SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 90759 / December 21, 2020

Admin. Proc. File No. 3-18895

In the Matter of the Application of

WILLIAM H. MURPHY & CO., INC.

and

WILLIAM H. MURPHY

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION — REVIEW OF DISCIPLINARY PROCEEDING

Registered securities association found that member firm engaged in the unregistered sale of securities when no exemption from the registration requirements applied. Association also found that firm and its president failed to have a supervisory system, including written procedures, reasonably designed to ensure compliance with restrictions on the unregistered offer or sale of securities. *Held*, association's findings of violations are *sustained*, the sanctions imposed are *modified*, and the proceeding is *remanded*.

APPEARANCES:

Dawn R. Meade, *Ashley M. Spencer*, and *Bonnie Spencer of The Spencer Law Firm* for William H. Murphy & Co., Inc., and William H. Murphy.

Alan Lawhead, Jennifer Brooks, and *Lisa Jones Toms* for FINRA.

Appeal filed: November 9, 2018
Last brief received: March 6, 2019

William H. Murphy & Co., Inc. ("WHM"), a former FINRA member, and William H. Murphy, the firm's former president and chief compliance officer (together, "Applicants"), seek review of FINRA disciplinary action.[1] FINRA found that, between March 2011 and January 2013, WHM participated in the unregistered sale of $1,031,700 in securities for which no exemption from the registration requirements applied. The securities were interests in three pooled real estate private investment offerings that sought to acquire multi-family apartment properties, renovate them, increase their occupancies, and improve their valuations.

FINRA found that WHM's conduct violated the registration requirements of Section 5 of the Securities Act of 1933 and, as a result, FINRA Rule 2010's prohibition on conduct that is inconsistent with "just and equitable principles of trade." FINRA further found that Applicants failed to establish and maintain a supervisory system, including written supervisory procedures ("WSPs"), reasonably designed to ensure compliance with restrictions on the unregistered offer or sale of securities, in violation of FINRA Rule 2010 and NASD Rule 3010.

For the Section 5 violations, FINRA ordered that WHM disgorge $23,230.05 and pay a fine of $50,000. For the supervisory violations, FINRA fined Applicants $50,000 jointly and severally. FINRA also suspended Murphy from associating with any FINRA member firm in all capacities for six months and required him to requalify by examination before reentering the industry in any capacity requiring qualification. Applicants contest liability and the sanctions imposed. We sustain the findings of violations but modify the sanctions and remand to FINRA.

I. Background

A. WHM established a relationship with LREA to promote offerings by the Funds.

This proceeding involves WHM's sale of the securities of a group of entities collectively known as Guardian.[2] Trey Stone founded and controlled Guardian and was its CEO. In 2010, Stone and another Guardian executive formed Liberty Real Estate Advisors ("LREA"). Stone was LREA's CEO for the majority of its existence and was always its financial backer. LREA shared employees, including some executives, with Guardian. An early business plan for LREA provided that it was to be Guardian's "captive broker-dealer" for the purpose of "introducing pre-qualified and suitable clients to" Guardian offerings "as well as to provide education services to persons interested in investing in real estate in Texas." But Guardian's effort to establish

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[1] In the summer of 2018, WHM voluntarily terminated its FINRA membership and Murphy's registrations. Murphy is currently not associated with a FINRA member. Murphy's liability stems from his role as the firm's former president and is not predicated on his responsibilities as the firm's former chief compliance officer.

[2] This group of entities included Guardian Equity Management, LLC, Guardian Equity Investor and Issuer Servicing, LLC, and Guardian Equity Services, LLC, as well as various other affiliated entities, many of which had "Guardian" in their names. The employees of the closely affiliated entities appear to have referred to them collectively as "Guardian."

LREA as a FINRA member was unsuccessful—LREA applied to be a FINRA member in 2010, but FINRA provided negative feedback on the application and the application was withdrawn.

In early 2011, Dan LeGaye, WHM's longtime outside securities lawyer, introduced WHM to Guardian and LREA. On LeGaye's advice, LREA became a WHM office of supervisory jurisdiction ("OSJ").[3] Beginning in June 2011, Guardian engaged WHM as the exclusive agent for sales of interests in three private funds ("Funds") it would soon launch. The OSJ agreement between LREA and WHM provided that WHM would "sponsor certain [LREA] employees who [were] eligible to be FINRA Registered Representatives to market and distribute" the Funds. Concurrent with the OSJ agreement, WHM and LREA also executed a "Joint Client Services" agreement ("JCS Agreement") under which WHM and LREA would "consult jointly" on structuring and preparing offering documentation and would work together on "securities activities" through the WHM-associated LREA employees.

LeGaye advised Applicants on their relationship with LREA and Guardian. He counseled that LREA's efforts to promote the Funds to the public would not constitute "offers" under the Securities Act so long as they did not specifically refer to the Funds and satisfied certain other conditions. LeGaye instructed Applicants to make LREA a WHM OSJ to "increase[] the supervision"; review and approve LREA seminar scripts and other communications "so that [LREA personnel] didn't inadvertently say something they shouldn't"; and require "thirty days for a cooling off period so that that would sort of break the chain of public solicitation" and a "waiting" period of at least thirty days between establishing a substantive relationship with a prospective investor and a sale of an interest in the Funds.[4]

LeGaye held himself out as a securities law expert, and Applicants had clean regulatory records over the many years during which they regularly consulted and relied on LeGaye's advice. LeGaye's firm took the lead on designing and drafting Murphy's WSPs, and Murphy expected LeGaye and his firm to keep WHM's WSPs updated and current.

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[3] An OSJ is "any office" of a FINRA member firm "at which any one or more of the following functions take place: (A) order execution or market making; (B) structuring of public offerings or private placements; (C) maintaining custody of customers' funds or securities; (D) final acceptance (approval) of new accounts on behalf of the member; (E) review and endorsement of customer orders . . . ; (F) final approval of retail communications for use by persons associated with the member, ...except for an office that solely conducts final approval of research reports; or (G) responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member." FINRA Rule 3110(f)(1); *see also* NASD Rule 3010(g) (outdated rule providing similar definition).

[4] LeGaye testified that he based his advice about a 30-day cooling off period on no-action letters issued by the Commission's staff. As discussed below, those no-action letters do not stand for the proposition that an exemption from registration is available so long as sales occur more than 30 days after an offer of securities is made. *See infra* Section II.A.1.b.

1. Two LREA employees became WHM registered representatives and engaged in promotional efforts that led to investments in the Funds.

Pursuant to the OSJ agreement, two LREA employees, Mindy Price and Mark Hutton, became associated with WHM as registered representatives. Price had no prior securities experience and Hutton, who was LREA's compliance officer, had worked in the securities industry for over two decades but had limited experience with private placements. Price and Hutton produced and/or hosted various promotional radio shows, in-person workshops, and other public communications extolling the benefits of real estate investing generally and, in particular, of passive investments in Houston-area apartment complexes.

To the extent potential investors responded favorably to LREA's promotional efforts, they could choose to meet one-on-one with Price or Hutton who would assess their financial situation and whether they were qualified to invest in the Funds. Qualified investors were then asked to complete WHM new account applications, which Murphy reviewed and approved. After Murphy accepted a new customer account, Price or Hutton referred the WHM customer to Guardian so that a Guardian employee could pitch an investment in the Funds, including by providing offering materials such as the Funds' Private Placement Memorandums ("PPMs").

The first of the Funds was the 2011 Guardian Equity Fund, designed to raise up to $10 million with a minimum investor purchase of $20,000 and whose offering opened in June 2011 and closed in January 2012. The second was the 2012 Multi-Family Release Estate Fund II, designed to raise up to $20 million with a minimum investor purchase of $10,000 and whose offering opened in May 2012 and closed in January 2013. The third was the 2012 Multi-Family Real Estate Fund III designed to raise up to $10 million with a minimum investor purchase of $10,000 and whose offering opened in September 2012 and closed in September 2013.

Applicants described the Funds as "Texas limited liability companies that issued exempt securities." According to the Funds' PPMs, each Fund was "formed to acquire multifamily apartment properties" in the Houston area "with the objective to renovate the properties as needed and try to improve the resident profile and/or occupancy." Each PPM also provided that Stone was the president of the Fund; that the Fund was "affiliated with" LREA, Hutton, and Price; and that LREA was an OSJ of WHM. In the PPMs and in "Notices of Exempt Offering of Securities" filed with the Texas State Securities Board on SEC Form D, the Funds claimed exemption from the Securities Act registration requirements based on Section 4(2) of the Securities Act and Rule 506 of Regulation D under the Securities Act.

Between June 2011 and January 2013, some individuals who attended LREA workshops expressed an interest in meeting with Price and Hutton about investment opportunities. Twenty-three workshop attendees ultimately became WHM customers and purchased a total of $1,031,700 in interests in the Funds. None had a relationship with WHM prior to attending LREA events, and WHM never sold any securities other than interests in the Funds to WHM customers introduced to the firm through the LREA OSJ. For WHM's sales of the Funds, the Funds, pursuant to the PPMs, paid WHM 1% commissions for a total of $23,230.05. During this period, WHM also received $54,980.86 in payments from LREA for the compliance and supervisory services it provided under the OSJ agreement.

2. Applicants did not adequately supervise LREA.

At the hearing, Murphy testified that it "bothered" him that Price and Hutton would both be doing radio shows and workshops on LREA's behalf while also acting as registered representatives of WHM. He acknowledged that Price and Hutton in effect "served two masters" by having educational duties and then also trying to qualify customers to go to Guardian for information on the Funds. Nonetheless, Applicants provided only limited supervision of LREA.

Despite Murphy's awareness that Hutton had little experience with private placements, Murphy assigned Hutton registered principal duties pursuant to LREA's status as an OSJ. Murphy also gave Hutton little guidance on how to carry out those duties, including how to monitor Price's meetings with prospective investors. Hutton did not take steps to ensure that investors were not offered the Funds' securities before they had established a substantive relationship with WHM. When asked at the hearing "what supervisory steps" he took "to ensure that customers that [he] or [Price] referred over to [Guardian] were not introduced to offerings that were open at the time their relationship with [WHM] began," Hutton hesitated to name any steps and described his and Price's role as to "introduce" customers who came through LREA's workshops to Guardian.

WHM also did not revise its WSPs until several months after the OSJ agreement was executed. Once it did, the WSPs merely referenced LREA's status within the firm as an OSJ and designated WHM personnel, including Murphy, as responsible for the OSJ's supervision. WHM's procedures never provided any guidance about how LREA and WHM would ensure availability of the Rule 506 exemption on which the Funds' offerings depended. And although the WSPs stated that "no general solicitation" of "the securities of any issuer in a private placement offering" should occur, they did not explain what type of language used in a public setting or publication might constitute a general solicitation. Nor did Murphy or anyone else at WHM provide written or verbal guidance to Price and Hutton regarding the requirements for a Rule 506 exemption, other than to warn them that they should not mention the name of a specific security as part of LREA's promotional efforts.

Although not required by WHM's WSPs, the OSJ agreement between WHM and LREA also required that Murphy pre-approve "all [LREA] marketing, advertising or sales documents and materials." But other than Murphy's hearing testimony, the record lacks evidence regarding the extent of his review of LREA radio show, radio advertisement, workshop, and website content. Applicants did not identify LREA's final and approved communications, including workshop scripts, or produce to FINRA, as it requested, an advertising file containing final and approved scripts and outlines for LREA's public communications.

Applicants conducted no annual review of the OSJ in 2011, although the WSPs provided that WHM must examine OSJs annually. And while Murphy testified that Applicants did conduct a review in 2012, it was not documented. Except for one introductory workshop that Murphy attended in 2011, Murphy did not attend or monitor LREA's workshops.

B. LREA's public communications generated interest in the Funds' offerings.

LREA engaged in public outreach just before and through the periods when the first two Funds were being offered and just before and through some of the period when the third Fund was being offered. Throughout those periods, LREA did not charge for its services and was funded entirely by Guardian. Although LREA did not provide investors with the Funds' PPMs, other offering materials, or otherwise reference the Funds' offerings as part of their promotional efforts, Hutton conceded that LREA's efforts were in part designed to generate interest in passive investing in multifamily real estate. LREA promoted such investing through radio shows, radio advertisements, in-person workshops, property tours, case studies on real estate transactions, webinars posted to LREA's website, and copies of the radio shows posted to LREA's website and available for download as podcasts. LREA's radio shows and ads during this period typically included the statement "[s]ecurities sold through William H. Murphy & Company, Incorporated, a registered broker-dealer, member FINRA/SIPC."

LREA's radio shows were aired to the general public beginning in March 2011 and focused on real estate as an investment vehicle. For example, in a March 2011 radio show, Price told listeners about a type of investment they "might not hear about every day: apartment complexes" and explained that a "private placement . . . is generally an offering that is available to . . . a select group of individuals that meet certain criteria." Price then said that investing passively in multi-family real estate through a private placement was something that the listener could do and that the listener could get started by registering for an LREA workshop "at whybuyapartments.com." In a November 2011 show, Price told listeners "why [they] should consider apartment complexes in [their] investment portfolio(s)."

A February 2012 show, in which Stone was introduced as LREA's president, touted apartment complexes as potentially lucrative investments because improving apartment properties could "increas[e] the value" "for the shareholders." During that show, Price specifically discussed her own investment in a "deal," which was an investment in the Guardian Equity Fund, and stated that she was "absolutely loving" the passive investment experience, expected a financial benefit, and was seeking out another private placement after years of being only on the operations (non-investor) side of multi-family real estate transactions. She added:

> I made a lot of people money when I was the operations side. I would go into deals that were distressed and were down and beat up and go in fix all the issues . . . so that they could try and make some type of profit to keep their investors happy. And I just have to say it's about time that I've got my own deal now. . . . And I'm going after my next one right now. . . . There are so many reasons I went into the deal . . . . Our number to call to get registered is [redacted]. If somebody wants to go on the educational property tour that we have, it's going on this week. They want to get signed up for one of our workshops. But then when we come back I'll talk a little bit about what got me so excited about this deal.

The "property tour" Price referenced was an LREA-sponsored tour of an apartment complex being redeveloped by the Guardian Equity Fund.

In late 2012, LREA posted a video about a "multi-family apartment complex" to its website. It featured Bryan Upton, a Guardian executive listed as a "promoter" of two of the Funds in Forms D. In this video, Upton discussed the potential benefit of buying a distressed 100-unit apartment complex and improving the property and its occupancy rate, noting that "[w]hat you want to do is . . . stabilize the property and then sell it; and that's how we make money in the apartment business." Asserting the possibility of a 100 percent return on investment in three years, Upton commented that "[t]hat's why we like apartment complexes."

The radio ads echoed these favorable claims about investments in apartment complexes, stating "investors are making money . . . by recogniz[ing] undervalued apartment complexes" and "conservative investors," rather than investing in exchange-traded funds, "are looking at income-producing assets like apartment complexes that they can see and touch." The ads encouraged investors to attend LREA's workshops on "investing in multi-family apartment complexes" where "we discuss how multi-family deals are structured" and "ways real estate can potentially make you money." In-person workshops similarly touted the prospective benefits of passive real estate investing, noting that LREA is "focus[ed] on educating the public on an alternative to your traditional 401(k) and IRA investments like stocks, bonds, and mutual funds" and on "multi-family housing," potentially "eliminat[ing] the need for" a 401(k) or IRA.

By late 2012, LREA told its customers that while it was in the business of "provid[ing] free education," it had "an affiliate company that offers multi-family opportunities for those who are deemed suitable." LREA also told prospective investors that "to learn more" they could "see any of our [LREA] employees to set up a time to discuss further."

C. FINRA found that Applicants violated the securities laws and FINRA rules.

FINRA's Department of Enforcement filed a complaint alleging that WHM violated FINRA Rule 2010 "by engaging in unregistered sales . . . in contravention of Section 5 of the Securities Act," and that Applicants failed to reasonably supervise the unregistered sale of securities in violation of FINRA Rule 2010 and NASD Rule 3010.

An extended hearing panel ("Hearing Panel")[5] found that WHM sold securities when the offerings were neither registered nor qualified for an exemption from registration in violation of FINRA Rule 2010, and that Applicants, in violation of FINRA Rule 2010 and NASD Rule 3010, failed to establish and maintain a supervisory system, including written WSPs, reasonably designed to ensure compliance with Securities Act Section 5. The Hearing Panel imposed a fine of $50,000 and disgorgement of $78,210.91 on WHM for selling unregistered securities that did not qualify for an exemption from registration. For the inadequate supervision of the unregistered offerings, the NAC imposed a fine of $50,000 on WHM and a fine of $50,000 on

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[5] FINRA Rule 9231(a) provides for the appointment of "a Hearing Panel or an Extended Hearing Panel to conduct the disciplinary proceeding and issue a decision." FINRA Rule 9231(a). A matter "shall be designated an Extended Hearing, and . . . shall be considered by an Extended Hearing Panel," upon "consideration of the complexity of the issues involved, the probable length of the hearing, or other factors." FINRA Rule 9231(c).

Murphy, and suspended Murphy for six months with a requirement of requalification by examination before reentering the securities industry in any capacity.

Applicants appealed to FINRA's National Adjudicatory Council ("NAC"), which sustained the Hearing Panel's findings of violations. The NAC modified the sanctions, imposing a fine of $50,000 and disgorgement of $23,230.05 on WHM for selling unregistered securities that did not qualify for an exemption from registration. For inadequate supervision of the unregistered offerings, the NAC imposed a fine of $50,000 on Applicants jointly and severally and suspended Murphy for six months with a requirement of requalification by examination before reentering the securities industry in any capacity. This appeal followed.

II. Analysis

In reviewing FINRA disciplinary action under Section 19(e) of the Securities Exchange Act of 1934, we must determine whether Applicants engaged in the conduct that FINRA found, whether such conduct violated FINRA's rules, and whether those rules are, and were applied in a manner, consistent with the purposes of the Exchange Act.[6] We base our findings on an independent review of the record, applying a preponderance of the evidence standard.[7] As explained below, we find that the requisite Exchange Act elements have been met here and therefore decline to set aside FINRA's findings of liability.

A. WHM acted inconsistently with just and equitable principles of trade by offering and selling interests in the Funds when no registration statement was filed or in effect and no exemption from registration was available.

1. WHM violated Securities Act Section 5 by offering and selling interests in the Funds when no registration statement for their offer or sale was filed or in effect and no exemption from registration was available.

Securities Act Section 5 prohibits the offer to sell any security by means or instruments of interstate commerce "unless a registration statement has been filed as to such security" and the sale of any security by means or instruments of interstate commerce "unless a registration statement is in effect."'[8] Section 5 imposes strict liability on those who offer or sell securities in unregistered offerings without an exemption from registration.[9] FINRA's Department of

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6 15 U.S.C. § 78s(e)(1).

7 *See Rani T. Jarkas*, Exchange Act Release No. 77503, 2016 WL 1272876, at *4 (Apr. 1, 2016); *Richard G. Cody*, Exchange Act Release No. 64565, 2011 WL 2098202, at *1, 9 (May 27, 2011) (citing *Seaton v. SEC*, 670 F.2d 309, 311 (D.C. Cir. 1982) (upholding preponderance of evidence standard in FINRA disciplinary proceeding)), *aff'd*, 693 F.3d 251 (1st Cir. 2012).

8 15 U.S.C. § 77e(a), (c).

9 *SEC v. Calvo*, 378 F.3d 1211, 1215 (11th Cir. 2004). Securities Act Section 5 liability attaches to those who "have a 'significant role' in an unregistered sale, *i.e.*, if a person is a 'necessary participant' and a 'substantial factor' in the unregistered sale." *Ronald S. Bloomfield*, Exchange Act Release No. 71632, 2014 WL 768828, at *9 n.45 (Feb. 27, 2014) (citations

Enforcement made a prima facie showing that WHM violated Section 5 by presenting evidence that WHM offered to sell and sold securities by means or instruments of interstate commerce when no registration statement was filed or in effect for those securities.[10]

Upon the establishment of a prima facie case of a Section 5 violation, the burden shifted to WHM to show that the offers and sales at issue were exempt from the registration requirements.[11] Exemptions from registration are strictly construed "to promote full disclosure of information for the protection of the investing public."[12] Because "public policy strongly supports registration," the burden of proof rests with the party claiming the exemption.[13]

WHM claims that the offers and sales of the Funds were exempt from registration under Rule 506 of Regulation D. At the time of the offers and sales at issue here, that exemption required "that neither the issuer nor any person acting on its behalf offered or sold the securities by general solicitation or general advertising, that the securities were sold to no more than 35 purchasers who were not accredited investors, and that those purchasers who were not accredited investors met certain criteria regarding knowledge and experience."[14] Because we find that the

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omitted), *aff'd*, 649 F. App'x 546 (9th Cir. 2016). WHM was a necessary participant and substantial factor for purposes of primary liability under Securities Act Section 5 because it played an indispensable role in brokering the transactions at issue. *See id*. (finding individuals who "played an indispensable role in brokering the transaction at issue" liable under Section 5).

10 *SEC v. Big Apple Consulting USA, Inc*., 783 F.3d 786, 806-07 (11th Cir. 2015); *SEC v. Cont'l Tobacco Co. of South Carolina, Inc.*, 463 F.2d 137, 155 (5th Cir. 1972). The record demonstrates, and WHM does not dispute, that the interests in the Funds were securities because they constituted "investment contracts." *See* 15 U.S.C. §77b(a)(1) (defining "security" to include "any . . . investment contract"); *Kenny Akindemowo*, Exchange Act Release No. 79007, 2016 WL 5571625, at *5 (Sept. 30, 2016) (defining "investment contract" as a "'scheme whereby a person invests his or her money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.'") (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946)). The record also establishes, and WHM does not dispute, that the offers and sales at issue involved interstate commerce because WHM and its customers used email and telephones in connection with the offers and sales. *See, e.g., SEC v. Blackburn*, 431 F. Supp. 3d 774, 803 (E.D. La. 2019) (stating that the "jurisdictional nexus can be met simply by showing that the means of interstate commerce—telephones, e-mail, and the mail—were used to communicate with investors, potential investors, transfer agents, or broker-dealers").

11 *SEC v. Cavanagh*, 445 F.3d 105, 111 n.13 (2d Cir. 2006).

12 *Id.* at 115.

13 *Quinn & Co. v. SEC*, 452 F.2d 943, 945-46 (10th Cir. 1971).

14 *KCD Fin. Inc.*, Exchange Act Release No. 80340, 2017 WL 1163328, at *5 (Mar. 29, 2017); *see also* Rule 506(b)(1), 17 C.F.R. § 230.506(b)(1) (2009) (stating that to qualify for an exemption under Rule 506 offers and sales must "satisfy all the terms and conditions of [Rules 501 and 502, 17 C.F.R.] §§ 230.501 and 230.502."); Rule 502(c), 17 C.F.R. § 230.502(c) (providing that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including . . . [a]ny

interests in the Funds were offered by means of a general solicitation, the Rule 506 exemption was unavailable regardless of the number of accredited investors or the knowledge and experience of the purchasers who were not accredited investors.[15]

a. LREA's public communications were offers of securities.

Under Section 2(a)(3) of the Securities Act, an "offer" includes "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."[16] The Supreme Court has recognized that "Congress expressly intended to define" this term "broadly."[17] Its definition "extends beyond the common law contract concept of an offer."[18]

The Commission has long held that "the publication of information and statements, and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities constitutes an offer."[19] As long ago as 1964, we held that the statutory definition of "offer to sell" included "any communication which is designed to procure orders for a security," and that even a communication that did not on its face refer to a particular offering could nonetheless constitute an offer as long as it was "designed to awaken an interest" in the security.[20] We have also interpreted "offer to sell" to include "publicity efforts that may not be phrased expressly in terms of an offer but [that] . . . stimulate interest" in a securities offering.[21]

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advertisement . . . or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and [a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising") (formatting altered).

15 *See, e.g.*, *KCD Fin.*, 2017 WL 1163328, at *5 (noting that because there was an offer by means of general solicitation, the exemption was "unavailable regardless of the number of accredited investors or the knowledge and experience of the purchasers who were not accredited investors") (citing *Solicitations of Interest Prior to an Initial Public Offering*, Securities Act Release No. 7188, 1995 WL 385857, at *7 (June 27, 1995)).

16 15 U.S.C. § 77b(a)(3).

17 *United States v. Naftalin*, 441 U.S. 768, 773 (1979).

18 SEC v. *Cavanagh*, 155 F.3d 129, 135 (2d Cir. 1998).

19 *Guidelines for Release of Information by Issuers Whose Securities are in Registration*, Securities Act Release No. 5180, 1971 WL 120474, at *1 (Aug. 20, 1971); *accord Securities Offering Reform*, Securities Act Release No. 8501, 2004 WL 2610458, at *13 n.52 (Nov. 3, 2004).

20 *Gearhart & Otis, Inc.*, Exchange Act Release No. 7329, 1964 WL 66874, at *18 (June 2, 1964), *aff'd on other grounds*, 348 F.2d 798 (D.C. Cir. 1965).

21 *The Regulation of Securities Offerings*, Securities Act Release No. 7606A, 1998 WL 792508, at *57 n.276 (Nov. 17, 1998) (citing *First Maine Corp.*, Exchange Act Release No. 5898, 1959 WL 59420 (Mar. 2, 1959); *Loeb, Rhoades & Co.*, Exchange Act Release No. 5870, 1959 WL 59531 (Feb. 9, 1959)).

The inquiry into whether or not a communication is an offer "is a facts and circumstances determination."[22] We find that LREA's public communications, which occurred while the Funds were being contemplated (i.e., LREA was actively working to pool assets to purchase and renovate specific properties) and interests in the Funds were being sold, constituted offers. We do so based on our consideration of the particular facts and circumstances here.

LREA's promotional efforts were designed to "awaken an interest" in the securities offerings at issue. The advertisements, radio shows, and workshops all touted passive investments in distressed apartment properties as an attractive alternative to other investment options and told prospective investors that pooling funds to invest in local apartment properties, through private offerings, could be better than "traditional" investing, through a 401K or IRA, in public offerings. Prospective investors were also told that LREA had "an affiliate company that offers multi-family opportunities for those who are deemed suitable," that "to learn more" they could "see any of our [LREA] employees to set up a time to discuss further," and that securities were "sold through William H. Murphy & Company, Incorporated, a registered broker-dealer." Prospective investors who responded favorably to LREA's promotional efforts could choose to meet with Price or Hutton who would assess their financial situation and whether they were qualified to invest in the Funds. Although WHM asserts that LREA's primary purpose was educational, the JCS Agreement establishes that its purpose was at least in part to work with WHM on "securities activities," and the record shows that LREA promoted the type of investments that WHM offered through the Funds.[23] Under these particular facts and circumstances, the public communications constituted offers.[24]

Asserting that "[t]he main issue in this case is when the 'offer' of securities occurred," WHM argues that FINRA erred in finding that LREA's "public advertisements and radio shows" were offers because they were "generic" and did not mention the Funds. But, as discussed above, we have held that a communication that does not refer to a particular offering may constitute an offer if designed to awaken an interest in the security. Here, LREA touted the type

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22 *Securities Offering Reform*, Securities Act Release No. 8591, 2005 WL 1692642, at *25 (Aug. 3, 2005).

23 *See KCD Fin.*, 2017 WL 1163328, at *6 (stating that even if public communications were not "'aimed at investors, but at owners of distressed residential properties'" and "designed in part to alert potential sellers of distressed properties to the [fund's] possible interest, that would not preclude the articles from also constituting offers").

24 *See Gearhart & Otis*, 1964 WL 66874, at *18 (finding that communications constituted offers even though "the literature in question made no specific reference to National Lithium or to the prospective offering of its securities" because it "was designed to awaken an interest in lithium securities which could shortly afterwards be focused on the National Lithium stock"); *Brian Prendergast*, Exchange Act Release No. 44632, 2001 WL 872693, at *10 (Aug. 1, 2001) (finding that an advertisement that "announced a seminar regarding hedge funds" involved an offer where, although the seminar content was "generic," the applicant stated in a letter to the hedge fund's investors that the purpose of the planned seminar was to attract investors to the hedge fund).

of passive investment the Funds offered: multi-family real estate in Texas. LREA's communications were offers because they were designed to awaken an interest in passive real estate investments to be focused later on specific investments in the Funds.[25]

b. LREA's public communications were a general solicitation.

The terms "general solicitation" and "general advertising," as used in Rule 502(c), include "[a]ny advertisement . . . or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio" and "[a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising."[26] Publication of information on an unrestricted website can constitute general solicitation.[27] LREA's public communications fall well within the meaning of a general solicitation under Rule 502(c).

WHM argues that the communications did not constitute offers by means of a general solicitation because they were typically followed by disclaimers that stated that the information provided did not constitute an offer to buy or sell securities or an investment recommendation. But a "disclaimer" that a communication "is not an offer to sell securities," we have held, "cannot alter the character of Applicants' solicitation of interest in securities investments."[28]

According to WHM, the Funds were not offered until "WHM introduced a qualified and suitable client to an issuer who then offered that client offering information and materials." WHM further asserts that "it is undisputed that no [prospective investor] had access to private placement information" until they "passed three tiers of scrutiny, were found qualified and sophisticated, a cooling off period expired and a substantive relationship between WHM and the prospective investor was formed." In support, WHM notes that Price testified that she "never spoke of a specific investment ever," and asserts that neither Price nor "anyone actually used 'sales pitch' language on any radio show, workshop or seminar . . . ." As a result, WHM contends that "no general solicitation occurred."

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[25] *Statement of Commission Relating to Publication of Information Prior to or After Effective Date of Registration*, 22 Fed. Reg. 8359, 8359-60 (Oct. 24, 1957) (stating that a brochure distributed in advance of an offering for a mining venture that "made no reference to any issuer or any security nor to any particular financing" but that "described in glowing generalities the future possibilities for use of the mineral and the profit potential to investors who would share in the growth prospects of a new industry" "obviously was designed to awaken an interest which later would be focused on the specific financing to be presented in the prospectus").

[26] 17 C.F.R. § 230.502(c).

[27] *KCD Fin.*, 2017 WL 1163328, at *6 (where information posted on an "unrestricted website" was found to constitute a general solicitation) (citations omitted).

[28] *First Capital Funding, Inc.*, Exchange Act Release No. 30819, 1992 WL 150797, at *2 (June 17, 1992).

WHM claims that no-action letters issued by our staff support the proposition that WHM was able "to implement protective measures that br[oke] the chain of general solicitation so that LREA's solicitations were not general solicitations in violation of [Rule] 502(c)." But we have held that the question is whether "a general solicitation was 'used by the issuer or by someone on the issuer's behalf to offer or sell securities.'"[29] Once there was an offer to sell the securities by means of a general solicitation, the Rule 506 exemption was not available for subsequent sales by the issuer of those securities regardless of WHM's attempts to "break the chain."[30] In other words, WHM violated Section 5 because its public communications constituted an offer of securities that was not registered, and it could not avail itself of the Rule 506 exemption because the offer was by a general solicitation. There was no chain for WHM to break because it had already made an offer of securities that was not registered or exempt from registration.[31]

The letters on which WHM relies do not support its position that no violation occurred here.[32] In *Bateman Eichler, Hill Richards, Inc.*, the staff granted no-action relief where the firm sought "to assist its account executives in expanding their pool of qualified offerees by establishing a program" that "would serve as the first step in establishing a business relationship with new clients."[33] The staff's letter noted that "the proposed solicitation would be generic in nature and would not make reference to any specific investment currently offered or contemplated for offering."[34] The staff's letter also noted that the firm would "implement

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29 *KCD Fin.*, 2017 WL 1163328, at *7 (citation omitted).

30 *See id.* (finding that the issuer offered securities in a fund to the general public by publishing newspaper articles on an affiliate's website, and that once it did so, the exemption was not available for subsequent sales of the fund, regardless of attempts to limit the sales to investors who did not see the articles). As a result, LeGaye's advice that an exemption from registration would be available so long as WHM waited 30 days between the time of LREA's seminars and the time details about the Funds were provided to prospective investors was flawed because LREA's public communications themselves constituted offers of securities.

31 *See, e.g.*, *Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities*, Securities Act Release No. 6688, 1987 WL 847505, at *3 (Feb. 6, 1987) ("Under the Securities Act of 1933, public offerings of securities must be registered unless an exemption from the registration requirements is available.").

32 WHM's reliance on the no-action letters is unavailing for another reason: "[w]e are not bound by the statements of Commission staff in the letters on which Applicants rely." *FCS Secs.*, Exchange Act Release No. 64852, 2011 WL 2680699, at *7 (July 11, 2011). No-action letters "do not constitute Commission precedent, nor do they limit subsequent Commission action" and simply express the views of Commission staff. *Id*.; *see also, e.g., Pac. Drilling, S.A.*, 2020 WL 6710904 (Apr. 6, 2020) (no-action letter emphasizing that the Division of Corporation Finance staff's response is based on the facts presented and on the representations made in the incoming letter and that "[a]ny different facts or conditions might require the Division to reach a different conclusion"); *Turnkey Jet, Inc.*, 2019 WL 1471132, at *1 (Apr. 3, 2019) (same).

33 1985 WL 55679, at *2 (Dec. 3, 1985) (SEC staff letter).

34 *Id.* at *1.

procedures designed to insure that persons solicited are not offered any securities that were offered or contemplated for offering at the time of the solicitation."[35] As a result, the staff concluded that the firm's efforts would not "constitute an offer to sell securities."[36] Unlike in *Bateman Eichler*, LREA's public communications were intended to get new clients to invest in securities offerings that were either ongoing or contemplated at the time of the solicitations. As discussed above, these communications therefore constituted "offers" because they were designed to awaken an interest in the public for LREA's specific securities offerings.

In both *E.F. Hutton & Co.*[37] and *H.B. Shaine & Co.*,[38] unlike in *Bateman Eichler*, the issue was not whether there was an offer of securities but rather whether the offer could be made without violating the prohibition on general solicitation under Rule 502(c). The staff stated that to avoid a general solicitation there would have to be a pre-existing relationship between the firm and the offerees. The staff concluded that an "offer could be made to the person with whom the relationship was established" without violating Rule 502(c).[39] Here, there was no pre-existing relationship between LREA or WHM and the recipients of LREA's public communications. The offer of securities preceded any relationship between LREA or WHM and the investors.[40]

And in *IPONET*[41] and *Lamp Technologies, Inc.*,[42] the issue was also whether an offer of securities could be made without violating the prohibition on general solicitation in Rule 502(c). The firms wanted to use a questionnaire to qualify investors as accredited or sophisticated and then provide those investors with access to offers of securities through a password-protected webpage.[43] The staff stated that offers made through password-protected webpages where access was limited to investors that the firm had previously determined to be accredited or

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35 *Id.*

36 *Id.*

37 1985 WL 55680 (Dec. 3, 1985) (SEC staff letter).

38 1987 WL 107907 (May 1, 1987) (SEC staff letter).

39 *E.F. Hutton*, 1985 WL 55680, at *1; *accord H.B. Shaine & Co.*, 1987 WL 107907, at *1.

40 *E.F. Hutton*, 1985 WL 55680, at *1 ("In determining what constitutes a general solicitation the Division has underscored the existence and substance of prior relationships between the issuer and its agents and those being solicited. It is important (i) that substantive relationships be created with offerees, and (ii) that the relationships be pre-existing."); *H.B. Shaine*, 1987 WL 107907, at *1 ("In making a determination of what constitutes a general solicitation, the Division has indicated that in most cases a substantive relationship must exist between the issuer or its agents and the offerees *before* the solicitation of such offerees.") (emphasis added).

41 1996 WL 431821 (July 26, 1996).

42 1997 WL 282988 (May 29, 1997).

43 *IPONET*, 1996 WL 431821, at *1; *Lamp Technologies*, 1997 WL 282988, at *2-5.

sophisticated would not involve a general solicitation.[44] Here, LREA made offers of securities to potential investors before determining that they were qualified and sophisticated. Although LREA did not provide investors with information about a specific offering until after it determined that they were qualified and sophisticated, its communications through its radio shows, advertisements, and unrestricted website constituted offers because they were designed to awaken an interest in the specific securities offerings. And, as discussed above, there is no question that those offers were made through a general solicitation.[45]

WHM also cites no-action letters that do not discuss Rule 502(c), general solicitation, or the registration requirements of the Securities Act. Rather, the letters involve the broker-dealer registration requirements of Exchange Act Section 15.[46] Accordingly, these letters provide no support for WHM's position that there was not a general solicitation in violation of Rule 502(c).

c. WHM's arguments that it should not be held liable lack merit.

WHM claims that it relied on the advice of counsel in seeking to comply with the registration requirements and that FINRA erroneously rejected such reliance as a defense to Section 5 violations. The record supports WHM's claim that it relied on counsel, and as discussed below we have considered that reliance in our assessment of sanctions, but FINRA did not err in rejecting such reliance as a defense to liability. "'Section 5 is a strict liability statute' so 'good faith reliance on counsel' cannot 'preclude liability under the statute.'"[47]

WHM also claims that the Hearing Panel should have credited the witnesses who testified that "LREA's primary purpose was educational" and whose testimony they believe supports the

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44 1996 WL 431821, at *1; 1997 WL 282988, at *3-4.

45 WHM claims that, because FINRA disregarded guidance on general solicitation expressed in the staff letters discussed above, it "lacked fair notice in violation of the Administrative Procedure Act" in that WHM "had no way of knowing that a cooling off period and all the other factors of a general solicitation would not apply." But the finding of a general solicitation here is a straightforward application of longstanding Commission precedent. And the no-action letters on which WHM relies do not suggest otherwise.

46 *See Insurance Networking Arrangements*, 2013 WL 1771299, 2013 SEC No-Act. LEXIS 435 (Apr. 23, 2013) (staff letter); *Welton Street Inv., LLC*, 2006 WL 1896896 (June 27, 2006) (staff letter); *The Somerset Group, Inc.*, 1996 WL 33360734 (Dec. 20, 1996) (staff letter); *Chubb Sec. Corp.*, 1993 WL 1620426 (Nov. 24, 1993) (staff letter); *Mid-Hudson Savings Bank FSB*, 1993 WL 199094 (May 28, 1993) (staff letter).

47 *SEC v. Schooler*, 905 F.3d 1107, 1115 (9th Cir. 2018) (quoting *SEC v. CMKM Diamonds, Inc.*, 729 F.3d 1248, 1256 n.6 (9th Cir. 2013)); *see also SEC v. Holschuh*, 694 F.2d 130, 137 n.10 (7th Cir. 1982) (stating that "good faith is not relevant to whether there has been a primary violation of the registration requirements"); *Swenson v. Engelstad*, 626 F.2d 421, 424 (5th Cir. 1980) (stating that Section 5 "imposes strict liability on offerors and sellers of unregistered securities" regardless of "any degree of fault, negligent or intentional, on the seller's part"); *accord Calvo*, 378 F.3d at 1219 (quoting *Swenson*, 626 F.2d at 424).

view that "referring prospective clients to WHM" was merely a "secondary purpose." But the only evidence corroborating this testimony was an amended version of the JSC Agreement that WHM's counsel created during FINRA's investigation. Murphy signed this amended agreement, which purported to be effective as of March 2011 although the agreement itself was undated. The amended version of the agreement omitted the language suggesting that LREA would offer securities to investors and limited LREA's business activities to "educational and networking services." The Hearing Panel "did not find the testimony regarding LREA's primary function as stated in the" amended version of the JCS agreement "to be credible." We generally defer to a FINRA Hearing Panel's "credibility determinations in the absence of substantial evidence to support overturning them,"[48] and we find no such substantial evidence here.

WHM claims further that there can be no general solicitation without "direct evidence establishing that the *only* purpose for the public advertisement is to recruit investors for a *specific* private offering."[49] But its assertion that our opinions in *Brian Prendergast*[50] and *Gearhart & Otis*[51] and a no-action letter in *Gerald F. Gerstenfeld*,[52] stand for that proposition is unavailing. *Prendergast, Gearhart & Otis*, and the *Gerstenfeld* no-action letter state that the issue is not whether the communication at issue had multiple purposes but rather whether the communication constituted an offer to sell securities. As discussed above, LREA's communications to the public constitute offers. And these offers were made by means of a general solicitation.

WHM also argues that FINRA erred in relying on unused workshop scripts that were developed before "sales pitch" language was purportedly eliminated from LREA's communications with the public. But the marketing materials that LREA used are sufficient to support the findings of violation. We therefore consider the unused workshop scripts to be cumulative and need not consider them or whether FINRA erred in doing so.

WHM suggests further that WHM's sales were exempt under Rule 506(c). That exemption, which became available in late 2013, allows general solicitation for an unregistered offering if (1) sales are made only to accredited investors and (2) reasonable steps are taken to verify that purchasers are accredited investors.[53] But Applicants stipulated that any exemption on which WHM relied "require[d] compliance with the general solicitation prohibition found in SEC Rule 502(c)," as the period at issue here preceded the September 23, 2013 effective date of

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48 *John Edward Mullins*, Exchange Act Release No. 66373, 2012 WL 423413, at *13 (Feb. 10, 2012).

49 Emphasis in original.

50 2001 WL 872693.

51 1964 WL 66874.

52 1985 WL 55681 (Dec. 3, 1985) (staff letter).

53 17 C.F.R. § 230.506(c); *see also Eliminating the Prohibition Against Gen. Solicitation & Gen. Advert. in Rule 506 and Rule 144A Offerings*, Securities Act Release No. 9415, 2013 WL 3817300 (July 10, 2013) (amending Rule 506 to add new subsection (c)).

Rule 506(c).[54] And even were the Rule 506(c) exemption available, the exemption requires that reasonable steps be taken to verify that purchasers are accredited and the record does not contain evidence about WHM's efforts to restrict sales of interests in the Funds to accredited investors.[55]

WHM also invokes Rule 508 under Regulation D, which provides that certain insignificant deviations from Rule 506's requirements do not cause the loss of that exemption.[56] Rule 508(a), however, states explicitly that a failure to comply with the general solicitation restriction is necessarily significant and precludes relying on Rule 508.[57]

2. A violation of Securities Act Section 5 is a violation of FINRA Rule 2010.

Having found that WHM violated Securities Act Section 5, we find that FINRA found correctly that WHM violated FINRA Rule 2010 as a result. "We have long held that a violation of Securities Act Section 5 is also a violation of FINRA Rule 2010."[58]

We reject WHM's argument that FINRA lacks the authority to enforce the Securities Act's registration requirements. The Exchange Act authorizes FINRA to enact its own rules and enforce compliance with them,[59] and FINRA Rule 2010 requires members to observe "high standards of commercial honor and just and equitable principles of trade." We have long held that the prohibition of conduct inconsistent with just and equitable principles of trade "appropriately encompasses the myriad types of misconduct that may injure public investors and the marketplace" and that "it should not be surprising that selling unregistered securities without an available exemption . . . would be regarded as violations of 'just and equitable principles of trade.'"[60] Indeed, we have found repeatedly that a violation of the Securities Act, including the unregistered offer and sale of securities in violation of Section 5, violates Rule 2010.[61] Applicants provide no basis for reaching a different result here.

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54 *Eliminating the Prohibition Against Gen. Solicitation*, 2013 WL 3817300, at *1.

55 17 C.F.R. § 230.506(c).

56 17 C.F.R. § 230.508(a).

57 17 C.F.R. § 230.508(a)(2); *see Eliminating the Prohibition Against Gen. Solicitation*, 2013 WL 3817300, at *5 n.41 ("The failure to comply with Rule 502(c) is deemed to be significant to the offering as a whole, which means that an issuer cannot rely on the 'insignificant deviation' relief in Rule 508 of Regulation D for violations of Rule 502(c).").

58 *Fuad Ahmed*, Exchange Act Release No. 81759, 2017 WL 4335036, at *20 (Sept. 28, 2017).

59 Exchange Act Section 15A(b)(2), 15 U.S.C. § 78*o*-3(b)(2).

60 *Protective Grp. Sec. Corp.*, Exchange Act Release No. 34547, 1994 WL 455492, at *6 (Aug. 18, 1994).

61 *See, e.g.*, *Merrimac Corp. Sec., Inc.*, Securities Act Release No. 106662, 2019 WL 3216542, at *6 (July 17, 2019) (finding a FINRA Rule 2010 violation based on the offer and sale of securities not subject to an exemption); *KCD Fin.,*2017 WL 1163328, at *4 (finding that a

3. FINRA Rule 2010 is, and was applied in a manner, consistent with the purposes of the Exchange Act.

Rule 2010 is consistent with the purposes of the Exchange Act because it reflects the mandate of Exchange Act Section 15(A)(b)(6) that FINRA adopt rules to promote just and equitable principles of trade.[62] Because we find that WHM's actions here were inconsistent with just and equitable principles of trade, FINRA applied the rule in this case in a manner consistent with the purposes of the Exchange Act.[63]

B. Applicants failed to establish a reasonable supervisory system.

NASD Rule 3010(a) required firms to establish and maintain a supervisory system, including WSPs, "reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules."[64] "[S]upervisory procedures must establish mechanisms for ensuring compliance and detecting violations."[65] "It is well established that '[t]he presence of procedures alone is not enough'" because "'[w]ithout sufficient implementation, guidelines and strictures do not assure compliance.'"[66] "We have long maintained that '[f]inal responsibility for supervision of the trading activities at a member firm . . . rests with the firm's president, until the president reasonably delegates the duties to someone

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violation of Section 5 is a violation of FINRA Rule 2010); *Midas Sec., LLC*, Exchange Act Release No. 66200, 2012 WL 169138, at *11 n.63 (Jan. 20, 2012) (finding that a violation of Section 5 also violates NASD Rule 2110, predecessor to FINRA Rule 2010) (citing *Sorrell v. SEC*, 679 F.2d 1323, 1326 (9th Cir. 1982)); *see also Scottsdale Cap. Advisors Corp. v. FINRA*, 844 F.3d 414, 422 (4th Cir. 2016) (finding plausible FINRA's view that "grounding violations of the Securities Act in its Rule 2010 is an exercise of its statutory authority to 'promote just and equitable principles of trade'") (citing 15 U.S.C. § 78*o*-3(b)(6)), *cert. denied*, 137 S. Ct. 1838 (Apr. 24, 2017).

62 15 U.S.C. § 78*o*-3(b)(6); *see also Ahmed*, 2017 WL 4335036, at *17, 20 (finding Rule 2010 to be consistent with the purposes of the Exchange Act) (citing *Rani T. Jarkas*, Exchange Act Release No. 77503, 2016 WL 1272876, at *10 (Apr. 1, 2016)).

63 *See Ahmed*, 2017 WL 4335026; *accord KCD Fin.*, 2017 WL 1163328, at *4 (finding that Rule 2010's application was consistent with the purposes of the Exchange Act where there was a general solicitation of unregistered securities yet no applicable exemption from registration).

64 Since the time of the misconduct at issue here, FINRA Rule 3110(a) superseded NASD Rule 3010(a). *Order Granting Approval of a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook*, 78 Fed. Reg. 79542-01, 2013 WL 6836375 (Dec. 30, 2013).

65 *John A. Chepak*, Exchange Act Release No. 42356, 2000 WL 49226, at *2 (Jan. 24, 2000) (citing *Gary E. Bryant*, Exchange Act Release No. 32357, 1993 WL 183715, at *6 (May 24, 1993)).

66 *KCD Fin.*, 2017 WL 1163328, at *9 (quoting *Rita H. Malm*, Exchange Act Release No. 35000, 1994 WL 665963, at *4 n.17 (Nov. 23, 1994)).

else and has no reason to know that person is not properly performing the delegated duties.'"[67] We agree with FINRA that Applicants violated Rule 3010(a) by failing to establish a reasonable supervisory system, including WSPs, to achieve compliance with Securities Act Section 5.

As discussed above, although Murphy designated Hutton as a compliance principal for LREA, Hutton had little experience with private offerings. Price was inexperienced with securities generally. Yet LREA was designed to engage in continual public outreach at least in part to promote offerings by the Funds. And, as Murphy testified at the hearing, he was attuned to a risk that LREA's public overtures might "condition the market." Given these circumstances, it was unreasonable that WHM's procedures did not address the firm's arrangement with LREA or the restrictions to which LREA was subject in its promotional communications or how to avoid having its public communications be deemed general solicitations or general advertising. Nor did WHM's procedures, until the end of 2011, identify LREA as a branch office of WHM or detail the compliance functions that WHM was to provide to LREA.[68]

Applicants also acted unreasonably in not conducting an annual review of LREA during its first operative year, which WHM's WSPs required for any OSJ, and for failing to document the review that, according to Murphy's testimony, was conducted in 2012.[69] Also unreasonable was the limited role Murphy played in actually supervising the operations of LREA, including his failure to attend more than one of its workshops, his failure to provide Hutton with any formal supervisory training, and his failure to provide Price with any guidance beyond warning her not to mention, during her promotional efforts, any specific securities.[70]

Applicants maintain that they took numerous steps to "to ensure compliance with the securities laws" and "to ensure no 502(c) violation," including: "hiring a FINRA legal expert"; "plac[ing] an OSJ at LREA's office and plac[ing] [Price and Hutton] in the office to work in a dual capacity"; "pre-approv[ing] all LREA public communications"; "requir[ing that] LREA employees follow specific guidelines to ensure separation between LREA's educational functions and WHM's functions"; and creating "written supervisory procedures, training sessions, hands on monitoring, [and] written instructions" as well as "monitored email accounts,

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67 *Robert J. Prager*, Exchange Act Release No. 51974, 2005 WL 1584983, at *11 n.45 (July 6, 2005) (citation omitted).

68 *Cf. La Jolla Cap. Corp.*, Exchange Act Release No. 41755, 1999 WL 624046, at *5 (Aug. 18, 1999) (noting as contributing to a supervisory system's failure that "[d]espite [a] need for close supervision," an "inexperienced" manager was "put in charge of inexperienced staff"); *Castle Sec. Corp.*, Exchange Act Release No. 39523, 1998 WL 3456, at *4-5 (Jan. 7, 1998) (finding an unreasonable supervisory system when a firm's procedures "did not address" or "provide for prevention or detection" of relevant compliance issues).

69 *See* FINRA Rule 3110(c)(1)(A) (requiring a FINRA member firm to "inspect at least annually (on a calendar-year basis) every OSJ").

70 *Cf. La Jolla Cap. Corp.*, 1999 WL 624046, at *3-5 (finding inadequate supervisory system for a firm's New York office when the president and chief compliance officer never visited the office and never held compliance meetings with the office's personnel).

[a] CRM system to monitor client relationships" and "an onsite compliance officer at all LREA events." But we must consider whether Applicants' supervision "'was reasonably designed to prevent the violations at issue, not weigh [their] supervisory performance in other areas against [their] deficiencies in the area under review.'"[71] For the reasons discussed above, neither the WSPs nor their implementation were reasonably designed to prevent Section 5 violations.[72]

We recognize, as mentioned above, that WHM's counsel advised Applicants regarding what needed to be done from a compliance and supervisory perspective and that it was not unreasonable for Applicants to rely on this advice because Murphy viewed LeGaye as a securities law expert and believed that LeGaye had given him sound legal advice previously. But it was unreasonable for Murphy to not follow all of LeGaye's advice on establishing a strong compliance and supervision structure. Although LREA was made an OSJ, Murphy did not provide Hutton with guidance on how to carry out his duties as a registered principal or how to monitor Price's meetings with prospective investors. Murphy also never included in WHM's WSPs thirty-day "cooling off" and "waiting" periods, as LeGaye advised were necessary.[73] Further, it does not appear that LeGaye advised Applicants, or that Applicants sought LeGaye's counsel, regarding what changes should have been made to WHM's WSPs following the establishment of LREA as an OSJ. And while LeGaye told Applicants that all of LREA's public communications should be reviewed and approved, Murphy could not recall reviewing the LREA videos and podcasts posted to its website, although he reviewed other LREA marketing materials. Moreover, such review was not incorporated into WHM's WSPs. In these circumstances, LeGaye's counsel does not excuse Applicants' deficient supervision.

Because "we have 'long emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the federal regulatory scheme,'"[74] and because FINRA's application of NASD Rule 3010 was appropriate in this case given the unreasonableness of WHM's WSPs and Applicants' oversight of Price and Hutton, we find that NASD Rule 3010 is and was applied in a manner consistent with the purposes of the Exchange Act. FINRA found that Applicants also violated FINRA Rule 2010 because a violation of NASD Rule 3010(a) constitutes a violation of FINRA Rule 2010.[75] We found previously that FINRA Rule 2010 is consistent with the Exchange Act's purposes, and its application to

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71 *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 WL 5328765, at *13 (Dec. 19, 2008) (citation omitted).

72 *See id.* (finding that, "[i]n these circumstances, the other supervisory steps Pellegrino executed do not render his supervision reasonable").

73 Although observing such waiting periods would not have rendered WHM's sales exempt from the registration requirements, the failure to include such waiting periods in the WSPs is relevant to whether Applicants reasonably relied in good faith on LeGaye's advice.

74 *Meyers Assocs. L.P.*, Exchange Act Release No. 86497, 2019 WL 3387091, at *13 (July 26, 2019) (quoting *Wedbush Sec. Inc.*, Exchange Act Release No. 78568, 2016 WL 4258143, at *10 (Aug. 12, 2016) (internal quotations and citations omitted)).

75 *Meyers Assocs., L.P.*, Exchange Act Release No. 86193, 2019 WL 2593825, at *10 (June 24, 2019).

Applicants' "failure to maintain a reasonable supervisory system furthered the objective of promoting just and equitable principles of trade."[76]

C. WHM and Murphy's procedural and other arguments against liability are unavailing.

Applicants argue that FINRA erred by not allowing WHM to present expert testimony since the Hearing Panel lacked "the requisite expertise" regarding a Rule 502(c) analysis. FINRA Rule 9263(a) provides that it is within a Hearing Panel's discretion to "exclude all evidence that is irrelevant, immaterial, unduly repetitious, or unduly prejudicial." Under FINRA Rule 9263(a), a Hearing Panel has "'broad discretion in determining whether to admit or exclude evidence, and this is particularly true in the case of expert testimony.'"[77]

We agree with FINRA that the Hearing Panel acted within its discretion in denying Applicants' proposed expert testimony. The proposed expert testimony included that of LeGaye. LeGaye was permitted to testify about factual matters, including the legal advice that he had provided, but was precluded from offering testimony regarding the ultimate legal question of whether WHM had complied with regulatory requirements. The Hearing Panel similarly refused to permit the testimony of two other attorneys retained by Applicants, who proposed to opine on various legal issues in the case. Nothing prevented Applicants from incorporating the legal arguments of these three lawyers into their briefs before FINRA and, indeed, in this appeal. We therefore see no possible prejudice from the Hearing Panel's decision. For these reasons, we find that FINRA's rejection of Applicants' proposed expert testimony was within its discretion.[78]

Applicants also argue that FINRA violated their rights under the Confrontation Clause of the Sixth Amendment to the Constitution by preventing them at the hearing from engaging in "cross examination by ruling [their] questions to adverse witnesses [were] 'not relevant.'" But the Supreme Court has held that Sixth Amendment protections "are explicitly confined to 'criminal prosecutions.'"[79] In any case, the Hearing Panel's rulings were not erroneous because a Hearing Panel has broad discretion to restrict questioning to relevant issues and the Hearing

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[76] *Thaddeus J. North*, Exchange Act Release No. 84500, 2018 WL 5433114, at *7 (Oct. 29, 2018).

[77] *Ahmed*, 2017 WL 4335036, at *23 (quoting *Scott G. Monson*, Investment Company Act Release No. 28323, 2008 WL 2574441, at *6 n.27 (June 30, 2008)).

[78] *See U.S. v. Russo*, 74 F.3d 1383, 1395 (2d Cir. 1990) (stating that experts should not "offer[] legal conclusions"); *Wechsler v. Hunt Health Sys., Ltd.*, 381 F. Supp. 2d 135, 146 (S.D.N.Y. 2003) (stating that an expert "'may not give testimony stating ultimate legal conclusions based on those facts"') (quoting *United States v. Bilzerian*, 926 F.2d 1285, 1294 (2d Cir. 1991)); *cf. Ahmed*, 2017 WL 4335036, at *23 (concluding that a FINRA hearing officer did not abuse her discretion in excluding the proposed expert testimony of a finance professor).

[79] *Austin v. United States*, 509 U.S. 602, 608 (1993) (citing *United States v. Ward*, 448 U.S. 242, 248 (1980)).

Panel acted within its discretion here.[80] The questions that the Hearing Panel determined were irrelevant concerned Applicants' efforts to cross-examine FINRA's examiner, who testified as a fact witness, about matters beyond his direct testimony such as his legal opinion regarding the application of Regulation D to the facts of this case and whether Murphy had adequate procedures in place to prevent the sale of nonexempt securities.[81]

Applicants argue further that FINRA proceedings are biased, that the Hearing Panel in this case was biased and had conflicts of interest, and that the Hearing Panel lacked the necessary qualifications, including expertise in Regulation D, to adjudicate the claims at issue against Applicants. As to FINRA proceedings generally, Applicants provide statistics regarding historical FINRA disciplinary proceedings. But such statistical evidence cannot establish bias,[82] and Applicants did not provide any further evidence of bias.

As to the Hearing Panel in this case, a party seeking to disqualify a Hearing Officer or Panelist on grounds of "conflict of interest or bias" or other circumstance where the Hearing Panel member's "fairness might reasonably be questioned" must move for disqualification within fifteen days of learning the facts that are the grounds for disqualification.[83] By failing to timely move for disqualification of any member of the Hearing Panel, Applicants forfeited their objections.[84] In any event, to prevail on a bias claim, the alleged bias must stem from an "extrajudicial source" and "result[] in a decision on the merits based on matters other than those gleaned from participation in a case."[85] Applicants pinpoint no valid basis to conclude that any

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80 *Ahmed*, 2017 WL 4335036, at *23; FINRA Rule 9263(a).

81 *See, e.g.*, *Hyland v. HomeServices of America, Inc.*, 771 F.3d 310, 322 (6th Cir. 2014) (stating that "a witness may not testify to a legal conclusion").

82 *S. Pac. Comm. Co. v. AT&T*, 740 F.2d 980, 995 (D.C. Cir. 1984) (holding that statistical one-sidedness in rulings cannot, by itself, support an inference of judicial bias); *In re IBM*, 618 F.2d 923, 930 (2d Cir. 1980) (explaining that "[i]t seems evident that statistics alone, no matter how computed, cannot establish extrajudicial bias"); *see also Electronic Transaction Clearing, Inc.*, Exchange Act Release No. 78093, 2016 WL 3345702, at *9 & n.42 (June 16, 2016) ("But generalized statistical evidence alone does not demonstrate that CBOE rendered an unfair judgment in this matter.") (citing *AT&T* and *IBM*).

83 FINRA Rules 9233(b), 9234(b); *see Ahmed*, 2017 WL 4335036, at *21 ("We have required that objections to the composition of the Hearing Panel be raised first to the Hearing Panel so that the situation can be considered and, if appropriate, remedied as soon as possible. This is because a respondent cannot be permitted to gamble on one course of action and, upon an unfavorable decision, to try another course of action.") (internal quotation marks and citation omitted).

84 *See Merrimac*, 2019 WL 3216542, at *25 (finding the respondent forfeited bias objection on the basis of rulings and prior prosecutorial experience by failing to timely move for disqualification).

85 *Phlo Corp.*, Exchange Act Rel. No. 55562, 2007 WL 966943, at *12 (Mar. 30, 2007) (citing *United States v. Grinnell Corp.*, 384 U.S. 563, 583 (1966)).

member of the Hearing Panel exhibited improper bias. Their claims are not supported other than by identifying adverse evidentiary rulings, which by themselves do not establish bias.[86]

Applicants also provide no evidence that the Hearing Panel members lacked the necessary expertise. Nor do they provide any authority for disqualifying Hearing Panel members based on an asserted lack of expertise. In any case, Applicants make no showing of how any such lack of expertise prejudiced them given that the legal conclusions reached by the Hearing Panel were reviewed by the NAC: "it is the decision of the NAC, not the decision of the Hearing Panel, that is the final action of [FINRA] which is subject to Commission review."[87]

We also reject Applicants' contention that their due process rights were violated. Because FINRA is not a part of the government or otherwise a state actor, the requirements of constitutional due process do not apply.[88] And while the Exchange Act requires FINRA to provide fair procedures,[89] FINRA did so. FINRA filed a complaint notifying Applicants of the charges against them; held an eight-day hearing to present evidence regarding the allegations at which Murphy, Price, Hutton, and LeGaye, among other witnesses, testified; had a Hearing Panel issue a decision with findings of violations and sanctions; provided Applicants with an appeal to the NAC; and had the NAC issue its own decision sustaining the findings of violations and modifying the sanctions the Hearing Panel had imposed. Nothing in the record indicates that Applicants were denied a full opportunity to challenge FINRA's allegations or the appropriate sanctions or that the proceedings were otherwise conducted in an unfair manner.

Finally, Applicants contend that FINRA Hearing Officers are "officers" of the United States who must be, but were not, appointed in a manner consistent with the Constitution's Appointments Clause. The Commission recently rejected this argument and does so again for the same reasons.[90]

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86 *See Scott Epstein*, Exchange Act Release No. 59328, 2009 WL 223611, at *18 (Jan. 30, 2009).

87 *Philippe N. Keyes*, Exchange Act Release No. 54723, 2006 WL 3313843, at *6 n.17 (Nov. 8, 2006).

88 *See, e.g.*, *Epstein v. SEC*, 416 F. App'x 142, 148 (3d Cir. 2010) ("Epstein cannot bring a constitutional due process claim against the NASD [FINRA's predecessor], because '[t]he NASD is a private actor, not a state actor.'") (alteration in original) (citation omitted); *Desiderio v. Nat'l Ass'n of Sec. Dealers*, 191 F.3d 198, 206 (2d Cir. 1999) (finding that "NASD is a private actor, not a state actor").

89 *See* 15 U.S.C. § 78*o*-3(b)(8); *see also Epstein*, 416 F. App'x at 148 (noting, despite the fact that constitutional due process does not apply, that "the Exchange Act requires [SROs], such as the NASD, to provide fair procedures in disciplinary actions").

90 *Newport Coast Sec., Inc.*, Exchange Act Release No. 88548, 2020 WL 1659292, at *18-19 (Apr. 3, 2020).

III. Sanctions

Exchange Act Section 19(e)(2) directs us to sustain FINRA's sanctions unless we find, with due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition.[91] Under this standard, we consider any aggravating or mitigating factors and whether the sanctions are remedial and not punitive.[92] Although they are not binding on us, FINRA's Sanction Guidelines serve as a benchmark in our review.[93]

For the unregistered sales of securities, the Guidelines recommend fines between $2,500 and $73,000 or "higher" in egregious cases,[94] and "disgorgement of some or all of the financial benefit derived, directly or indirectly."[95] Specific considerations for sanctions based on the unregistered sales of securities include: whether there was a reasonable attempt "to ensure non-participation in an unregistered distribution"; the share volume and dollar amount of transactions involved; the presence of red flags indicating the possibility of an unregistered distribution; and "[w]hether the . . . sales resulted from an intentional act, recklessness or negligence."[96] The Guidelines' general principles also direct consideration of "[w]hether the respondent demonstrated reasonable reliance on competent legal . . . advice."[97]

We agree with FINRA that WHM should be required to disgorge the $23,230.05 in commissions it received, plus prejudgment interest, from the unregistered sales at issue. We recently held that "FINRA's disgorgement orders pursuant to which a violator must give up the ill-gotten gains causally connected to the violations" are "appropriately remedial."[98] Exchange

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91 15 U.S.C. § 78s(e)(2). Applicants do not allege, nor does the record show, that the sanctions imposed create an undue burden on competition.

92 *See Saad v. SEC*, 718 F.3d 904, 906 (D.C. Cir. 2013); *PAZ Sec., Inc. v. SEC*, 494 F.3d 1059, 1065 (D.C. Cir. 2007).

93 *John Joseph Plunkett*, Exchange Act Release No. 69766, 2013 WL 2898033, at *11 & n.68 (June 14, 2013).

94 FINRA Sanction Guidelines 24 (Mar. 2017 ed.), available at www.finra.org/sites/default/files/2017_Sanction_Guidelines.pdf (last visited Dec. 18, 2020). This is the version of the Guidelines that the NAC used. The May 2018 version of the Guidelines, which was in effect at the time of the NAC decision, is identical in all relevant parts.

95 *Id.* at 5.

96 *Id.* at 24.

97 *Id.* at 7; *see also Jarkas*, 2016 WL 1272876, at *12 n.56 (noting that, although reliance on counsel is "not relevant to liability" when scienter is not an element of the violation, it may be relevant "as to sanctions") (citation omitted).

98 *Kimberly Springsteen-Abbott*, Exchange Act Release No. 88156, 2020 WL 605918, at *20 (Feb. 7, 2020) (rejecting the argument that the Supreme Court's decision in *Kokesh v. SEC* means that FINRA's disgorgement orders are impermissibly punitive).

Act Section 15A authorizes FINRA to impose any "fitting sanction," and disgorgement is a "fitting sanction in a FINRA disciplinary action where the disgorgement ordered is a reasonable approximation of the violator's ill-gotten gains causally connected to the violations."[99] In such circumstances, disgorgement is remedial because it is intended "to prevent unjust enrichment."[100] We again adhere to that reasoning here and find the disgorgement ordered to be remedial.[101]

Although we sustain the disgorgement order, we believe that the fine FINRA imposed should be set aside given the firm's efforts to comply with an exemption from registration. As discussed above, the record demonstrates that the reason WHM violated Securities Act Section 5 is that LeGaye, who introduced WHM to LREA, advised WHM that LREA could avoid offering securities by means of a general solicitation if it did not mention the Funds in its promotional efforts. WHM had relied on LeGaye's advice previously, and there is no evidence in the record that it did not rely on LeGaye's advice in good faith here. Under the circumstances, fining WHM in addition to ordering disgorgement is excessive.

With respect to the supervisory violations, the Guidelines for deficient written supervisory procedures recommended a fine between $1,000 and $37,000; in egregious cases, the Guidelines recommend suspending the responsible individual in any or all capacities for up to one year and suspending or limiting the firm's activities for up to thirty business days or until the problematic procedures are reformed.[102] For failures to supervise, the Guidelines recommend fines of $5,000 to $73,000, and a suspension in all supervisory capacities for up to thirty days; in egregious cases, the Guidelines recommend up to a two-year suspension in all capacities or a bar of the responsible individual.[103] Specific considerations for sanctions based on supervisory violations include: whether "red flag" warnings that "should have resulted in additional supervisory scrutiny" were ignored; whether there was an attempt to conceal the misconduct; the nature, extent, size and character of the underlying misconduct; and the quality

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99 *Id*.

100 *Id.* at 19.

101 *See generally Sanction Guidelines*, Regulatory Notice 11-13, 2011 WL 1099488, at *1-2 (Mar. 22, 2011) (announcing revisions to FINRA's Sanction Guidelines and stating that "General Principle 5 of the Sanction Guidelines recognizes that FINRA adjudicators may order restitution where necessary to remediate misconduct" and "restore the status quo ante where a respondent's victim would otherwise unjustly suffer loss"; that "General Principle 6 of the Sanction Guidelines instructs FINRA adjudicators to consider the disgorgement of a respondent's ill-gotten gains where the respondent has obtained a financial benefit from his wrongdoing"; and that "disgorgement seeks to remediate misconduct by depriving a respondent of his or her unlawful profits irrespective of the actual losses suffered by the respondent's victims").

102 Guidelines at 108.

103 *Id.* at 105.

and degree of the supervisor's implementation of the firm's supervisory procedures and controls.[104]

We find FINRA's sanctions for the supervisory violations to be excessive because we disagree with FINRA's finding that the record supports that the supervisory violations were egregious. In explaining that finding, the NAC stated only that "[t]he WSPs did not include LREA or its marketing activities, and the WSPs did not specify who was responsible for ensuring compliance with respect to these omitted activities. These failures led to investors purchasing unregistered securities that were not subject to an exemption from registration, which we find to be egregious."

That explanation does not mention, let alone address, the significant role played by counsel, which is not a defense to Applicants' supervisory failure under the facts and circumstances here but is relevant to the issue of sanctions. As discussed above, LeGaye advised Applicants regarding what needed to be done from a compliance and supervisory perspective and it was not unreasonable for Applicants to rely on this advice. Murphy viewed LeGaye as a securities law expert and believed that LeGaye had given him sound legal advice previously. To be clear, the record demonstrates that Applicants deviated from, or failed to act on, certain aspects of LeGaye's advice, which supports our finding of liability for the supervisory failures. The failure to follow or implement legal advice may, in certain circumstances, form the basis for a finding that supervisory failures were egregious. However, the record before us here does not clearly indicate that Applicants' supervisory deficiencies were egregious, in light of the specific considerations for sanctions based on supervisory violations enumerated in the Guidelines or any other aggravating consideration. We recognize the possibility that there may be additional facts that could support a finding of egregiousness, but we cannot make that finding on this record.[105] Accordingly, we remand to FINRA so that it can determine what sanctions are appropriate for the supervisory violations under the guidelines applicable to non-egregious supervisory violations.

An appropriate order will issue.[106]

By the Commission (Chairman CLAYTON and Commissioners PEIRCE, ROISMAN, LEE, and CRENSHAW).

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104 *Id.*

105 Egregiousness is necessarily a fact-based inquiry that requires a record with information sufficient to make that determination. *Cf. KCD Fin.*, 2017 WL 1163328; *Randolph K. Pace*, Exchange Act Release No. 32153, 1993 WL 119813 (Apr. 15, 1993).

106 Applicants requested oral argument. Because our decisional process would not be "significantly aided by oral argument," that request is denied. 17 C.F.R. § 201.451(a). We have considered all of the parties' contentions. We have rejected or sustained them to the extent they are inconsistent or in accord with the views expressed in this opinion.

Vanessa A. Countryman
Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 90759 / December 21, 2020

Admin. Proc. File No. 3-18895

WILLIAM H. MURPHY & CO., INC.

and

WILLIAM H. MURPHY

For Review of Disciplinary Action Taken by

FINRA

ORDER SUSTAINING IN PART DISCIPLINARY ACTION TAKEN BY FINRA

On the basis of the Commission's opinion issued this day, it is

ORDERED that FINRA's findings of violations against William H. Murphy & Co., Inc., and William H. Murphy are sustained; and it is further

ORDERED that the disgorgement FINRA imposed against William H. Murphy & Co., Inc. is sustained; and it is further

ORDERED that the remaining sanctions FINRA imposed are set aside and the proceeding is remanded in accordance with the accompanying opinion.

By the Commission.

Vanessa A. Countryman
Secretary