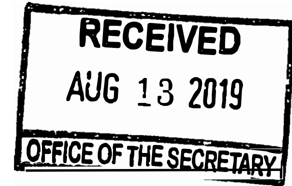

UNITED STATES OF AMERICA

Before the

SECURITIES AND EXCHANGE COMMISSION

In the Matter of the Application of: **Cantone Research Inc., Anthony Cantone, and Christine Cantone,** **For Review of Disciplinary Action Taken By** **FINRA**	**ADMINISTRATIVE PROCEEDING** **File No. 3-18999**

APPLICANTS' REPLY BRIEF IN SUPPORT OF APPLICATION FOR REVIEW

Alan M. Wolper
Heidi VonderHeide
Ulmer & Berne LLP
500 W. Madison, Suite 3600
Chicago, IL 60661
(312) 658-6500
awolper@ulmer.com
hvonderheide@ulmer.com

Attorneys for Applicants

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I. INTRODUCTION

This Reply responds only to matters FINRA raised in its Opposition. For clarity and consistency, the defined terms and abbreviations used by Applicants in their Opening Brief have the same meaning here.[1]

II. ARGUMENT

A. The Brogdon Background Facts Were Not Material at the Time of the Offerings

Determining materiality is an inherently contextual analysis.[2] That is, whether or not a specific statement is material to a reasonable investor must be determined by evaluating "the context in which it is made."[3] Enforcement applies a different test, ignoring the context in which the statement was made and instead reviewing materiality based on what happened *afterwards.* This is an improper and unworkable application of the law, and should be rejected.

Moreover, by focusing in on remote background facts relating to Mr. Brogdon, FINRA fails to assess the Firm's due diligence as a whole. While Mr. Brogdon was a part of it,[4] the majority of the review was focused on the merits of the proposed development – the actual construction/redevelopment that the investor was investing in – and its likelihood of profitability based on all information available, including property appraisals,[5] environmental assessments, historical financials, market demand for nursing/assisted living services, floor plans, tax bills, and

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[1] Applicants' Opening Brief in Support of their Notice of Appeal is referred to herein as "Opening Brief." Enforcement's Brief in Opposition is referred to herein as FINRA's "Opposition".

[2] 17 C.F.R. §230.156(b). *Basic v. Levinson,* 485 U.S. 224, 239 (1988).

[3] *Id.*

[4] The NAC and FINRA conclude that CRI did "little to no independent due diligence on Brogdon," but that is incorrect. ROA 014189. CRI's due diligence included not only the collection information on Brogdon (ROA006803-7392) it also included 6 years of personal experience underwriting similar nursing home developments involving Mr. Brogdon. Moreover, the record showed that, from a disclosure perspective, CRI utilized the same counsel for the COP offerings who had prepared the disclosures in the prior municipal offerings. E.g. ROA010016,10025.

[5] These analyses were performed by independent third parties.

operating agreements for the facilities.[6] This evidence, rejected by the NAC as irrelevant, is necessary in order to view the facts at issue in the context of the entire offering and, in turn, determine if they are material

Similarly, the NAC failed to take into consideration the information reflecting CRI's recent success with similar Brogdon projects. From 2003-2006, immediately prior to the COP offerings, CRI underwrote ten municipal bond offerings and one COP investment[7] involving similar developments by Mr. Brogdon.[8] This personal experience carried tremendous value from a due diligence perspective in CRI's assessment of Mr. Brogdon and led CRI and Mr. Cantone to honestly believe in Mr. Brogdon's ability to profitably complete the projects.[9]

By failing to properly consider CRI's immediate experience with Mr. Brogdon and the depth of the review performed by CRI prior to each offering– including numerous site visits to personally inspect the underlying properties - the NAC improperly ignored evidence reflective of the sufficiency of the overall due diligence as well as CRI and Mr. Cantone's mindset in deciding to go forward with the offering. Importantly here, the totality of the review – of which Mr. Brogdon was merely one facet – shows that CRI and Mr. Cantone did not act negligently, willfully, or with scienter in "failing" to disclose the facts addressed below.

1. The NHC Bankruptcy

As stated in the Opening Brief, the fact that Mr. Brogdon's biography in the CDM correctly noted that he had served as the Chairman of NHC did not give rise to an obligation to disclose

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[6] *See,* Due Diligence files at ROA006803-7392- 007513 (Hoover); ROA007517-7902 (Columbia); ROA7911-9322 (Chestnut); ROA009323-9620 (Oklahoma); ROA009621-9716 (Cedars).
[7] The Hoover investments, the first Brogdon COP, matured early and investors received full principal, interest and an additional 12% equity return. ROA001117. Two other Brogdon COPs, not mentioned in the complaint also matured profitably and without issue. ROA001193-5.
[8] ROA001108-001114; *E.g.*, ROA009965-010098; ROA010127-010164.
[9] ROA00940-941; ROA00948-949.

every negative event in that Company's history.[10] The NAC's conclusion that this fact rose to the level of materiality is erroneous and should be reversed for the reasons already articulated.[11]

In its Opposition, FINRA argues that NHC bankruptcy became material because the CDM contained "positive" facts about Brogdon which were "highlighted" to investors. Thus, disclosure of balancing "negative" facts about NHC were required to make those positive statements not misleading.[12] These arguments misstate and misapply the applicable law.

a. The language of the CDM did not trigger a duty to disclose.

Materially misleading omissions of past performance occur when one makes optimistic statements about the future prospects of the business, but fails to disclose past performance that would be useful to a reasonable investor in assessing the positive, forward-looking statements. *S.E.C. v. Merch. Capital, LLC,* 483 F.3d 747, 768 (11th Cir. 2007). The obligation to disclose past negative performance arises when one puts a fact at issue by "touting, in great detail" a positive set of facts. *Id.* at 770–71.

Pursuant to this framework, the first step is determining whether or not the CDM made optimistic statements capable of triggering this obligation to disclose balancing negative facts. FINRA's Opposition underscores the absence of such positive statements. Instead of pointing to some specific statement of optimism, touting or emphasis,[13] FINRA argues that merely by mentioning that Brogdon was the Chairman of NHC, the CDM "invited investors" to draw conclusions about his experience or "fostered" impressions. FINRA then goes on to speculate as to what possible, positive, conclusions investors would have drawn from that fact, and what impressions of success could have been "fostered." Then, even though these hypothesized

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[10] Opening Brief pp. 12-14.
[11] *Id.*
[12] Opposition p. 21-22.
[13] As exists in the sole decision FINRA relies upon, *In re Louis*, Release No. 83555 (June 28, 2018).

optimistic statements were never actually made in the offering document – a necessary predicate for the duty to make offsetting negative statements – FINRA argues that CRI and Mr. Cantone somehow had an affirmative obligation to make those contrary disclosures.

The flaw in FINRA's reasoning is obvious. Further, the argument itself admits the *absence* of the kind of statements that must be *actually made in the offering documents* in order to trigger the obligation FINRA seeks to impose here. This optimism-by-inference rationale should be rejected and the NAC's conclusion on this issue reversed.

b. The bankruptcy was not material.

Even if the Commission were willing to entertain FINRA's optimism-by-inference theory, and find that the CDM touted Brogdon's positive success at NHC, thus triggering an obligation to disclose negative material facts, it must still determine whether the bankruptcy was material to investors deciding whether to invest in the offerings at issue here. In order to be material, it must be *substantially* likely that disclosure of this fact would *substantially alter* a reasonable investor's analysis of the total mix of information provided.

The facts here run contrary to those in the sole case FINRA relies upon. *Ottimo* involved a recent bankruptcy resulting in the total failure of the corporation (opposed to reorganization under the bankruptcy statute).[14] The evidence presented in that case showed that investors in the prior venture lost their entire principal when the company *failed.* The materiality of the bankruptcy in that case was not, therefore, merely that a bankruptcy proceeding had been filed, but its causes (the individual at issue) and its effect on investors (the company failed and investors lost everything).

[14] *In the Matter of the Application of Louis Ottimo,* Release No. 83555 (June 28, 2018) (Evidence showed that outside investors lost their entire investment as a result of the prior company's bankruptcy).

Here, unlike in *Ottimo*, FINRA did not introduce any facts into the record connecting Mr. Brogdon to NHC's bankruptcy filing. Nor did FINRA introduce evidence similar to that in *Ottimo*, i.e., that the result of the bankruptcy was corporate failure (or some other investor harm). Without these facts, the record does not support a finding that the bankruptcy filing was a material fact that would substantially aid an investor in weighing the success of the project. Accordingly, the evidence is insufficient to support a finding that NHC's 1999 bankruptcy was "related to the financial condition or prospects" of the entity offering the COPs.[15]

Also, *Ottimo* involved a recent bankruptcy, whereas the bankruptcy here was more than ten years old at the time of the *first* COP offering. As Applicants already discussed in their Opening Brief, the passage of time decreases the potential materiality of events and Courts have held that bankruptcies occurring six or nine years[16] prior are not material.[17]

2. RCA Liens are not Material

Here, FINRA's sole argument in support of materiality is that "Courts and the Commission have both recognized that substantial tax liens are material information that must be disclosed to investors."[18] FINRA cites a single case in support,[19] but it did not involve a securities offering; rather, it involved an advisor who failed to properly disclose his tax liens on his Form U-4. Accordingly, the *Mathis* case provides no guidance to determining the issues presented here.

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[15] *Fisher v. Ross*, 1996 WL 586345, at *10 (S.D.N.Y. Oct. 11, 1996). ("The bankruptcy at issue occurred more than six years before. There is no evidence proffered to indicate that there was anything about the bankruptcy of Magic that was related to the financial condition or prospects of Ilio at the time of this offering.").

[16] *Id., see also Feinberg v. Leighton*, No. 1987 WL 6147, at *12 (S.D.N.Y. Jan. 30, 1987) ("In addition, I find that Leighton's alleged "omitting" to tell Feinberg that he had previously been involved in a company that went bankrupt cannot be considered to be so material that a reasonable investor would not have made the investment in Compu-Com had he known of that bankruptcy. The bankruptcy which had taken place nine years before was of a company which had no connection with commodity trading.").

[17] Relatedly, as set forth in pages 15 and 33 of Applicants' Opening Brief, even if this fact is found to be material and a required disclosure item, neither Cantone nor CRI acted negligently in "failing" to disclose it.

[18] Opposition p. 19.

[19] *Mathis v. S.E.C.*, 671 F.3d 210, 218 (2d Cir. 2012).

First, as a registered person, Mathis had a clear, non-discretionary obligation under FINRA, SEC and state rules to disclose his tax liens on Form U-4. *Second, Mathis* involved current tax liens. Thus, it does not assist in determining whether 14-year old tax liens filed against an entity with which an individual was once associated, are material.[20] *Third,* to the extent that the Commission wishes to take any guidance from *Mathis*, it should be to note that Form U-4, upon which Mathis turns, requires the disclosure of *pending* liens[21] Thus, looking to Form U-4 and *Mathis* for direction, the Commission should conclude that inactive, 14-year old, corporate liens are not required disclosure obligations here.

Moreover, the record does not contain sufficient evidence to support a materiality finding. FINRA tacitly admits that there is no evidence connecting Brogdon to the tax liens, establishing why they were imposed, when they were repaid, and/or what harm they caused to investors in RCA (the company they were imposed against). Faced with this evidentiary deficit, FINRA instead can argue only that "it is at least just as likely that Brogdon contributed to RCAs tax issues [than that he did not]."[22] This admission is fatal for FINRA, which carried the burden of proving every element of its case – including the element of materiality – by a preponderance of the evidence.[23] By admitting that there is, at best, a 50/50 chance that the liens had anything to do

[20] It is also worth noting that *Mathis* considered not only whether outstanding liens were material information to "reasonable investors," but also to regulators and potential employers – an entirely different test. Indeed, in finding materiality, the Commission's opinion specifically relies upon Mathis' admission that a pending lien would be of interest to an employer because it could reflect that the broker was under financial pressure (something the employer would be required to watch for). None of this analysis assists the Commission in reviewing the facts presented here, however.

[21] Form U-4, Question 14M. As to bankruptcies, only those within 10 years are required disclosures.

[22] Opposition p. 20.

[23] The Commission should consider the breadth of FINRA's position: that executives are required to disclose any arguably negative event that happened to an entity in which they previously held a management position. Negative events include past liens of the company (without regard to whether those debts were improper or otherwise indicative of poor performance) and instances where the company was unsuccessful in litigation (discussed in the following section). Not only would such a standard conflict with the current test for materiality – requiring "substantial likelihood" that a particular fact would "significantly alter" the information available – it would inundate potential investors with useless information and make it *more* difficult for them to make reasoned investment decisions.

with Mr. Brogdon, FINRA has admitted the record contains insufficient evidence to support the NAC's finding of materiality.[24] As such, the Commission must reverse.

3. The Georgia Summary Judgment Order

Similar to the above, FINRA tests the bounds of reason in suggesting that CRI and Mr. Cantone erred in failing to disclose that in 2003, a Georgia court ruled against Mr. Brogdon and in favor of the plaintiff in a breach of contract case. The alleged materiality of this event is the Georgia court's comment that the contract between Brogdon and the plaintiff was "essentially" a guarantee. Thus, FINRA argues that because the court used the word "guarantee" in its order and the offerings at issue here involved an (actual) guarantee from Mr. Brogdon, this fact is material.

This is an oversimplified and entirely hindsight-driven analysis, which is improper when determining materiality (inasmuch as the standard requires that statements be considered in the context they were made). The sole importance FINRA is able to attribute to this litigation is that it could create an inference in the mind of the investor that if the project failed and he was forced to collect upon the personal guarantee, he "might" have to sue to enforce that agreement. This fact, however, is hardly unique to Mr. Brogdon or the offerings at issue. Indeed, enforcement of any agreement "might" involve litigation, especially where the parties disagree.

Beyond that, while the Georgia case involved "essentially" a guarantee, the nursing home developments contained *actual* express guarantees extended pursuant to a written contract[25] wherein the guarantors "absolutely and unconditionally, jointly and severally" extended the guarantee. Moreover, the guarantee agreements expressly provided that the guarantors would be responsible for any costs incurred in enforcing the agreement, including all attorneys' fees.

[24] *S.E.C. v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996) (Materiality must be proved by preponderance).
[25] E.g., ROA006565-006571.

When the Georgia order is considered in the "mix" of information that included this express guarantee – with a cost shifting provision designed to deter litigation – it is *un*likely that it would have had any impact on an investor at all, let alone "significantly altered" the mix of information available.

For this reason and those already set forth in the Opening Brief, the NAC's finding of materiality should be reversed.

4. NASD Bars

FINRA's Opposition fails to respond to the majority of arguments raised in the Opening Brief, including: (1) the age of the NASD bars, (2) the fact that they were entered in default (i.e., were uncontested), (3) the fact that CRI's attorney, Michael Gardner, opined they were too old to still require disclosure, and (4) the fact that the Hearing Panel, comprised of experienced industry professionals, concluded that the NASD bars were *not material*. FINRA's silence speaks loudly as to the questionable nature of the materiality of the NASD bars, and, in turn, the *reasonableness* of CRI's conclusion that the bars were too old to warrant disclosure.

Instead of responding, FINRA's Opposition merely sets forth the importance *FINRA* places on the historical bars. Its arguments are unavailing. Moreover, FINRA's arguments fail to answer the sole question presented: why these old decisions by the NASD, which did not prohibit Brogdon from acting as the Chairperson for two publicly-traded companies or from participating in multiple municipal offerings, would have altered someone's investment analysis 25 years after they were imposed.

Indeed, to the extent any evidence exists reflective of the impact these bars had on investors, there is one telling example. On January 21, 2011, investor DM[26] sent an email to Mr.

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[26] ROA001985.

Cantone attaching a 1999 article from the Dallas Business Journal about Mr. Brogdon.[27] Mr. Cantone forwarded the article to Mrs. Cantone. Christine replied to Anthony, stating, "[w]hen we asked about that very article, Mr. Brogdon sent us the attached letter for his explanation. Please show to [DM]." The "attached letter" Mrs. Cantone referenced was the May 2008 letter from Mr. Brogdon's counsel (the same letter discussed in Section III.B., below). That letter discussed, amongst other things, the fact that Brogdon had been barred and sanctioned by the NASD in the 1980s. Mr. Cantone forwarded his email communications with Mrs. Cantone, along with the May 2008 letter, to DM. A few weeks later, despite knowledge of the NASD bars, DM proceeded to invest in the Chestnut offering.[28]

While materiality is, admittedly, an objective standard, the above record evidence weighs against FINRA's entirely unsupported assertion that the NASD bars materially altered investor impression of Brogdon's "competence, integrity and reliability."[29]

For the reasons already set forth in Applicant's Opening Brief, the 25-year-old NASD bars are not material, and the NAC's finding to the contrary should be reversed.[30]

B. No Negligence

Even assuming some disclosure failure occurred, FINRA's Opposition fails to set forth any facts supportive of a negligence finding. Applicants and FINRA appear to agree that negligence is "culpable carelessness."[31] FINRA addresses negligence only briefly, arguing that CRI and Mr. Cantone acted negligently because they failed to disclose the background events discussed above. Establishing negligence, however, requires more than showing a disclosure failure occurred.

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[27] ROA001985.
[28] ROA003569-3618. DM and other investors submitted declarations reflecting similar awareness. ROA10443-10465.
[29] Opposition p.17.
[30] FINRA's request for Judicial Notice (Opposition p.8-9) should be denied. The pleading FINRA seeks to introduce through citation to a narrative website is already in the record. The website cited by FINRA is not a pleading or a docket, and judicial notice of the webpage is improper.
[31] Opening Br. pp 24, 33.

FINRA was required to also prove that the disclosure failure was *culpable conduct* because CRI and Mr. Cantone acted unreasonably in determining the information was not material.

FINRA's Opposition is tellingly silent on this part of its claim. The record, however, is not. *First,* the record shows that Mr. Cantone and CRI retained competent counsel to assist them with drafting the CDM. With regard to the NASD bars, as discussed below, Mr. Gardner specifically opined that those events were too old to be "relevant."[32] While reliance on counsel is not a defense to negligence (as it is to scienter), it is evidence reflecting the *reasonableness* of Applicants' belief at the time the offering documents were prepared that these facts were not material to each investment.

Second, and specifically with regard to the NASD bars, the procedural history of this case itself evidences their questionable materiality in light of their advanced age. It is not enough for FINRA to argue that CRI and Mr. Cantone made the wrong decision on the question of materiality; FINRA must also prove that CRI and Cantone's decision, if incorrect, was unreasonable. Here, following a full hearing on the merits, the Hearing Panel – comprised of knowledgeable members of the industry – held that the bars were no longer material, given the passage of time and the intervening approval by the Nasdaq for Brogdon to act as a control person for a publicly traded entity.[33] The NAC, a separate body of industry experts, concluded the opposite.

These differing opinions underscore how difficult it is to determine whether or not a fact is material, i.e., whether a fact is "substantially likely" to "significantly alter" the information presented to an investor. They also strongly suggest that the conclusion reached by CRI, Mr. Cantone, and the Hearing Panel was, at least, *reasonable.* If it is reasonable, it could not have been

[32] ROA0013391.
[33] ROA013715.

negligent, and the NAC's finding that Mr. Cantone and CRI violated Section 17(a)(2) and (3) must, therefore, be reversed.

C. FINRA Misrepresents the Evidence Showing Reasonable Reliance Upon the Advice Of Counsel[34]

1. Reliance upon counsel with regard to Brogdon's payment delays

The NAC concluded that CRI and Mr. Cantone acted with scienter when they "failed" to disclose, in connection with the Cherokee offering[35] and the Columbia and Oklahoma extension agreements,[36] Mr. Brogdon's past payment delays. Applicants' Opening Brief sets forth the reasons why the NAC's conclusion is erroneous and should be reversed.[37] Additionally, and in the alternative, Applicants stated that even if the late payments were material disclosures, they have demonstrated that they did not act with scienter in "failing" to make those disclosures because they relied upon the advice of their counsel who drafted the extension agreements.[38]

In its Opposition, FINRA argues against reasonable reliance by asserting that: "there is no evidence that Cantone or CRI disclosed to their attorney the details of the many times between May 2010 and February 2013 that a Brogdon entity failed to make a required interest payment or failed to return investors' principal."[39] This is false, and FINRA's arguments based on misrepresentations of the record should be rejected. Not only is there clear, written evidence showing that Cantone and CRI disclosed Brogdon's late payments to their attorney (as well as written documentation showing the attorney's knowledge of the same[40]), FINRA even cites to some of it in its Opposition.

[34] The NAC also failed to take this evidence into consideration when assessing what, if any, sanction was proper in this context. Principal Consideration No. 7.
[35] ROA014220.
[36] *Id.;* ROA014215 (footnote 19).
[37] Opening Brief pp. 26-30 (Cherokee); 34-38 (Extension Agreements).
[38] Opening Brief pp. 38-39.
[39] Opposition p. 36-37.
[40] ROA006297-98.

For example, on page 29 of its Opposition, FINRA identifies the "numerous emails" that Brogdon exchanged with Cantone regarding his "failures to pay interest and principal" over the years (2010-2012). Mr. Gardner, CRI's attorney, is directly copied on many of the quoted communications.[41] Furthermore, looking beyond the quotations on page 29, the record is replete with examples of Mr. Gardner's awareness of Brogdon's payment delays[42] long before either the extension agreements or the Cherokee offering.

As a result, the record is clear that Mr. Gardner, at the time he drafted both the extension agreements[43] and the Cherokee CDM, was aware of Mr. Brogdon's late and missed payments. Despite this awareness, he did not advise that these were required disclosures in connection with either (1) the extension agreements or (2) Cherokee. CRI and Mr. Cantone relied upon this advice.[44]

Accordingly, FINRA's arguments in opposition should be rejected and the Commission should reverse the NAC's scienter finding on these issues in light of the evidence presented by Applicants reflecting their reasonable reliance on their counsel.

Because Applicants have, indeed, presented evidence that Brogdon's payment issues were disclosed to Mr. Gardner *before* the extension agreements were drafted, they have met their burden of proving reasonable reliance on his advice.[45]

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[41] ROA003499-3500 (June 2011), 003555 (March 2013).

[42] ROA003513 (March 2012); 3521 (July 2012); 003539-3541 (September 2012–month immediately before the first extension agreement in Columbia); 004933 (August 2011).

[43] Each extension agreement was drafted by Mr. Gardner. ROA000979.

[44] ROA001121 (820-821); ROA001292 (1150-1151).

[45] FINRA argues that Mr. Gardner was no longer CRI's attorney after May 28, 2013. This is of no consequence because the advice Mr. Cantone and CRI received from Mr. Gardner regarding the Brogdon guarantee was given over a month earlier, on April 10, 2013.

2. Reasonable Reliance in the Record as to Brogdon Background Events

FINRA also incorrectly asserts that the record contains incomplete evidence on CRI and Mr. Cantone's reliance on Mr. Gardner's advice about the Brogdon background events. *First,* FINRA states that there is insufficient evidence that Gardner was provided with Brogdon's NASD history.[46] FINRA is wrong. Both Mr. and Mrs. Cantone testified that they had discussed the NASD action with Mr. Gardner.[47] Additionally, John Cantone, who assisted his father with the due diligence on the Brogdon offerings, testified that he sent the May 2008 letter to Mr. Gardner.[48] Finally, and contrary to FINRA's representation that "Gardner did not reduce [his] purported advice to writing,"[49] both the Firm's due diligence file on Mr. Brogdon and the record in this appeal contain an email from Mr. Gardner stating that, as of 2008, he did not believe the bar was a relevant disclosure.[50]

Moreover, the record contains ample evidence that CRI and Mr. Cantone sought Mr. Gardner's advice on the preparation of the offering memoranda and required disclosures therein. This would include his professional assessment of what facts in Brogdon's background were still relevant in 2010-2013. Mr. Gardner did opine, in writing, that events from Brogdon's past could become too old to warrant disclosure. This includes the email discussed above, relating to the NASD bar, as well as his opinion that a 1990 bankruptcy was "well beyond the period of relevancy."[51] This specific advice, combined with (1) the evidence showing Mr. Gardner's

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[46] Opposition p. 36.
[47] ROA001600-1601; 001602-1603; ROA001315 (Christine); ROA001109-001110 (Anthony).
[48] Additionally, the record contains a copy of an email from John Cantone to Antony Cantone that says, "Michael, Here is information on Chris Brogdon's past activities." ROA001579. Although the email's recipient is Anthony Cantone, John Cantone testified he sent the same email to Mr. Gardner, forgot to CC Anthony, then sent it to Anthony directly. When called to explain the email at hearing, John Cantone testified that email appearing as Respondents' Exhibit 5 was preserved because the hard copy was with the Firm's due diligence materials. ROA001580. He and Christine Cantone testified that the same email that he sent to Mr. Gardner was not printed or preserved, and could no longer be retrieved given the passage of time. *Id.* ROA001580; ROA001602.
[49] Opposition p. 36.
[50] ROA13391.
[51] ROA13389.

involvement in preparing each COP offering at issue[52] and (2) the evidence showing Mr. Gardner's experience drafting disclosures about Mr. Brogdon's background prior to the COP offerings at issue,[53] is sufficient to show that CRI and Mr. Cantone reasonably believed the disclosures regarding Mr. Brogdon were proper at the time they were made.

For these reasons and the reasons set forth in the Opening Brief, CRI and Mr. Cantone ask that the Commission reverse the NAC's finding regarding reliance on counsel. In turn, because the reasonable reliance on counsel rebuts the allegation of scienter, Applicants ask that the scienter-based finding be reversed.

D. Extension Agreements

1. FINRA and the NAC's reliance on *Durham* is Improper

As previously stated, the NAC and FINRA rely exclusively on *Durham* as authority that the extension agreements constitute sales of securities under Section 17(a) and Rule 10b-5. For the reasons already set forth, *Durham* is inapplicable precedent and FINRA's attempt to salvage the authority is unavailing. In determining the propriety of the jury instruction on the "in connection with element," *Durham* expressly stated that what "mattered" to the Court's analysis was "the scope of substantive *criminal* liability."[54] Beyond that, and perhaps more importantly, *Durham* does not involve extension agreements or analyze whether or not they satisfy this requisite element. For these reasons and those previously stated, the Commission should conclude that the extension agreements were not made "in connection with" the purchase or sale of a security.

[52] ROA10467-13059. (Attorney communications by offering).
[53] ROA10099,010113.
[54] *United States v. Durham*, 766 F.3d 672, 683 (7th Cir. 2014).

2. FINRA Misrepresents the terms of the Extension Agreements

FINRA also mischaracterizes the terms of the extension agreements. FINRA argues that the extension agreement "forthrightly stated that Brogdon was unable to make required payments" – plural – whereas the letter sent to investors stated the extension had been granted "only" because there was a prospective purchaser.[55] Therefore, it contends, Mr. Cantone "misrepresented" or "concealed" something.

This is not true. The first Columbia extension agreement stated:[56]

> Because the Facility has not yet attained the expected occupancy, the Company is unable to pay its obligations under the Note in accordance with the provisions thereof. Accordingly, the Company has requested that the Note Purchaser agree to a further maturity date of the note.

According to the CDM, the expected occupancy (which the offering hoped to increase through improvements to the property) was expected to rise from 31% in the first year to 66% thereafter. At the time the facility was purchased, for $3.1 million, occupancy was at 0%.[57] If the occupancy rose as expected, the facility was estimated to be worth $6,300,000.[58] Thus, the delay in achieving increased occupancy caused a resultant delay in selling the property at a profitable level.

The extension agreement recites that the intent of the extension is to allow occupancy to rise so that a better sale price can be achieved in the future. Likewise, the letter to investors, announcing the extension, stated that the extension had been granted because the Debtor believes that he can secure a buyer at a better price in the future, increasing the potential profit.[59] These

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[55] Opposition p. 31.
[56] ROA002805.
[57] ROA006538; ROA006542.
[58] ROA006540.
[59] ROA002811.

terms are worded differently, given they are for different purposes (investor communications versus a contract) but they communicate the same reasoning behind the extension.[60]

As for the interest payments, FINRA argues that was a requisite disclosure to investors when advising them of the decision to extend. However, the extension agreement *defers* those payments until the extended maturity date or the date the property is sold.[61] As of the date of the extension agreement, therefore, those "late" or "unpaid" amounts, were not due for *at least* a year – if not longer. This process repeated in the second extension agreement.[62]

In the end, despite taking longer than initially anticipated, Columbia did sell and, thanks to the extended maturity deadline, sold for $5 million.[63] Investors received 100% of the principal invested and the interest owed.[64]

Further, extending the maturity deadline to allow the development to be completed (and sold profitably) aligns with the purpose of the investment. FINRA states, without citation, that Mr. Cantone extended the offerings in order to "[make] more money for himself." The record reflects the opposite. While extending the agreements involved a fee payable to the LLC entity, there is no evidence this resulted in a profit to CRI who had also incurred the expense of (1) making interest payments and (2) returning principal to investors who did not wish to continue to the new maturity deadline. Additionally, this characterization of the agreements ignores the stated objective of the COP offering. Investors hoped *not only* to receive their principal back, plus interest, but to ultimately receive up to a 20% equity interest in the capital gains earned upon sale or refinance of

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[60] The payment that the extension agreement "forthrightly" states Polo Road is unable to pay is the *principal* repayment.
[61] ROA002806 paragraph 5.
[62] ROA002829 (again discussing delay in expected occupancy).
[63] ROA0013595; 013601-13666.
[64] With regard to the increase in the interest in connection with the extension, Respondents testified that the 4% increase was to be paid to investors. ROA001280; ROA001603.

the property.[65] Thus, by allowing the projects additional time to mature, the extension agreements *protected* the value of the investment and the potential return to investors.[66]

E. Brogdon Facts are not Material to the Cherokee Offering

Both the NAC and FINRA conclude that because the guarantor of the Cherokee offering, Chelsea, LLC, was a corporate entity that Mr. Brogdon controlled, information about Mr. Brogdon is, therefore, material to investors in Cherokee.[67]

There are three errors in this reasoning. *First,* Chelsea is a distinct legal entity from Mr. Brogdon. There is no evidence that Brogdon guaranteed Chelsea's obligations or that Chelsea could otherwise utilize Brogdon's personal assets as its own. As already set forth in Applicant's Opening brief, potential materiality of the facts relating to Brogdon hinges on whether he was the guarantor of the project (meaning his financial ability to cover the guarantee was important to investors). Because Mr. Brogdon was not a guarantor, it necessarily follows that facts regarding his financial status were no longer relevant.[68]

Second, the fact that Brogdon is a part owner of Arcadia does not automatically make his background information material. FINRA summarily states that Mr. Alexander was "merely the contractor" responsible for construction.[69] FINRA's representation conflicts with the offering documents which state that Mr. Alexander was (1) the sole individual responsible for turning a vacant piece of property into a 108-home real estate development including a clubhouse and other amenities within a five-year period; and (2) a 30% owner in Arcadia.[70]

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[65] E.g. ROA006530.
[66] This is exactly what happened with Columbia.
[67] The NAC summarily concluded that "the entity that was giving the guarantee was owned by and entirely under Brogdon's control...this means that Brogdon's financial problems and lack of personal and business integrity would just as significantly influence the purchasers of the COP as would a personal guarantee." ROA014217. FINRA's Opposition similarly argues that "the entity that was giving the guarantee was owned by and under Brogdon's control."
[68] *See* Opening Brief p. 26-28.
[69] Opposition p. 34.
[70] ROA014217; ROA006749.

In addition, FINRA argues Mr. Brogdon is still "central" to Cherokee because "Arcadia Partners would still operate under Brogdon's direction as its managing member" after the issuance of the COPs.[71] This is only partly true and entirely irrelevant. After the issuance of the COPs, Brogdon and Cherokee Financial would hold equal shares and control of Arcadia (35%) – but that is not relevant here. The issue is whether information relating to Mr. Brogdon was material in the absence of a personal guarantee of the project by Mr. Brogdon and where a professional developer (not Mr. Brogdon) was responsible for the construction of the residential (not nursing home) development. Stated differently, would the Brogdon information substantially alter the information available to the potential investors in the Cherokee development?

The answer to this is no. Mr. Brogdon had only a limited connection to the offering and no role in the actual development of the community. According to the CDM[72] The Developer (not Brogdon, not Arcadia) was responsible construction including its speed and estimated cost.

With regard to the Chelsea Guarantee, the CDM stated[73]

- **Value of the Chelsea Guaranty Agreement.** Although Arcadia Partners' payment and other obligations under the Cherokee Note will be guaranteed by Chelsea . . ., there can be no assurance that, if called upon, Chelsea would have the liquid assets necessary to meet all of its obligations under the Chelsea Guaranty Agreement in a timely manner, or at all.
- **POTENTIAL INVESTORS SHOULD MAKE THEIR INVESTMENT DECISION BASED UPON THEIR EVALUATION OF THE DEVELOPMENT PROJECT, AND NOT IN RELIANCE UPON THE CHELSEA GUARANTY AGREEMENT.**
- **There can be no assurance that Chelsea will have the resources needed for it to make any such payments.**

[71] Opposition p. 34.
[72] ROA006759.
[73] ROA006765.

Given that Brogdon was not responsible for either the physical development of the real estate project or paying the personal guarantee if needed, neither his business skill nor his financial history were material. Reasonable investors reviewing the Cherokee offering and the Arcadia development – especially in light of the express language warning investors to make investment decisions based on their evaluation of the development and not the value of the guarantee – would be substantially *un*likely to significantly alter their decision making based on the disclosure of irrelevant and, in some cases ancient, background facts relating to Mr. Brogdon or his unrelated nursing home developments.

Accordingly, these facts are not material to the Cherokee offering and FINRA has failed to establish liability under Section 10(b), Rule 10b-5 or Section 17(a).

F. No Scienter or Negligence With Regard to Cherokee

Even if the Brogdon background facts were requisite disclosures, they were not omitted negligently or with scienter for the reasons set forth in Applicant's Opening Brief and in Sections II.A.1, II.B. and II.C. above.

G. No Failure to Supervise

For the same reasons the Commission should reverse the NAC's findings against CRI and Mr. Cantone, it should reverse the finding that Mrs. Cantone failed to supervise the same. Additionally, for reasons set forth in Applicants' Opening brief, even if a supervisory violation is found, the Commission should reverse the NAC's sanctions, which are excessive and punitive under the circumstances.

H. Sanctions

1. The NAC Erroneously Found Aggravating Factors Exist

To the extent the Commission reverses the NAC's findings, the sanctions must be reduced correspondingly. The NAC found there to be four aggravating factors: (1) intentional nature of

conduct; (2) pattern of conduct over time; and (3) failure to accept responsibility and (4) "lack of candor" with examiners.

The *first* of these factors (intentional conduct) is addressed above. For the *second* factor, the NAC erroneously found that the misrepresentations constituted a pattern, or occurred over a significant period of time. Yet, the NAC's sanctions for intentional conduct are limited to the extension agreements in Columbia and Chestnut and the Cherokee offering, all of which occurred over only a nine-month period (October 2012 – July 2013).[74] This is not a "significant" time period sufficient to justify an aggravated sanction.

Additionally, these are three distinct events that do not form any sort of pattern. The extension agreements were entered into to allow the specific nursing homes to continue development/operations until it could be sold profitably. The Cherokee offering was a wholly separate real estate development. Relatedly, even if these events constitute a "pattern" of non-disclosure, they are the result of a single determination that an event or kind of event did not need to be disclosed to investors. Where, as here, a violation is (1) the violative conduct was unintentional or negligent; (2) the conduct did not result in injury to public investors; *or* (3) the violations resulted from a single systemic problem or cause that has been corrected, aggregation or "batching" of the events is appropriate.[75] Instead of "batching" these offenses, the NAC concluded the opposite – finding that the events were part of a prolonged series of individual events. This reasoning was in error and should be reversed, resulting in decreased (or no) sanctions.

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[74] ROA014226; ROA02805;7
ROA004147.
[75] *Sanction Guidelines*, p. 4.

Third, Applicants have not "failed to accept responsibility" simply because they disputed the allegations made by FINRA in this dispute. Indeed, many of those charges were never proven and have been dismissed. The record reflects that Applicants did take responsibility, made changes to their procedures, and admitted where they could do better.[76] This included updating the Firm's policies and its due diligence procedures[77] in an effort to improve its systems.[78] Cantone undertook this obligation because it "wanted to take the constructive criticism" provided by the FINRA staff, and "considered [the changes] a positive thing."[79]

Fourth, the NAC erroneously found that Mr. Cantone exhibited a lack of candor with the examiner because he supposedly told her that there had been no defaults on the Brogdon projects. Specifically, the NAC based its finding on the "fact" that an examiner had directly asked Mr. Cantone whether or not there had been any late interest payments and he responded in the negative."[80] The actual testimony, amounting to no more than a few sentences, is far less specific. The supposed conversation was about the firm's entire private placement business – not just the offerings at issue here. Nor was it clear which answers are attributable to Mr. Cantone. When asked "who gave you that answer" the examiner stated "I believe, for the most part, it was Anthony Cantone who did most of the talking.[81] This single, vaguely-described exchange is not sufficient to evidence that the Firm and Mr. Cantone exhibited a "lack of candor" during the examination process. Indeed, this supposed statement mentioned or referenced anywhere in the examination documents – including the examination report detailing FINRA findings and concerns.

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[76] ROA004647-004712.
[77] *Id.*
[78] *Id.*
[79] ROA001604.
[80] ROA04226.
[81] ROA001544.

Thus, the finding that aggravating factors exist should be reversed, along with all sanctions based thereon.

2. The NAC Erroneously Ignored Mitigating Factors

The NAC also erred in ignoring evidence of mitigating factors, including (1) absence of investor losses;[82] (2) that Applicants acted in good faith, retained counsel to assist, and believed their disclosures were proper; (3) Mr. and Mrs. Cantone acted in the best interest of their investors, ensuring timely interest was paid and offering to purchase the investments from their clients if the client was unhappy with the extended maturity and (4) when it became clear that Brogdon would not voluntarily make good on his guarantees, the LLCs, through Mr. Cantone, retained an attorney and obtained judgments against Brogdon, incurring legal fees in excess of $300,000[83]

The NAC improperly concluded that the evidence showing that CRI and Mr. Cantone always acted to protect investors was "neither aggravating nor mitigating".[84] Yet, FINRA's Guidelines clearly state that disciplinary sanctions – above all else - must be designed to protect the investing public.[85] Evidence reflecting a respondent's actions taken in furtherance of that *exact* objective is inherently relevant to the sanction determination. Because the NAC's sanction assessment failed to take into consideration this mitigating evidence, the sanction award should be reversed or reduced.

[82] FINRA brought this case alleging that investors had lost over $6 million as a result of the conduct at issue. Both the Hearing Panel and the NAC found there was no evidence of any investor loss and, to the contrary, the majority of the projects were profitable for investors.

[83] ROA010257-010266; ROA001189; ROA001192;ROA001218; ROA001216-001217. Principle Considerations Nos. 13-16, 18.

[84] FINRA014227-8. Sanctions are inherently a "facts and circumstances" analysis that must be tailored to be remedial, not punitive. Guidelines pp. 1,

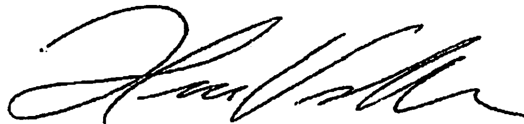
[85] Guidelines p. 2, Principle 1.

III. CONCLUSION

For the reasons set forth herein, as well as in their Opening Brief, Applicants respectfully request that the Commission reverse the NAC's findings of liability and any sanctions imposed thereon. In the alternative, to the extent some liability is imposed, Applicants request that the Commission reduce or eliminate the sanctions imposed by the NAC so that they comport with the evidence and the Sanction Guidelines.

Respectfully submitted this 12th day of August, 2019.

ULMER & BERNE LLP

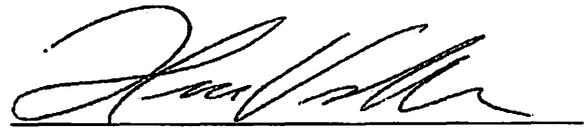


Heidi E. VonderHeide
Alan M. Wolper
hvonderheide@ulmer.com
awolper@ulmer.com
500 West Madison Street, Suite 3600
Chicago, Illinois 60661
(312) 658-6500 – General
(312) 658-6565 – Fax

Counsel for Applicants

CERTIFICATE OF COMPLIANCE

In accordance with Rule 450(d) of the Rules of Practice, I certify that this brief, exclusive of the cover page, table of contents, table of authorities, and signature blocks is in compliance with the 7,000-word limit. The brief contains 6,996 words, according to the word processing system used to prepare the brief.



Heidi E. VonderHeide

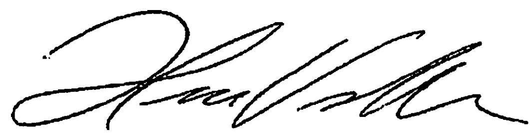
CERTIFICATE OF SERVICE

I hereby certify that this **APPLICANTS' REPLY BRIEF IN SUPPORT OF APPLICATION FOR REVIEW** has been sent to the following parties entitled to notice as follows:

Securities and Exchange Commission
Office of the Secretary
100 F. Street N.E.
Mail Stop 1090-Room 10915
Washington D.C. 20549
Fax: 202-772-9324
(One copy via fax; original and three copies via overnight mail)

Colleen Durbin
Alan Lawhead, Esq.
Office of the General Counsel
FINRA
1735 K Street, NW,
Washington, DC, 20006-1506
Fax: (202) 728-8264
(One copy via fax and one copy via overnight mail; courtesy copy via email)

This 12th day of August 2019.



Heidi E. VonderHeide
Counsel for Applicants