435:4, 2519:4–2520:8, 2522:3–2524:6 (FINRA 004825–26, 004828–29, 004831–32, 004916–17, 004919–21).

"red flags" that Enforcement and the NAC focused upon are unrelated to whether a distribution may have been occurring.

When evaluating this matter, the Commission should note that Enforcement never alleged any AML violations, meaning that there were no allegations that SCA failed to report potentially suspicious activities when necessary. Indeed, the Hearing Officer specifically prohibited the Petitioners from presenting information about AML compliance, including with respect to the specific deposits at issue, because she said that was irrelevant to these proceedings.[85]

The NAC pointed out that "[t]he NHPI, VPLM, and ORFG deposits consisted of large blocks of thinly traded, low-priced stocks that were issued by obscure companies."[86] In the context of a broker-dealer like SCA that focuses almost exclusively on microcap stocks, this statement is devoid of meaning because it assigns a red flag to the entire microcap market.[87] Of course, there have been a variety of FINRA and Commission pronouncements about such types of deposits being red flags, but, again, the context matters. A broker-dealer receiving such a deposit from a customer that does not have a history of doing similar transactions is something that should prompt the broker-dealer to ask additional questions. Similarly, a broker-dealer that does not have a customer base that liquidates microcap stocks and therefore does not have institutional expertise with those types of securities should logically take extra care with a new customer that starts doing that business. But neither of those situations was the case here. Although the context must necessarily matter when determining whether something is a "red flag" warranting further analysis,

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[85] *See* Tr. of Final Pre-Hearing Conf. at 32, 35–36 (FINRA 002322, 002325–26); Tr. 1834:9–18 (FINRA 004176)

[86] NAC Decision at 8 (FINRA 010918).

[87] *See* Tr. 138:18–24; Tr. 2427:20–2429:10; Tr. 2429:11–2430:8 (Menchel observing that the subject deposits were not even unusually or suspiciously large quantities).

the NAC refused to acknowledge that basic point as it interferes with FINRA's desired narrative. The Commission should not make the same mistake.

2. Subsequent Distribution of Proceeds is Unrelated to Whether the Deposit Should Have Been Accepted

The NAC faulted Mr. Cruz and SCA for "not investigat[ing] who ultimately received the funds from the microcap securities sales."[88] SCA's customer was CSCT and there is no dispute that the funds went back to CSCT for further distribution to its customers who submitted the deposits. Indeed, Enforcement made no allegations that the proceeds were not disbursed to the entities that submitted the deposits or their stated beneficial owners. The NAC raising that speculative possibility is not tethered to any evidence.

Importantly, the distribution of proceeds is necessarily a question about events that post-dated the deposit due diligence review. Thus, the subsequent distribution of proceeds cannot logically have any bearing on whether Mr. Cruz and his team properly conducted their due diligence on whether to accept the deposits in the first instance. One has nothing to do with the other.

Similarly, to the extent that proceeds of securities transactions were ultimately going to people who were not the actual customers, that would be a potential AML issue. As described above, however, Enforcement made absolutely no AML allegations in this case. Thus, the Hearing Officer prohibited Mr. Cruz and SCA from introducing exhibits regarding SCA's post-trade and money movement reviews and AML compliance issues.[89] It would therefore be manifestly

[88] NAC Decision at 89 (FINRA 010919).

[89] *See* Tr. of Second Pre-Hearing Conf. at 18 (FINRA 2254). *Id.* at 19–23, 27–29, 33–34 (FINRA 002255–59, 002263–65, 002269–70). As a result of this ruling, Petitioners had to withdraw numerous proposed exhibits on these issues. *See* Respondents' Ex. List at 1–7 (FINRA 001861–7); Tr. of First Pre-Hearing Conf. at 6–7 (FINRA 002094–95); Tr. of Second Pre-

improper to impose liability on Mr. Cruz and SCA for things that the Hearing Officer explicitly precluded them from pursuing at the hearing.

3. The Underlying Notes Were Not Recently Issued

The NAC noted that the NHPI, VPLM, and ORFG shares were recently issued, "a warning that the issuer or its control persons could be conducting a distribution."[90] That statement is misleading because it completely ignores a basic fact. Specifically, the underlying notes that were ultimately converted into stock had been outstanding for long periods of time. The NHPI note was issued on May 1, 2012,[91] approximately two years before the deposits at SCA.[92] The underlying VPLM debt was incurred in July 2012, memorialized in August, 2013,[93] and deposited on February 2014.[94] And the ORFG note was created on September 1, 2012,[95] and deposited on April 22, 2014.[96] The actual timeline associated with the issuance of the notes and their subsequent conversion into stock undercuts the impression created by the NAC's selective and misleading factual citations.

Agreeing with the NAC would require believing that the supposed illegal distributions were long-range plans that took years to execute. That is not a plausible conclusion, especially in the absence of any affirmative evidence to support it.

Hearing Conf. at 8–36, 43–44 (FINRA 002244–72, 002279–80); Tr. of Final Pre-Hearing Conf. at 5–6, 35–36 (FINRA 002295–96, 002325–26).

[90] NAC Decision at 88 (FINRA 010918).

[91] RX-1 at 106 (FINRA 008516).

[92] RX-1 at 2, 79, 159 (FINRA 008412, 008489, 008569).

[93] RX-2 at 26–27, 28 (FINRA 008664–65, 008666).

[94] RX-2 at 2 (FINRA 008640).

[95] RX-3 at 36–41 (FINRA 008962–67).

[96] RX-3 at 55 (FINRA 008982).

4. The Issuers Were Not Shell Companies

The NAC concluded that two of the issuers—NHPI and ORFG—appeared to be shell companies because of changes in business lines.[97] That rationale demonstrates the NAC's fundamental misunderstanding of the meaning of a shell company. Whether a company is a shell depends on other distinct factors. A shell company is one with "no or nominal operations" and either "no or nominal assets" or "assets consisting solely of cash and cash equivalents." 17 C.F.R. § 230.144(i)(1)(i). As the Commission has made clear, a company *need not be profitable* to avoid the shell label; it must just be conducting some business, which can include soliciting or effecting business transactions or engaging in research and development. *M&A Brokers*, SEC No-Action Letter at 2 & n.1 (Feb. 4, 2014), *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf. Likewise, the Commission has excluded startups from the definition, reasoning that a startup company, despite its limited operating history, does not meet the condition of having "no or nominal operations." 72 Fed. Reg. at 71,557 n.172. Thus, whether there have been changes or modifications to business lines has no bearing on the Commission's definition of a shell company.

The NAC incorrectly faulted Mr. Cruz's approach to analyzing a company's shell status by claiming that he simply "rel[ied] on representations by a principal of the issuer that the company was not a shell."[98] Mr. Cruz's testimony and the relevant due diligence packages demonstrate the falsity of that statement. For example, Mr. Cruz analyzed the issuers' public financial reports, the issuers' websites, and attorney opinion letters,[99] all with the purpose of determining whether there

[97] NAC Decision at 88 (FINRA 010918). Neither the Hearing Panel nor the NAC held that VPLM was a shell.
[98] NAC Decision at 88 (FINRA 010918)
[99] *See, e.g.*, RX-1 at 18-23, 44-49 (FINRA 008428-33, 54-59); RX-2 at 19-21, 189-191 (FINRA 008657-59, 008827-29); RX-3 at 24-26 (FINRA 008950-52); *see also* Tr. 263:21–264:12, 332:2–18 (FINRA 002601-02, 70).

was evidence of operations and operating expenses for each issuer.[100] That is precisely the type of thoughtful analysis that a regulator should expect.

In any event, SCA was aware of the changes to the business lines. As Mr. Cruz explained, NHPI's expansion into oil-and-gas exploration in 2008, 6 years before the relevant deposits, supplemented, rather than replaced, the company's existing pharmaceutical business line,[101] and the company had exhibited stable management over several years, making it less vulnerable to manipulation.[102] Similarly, Mr. Cruz explained that ORFG's change in business focus was fully disclosed in the company's OTC filings and therefore would not have been a reason to reject the deposit.[103]

5. Mr. Cruz Analyzed Information From Multiple Sources

The NAC also held that Mr. Cruz failed to reasonably supervise SCA because, "when [he] did respond to a red flag, he would be satisfied with an answer from an interested party."[104] The NAC's characterization flies in the face of the evidence. Mr. Cruz was never "satisfied" with information from a single source. Throughout his diligence efforts, he strove to gather and reconcile information from a range of sources, and as previously described, he routinely rejected deposits that did not meet his rigorous standards.

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[100] Tr. 263:25–264:11 (FINRA 002601–02); Tr. 332:6–13 (FINRA 002670); Tr. 629:1–17 (FINRA 002968); *see also* Tr. 2433:13–2435:4, 2437:19–2438:19, 2439:8–17 (FINRA 004830–32, 004834–35, 004836) (Menchel explaining the markers of shell status).
[101] Tr. 286:15–17, 287:13–14, 292:23–293:18 (FINRA 002624, 002625, 002630–31); Tr. 609:3–610:9, 677:9–10 (FINRA 002948–49, 003016).
[102] Tr. 288:17–20, 384:1–386:24 (FINRA 2626, 2722–24). NHPI had the same CEO (David Ambrose) since 2008 and the same COO (Gary Dutton) and President (Patrick Thomas) since 2012. CX-255 at 24 (FINRA 007808); CX-256 at 3–4 (FINRA 007811–12); RX-1 at 20–21, 41, 106 (FINRA 008430–31, 008451, 008516).
[103] Tr. 512:23–515:4 (FINRA 002851-54).
[104] NAC Decision at 89 (FINRA 10919)

In sum, Mr. Cruz discharged his duties in good faith, drawing on his experience and business judgment, and no evidence has emerged to refute any of his conclusions. That constitutes reasonable supervision.

VII. THE NAC IMPROPERLY SHIFTED THE BURDEN OF PROOF

The NAC's analysis is legally unsupportable because it conflated the distinct, independent standards for Rule 144 and Section 4(a)(4). The NAC wrote:

> [W]e find that Scottsdale Capital Advisors failed to conduct the searching inquiry that is required under Rule 144 and Section 4(a)(4). We also find that, as a consequence of Scottsdale Capital Advisors' failure to conduct the required searching inquiry, the Firm is unable to satisfy its burden of proof for the more technical aspects of Rule 144 that the parties discuss in their briefing, such as proving that the selling customers were not affiliates of the issuers, establishing that the selling customers met the requisite one-year holding period for resales of restricted securities, and demonstrating that the issuers of the subject deposits and liquidations were not shell companies.[105]

As described above, however, the applicability of Rule 144 is based on certain specific objective criteria. A "searching inquiry" is only relevant to Rule 144 if FINRA can prove—not speculate—that despite satisfaction of the objective criteria, the sales were part of a scheme to evade Section 5's registration requirements. Enforcement never proved, nor did the NAC find, a scheme to evade.

Instead, the concept of a "searching inquiry" relates to applicability of the Section 4(a)(4) exemption. *See, e.g. Midas Sec., LLC*, Exchange Act Release No. 66200, 2012 WL 169138, at *8 (Jan. 20, 2012) (discussing broker's duty of "searching inquiry" under Section 4(a)(4)). Accordingly, the NAC's finding that SCA failed to conduct a "searching inquiry" has no bearing on whether the sales in question complied with Rule 144. If the objective conditions of Rule 144

[105] NAC Decision at 63 (FINRA 010893).

were met, then the sales were exempt from registration unless Enforcement *actually proved* the existence of a scheme to evade Section 5's registration requirements.

By misunderstanding this critical point of law, the NAC improperly shifted the burden to Petitioners to *disprove* certain hypothetical conditions.[106] Federal courts have rightfully rejected this line of reasoning. *See Busch v. Carpenter*, 827 F.2d 653, 657 (10th Cir. 1987) (a seller claiming an exemption under Section 5 "should [not] be required to disprove all the possible circumstances that might establish the stock has not come to rest," and when the seller "has satisfied the facial requirement of the statute," the burden is on the opposing party to produce contrary evidence). A party that successfully invokes the safe harbor cannot fairly be required to negate the exception as part of its defensive case; that burden properly falls on the prosecution as part of its affirmative case, at least once the broker-dealer has demonstrated *prima facie* compliance with Rule 144's objective criteria.

On top of the improper burden shifting, the NAC somehow concluded that SCA could not rely on Rule 144 because it "failed to establish" that *its own compliance* with Rule 144 was *not* part of a plan or scheme to evade the federal securities laws.[107] According to the NAC: " [SCA] may not rely on an exemption under Rule 144 of the Securities Act because *the Firm failed to prove that its Due Diligence Packages were not part of a plan or scheme to evade the registration requirements of the Securities Act.*"[108] The NAC thus accused SCA *itself* of engaging in an unlawful scheme *through its own genuine compliance efforts*, and it placed the burden on SCA to *disprove* that baseless charge, rather than directing Enforcement to establish that such a scheme

[106] NAC Decision at 63, 72, 74 (FINRA 010893, 902, 904).
[107] NAC Decision at 74–75 (FINRA 010904-5).
[108] *Id.* at 75 (FINRA 010905) (emphasis added).

actually existed. In other words, the NAC charged SCA and Mr. Cruz with the impossible task of proving a negative.

In what is a troubling and recurring theme, the NAC invented this theory of liability after-the-fact. Enforcement never alleged or otherwise advanced this theory. Therefore, this theory of liability was never addressed at the hearing. As explained in the briefs for Mr. Hurry, imposing liability based upon uncharged theories is clearly improper, violates the Exchange Act's requirement for disciplinary proceedings to be fair, and is an approach that the Commission has routinely rejected.

Enforcement produced absolutely no evidence establishing a scheme to evade the registration provisions of the securities laws. In fact, while the Hearing Panel found that the alleged red flags meant that the transaction "could be a scheme to evade,"[109] the NAC took steps to distance itself even more from Enforcement's unproven argument, inverting the burden of proof and faulting SCA for failing to prove that its Rule 144 compliance was *not* part of a scheme to evade.[110] This despite years of investigation by FINRA and exacting scrutiny of the transactions by both the Hearing Panel and the NAC. Tellingly, the Commission itself has taken no action against any of the issuers or any of the beneficial owners of the securities at issue in this case. Against this backdrop, NAC's theory of liability cannot stand.

VIII. SCA ESTABLISHED THAT ALL OF THE TRANSACTIONS WERE EXEMPT FROM REGISTRATION

Applying the correct legal framework, the record amply demonstrates that SCA carried its burden of proof as to the objective criteria of Rule 144 and that, even if Rule 144 was technically

[109] Hearing Panel Decision at 86 (FINRA 009798).
[110] NAC Decision at 74 (FINRA 010904).

unavailable, SCA's reasonable diligence qualified the sales for the Section 4(a)(4) broker's exemption.

A. NHPI

Consistent with Rule 144, Petitioners gathered evidence that the one-year holding period was satisfied, including through permissible tacking, and that the relevant parties—Mr. Collins, Sky Walker, Swiss National, and Ireland Offshore—were not affiliates of the issuer. The three deposits were made on February 4, 2014, April 9, 2014, and April 24, 2014.[111] Each deposit tied to the promissory note that NHPI issued to Mr. Collins on May 1, 2012—well over one year earlier.

Mr. Collins was not an affiliate of NHPI. SCA obtained confirmation from Mr. Collins that he was not, and had never been, an officer, director, control person, or beneficial owner of more than ten percent of any class of securities of NHPI.[112] SCA verified that information by reference to NHPI's website, the company's profile page on OTCMarkets.com, stock-transfer-company records, and an attorney opinion letter.[113] None of those sources individually or in the aggregate indicated that Mr. Collins had any relationship to NHPI or that he held more than ten percent of its outstanding stock. Therefore, he was free to sell stock derived from his note by May 1, 2013.

Sky Walker, Ireland Offshore, and Swiss National were similarly free to sell the shares they received from Mr. Collins so long as they were not affiliates of NHPI. *See* 17 C.F.R. § 230.144(d)(1).[114] SCA obtained declarations certifying that the beneficial owners of the three entities were Patrick Gentle, Jeff Cox, and Talal Fouani, respectively.[115] Nothing in the large

[111] RX-1 at 2, 79, 159 (FINRA 008412, 008489, 008569).
[112] *E.g.*, RX-1 at 25 (FINRA 008435).
[113] *E.g.*, RX-1 at 18–23, 37, 41–49 (FINRA 008428–33, 008447, 008451–59).
[114] *See also* 55 Fed. Reg. at 17,941; Hicks, *Resales*, § 4:103.
[115] RX-1 at 11–12, 88–89, 169–70 (FINRA 008421–22, 008498–99, 008579–80).

evidentiary record in this matter contradicts the clear and unequivocal representations in the declarations that those individuals were the beneficial owners. The share ownership in NHPI for the entities, both individually and collectively, was well below the 10% threshold for affiliate status.[116] No public records suggested that that the named beneficial owners were not who they purported to be or that those individuals or their companies were somehow connected to NHPI.[117] In short, SCA obtained facts from multiple sources that satisfied the objective criteria of Rule 144.

Separate and apart from Rule 144, SCA's diligence rose to the level of a "reasonable inquiry" for purposes of Section 4(a)(4)'s broker's exemption. While the NAC attempted to cast doubt on the quality of SCA's diligence by fixating on purported discrepancies it discovered years after-the-fact and suggesting additional lines of inquiry that could have satisfied the NAC's curiosity, the record reflects that SCA addressed all material issues actually bearing on Section 5 compliance.

Distilled to its essentials, the NAC's critique focused on four issues: the parties' contact information, the unsworn character of certain records, the terms and timing of the transactions, and the incidence of promotional activity. None withstands scrutiny.

The NAC complained that particular transactional records did not list full contact information for certain parties, including the beneficial owners of Sky Walker, Swiss National, and Ireland Offshore, Mr. Collins, and the CEO and President of NHPI.[118] That complaint misses the mark. The NAC acknowledged that SCA, indeed, obtained the corporate addresses for Sky Walker, Swiss National, and Ireland Offshore.[119] In fact, it implied that the coincidence of those

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[116] *See* RX-1 at 1, 78, 158 (FINRA 8411, 8488, 8568); *see also* RX-1 at 37, 41, 43 (FINRA 008447, 8451, 8453).
[117] RX-1 at 41–71, 123–31, 135–56, 199–200, 206–27 (FINRA 008451–81, 008533–41, 008545–66, 008609–10, 008616–37).
[118] NAC Decision at 21, 23, 28 (FINRA 010851, 010853, 010858).
[119] *Id.* at 26 (FINRA 010856).

entities' addresses was a red flag.[120] But SCA presented unrefuted evidence that those addresses were for registered agents—hardly an uncommon or suspicious arrangement, particularly in small nations like Belize[121]—and that, when circumstances warranted (e.g., when multiple subaccounts were depositing stock in amounts approaching 10% of an issuer's outstanding shares, or when a depositor appeared to be connected to a stock promoter), SCA would obtain the beneficial owners' physical addresses.[122] As for Mr. Collins, the NAC elsewhere reluctantly acknowledged that the Collins–NHPI note itself included Mr. Collins' personal address,[123] and that address was confirmed in other records collected by SCA.[124]

The NAC also deemed it suspicious that none of the debt or legal instruments were witnessed or notarized.[125] However, there is no law, rule, or regulation conditioning the legal effect of such instruments on notarization, and the NAC pointed to no authority suggesting otherwise. Moreover, the NAC gave no weight to the fact that NHPI had specifically disclosed Mr. Collins' note in its publicly filed financial statements, and nobody—neither any party nor any government agency—has disputed the existence of the note or charged NHPI with issuing false financial statements.

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[120] *See id.* at 26 n.40 (FINRA 010856).
[121] *See, e.g.*, Tr. 352:15–18; Tr. 569:13–21; Tr. 1820:1–10 (FINRA 002690, 002707, 004162). Enforcement's own witness, Craig D'Mura, confirmed as much. Tr. 2324:6–2325:14 (FINRA 004667-68). And Mr. Menchel further noted that the use of common registered agents is rampant in the United States. Tr. 2440:7–12, 2440:20–2441:6 (FINRA 004837, 37-38). In fact, the parties stipulated at the hearing that 47,000 different corporations are registered at a single address in Carson City, Nevada. Tr. 2446:18–2447:5 (FINRA 004843-44).
[122] Tr. 1769:20–1770:9, 1771:1–1772:9; Tr. 1820:15–24 (FINRA 004110-11, 12-13; 004162). After the Relevant Period, SCA revised its policies and now obtains physical addresses as part of its standard due diligence. Tr. 547:13–19 (FINRA 002886).
[123] NAC Decision at 23 (FINRA 010853).
[124] *Compare* RX-1 at 31 (FINRA 008441), *with* RX-1 at 106 (FINRA 008516).
[125] NAC Decision at 21, 24, 25, 26, 28 (FINRA 010851, 010854, 010855, 010856, 010858).

The NAC's befuddlement about the timing and terms of the transactions reflects no more than its own disdain for the microcap market. The NAC focused on the fact that the SSI/Collins Note Satisfaction Agreement is dated September 16, 2013, which is before the declared default date of November 7, 2013.[126] Viewing the transaction as whole, however, and knowing that the stock was transferred in November and not September—as confirmed by transfer agent records—there is only one logical explanation for this otherwise legally irrelevant mystery—the September date was a typographical error.[127]

Importantly, whether the transfers were to have taken place in September 2013 instead of November 2013 has absolutely no bearing on the Rule 144 analysis because the one-year holding period expired on May 1, 2013. Thus, there was no need to post-date the documents if the parties had actually executed the documents in September 2013. So FINRA's fixation on this date issue is not probative of whether there was a scheme to evade to Section 5's registration requirements.

Similarly, the NAC was troubled because each of the notes had largely identical terms. As Mr. Diekmann testified, the identical terms were no cause for concern. Mr. Collins was likely looking for a loan of $150,000, but was not able to find a single lender willing to take on this entire amount.[128] Instead, Mr. Collins likely worked with someone who was able to locate three parties that were each willing to loan him $50,000.[129] That explains why each party used the same form

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[126] NAC Decision at 26-27 (FINRA 010856-57).

[127] Indeed, Respondents were able to able to corroborate this explanation after Enforcement seized on another document stating that the transfer of shares to Sky Walker happened on November 12, 2013, which preceded the dates referenced in the transactional documents. *See* RX-1 at 88 (FINRA 008498). During an overnight break at the hearing, SCA obtained a copy of the relevant stock certificate, which reflected a transfer date of November 21, 2013, thereby proving that SCA's conclusion was not only reasonable under the totality of the circumstances, but also demonstrably correct. RX-115 (FINRA 009419).

[128] Tr. 1697:17-24 (FINRA 004038).

[129] Tr. 1697:17-1700:3 (FINRA 004038-41).

agreement. As Mr. Diekman testified, this structure is commonplace and is in fact what he would expect for this type of transaction.[130]

In short, whether the documentation could have been drafted more clearly and without typos has no bearing on whether the beneficial ownership declarations were false or whether the real beneficial owners were other unspecified people who were affiliates of NHPI. As Mr. Menchel explained, a broker's duty of inquiry is limited to red flags probative of a distribution, not minor discrepancies in transactional documents or typographical errors.[131] The NAC's treatment of the NHPI transaction—hanging on hindsight-driven details immaterial to the possibility of an illegal distribution—reveals the erroneous legal principle underlying its analysis.

B. VPLM

Petitioners similarly adduced evidence that the one-year holding period for the VPLM shares had been satisfied, including through permissible tacking, and that the sellers in the chain—VHB, Locksmith, and their respective beneficial owners—were not affiliates of the issuer.

VHB's deposit at SCA in February 2014 tacked to the oral debt obligation that existed in July 2012, resulting in a holding period in excess of one year. Under federal case law, the oral debt agreement between Locksmith and VPLM was a security.[132] Further, as the SEC has made clear, where the parties to a loan agreement later add a conversion feature, the holding period for

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[130] Tr. 1697:17-24, 1700:10-17 (FINRA 004038, 004041).

[131] Tr. 2428:23–2429:8, 2431:25–2432:7, 2522:3–10 (FINRA 004825–26, 004828–29, 004919).

[132] An instrument designed to raise money for general business use or to finance capital investments is generally a security. *See Singer v. Livoti*, 741 F. Supp. 1040, 1049–50 (S.D.N.Y. 1990). Courts have consistently held that investment-driven loans related to lines of credit are securities. *See Griffin v. Jones*, 975 F. Supp. 2d 711, 721–23 (W.D. Ky. 2013); *Sias v. Herzog*, No. 04-3832 (JNE/JSM), 2006 WL 2418950, at *11–13 (D. Minn. Aug. 21, 2006). And it has long been settled that an agreement need not be written to qualify as a security. *E.g.*, *Canadian Imperial Bank of Commerce Trust Co. v. Fingland*, 615 F.2d 465, 466–67 & n.5 (7th Cir. 1980).

shares acquired on conversion tacks to the date of the original loan. *Technimed Corp.*, SEC No-Action Letter (June 8, 1987), 1987 WL 108207.[133] Thus, tacking to the date of the oral debt obligation in July 2012 was appropriate.

Therefore, Rule 144 is applicable provided there is *prima facie* evidence that neither Mr. Kipping nor Mr. Bretel were affiliates of VPLM. The NAC focused on the fact that the Due Diligence Package for VPLM did not have a specific resignation date for Mr. Kipping, suggesting that SCA did not do enough to ensure that Mr. Kipping was no longer with VPLM. But publicly available information, which was in the evidentiary record from the hearing, established that Mr. Kipping had resigned from VPLM by November 2009 and thus was not employed by VPLM within 180 days of Locksmith's sale of stock to VHB in August 2013.[134] It is inexcusable that the NAC wants to pretend as if that information does not exist simply because SCA did not print a copy VPLM's press release announcing Mr. Kipping's resignation and put it in the due diligence file.

Further, to remove any doubt as to Mr. Kipping's affiliation, VPLM's CEO provided a letter confirming the lack of any affiliation.[135] Similarly, Mr. Bretel affirmed in a declaration that *he* was the beneficial owner of VHB and therefore had the exclusive economic interest in the

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[133] This also aligns with Rule 144(d)(3)(ii), which provides that securities acquired from the issuer "solely in exchange for other securities of the same issuer"—that is, where no new consideration is exchanged—can tack to the holding period for the original securities, "even if the securities surrendered were not convertible or exchangeable by their terms." 17 C.F.R. § 230.144(d)(3)(ii); *see* Tr. 1718:9–10 (FINRA 004059).

[134] Tr. 441:1–16 (Day 2) (Cruz) (FINRA 002779); Tr. 1721:24–1722:6 (FINRA 004062–63); Tr. 2855:8–2856:3 (Day 12) (closing argument) (FINRA 005252–53). The press release remains available online today. *See* Press Release, VoIP-Pal.com Announces Reseller Website Development (Nov. 11, 2009), *available at* http://markets.financialcontent.com/stocks/news/read/10740091/voip. The NAC may take judicial notice of the date of the release's issuance. *See Dep't of Enforcement v. Trevisan*, Compl. No. E9B2003026301, 2008 WL 1946802, at *6 n.9 (NAC Apr. 30, 2008).

[135] RX-2 at 23–24 (FINRA 008661–62).

VPLM shares.[136] SCA was familiar with Mr. Bretel from prior transactions—in fact, he had been depositing VPLM stock at SCA for a year or more[137]—and had a copy of his passport.[138] Moreover, SCA's due diligence materials reflected that SCA reviewed VPLM's financial reports and public filings, records from the Nevada Secretary of State, and OTCMarkets.com, none of which indicated that Mr. Kipping or Mr. Bretel had any role at the company.[139]

The NAC also took issue with the VPLM Annual Report contained in SCA's Due Diligence Package for that transaction, because it showed that VPLM had issued more than 80 million shares of stock to Mr. Kipping and Locksmith Financial, which would be greater than the 10% of VPLM's outstanding shares.[140] The NAC, however, ignored the uncontested testimony that SCA had handled several prior sales of VPLM by VHB for more than a year before the Relevant Period, and that the report did not reflect any of those sales.[141] Because of this longstanding relationship, SCA knew that, at the time of the deposit, Locksmith did not own more than 10% of VPLM's outstanding stock.[142]

At bottom, Mr. Cruz and SCA established both a *prima facie* case that the Rule 144 exemption applied and reasonable due diligence to satisfy the Rule 4(a)(4) exemption. Therefore, the sales were subject to that safe harbor unless Enforcement could *prove* that the transactions were part of a scheme to evade the registration requirements of the securities laws. That did not happen. But the Panel never shifted the burden of persuasion to Enforcement and thus never

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[136] RX-2 at 12–13 (FINRA 008650–51).
[137] Tr. 626:10–18 (FINRA 002965); Tr. 1856:6–9, 1905:1–23 (FINRA 004198, 004247); *see also* RX-2 at 268–88 (FINRA 008906–26).
[138] RX-2 at 11 (FINRA 008649).
[139] RX-2 at 40–45, 60–61, 62–66 (FINRA 008678–83, 008698–99, 008700–04).
[140] NAC Decision at 60 (FINRA 010890); *See also* RX-2 at 40 (FINRA 008678).
[141] Tr. 103:3-4 (FINRA 002441); Tr. 626:10-18 (FINRA 002965). Tr. 1856:6-13 (FINRA 004198); Tr. 1904:17-1905:13 (FINRA 004246-47); Tr. 1905:21-23 (FINRA 004247).
[142] Tr. 1916:5-14 (FINRA 004258).

examined Enforcement's case under the correct legal standard. Its failure to do so is reversible error.

C. ORFG

Lastly, Petitioners demonstrated that the one-year holding period for the ORFG deposit had been met, including via tacking, and that the relevant parties—Mr. Forward, Anything Media, and Media Central Belize—were not affiliates of ORFG.

With respect to the holding period, Media Central Belize was able to tack back to ORFG's issuance of the original note to Mr. Forward on September 1, 2012, which preceded the deposit at SCA by more than one year. Although the conversion option on the original note expired and a new conversion was subsequently added when ORFG agreed to modify the note in connection with Mr. Forward's request for an assignment to Anything Media, that is not an impediment to tacking back to September 1, 2012. As discussed above, it is well-settled that subsequent modifications to a note, including changes to the interest rate and conversion terms, do not reset the holding period—that is, a person may tack to a holding period predating the modifications—provided that no additional cash consideration was paid to the issuer. That is exactly what happened here. Indeed, a May 19, 2014 letter from ORFG's Chairman and CEO confirmed that ORFG agreed to modify the note for no additional consideration.[143] Therefore, the holding period tacks back to September 1, 2012. *See* 17 C.F.R. § 230.144(d)(3)(ii). As a result, Rule 144's one-year holding period was satisfied by September 1, 2013, which preceded both Mr. Forward's assignment of the note to Anything Media in January 2014 and Anything Media's sale of the shares to Media Central Belize in April 2014.

[143] RX-3 at 21–22 (FINRA 008948–49).

With respect to the affiliate issue, SCA confirmed via multiple sources that neither Mr. Forward nor Anything Media was an affiliate of ORFG. The firm's diligence materials contained a signed letter from ORFG's Co-Chair and Executive Director stating that Mr. Forward, Anything Media, and Media Central "are not beneficial owners of 10% or more of any class of equity securities of the Company," and "are not, or were not 90 days prior to the sale, a director, officer, or an 'Affiliate' of the Company as that term is used in paragraph (a) of Rule 144 of the Securities Act of 1933 (i.e., a person or entity that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with the Company)."[144] The diligence materials also included ORFG's publicly filed disclosure statement for the quarter ending February 28, 2014, which lists the total shares of the company outstanding and the names of the "officers, directors, and control persons" of the company—details that together confirm the non-affiliate status of Mr. Forward and Anything Media.[145]

Media Central Belize's sale of stock through SCA clearly met the objective criteria of Rule 144. The beneficial ownership declaration form identified Giovanni Moh as the beneficial owner of Media Central Belize.[146] Nothing in SCA's extensive due diligence suggested a link between ORFG and Media Central Belize or Mr. Moh, nor did Enforcement point to any such information. To the contrary, the above-referenced letter from ORFG's Co-Chair and Executive Director confirmed that none of the relevant parties could be considered affiliates of ORFG.[147]

Consequently, there is *prima facie* compliance with Rule 144. Therefore, the sales were subject to that safe harbor unless Enforcement could *prove* that the transactions were part of a scheme to evade the registration requirements of the federal securities laws.

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[144] *Id.*
[145] RX-3 at 64–65 (FINRA 008991–92).
[146] RX-3 at 11–12 (FINRA 008937–38).
[147] RX-3 at 21–22 (FINRA 008948–49).

Further, SCA's careful scrutiny of promotional activity reflects how SCA critically evaluated the information it received and conducted additional follow up to resolve potential issues. Specifically, in following up on promotional activity for potential links to the customer, SCA was able to determine that a company named Media Central in Florida was promoting ORFG.[148] Given the similarity in the names of the Florida company and the Belize entity making the deposit, SCA engaged in additional due diligence,[149] which included obtaining a new legal opinion from a different attorney that included an analysis of this very issue.[150]

SCA also undertook the following verification steps: it (1) obtained (a) the organizational documents from the depositor to verify that it was incorporated in Belize and therefore not the same entity as the promoter in Florida;[151] (b) a passport and utility bill for Mr. Moh to confirm that he was living in Belize, not Florida;[152] and (c) a letter from Media Central Belize confirming that it was not engaged in any promotional activity;[153] (2) ensured that an attorney interviewed the owner of the Florida company tied to the promotion, who affirmed that the company had no affiliation with Media Central Belize;[154] and (3) secured a representation from ORFG's Co-Chair and Executive Director affirming that the company had not engaged Media Central "to directly or indirectly promote or maintain a market for [ORFG's] securities," and that the company had no knowledge of the depositor engaging any third parties to provide such services.[155] This type of

[148] RX-3 at 66–68, 77–85 (FINRA 008993–95, 009004–12); Tr. 538:6–20 (Day 3) (Cruz) (FINRA 002877).
[149] RX-3 at 86–89 (FINRA 009013–16).
[150] *Id.* at 70–74 (FINRA 008997–9001).
[151] *Id.* at 15–16 (FINRA 008941–42).
[152] *Id.* 3 at 13–14 (FINRA 008939–40).
[153] *Id.* 3 at 23 (FINRA 008949).
[154] *Id.* -3 at 71 (FINRA 008998).
[155] *Id.* -3 at 22 (FINRA 008948).

detailed follow-up demonstrates how SCA scrutinized the information it received and aggressively followed up when the circumstances warranted.

Based on SCA's significant due diligence and the Panel's faulty red flag analysis, the §4(a)(4) exemption also applied to the ORFG deposit.

IX. FINRA DOES NOT HAVE AUTHORITY TO ENFORCE SECTION 5

As a separate and independent grounds for reversal, FINRA does not have the statutory authority to enforce violations of Section 5 of the Securities Act. The NAC, however, sanctioned SCA for violating Section 5 and the sanctions against Mr. Cruz are predicated on alleged Section 5 violations.

As explained in more detail in Mr. Hurry's Motion to Stay, and in Mr. Hurry's opening brief, FINRA's statutory authorization makes it clear that they do not have any authority over violations of the Securities Act. FINRA is a creation of the Exchange Act, and its disciplinary authority is governed by Sections 15A and 19 of the Exchange Act. *See* 15 U.S.C. §§ 78o-3, 78s; *see also Fiero v. FINRA*, 660 F.3d 569, 571–72, 577 (2d Cir. 2011) (describing the limits of FINRA's authority under the Exchange Act and holding that FINRA is not statutorily empowered to bring judicial actions to enforce disciplinary fines). Sections 15A(b), 15A(h), and Section 19(g) of the Exchange Act limit the disciplinary jurisdiction of registered securities associations and self-regulatory organizations, such as FINRA, to the Exchange Act alone. *See, e.g.*, 15 U.S.C. § 78o-3(b)(2) ([securities] association must "ha[ve] the capacity to . . . enforce compliance" by its members and associated persons "with the provisions of *this chapter*, the rules or regulations thereunder, the rules of the Municipal Securities Rulemaking Board, and the rules of the association" (emphasis added)); *id.* § 78o-3(b)(7) ([securities] association's rules must provide that its members and associated persons "shall be appropriately disciplined for violation of" the same

listed authorities); *id.* § 78o-3(h)(1)(B) (association's disciplinary sanctions must "be supported by a statement setting forth . . . the specific provision" of the same listed authorities the respondent has violated); *Id.* § 78s(g)(1)(B) ("[Self-regulatory organizations must] comply with the provisions of *this chapter*, the rules and regulations thereunder, and its own rules" and empowers it to "enforce compliance[,] in the case of a registered securities association, with *such provisions* . . . by its members.") (emphasis added). The term "this chapter" in Sections 15A(b), 15A(h), and 19(g) refers to the chapter of the United States Code where FINRA's enabling legislation appears: Chapter 2B of Title 15 of the Code—the Exchange Act.

Further, the relevant legislation is equally clear that *only* the Commission is empowered to discipline FINRA members for Securities Act violations. Section 19(h) of the Exchange Act specifically names the SEC as the only regulatory body with statutory authority to sanction members of registered securities associations and self-regulatory organizations (i.e., FINRA-member broker-dealers and associated persons) for violations of the Securities Act and other federal securities laws. *See* 15 U.S.C. § 78s(h)(3) (authorizing "[t]he appropriate regulatory agency for a national securities exchange or registered securities association" to impose sanctions, "in the case of a registered securities association," for violations of "any provision of the Securities Act of 1933"); *see also id.* § 78s(h)(2) (same, for "[t]he appropriate regulatory agency for a self-regulatory organization"); *Id.* § 78c(a)(34)(E) (defining the "appropriate regulatory agency" for a registered securities association as the Commission.).

The language of the underlying legislation is clear—FINRA has been limited to only enforcing violations of the Exchange Act, and the Commission is the only agency with the affirmative authority to enforce violations of the Securities Act. Since FINRA's enforcement

action here is entirely predicated on alleged violations over which they have no authority, it cannot continue. The Commission should vacate all of the NAC's findings and sanctions.

X. FINRA'S SANCTIONS ARE EXCESSIVE AND OPPRESSIVE

Despite honorably serving our country in the U.S. Marine Corps and maintaining a spotless record over the course of a decades-long career in the securities industry—including as an examiner at the NASD—Mr. Cruz has been handed among the most severe sanctions at FINRA's disposal: a $50,000 fine and a two-year suspension in all capacities.[156]

Mr. Cruz critically evaluated the facts surrounding each deposit, based on his knowledge of the microcap market, and made good faith judgments as to the applicability of Rule 144 and the issues requiring follow-up or remedial action. There is no evidence Mr. Cruz ever ignored or failed to consider issues brought to this attention. He created a detailed review manual and the beneficial ownership declaration, and voluntarily added himself to the secondary review process for all stock deposits emanating from FFIs, including CSCT, so that those deposits would receive additional scrutiny. The statistics show that nearly half of the deposits coming from CSCT were rejected, thereby demonstrating the rigor of Mr. Cruz's review processes.

Moreover, the NAC disregarded the unequivocal command of FINRA's Sanction Guidelines that "[a]djudicators *must always* . . . consider appropriate aggravating *and mitigating factors* in determining remedial sanctions in each case."[157] None of the nine sentences purporting to justify imposing career-threatening sanctions on Mr. Cruz even alludes to a possibility of mitigation.[158] But several mitigating factors are present here, including the small number and scale

[156] NAC Decision at 103 (FINRA 010933).
[157] FINRA, *Sanction Guidelines* 4 (2018) (emphasis added) (General Principle 3).
[158] *See* NAC Decision at 103 (FINRA 010933).

of allegedly violative transactions,[159] the lack of any personal financial gain to Mr. Cruz, and Mr. Cruz's leading role in strengthening the firm's diligence policies and practices.[160] FINRA was bound by its own Sanction Guidelines to at least *consider* these factors, but failed to do so.[161] *See Paz Sec., Inc. v. SEC*, 494 F.3d 1059, 1065 (D.C. Cir. 2007) (vacating NASD sanctions affirmed by the Commission in part because the Commission failed to consider certain mitigating factors, including that the petitioners' violation "was of no potential monetary benefit to them" and "did not result in any injury to the investing public").

Even if the Commission were to incorrectly conclude that Mr. Cruz failed to reasonably exercise his responsibilities, the sanctions far outweigh any conceivable harm caused by his conduct. This is especially true given that he received absolutely no economic benefit from the

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[159] SCA earned only $38,000 in revenue from the subject sales, including both commissions and fees, representing 0.03 percent of the firm's revenue during the Relevant Period. RX-40 at 1 (FINRA 009255); Tr. 1871:13–24 (FINRA 004213).

[160] *See supra* section IV.

[161] The Hearing Panel also allowed the introduction of two irrelevant and highly prejudicial government enforcement actions that postdated the Relevant Period: *SEC v. Affa*, No. 14-cv-12959 (D. Mass. July 11, 2014) and *United States v. Bandfield*, No. 14–cr–00476 (E.D.N.Y. September 8, 2014). Neither of these cases involved any of the issuers of the stock in this matter or any of the broker-dealers or foreign financial institutions that are relevant here, although they do relate to some individuals that did business with some individuals and entities relevant to this case. Despite this, the Hearing Panel managed to reference the *Bandfield* indictment five times, somehow reasoning that the indictment made the "risky nature" of SCA's Rule 144 business "undeniable." Hearing Panel Decision at 14, 22, 24, 31, 33 (FINRA 010321, 010328, 010330, 010337, 010339). The Hearing Panel also referenced *Affa*, suggesting that this post-relevant-period case confirmed the risk of sham transactions and nominees. *Id.* at 14 (FINRA 010321). These indictments are not themselves probative of whether the charged conduct actually occurred, and are nothing more than improper "guilt by association" evidence. *See Mkt. Regulation Comm. v. Shaughnessy*, Compl. No. CMS9.50087, 1997 WL 1121341, at *7 (NBCC June 5, 1997) (indictments of others "did not constitute legal argument" and "were not material factual evidence, as they only indicated other prosecutors' legal theories"); *Dep 't of Enforcement v. Meckler*, Disciplinary Proceeding No. C01020003, 2002 WL 31862088, at *5 (OHO Sept. 24, 2002) ("Complaint allegations, without more, are not probative; if they were, Enforcement could rest on the allegations in its own Complaint."). Even though the NAC claims not to have considered these two cases, their admission to the Hearing Panel proceedings is a bell that cannot be unrung. NAC Decision at 76 n.162 (FINRA 010906). The Commission should consider the impropriety of this evidence when considering the draconian sanctions levied against Petitioners.

alleged conduct. Thus, the $50,000 fine and two-year suspension should be vacated or at least substantially reduced.

XI. CONCLUSION

Based on the NAC's several significant material errors, which include the use of post-hoc theories that were never previously alleged and that Petitioners never had an opportunity to defend against, and the willful disregard of unrefuted and compelling evidence presented by Petitioners, the Commission should reverse all of the NAC's findings of liability against Mr. Cruz and SCA. Alternatively, the Commission should vacate or significantly reduce the sanctions levied against Mr. Cruz and SCA, as the totality of the evidence makes it clear that the current sanctions are punitive in nature, and are fundamentally unfair.

Dated: October 5, 2018

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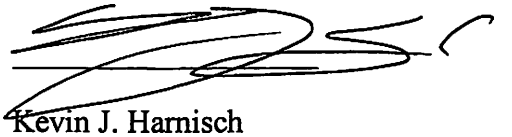
ATTORNEY CERTIFICATION

Pursuant to Rule 154(c) of the Commission's Rules of Practice, I hereby certify that foregoing document contains 13,418 words, exclusive of the tables of contents and authorities.



Kevin J. Harnisch

CERTIFICATE OF SERVICE

I hereby certify that on October 5, 2018, I caused the foregoing to be served by facsimile on the following:

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