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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

REPLY BRIEF FOR APPEAL OF DARREL MICHAEL CRUZ AND SCOTTSDALE CAPITAL ADVISORS CORPORATION

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INTRODUCTION

FINRA's only response to the litany of factual and legal errors infecting the NAC's decision is to parrot the very decision under review, often verbatim—typos, unsubstantiated assertions, misstatements of law, and all. But "because the NAC said so" is neither a valid legal theory nor cognizable evidence of a disputed fact. FINRA's cavalier approach to this appeal should cause the Commission grave concern given the enormity of the stakes for Petitioners.

Of even greater concern, however, is the undisputed fact that the NAC's decision to assess extraordinary sanctions on Michacl Cruz and SCA rests squarely on a theory that FINRA never advanced during the hearing or in any related pleadings. Specifically, the Hearing Panel and the NAC held that Rule 144 could not apply to the transactions at issue because the underlying notes, which Supreme Court precedent presumes to be securities, were not securities notwithstanding FINRA's outright failure to present any evidence or argument to rebut that presumption.

In addition, FINRA attempts to mischaracterize Cruz as an uncritical supervisor despite uncontroverted evidence that SCA routinely rejected deposits under Cruz's watch, including nearly half of CSCT's proposed deposits. FINRA strains to avoid the import of this evidencc by claiming that Cruz ignored "red flags" on deposits for three issuers. In the context of Rule 144, a "red flag" must be indicative of a public distribution of securities. FINRA's supposed "red flags," however, relate to simple typographical errors in certain documents and FINRA's *post hoc* criticism that other documents could have included additional detail. Far from bearing on the prospect of an unregistered distribution, these questions are no more than FINRA's unvarnished attempt to replace Cruz's reasoned business judgments with FINRA's baseless speculation.

ARGUMENT

I. The NHPI, VPLM, and ORFG Sales Were Exempt From Registration

The NAC grossly distorted both the law and the relevant facts. Application of the correct legal framework compels reversal.

A. FINRA Misunderstands Rule 144 and Section 4(a)(4)

While FINRA charges that Petitioners "misunderstand Rule 144, Section 4(a)(4) of the Securities Act, and the interplay between the two exemptions,"[1] FINRA's opposition confirms that it is FINRA that fails to grasp the nuances of the Securities Act—and further reinforces Congress's wisdom in trusting the Commission alone to police that statute.[2]

The plain text of Rule 144 confirms that it operates independently of the broker's exemption in Section 4(a)(4).[3] As explained in a leading treatise that FINRA cites repeatedly, the broker's exemption shields a broker from Section 5 liability ***even when the sale itself does not satisfy the objective elements of Rule 144***:

> Section 4(a)(4), without the support of Rule 144(g), continues to be important for a broker-dealer in those transactions where the person selling unregistered securities is unable to invoke the Rule .... Where a broker innocently executes a transaction for which Rule 144 is unavailable because the customer is actually engaged in a distribution, Section 4(a)(4) might still be available.

7B J. William Hicks, *Exempted Transactions Under the Securities Act of 1933*, at § 13:14 (2018 ed.).

FINRA next insists, incorrectly, that both Rule 144 and Section 4(a)(4) "require[] a searching inquiry into the circumstances surrounding the resale of restricted securities."[4] Contrary

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[1] Opp at 29–30,

[2] As detailed in Hurry's briefs, FINRA lacks authority over the Securities Act of 1933, including Section 5. *See* Hurry Reply Br. 15–20. Because the sanctions against Cruz and SCA are predicated exclusively on Section 5, this supplies an independent ground for reversal.

[3] *See* Cruz Br. 4–7.

[4] Opp. at 32.

to FINRA's repeated assertions, the term "searching inquiry" is found nowhere in Rule 144. *See* 17 C.F.R. § 230.144. Rather, as FINRA's own block quotation makes plain, a "searching inquiry" is necessary only "when the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters." Opp. at 32 (quoting *Midas Sec., LLC*, Exchange Act Release No. 66200, 2012 SEC LEXIS 199, at *31–32 n.42 (Jan. 20, 2012)). And, even then, the standard is always tempered by the element of reasonableness codified in Rule 144(g)(4). *See* 17 C.F.R. § 230.144(g)(4); *accord World Trade Fin. Corp. v. SEC*, 739 F.3d 1243, 1248 (9th Cir. 2014) (describing the contours of a "reasonable inquiry").

The NAC conflated these two distinct exemptions, leading it to impose an erroneously heightened standard of proof on Petitioners.[5]

B. The Sales Satisfied the Objectivc Elements of Rule 144

As detailed in Petitioners' briefing, the sales of NHPI, VPLM, and ORFG met the objective criteria of Rule 144.[6] None of the transactions traced to affiliates of the issuers; each of the depositors held the securities (or their predecessor instruments) for the requisite one-year period, including through permissible tacking; and the issuers wcrc not shell companies. FINRA identifies no record evidence disproving any of these factual premises and cites no legal authority contradicting Petitioners' analysis. Instead, FINRA insists that Petitioners failed to refute FINRA's own speculation. Of course, speculation is no substitute for evidence, and the Commission cannot fairly require Cruz to prove a negative on penalty of career-ending sanctions.

[5] FINRA 010893.
[6] Cruz Br. 10–14, 27–38.

1. None of the Relevant Parties Were Affiliates

With respect to Petitioners' resolution of the relevant parties' non-affiliate status, FINRA raises two meritless complaints. ***First***, FINRA criticizes SCA's beneficial ownership declarations and suggests that those declarations were the only means SCA used to evaluate affiliatc status.[7] The declarations, however, were but one part of SCA's diligence. As Cruz explained, the declarations represented "a start to the process."[8] SCA examined issuer filings, issuer websites, stock transfer company records, and attorney opinion letters, and confirmed that the information reported therein—including the names of each issuer's officers and directors, the number of shares of each issuer's stock issued and outstanding, and the individuals owning more than 10% of each issuer's stock—was consistent and revealed no connections between the beneficial owners and the issuers.[9] By no means did SCA and Cruz merely rely on the declarations.

FINRA's companion argument that SCA's beneficial ownership declarations are useless because they are "unsworn" cannot be taken seriously. FINRA offers no explanation of how or why any signer would behave differently if the declarations were sworn. And FINRA's critique rings even more hollow given that FinCEN subsequently endorsed the practice of using unsworn, unwitnessed beneficial ownership declarations. In other words, SCA and Cruz were ahead of the curve in designing and implementing this approach.

Tellingly, FINRA offers no substantive response on this front. FINRA only remarks that "FinCEN's rulemaking is not guidance from the Commission for compliance with Rule 144."[10]

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[7] Opp. at 44–45.
[8] Tr. 202:1–204:24 (FINRA 002540–42).
[9] *See* RX-1 at 1–2, 18–23, 37, 41–49, 78–79, 97–102, 119, 123–31, 158–59, 174–79, 182, 199–201 (FINRA 008411–12, 008428–33, 008447, 008451–59, 008488–89, 008507–12, 008529, 008533–41, 008568–69, 008584–89, 008592, 008609–11); RX-2 at 1–2, 19–21, 40–45, 60–66 (FINRA 008639–40, 008657–59, 008678–83, 008698–8704); RX-3 at 1–2, 24–26, 61–66, 71–75 (FINRA 008927–28, 008950–52, 008987–92, 08997–9001).
[10] Opp. at 44 n.40.

That is a distinction without a difference. The key takeaway of FinCEN's beneficial ownership rule is that the federal agency tasked with combatting money laundering and terrorist financing has approved the self-reporting of beneficial ownership in an unsworn, unwitnessed form. *See* 31 C.F.R. § 1010.230(b)(1) & app. A.[11] As the agency explained:

> FinCEN recognizes the necessity for permitting reliance on the identification supplied by the legal entity customer, considering the fact [that] the customer is generally the best source of this information, and that there is generally no other source of beneficial ownership information available to covered financial institutions, aside from the legal entity itself.

Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,398, 29,407 (May 11, 2016). This is no less true for Rule 144 compliance. Although FINRA asserts that FinCEN's form "provides far more information,"[12] it ignores a critical point: The information FinCEN requests (*e.g.*, name, address, and additional identifying details as appropriate)—and the information FINRA now demands (e.g., an explanation of how the beneficial owners came to own their shares)—is incorporated in SCA's diligence process and is found elsewhere in SCA's comprehensive due diligence packages.[13]

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[11] The regulation even authorizes financial institutions to "obtain[] from the individual the information required by the form [in appendix A] by another means, provided the individual certifies, to the best of the individual's knowledge, the accuracy of the information." 31 C.F.R. § 1010.230(b)(1).

[12] Opp. at 44 n.40

[13] *See* RX-1 at 1–2, 13, 16, 18–23, 31, 33, 37, 78–79, 86–87, 94, 97–102, 106, 117–18, 158–49, 168, 173–79, 182–83, 189, 195 (FINRA 008411-12, 008423, 008426, 008428–33, 008441, 08443, 08447, 08488–89, 008496–97, 008504, 008507–12, 008516, 008527–28, 008568–69, 008578, 008583–89, 08592–93, 008599, 008605); RX-2 at 1–2, 19–21, 23–25, 33–39, 40–45 (FINRA 008639–40, 008647–49, 008657–59, 008660–63, 008671–77, 008678–83); RX-3 at 1–2, 9–14, 17, 21–22, 24–26, 34, 36–45, 56–58, 61–66, 71–75 (FINRA 008927–28, 008935–40, 008943, 008947–48, 008950–53, 008960, 008962–71, 008983–85, 008987–92, 08997–9001). Several of the beneficial owners of the subject securities listed the same business address: 76 Dean Street in Belize City, Belize. FINRA declares this to be a "red flag" and dismisses Petitioners' commonsense explanation—the use of a common registered agent—as "unsubstantiated." Opp. at 39 & n.35. FINRA is wrong on both counts. FINRA never explains why the use of a registered agent is suspicious from a Rule 144 perspective, particularly when the beneficial owner resides in a less-developed nation like Belize; indeed, Enforcement's own witness, Craig D'Mura, testified

FINRA does not dispute that (1) the underlying instruments in the NHPI and ORFG transactions werc notes; (2) the Supreme Court's holding in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), mandates that all "notes" are presumed to be securities;[22] and (3) FINRA never made any argument whatsoever during the hearing to rebut the *Reves* presumption as to the NHPI and ORFG deposits.[23] The NAC's conclusion, therefore, that Petitioners "failed to prove" that the debt instruments to which the NHPI and ORFG shares traced were "securities" cannot stand.[24] To the contrary, foundational principles of evidence—not to mention basic fairness—compel a finding that the notes in question were "securities."[25]

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[22] FINRA repeats the NAC's misplaced reliance on "[t]he Exchange Act's clearly articulated presumption that notes of a duration shortcr than nine months do not constitute securities." Opp. at 51; *see also* FINRA 010898. In fact, the Supreme Court "express[ed] no view" on how the statutory exception for notes with a maturity of nine months or less "might affect the presumption that a note is a 'security.'" *Reves*, 494 U.S. at 65 n.3. The Court specifically declined to adopt the Second Circuit's formulation of the "family resemblance" test that so limited the presumption. *Id.* And rcccnt casc law interpreting *Reves* has faithfully applied the Court's broad formulation, extending the presumption to *all notes. See, e.g.*, *SEC v. Thompson*, 732 F.3d 1151, 1159 n.7 (10th Cir. 2013) (surveying post-*Reves* authority).

[23] *See* Opp. at 49–55.

[24] FINRA 010896. For the reasons detailed in Petitioners' opening brief, SCA established that the VPLM debt agreement constituted a security for purposes of tacking. *See* Cruz Br. 32–33. In fact, courts have observed that the convertibility feature of an instrument may obviate resort to the *Reves* test altogether. *See, e.g.*, *Solid Q Holdings, LLC v. Arenal Energy Corp.*, No. 2:15-cv-419-DN, 2018 WL 5268208, at *4 (D. Utah Oct. 23, 2018) ("[T]he convertibility feature of the instruments in this case may in effect eliminate the need to examine thesc instruments under the 'family resemblance' test . . . because, regardless of whether the instruments are within the term 'note' in § 3(a)(10), they are squarely within its terms 'option' and 'right to subscribe to or purchase' an interest in stock."); *Fletcher Int'l, Ltd. v. ION Geophysical Corp.*, No. 5109-VCP, 2010 WL 2173838, at *5 (Del. Ch. May 28, 2010) ("[S]ome courts have held convertible notes to be securities without any apparent examination under *Reves*.").

[25] In a transparent attempt to paper over Enforcement's failure of proof, the NAC held that, based on Enforcement's questions regarding the *VPLM* deposit, Respondents were "on notice" that they would need to present evidence establishing that the *NHPI* and *ORFG* notes were securities. *Id.* But those deposits involved different instruments—the VPLM deposit traced to a line of credit, while the NHPI and ORFG deposits traced to classic promissory notes—and *Reves* mandates a presumption that *all notes* are securities. It was Enforcement's burden to rebut that presumption, and it made no effort to do so. The *Reves* presumption therefore continues in full force, and the NAC committed reversible legal error in refusing to apply it.

Second, FINRA avers that, in the case of the VPLM deposit, SCA knew that Richard Kipping was the former CEO of VPLM yet did not consider that fact when examining the parties' non-affiliate status.[14] The record refutes FINRA's claim. While there is no dispute that VPLM publicly announced Kipping's resignation more than four years before the deposit, FINRA suggests that the Commission ignore that information because SCA did not print a copy of the press release and place it in its diligence file.[15] Leaving aside the absurdity of that position, the diligence package contains ample information confirming Kipping's non-affiliate status at the time of the deposit. For example, there are printouts from the Nevada Secretary of State website and OTCMarkets.com, both of which listed the company's current officers and directors,[16] an attorney opinion letter noting that Kipping "resigned as CEO [of VPLM] more than 2 years ago,"[17] and a signed letter from the Chairman and CEO of VPLM disavowing any affiliation between VPLM

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to the contrary, Tr. 2324:3–2325:14 (FINRA 004667–68), and 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). Further, Petitioners consistently testified that, to their knowledge and in their experience, 76 Dean Street was a common registered agent address in Belize City. *See, e.g.*, Tr. 541:24–542:2, 569:7–570:7 (Cruz) (FINRA 002880–81, 002908–09); Tr. 870:10–14, 993:24–994:12 (Diekmann) (FINRA 003209, 003332–33). Even Enforcement's own examiner testified that he knew 76 Dean Street to be a registered agent address. Tr. 2200:15–18 (Byrne) (FINRA 004542). And, in any event, Petitioners presented ample evidence that SCA obtained physical addresses for beneficial owners when appropriate, as in the case of the ORFG deposit. *See, e.g.*, Tr. 1708:14–1709:3, 1769:20–1770:25, 1776:14, 1780:19–21, 1821:19–25 (Diekmann) (FINRA 004049–50, 004110–11, 004117, 004121, 004163).

[14] Opp. at 46.

[15] Cruz also testified that SCA was aware of Kipping's resignation, Tr. 441 (FINRA 002779), and a simple Google search during the hearing located VPLM's own press release. Tr. 2855–56 (closing argument); *see also* Press Release, VoIP-Pal.com Announces Reseller Website Development (Nov. 11, 2009), *available at* http://markets.financialcontent.com/stocks/news/read/10740091/voip. The Commission may take official notice of the date of the release's issuance. *See* 17 C.F.R. § 201.323.

[16] RX-2 at 60–66 (FINRA 008698–8704).

[17] RX-2 at 20 (FINRA 008658).

and Kipping.[18] Clearly, there are a multitude of data points uniformly indicating that Kipping was not an affiliate of VPLM.

Undeterred, the Hearing Panel and the NAC relied on inadmissible evidence—a forensic audit report commissioned by VPLM in June 2014—to suggest that Kipping was an affiliate of VPLM despite his resignation.[19] Aside from the fact that his hearsay report postdated the deposit and therefore did not exist at the time of SCA's review, the report neither addressed whether Kipping was an affiliate nor questioned the existence of the rclcvant debt obligations.[20] Despite Petitioners' objection, however, the Hearing Panel admitted the report, and both the Panel and the NAC used the report to question SCA's ***earlier*** diligence.[21]

2. The One-Year Holding Periods Were Satisfied

The NAC held that the original notes underlying the subject deposits were not securities and therefore not subject to tacking dcspitc FINRA offering no evidence during the hearing to rebut the Supreme Court's mandatory presumption that all notes are securities. Indeed, FINRA never even ***alleged*** that the NHPI and ORFG notes were not securities—the Hearing Panel invented that theory long after the hearing had concluded.

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[18] RX-2 at 23–24 (FINRA 008661–62). As Petitioners pointed out to the NAC, there is no reason to believe that VPLM's Chairman and CEO, Thomas Sawyer, was beholden to Kipping or acting in concert with him to perpetrate a fraud; after the Relevant Period, Sawyer led a lawsuit against Kipping and Locksmith Financial, charging the defendants with enriching themselves at VPLM's expense. *See* FINRA 010174–75.

[19] FINRA 010052; FINRA 010901 n.151; *see* CX-292 at 1–30 (FINRA 008081–8110).

[20] *See* CX-292 at 2, 3–8 (FINRA 008082, 008083–88).

[21] Whcreas the Panel openly cited the report, the NAC silently endorsed it. The NAC noted that Kipping "had check-writing authority for VPLM's accounts," casting doubt on Locksmith's non-affiliate status for purposes of tacking. FINRA 010901 n.151. The NAC did not identify any source for this finding, but the forensic audit report constitutes the only record evidence of Kipping's alleged authority over VPLM's accounts. *See* FINRA 010052 (citing RX-292). Even then, the report did not conclude that Kipping knew VPLM had not removed him from its bank account or that Kipping ever attempted to write any checks after his resignation.

It is an elementary rule of evidence that "the party against whom a presumption is directed has the burden of producing evidence to rebut the presumption." Fed. R. Evid. 301. And that burden is not insubstantial: "Evidence presented to rebut a presumption must be sufficient to overcome a directed verdict." 1 Jack B. Weinstein & Margaret A. Berger, *Weinstein's Federal Evidence* § 301.02[2] (2d ed. 1997 & Supp. 2018).[26] FINRA apparently believes these basic evidentiary rules do not apply because Petitioners bore the burden of demonstrating the applicability of Rule 144 and/or Section 4(a)(4). Once again, FINRA baldly misstates the law. When, as here, an affirmative defense involves a presumption that operates against the plaintiff (i.e., FINRA), the plaintiff must offer evidence to rebut that presumption, even though the ultimate burden of persuasion with respect to the affirmative defense remains on the defendant (i.e., Petitioners). *See, e.g., ART+COM Innovationpool GmbH v. Google Inc.*, 155 F. Supp. 3d 489, 504 (D. Del. 2016) (while defendant bears the ultimate burden of persuasion on the affirmative defense of laches, a rebuttable presumption of laches arises from plaintiff's delay, and plaintiff must present evidence that its delay was reasonable or excusable to rebut that presumption).

"[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." *Thompson*, 732 F.3d at 1161–62. Because FINRA failed to present *any* evidence or argument rebutting the *Reves* presumption, that presumption remains intact and Petitioners are entitled to the resolution of that issue in their favor. *See, e.g., Officer v. Duran*, No. 12 C 10195, 2014 WL 5439782, 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"). This conclusion is uncontroversial and is fully in accord with the application of other presumptions in securities law.

[26] The Supreme Court has applied Rule 301 to analyze the effect of presumptions under the federal securities laws. *See Basic Inc. v. Levinson*, 485 U.S. 224, 245-46 (1988).

attorney opinion letters and determined, based on Petitioners' considerable experience with the microcap market, that the companies in question appeared to have bona fide operations.[34] That is enough for Rule 144. *See* 17 C.F.R. § 230.144(i).

FINRA's only response is to copy-and-paste the text of the NAC's decision, questioning the veracity and reliability of the issuers' financial reports—absent any evidence that those reports were inaccurate—and citing an ORFG Form 10-K filed two years ***after*** the Relevant Period.[35] FINRA takes the view that because NHPI and ORFG were struggling financially and had not turned profits, the companies must be shells. That position has no grounding in the law and reflects FINRA's deep-seated animosity toward the microcap market—even though that market plays a vital role in facilitating small and nascent companies' access to capital. FINRA cannot fairly assume that microcap companies that do not trade on the primary stock exchanges publish false financial statements and should be treated as presumptive shell companies.

C. FINRA Did Not Prove a "Scheme to Evade"

If the objective elements of Rule 144 are satisfied, a stock sale is permissible unless FINRA can prove that the sale was part of a scheme to evade the registration requirements of the federal securities laws.[36] The NAC, however, inverted the burden proof and sanctioned Petitioners because they did not prove the lack of a scheme to evade.[37] FINRA essentially concedes error on that point.[38] The NAC's ruling is indefensible and the decision must be reversed.[39]

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[34] *See id.*

[35] Opp. at 56–57.

[36] *See* Cruz Br. 25–27.

[37] FINRA 010904–05.

[38] Opp. at 59 n.55.

[39] Petitioners do not dispute that, as a general matter, once FINRA establishes a *prima facie* Section 5 violation, Petitioners then have the burden of proving the applicability of an exemption. *See, e.g.*, *World Trade*, 739 F.3d at 1247. However, Rule 144 creates a "safe harbor" from "underwriter" status, and the "scheme to evade" proviso sets forth an exception to that safe harbor. *See* 17 C.F.R. § 230.144 preliminary note. A party that successfully invokes the safe harbor cannot

See, e.g., *Banghart v. Hollywood Gen. P'Ship*, 902 F.2d 805, 808 (10th Cir. 1990) (plaintiffs "offered no evidence" to rebut the presumption that general partnership interests were not securities, and "[t]he absence of such evidence was fatal"); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 241–42 (4th Cir. 1988) (affirming summary judgment for defendants because plaintiffs did not present evidence sufficient to rebut the presumption that general partnership interests were not securities).

As for the remainder of FINRA's argument, FINRA relies principally on speculation as to the parties' intentions in drafting and negotiating the instruments and the expectations of the investing public.[27] But that is precisely the type of evidence that *Reves* directs the party opposing the designation of a note as a "security" to produce. *See Reves*, 494 U.S. at 65–69; *see also Thompson*, 732 F.3d at 1161–62; *Officer*, 2014 WL 5439782, at *4. And conjecture will not discharge that evidentiary burden. *See Rivanna Trawlers*, 840 F.2d at 241–42.[28]

Given that the NHPI and ORFG notes were presumptively securities, and the VPLM debt instrument constituted a security under federal law, Cruz Br. at 16, the application of tacking is straightforward. FINRA takes issue with only two aspects of SCA's tacking analysis: The addition of a conversion feature to the VPLM line of credit and the modification and assignment of the ORFG note.[29] Again FINRA refuses to engage with the Commission's precedents and the

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[27] *See* Opp. at 52–55. FINRA also misrepresents the governing legal principles. For instance, FINRA gives no weight to the interest rates in the NHPI and ORFG notes, despite the Court's explanation in *Reves* 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. Likewise, while FINRA repeatedly invokes the premise that a "single transaction . . . not offered to the public" cannot be a security, federal case law has long been clear that "[a] debt instrument may be distributed to but one investor, yet be a 'security.'" *Nat'l Bank of Yugoslavia v. Drexel Burnham Lambert, Inc.*, 768 F. Supp. 1010, 1015–16 (S.D.N.Y. 1991).

[28] In light of FINRA's limited authority to compel non-members—including, critically, issuers of securities and individual investors—to participate in its proceedings, the course of this matter showcases FINRA's unfitness to police the Securities Act.

[29] *See* Opp. at 52–55.

text of Rule 144, which together leave no doubt that the holding period was satisfied in all cases. Relevant to VPLM, thc introduction of convertibility after default has no effect on the holding period. *See, e.g.*, *Technimed Corp.*, SEC No-Action Letter (June 8, 1987), 1987 WL 108207 (where a party makes a loan to an issuer, thc issucr defaults, and the parties agree to add a conversion feature to the loan agreement, the holding period for shares acquired on conversion tacks to the date of the original loan). And relevant to ORFG, modifications to a note, including changes to the interest rate and conversion price, do not reset the holding period, provided that no additional cash consideration is paid to the issuer—as plainly was the case here.[30] *See, e.g.*, *Aztech Int'l*, SEC No-Action Lcttcr (May 31, 1988), 1988 WL 234415 (permitting tacking for note exchange that resulted in new maturity date and different conversion rate).[31]

The NAC's decision is irreconcilable with *Reves* and decades of federal case law, not to mention bedrock principles of evidence. And its tacking analysis conflicts with the text of Rule 144 and related Commission guidance. The Commission must reverse.

3. The Issuers Were Not Shell Companies

FINRA makes no meaningful effort to address the myriad of reasons detailed in Petitioners' opening brief as to why NHPI and ORFG were not shell companics,[32] including the Commission's own releases indicating that evidence of business operations, not success or profits, is dispositive.[33] For each issuer, SCA examined, among other things, public financial reports, issuer websites, and

[30] RX-3 at 21 (FINRA 008947) (ORFG's chair confirming that the parties "agreed to amend the terms of the Note for no additional consideration").

[31] Additionally, there is no dispute that the ORFG securities sold by SCA, which were beneficially owned by Anything Media, "were acquired from the issuer solely in exchange for other securities of the same issuer," 17 C.F.R. § 230.144(d)(3)(ii), namely, a portion of the ORFG note that originated in September 2012. That Anything Media obtained its interest in that note in exchange for stock in Anything Technologies Media in January 2014, sixteen months after the note was executed, has no bearing on the satisfaction of the one-year holding period.

[32] Not even the NAC could attach that label to VPLM. *See* FINRA 010902.

[33] *See* Cruz Br. at 23–24.

Moreover, in addition to proving a scheme to evade, FINRA also would have to prove that Petitioners were implicated in or aware of that scheme. The Commission made this clear when it added the "scheme to evade" language to the preliminary note to Rule 144 in 2007, explaining that, "[i]n view of the objectives and policies underlying the Act, the rule shall not be available to any individual or entity with respect to any transaction which, although in technical compliance with the provisions of the rule, is part of a plan ***by such individual or entity*** to distribute or redistribute securities to the public." Revisions to Rule 144 & Rule 145 to Shorten Holding Period for Affiliates and Non-Affiliates, 72 Fed. Reg. 36,822, 36,824 (July 5, 2007) (quoting Notice of Adoption of Rule 144, Securities Act Release No. 33-5223 (Jan. 11, 1972) (emphasis added)).

Case law is fully in accord, applying the scheme to evade exception only when the prosecution has adduced evidence that a scheme in fact exists ***and*** the respondent participated in or could be charged with knowledge of that scheme. *See, e.g.*, *SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1090 (9th Cir. 2010) (finding scheme to evade where former chair and CEO of issuer also controlled entity that transferred issuer's restricted shares to other corporate insiders, who then sold the shares to the public); *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 861 (S.D.N.Y. 1997) (Sotomayor, J.) (same, where defendant's "pre-litigation testimony revealed that Softpoint was not engaged in *bona fide* overseas transactions"), *aff'd*, 159 F.3d 1348 (2d Cir. 1998); *Robert G. Weeks*, Exchange Act Release No. 8313, 2004 WL 828, at *13 (Oct. 23, 2003) (same, where

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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. *Cf., e.g.*, *United States v. Green*, 962 F.2d 938, 943 (9th Cir. 1992) (statute creating exceptions to liability embodied burden-shifting scheme under which defendant bears the burden of "rais[ing] and establish[ing]" the exception, at which point "the burden shifts to the government to prove that the exception does not apply"); *Cal. Dep't of Toxic Substances Control v. Interstate Non-Ferrous Corp.*, 298 F. Supp. 2d 930, 967 (E.D. Cal. 2003) (under CERCLA, once the government makes out a *prima facie* case for strict liability, the burden shifts to the defendant to demonstrate an exemption, at which point "the burden shifts back to the government to prove [an] exception[] to the exemption").

"[t]he record demonstrates" that "nominees controlled by [the respondent] and his associates" were "used as conduits for the unregistered distribution of shares in the United States"). And federal courts have placed the burden squarely on the prosecution to present this kind of evidence at trial. *See, e.g.*, *SEC v. Autocorp Equities, Inc.*, 292 F. Supp. 2d 1310, 1329 (D. Utah 2003) (denying summary judgment against the defendant because "the SEC can only establish that [the defendant] was 'part of a plan' if he was aware of the larger fraud"); *SEC v. Parnes*, No. 01 CIV 0763 LLS THK, 2001 WL 1658275, at *7 (S.D.N.Y. Dec. 26, 2001) (denying motion to dismiss based on allegations that "defendants 'nominally placed' convertible debentures with Panamanian corporations, then effected unreported short sales in the United States in violation of securities regulations," but noting that "[w]hether the proof is sufficient to establish a scheme to evade registration requirements and preclude application of the exemption is a question for trial").

Not only has FINRA failed to prove any scheme to evade existed, but there is absolutely no evidence that Petitioners knew of any such scheme or agreed to participate in it. The NAC confirmed as much when it premised liability on SCA not affirmatively proving that it was ***not*** part of a scheme to evade.[40]

D. The Broker's Exemption Applied to the NHPI, VPLM, and ORFG Sales

The broker's exemption applies when, after performing "reasonable" due diligence, the broker-dealer concludes that the deposited securities may be sold. The diligence packets for each deposit here reflected the culmination of a long series of investigative steps, stretching from an examination of the underlying transaction documents to a review of issuer filings and an analysis of promotional activity. By mischaracterizing those steps as "mechanical" and "cursory,"[41] FINRA seeks to hold Petitioners to standards found nowhere in the law.

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[40] FINRA 010904.

[41] *See, e.g.*, Opp. at 34, 41

FINRA's case effectively erases the concept of "reasonableness" from the broker's exemption. The NAC questioned each miniscule detail of each deposit to transform each minor typographical error or each instance of sloppy draftsmanship by parties with limited resources into a "red flag" necessitating the equivalent of a forensic investigation.[42] Yet FINRA cannot reconcile its position here with its own regulatory guidance and administrative case law indicating both that "red flags" must be probative of a distribution, and that a broker's response to a "red flag" is properly informed by the factual context and the broker's industry experience.[43] Indeed, many of the purported "red flags" over which FINRA obsesses cannot possibly bear on the prospect of a distribution, as they post-date either the close of the one-year holding period (e.g., scrivener's errors in certain transactional documents) or the completion of SCA's diligence (e.g., post-deposit trading and money movement).[44] Rather than objectively assessing the evidence relevant to Rule 144, FINRA has sought at every turn to substitute its own hindsight-colored, subjective judgments as to whether *it* would have negotiated a loan under the circumstances or whether *it* could have drafted

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[42] FINRA continues that line of argument here, chastising Petitioners for typographical errors in their internet research and declaring every line of inquiry "inadequate" with no guiding principles. *E.g.*, Opp. at 39–40 & nn.34–38. FINRA is in no position to demand perfection. Its own summary exhibits were so riddled with errors that the Hearing Officer refused to admit them and instead ordered the parties to create new joint exhibits accurately reflecting the intended subject matter. *See generally* FINRA 004717–54; *see also* Tr. 2156–63, 2170–71, 2370–71 (FINRA 004498–4505, 004512–13, 004767–68). In addition, the Hearing Panel unilaterally withdrew its original decision to correct what it inaccurately portrayed as a "non-substantive" factual error. *See* FINRA 009985–87; FINRA 09999 n.1.

[43] *See* Cruz Br. 18–19 & nn.82–84.

[44] *See* Opp. at 77–78. Troublingly, the NAC raised a number of these "red flags" for the first time in its decision. For example, the NAC expressed concern that SCA "did not follow the funds" from the sales of NHPI, VPLM, and ORFG stock. FINRA 010847, 010861, 010873. The profound unfairness of the NAC's post-hearing criticism is only compounded by the fact that FINRA never charged Petitioners with maintaining an inadequate anti-money laundering system, and, as a result, the Hearing Officer ***excluded*** Petitioners' proposed evidence bearing on post-deposit trading, money movement, and suspicious activity reporting. *See* FINRA 02255–59, 02263–65, 02269–70; FINRA 02295–96, 02325–26.

clearer or more detailed agreements. A difference in business judgment does not transform something into a "red flag" that prevents an otherwise fully conforming sale from going forward.

Similarly, despite recognizing that "industry practice may help provide context for evaluating the contours of a searching inquiry," the NAC ignored evidence of industry practice altogether.[45] The NAC did not so much as acknowledge Menchel's expert testimony and accompanying expert report, which confirmed that SCA's diligence procedures met or exceeded industry standards.[46] To date, FINRA has not cited a single case where diligence akin to that performed by SCA was deemed "unreasonable." To the contrary, in every case on which FINRA has relied, the respondents have performed *no diligence at all* or, at most, have rested entirely on the lack of a restrictive legend and/or transfer agent approval.[47]

Affirming the NAC's decision would set an unprecedented standard of liability and would communicate to the securities industry that, despite its framing as a "reasonable inquiry," Section 4(a)(4) demands what amounts to a full forensic examination. The Section 5 charge must fail.

II. <u>Cruz Acted Reasonably</u>

The NAC found Cruz's supervision deficient in two narrow respects—the analysis of tacking and the investigation of purported "red flags"—and, as Cruz's opening brief demonstrated, neither finding withstands scrutiny.[48] In opposition, FINRA again does no more than import the text of the NAC's decision directly into its brief.[49] This properly is treated as a waiver of any responsive arguments. *See* 17 C.F.R. § 201.450(b); *David J. Montanino*, SEC Release No. 773,

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[45] FINRA 010889 (citing *World Trade*, 739 F.3d at 1248–49).
[46] Tr. 2413–19, 2423 (FINRA 004810–16, 004820); RX-38 at 7–14 (FINRA 009239–46).
[47] *See World Trade*, 739 F.3d at 1247, 1250 (petitioners conducted no inquiry); *ACAP Fin., Inc.*, Exchange Act Release No. 70046, 2013 WL 3864512, at *9–10 (July 26, 2013) (petitioners relied entirely on clearing firm and absence of restrictive legend); *Midas*, 2012 WL 169138, at *8, *10 (same).
[48] Cruz Br. 14–25.
[49] Opp. at 76–79.

2015 WL 1732106, at *35 n.40 (holding that the Division of Enforcement waived arguments by neither raising them in its brief nor presenting evidence at the hearing).[50]

The Commission has long recognized that the question of "[w]hether supervision is 'reasonable' [under FINRA rules] depends on the particular circumstances of each case." *Wedbush Sec., Inc.*, Exchange Act Release No. 78568, 2016 WL 4258143, at *6 (Aug. 12, 2016). "The burden is on the staff to show that the respondent's procedures and conduct were not reasonable. It is not enough to demonstrate that an individual is less than a model supervisor or that the supervision could have been better." *Dist. Bus. Conduct Comm. for Dist. No. 7 v. Lobb*, 2000 WL 1299576, at *5 (NASD NAC Apr. 6, 2000) (citing *Arthur James Huff*, 50 S.E.C. 524 (1991); *Louis R. Trujillo*, 49 S.E.C. 1106 (1989); *Wedbush Sec., Inc.*, 48 S.E.C. 963 (1988)). FINRA cannot simply cite others' misdeeds. *See Dep't of Mkt. Regulation v. Leighton*, 2010 WL 781457, at *44–48 (FINRA NAC Mar. 3, 2010) (reversing supervisory violation "informed by injudicious views of [a primary wrongdoer's] conduct" and "perched largely upon the bald assertion that 'high profit[s] are an indicium of wrongdoing'"). Nor can FINRA hide behind the vague concept of "red flags," absent evidence both that there was some indication of irregularity and that the supervisor unreasonably failed to respond. *See id.* at *48–50 (reversing supervisory violation in part because "there were no red flags for [the respondent] to address" and in part because the respondent reacted "promptly and appropriately" to concerns); *Dep't of Enforcement*

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[50] FINRA defends the NAC's holding that a table in RX-40 showing SCA's rejection rate of ***nearly 50% of CSCT deposits*** was "not reliable" because there was "no explanation concerning how Henry Diekmann . . . compiled it." Opp. at 80. FINRA neglects to mention, however, that the exhibit was admitted into evidence without objection and that Diekmann testified that he prepared the exhibit using SCA's books and records. Further, neither Enforcement nor the members of the Panel raised any questions about the table at the hearing, even as both Enforcement and the Panel questioned Diekmann about ***other parts*** of RX-40. *See* Tr. 1868:20–1874:3, 1910:21–1911:19 (FINRA 004210–16, FINRA 004252–53). This is, therefore, uncontroverted quantitative evidence that Cruz was no mere rubber stamp.

v. Jennings, 2013 WL 2146654, at *18–19 (FINRA OHO Mar. 4, 2013) (finding supervision to be reasonable and dismissing supervisory charge where Enforcement failed to prove that the circumstances "constituted a red flag of possible misconduct that Respondent 3 was obliged to investigate and stop").

FINRA has not pointed to a single case even remotely like this one, where a supervisor has discharged his duties in good faith, drawing on his experience and business judgment, and no evidence has emerged to refute any of his conclusions. FINRA's speculation as to the possibility of contrary facts does not render Cruz's business judgments unreasonable. *See Thaddeus J. North*, Exchange Act Release No. 84500, 2018 WL 5433114, at *9 (Oct. 29, 2018) (explaining that, "in general, good faith judgments . . . made after reasonable inquiry and analysis should not be second guessed," and "indicia of good faith . . . are important factors in assessing reasonableness, fairness and equity").

III. <u>FINRA's Sanctions Are Excessive</u>

The sanctions against Cruz are far out of proportion to any personal benefit—he received none—and any demonstrable harm to the investing public.[51] Furthermore, FINRA failed to adhere to its own Sanction Guidelines by foregoing any consideration of mitigating factors.[52] This calls for vacatur. *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 mitigating factors); *see also ACAP Fin., Inc. v. SEC*, 783 F.3d 763, 767 (10th Cir. 2013) (Gorsuch, J.) ("[A]n agency's unexplained failure to consult its own decisional guidelines can be the makings of a claim of arbitrary decisionmaking and the basis for reversal."). Under the totality of the

[51] The sanctions imposed against Cruz and SCA are greater than in other cases involving more extensive findings of misconduct. *See* Respondents' NAC Opening Br. at 72, n.312 (FINRA 010211).
[52] Cruz Br. 40–42.

circumstances, a two-year suspension—which is punitive per se—and a $50,000 fine cannot rationally be considered remedial.[53]

SCA is similarly situated. Although SCA earned only $38,000 in revenues from the deposits at issue,[54] the NAC imposed a fine of $1.5 million—$250,000 for each of the deposits and $250,000 for the supervisory violation.[55] Not only is this wildly disproportionate, but it far exceeds SCA's net capital and would likely drive the firm out of business.[56] Further, FINRA's own purported justification for the sanctions sounds in deterrence,[57] rendering the sanctions "inherently punitive" and therefore suspect under *Kokesh*. *See* 137 S. Ct. at 1643.

CONCLUSION

For the foregoing reasons, Petitioners respectfully request that the Commission vacate FINRA's findings of liability against Cruz and SCA, and either vacate or substantially reduce the corresponding sanctions.

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[53] In *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), the Supreme Court ruled that sanctions imposed for deterrence arc necessarily punitive because deterrence is not a legitimate non-punitive governmental objective. *Id.* at 1643. As now-Justice Kavanagh has explained, the logical import of *Kokesh* is that suspensions, which serve only a deterrent purpose, are inherently punitive. *Saad v. SEC*, 873 F.3d 297, 305 (D.C. Cir. 2017) (Kavanagh, J. concurring). Accordingly, administrative and judicial "precedents characterizing expulsions or suspensions as remedial are no longer good law," and FINRA must "reasonably explain . . . why an expulsion or suspension serves the purposes of punishment and is not excessive or oppressive." *Id.* at 306. The NAC did nothing of the sort. To the contrary, it only mischaracterized Cruz's actions and the quality of his supervision, without any effort to justify a sanction so far in excess of FINRA's guidelines. *See* FINRA 010933.

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

[55] FINRA 010934.

[56] *See* FINRA 005323–46, 005347–78 (reflecting net capital of less than $400,000 and excess net capital of less than $300,000).

[57] *See* FINRA 010928 ("[W]e find that significant sanctions are required to remind Scottsdale Capital Advisors, and other similarly situated Firms acting in risky areas such as microcap deposits and liquidations, of their compliance obligations in this area.").

Dated: November 30, 2018

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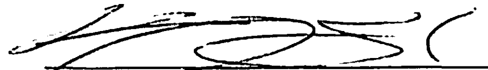
ATTORNEY CERTIFICATION

Pursuant to Rule 154(c) of the Commission's Rules of Practice, I hereby certify that the foregoing document contains 6,999 words, exclusive of the tables of contents and authorities.



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CERTIFICATE OF SERVICE

I hereby certify that on November 30, 2018, I caused the foregoing to be served via courier on the following:

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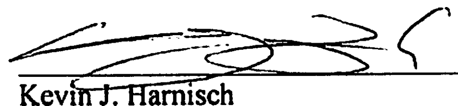
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