SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 80340 / March 29, 2017

Admin. Proc. File No. 3-17512

In the Matter of the Application of

KCD FINANCIAL INC.

For Review of Disciplinary Action Taken by FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDINGS

Registered securities association found that member firm engaged in the unregistered offer and sale of securities when no exemption was in effect. Association also found that firm failed to supervise its representatives' sales of those securities. *Held*, association's findings of violation and sanction imposed are *sustained*.

APPEARANCES:

Jill G. Fieldstein, P.C., for KCD Financial Inc.
Alan Lawhead, *Gary Dernelle*, and *Michael Garawski*, for FINRA.

Appeal filed: August 29, 2016
Last brief received: December 6, 2016

KCD Financial Inc., a FINRA member, seeks review of FINRA disciplinary action. FINRA found that, between April 2011 and October 2011, representatives of KCD engaged in the unregistered offering and sale of at least $2 million in securities in transactions as to which no exemption from the registration requirements of the federal securities laws applied. FINRA found that this conduct violated FINRA Rule 2010's prohibition on conduct inconsistent with just and equitable principles of trade. FINRA further found that KCD failed to supervise the sales of those securities in violation of FINRA Rule 2010 and NASD Rule 3010 which required members to establish and maintain a supervisory system designed to achieve compliance with applicable securities laws and regulations and applicable NASD rules.[1] Based on these violations, FINRA censured KCD, imposed a fine of $73,000, and assessed costs.

KCD admits that the offers and sales of the securities in question were not registered, but it contends that the offers and sales were made pursuant to Rule 506(b) of Regulation D under the Securities Act of 1933,[2] which, at the time, allowed the unregistered offer and sale of securities if, among other requirements, there had been no general solicitation in the offer or sale of the securities. KCD further argues that its supervision of the offering was appropriate. Based on our independent review of the record, we reject KCD's contentions and sustain FINRA's findings of violation and its imposition of sanctions.

I. Facts

A. KCD and its Dallas branch office

KCD is an independent broker-dealer headquartered in De Pere, Wisconsin. This case involves KCD's Dallas office, which also did business under the name Westmount Realty Finance LLC. Isaac Gregory was senior vice-president of capital markets for Westmount Realty Finance and branch manager of the Dallas office. He testified that Westmount Realty Finance had an "issuer side" that put together offerings and a "FINRA sales side" comprised of a "captive" team of registered representatives who sold no securities other than those offered by Westmount Realty Finance. The registered representatives in the Dallas branch office were supervised by KCD's home office and its chief compliance officer ("CCO"). Jeffrey Larson was KCD's CCO in early 2011; he was succeeded by Lori Rastall that fall.

B. Westmount Realty Finance and the WRF Distressed Realty Fund 2011, LLC

In early 2011, Westmount Realty Finance sponsored an offering of the WRF Distressed Residential Fund 2011, LLC (the "WRF Fund" or the "Fund"). The private placement memorandum ("PPM") for the WRF Fund, dated March 15, 2011, stated that the Fund would invest up to $10 million "to fund the bulk acquisition of distressed residential properties and related assets . . . at deep discounts." The minimum subscription amount was $1 million.

The PPM stated that the offer and sale of interests in the Fund were "being made in reliance on an exemption from the registration requirements" of the Securities Act and that interests in the Fund were being offered only to persons who were accredited investors as set forth in Regulation D. In a Notice of Exempt Offering of Securities it filed with the Commission

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[1] As a result of the consolidation of the regulatory functions of NASD and NYSE Regulation into FINRA and the development of a new consolidated FINRA rulebook, *see* Exchange Act Release No. 56148, 2007 WL 2159604, at *2 (July 26, 2007), KCD was subject to both FINRA and NASD Rules during the period at issue. The conduct rules that apply are those in effect at the time of the relevant conduct. *See, e.g., John Joseph Plunkett*, Exchange Act Release No. 69766, 2013 WL 2898033, at *1 nn.3-4 (June 14, 2013) (applying both NASD and FINRA rules, depending on whether conduct occurred before or after consolidation).

[2] 17 C.F.R. § 230.506(b).

on August 24, 2011, the WRF Fund claimed that the offering was exempt pursuant to Rule 506 under Regulation D.

To qualify for the exemption under that rule at all relevant times, there could be no general solicitation or general advertising of the WRF Fund offering by the issuer or anyone acting on the issuer's behalf,[3] and the Fund interests could be sold only to accredited investors[4] and to no more than 35 other investors who satisfied specified criteria regarding knowledge and experience in financial and business matters.[5]

When the "issuer side" of Westmount Realty Finance completed its work on the PPM, the LLC agreement, and the subscription documents for the WRF Fund, Gregory sent them, along with sales and marketing documents, to KCD. On March 15, 2011, Larson signed a soliciting dealer agreement in which KCD agreed to solicit purchasers of membership interests in the WRF Fund. Shortly after this agreement was signed, KCD sent e-mails to approximately 1,200 individual accredited investors and registered investment advisors in KCD's database of preexisting investors, informing them that the new offering was available.

C. Newspaper articles about the WRF Fund

On April 26, 2011, before KCD's registered representatives had sold any interests in the WRF Fund, two Dallas newspapers published articles about the WRF Fund, based on a press release issued by Westmount Realty Finance. Both articles were generally available without restriction on the websites of the respective newspapers.

One article appeared in the Dallas Business Journal. The article reported that Westmount Realty Finance had announced "that it launched a $10 million real estate fund to acquire bank-owned residential properties and non-performing, discounted residential loans," that the fund would have a 12-month investment period, and that Westmount Realty Finance "expects to reinvest sales proceeds in additional assets during the period."

The second article, headlined "Dallas investor launches residential property investment fund," appeared in the Dallas Morning News. It reported that Westmount Realty Finance "has set up a special residential investment fund to acquire residential properties and non-performing

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3 *See* 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 were required to "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").

4 *See* Securities Act Rule 501(a), 17 C.F.R. § 230.501(a) (defining "accredited investor" for purposes of Regulation D); *see also* Section 2(15)(ii) of the Securities Act, 15 U.S.C. § 77b(15)(ii) (authorizing the Commission to prescribe qualifications of an accredited investor).

5 *See* Rule 506(b)(2), 17 C.F.R. § 230.506(b)(2) (limiting the number of purchasers in an offering under Rule 506(b) to 35); Rule 501(e)(1)(iv), 17 C.F.R. § 230.501(e)(1)(iv) (excluding accredited investors from the calculation of number of purchasers under Rule 506(b)); Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii) (setting forth the knowledge and experience requirements for purchasers who are not accredited investors).

loans from lenders. The [Fund] will partner with firms that specialize in bulk purchases of distressed residential assets. The $10 million fund will focus on U.S. residential markets with high foreclosure rates." In the article, Westmount Realty Finance's chief investment officer said that the Fund saw "a steady stream of buying opportunities," and that "the U.S. [is] experiencing record-level foreclosure activity, [and] most industry experts aren't anticipating a slowdown for at least the next couple of years."

Shortly after these articles appeared, Westmount Realty Finance's securities attorney, who had drafted the PPM and knew that Westmount Realty Finance was relying on a Regulation D exemption, contacted Gregory to tell him that the Dallas Business Journal article was a "breach of the prohibition against general solicitation." It is unclear when Gregory learned about the Dallas Morning News article. The attorney warned Gregory not to post the Dallas Business Journal article on "the Westmount website," apparently referring to a website maintained by Westmount Realty Capital, LLC ("WRC"), an affiliate of Westmount Realty Finance.

Gregory promptly telephoned Larson to tell him about the attorney's concerns. Larson did not tell Gregory to have the registered representatives stop selling interests in the WRF Fund. Instead, Larson and Gregory decided to tell the representatives that if anyone who did not have a prior business relationship with Westmount Realty Finance or KCD contacted them about the WRF Fund, they should ask how that person learned about the offering. If the potential investor learned of the offering from a newspaper article, the representatives were not to let that person invest. At least one potential investor who had learned about the offering from the Dallas Morning News article was told by a representative that he could not participate in the offering.

Several days later, Gregory learned that the Dallas Business Journal article had been published on an unrestricted section of the WRC website. A link accompanying the article on the WRC website invited the visitor to the site to "contact us." At some point, Gregory learned that the Dallas Morning News article had also been published on WRC's website. A similar link appeared with that article. Gregory asked the Westmount technology team to remove the articles from the WRC website, but did not follow up to see whether the articles were removed.

During an FINRA examination of KCD in the fall of 2011, a FINRA examiner found that the articles were still posted on the WRC website. The examiner brought the articles to the attention of Rastall, who had succeeded Larson as KCD's CCO shortly before the examination. Rastall, like Gregory, thought that the articles were general solicitations, but she did not tell Gregory that the registered representatives must stop selling interests in the Fund.

KCD registered representatives first sold interests in the WRF Fund on May 5, 2011, nine days after the newspaper articles were published. Sales continued until at least October 2011. As of August 2011, KCD was the only broker-dealer that had sold interests in the Fund, it had raised at least $2 million, and it received sales compensation for its efforts.

II. Procedural History

On November 14, 2013, FINRA's Department of Enforcement filed a complaint against KCD. Enforcement alleged that KCD registered representatives sold WRF Fund securities that were neither registered nor qualified for an exemption from registration and therefore violated FINRA Rule 2010 "by virtue of acting in contravention of Section 5 of the Securities Act of 1933." Enforcement alleged further that KCD failed to reasonably supervise the unregistered securities offering in violation of NASD Rule 3010.

On August 3, 2016, FINRA found that KCD violated Section 5 of the Securities Act because it offered and sold interests in the WRF Fund in interstate commerce when no registration statement was filed or in effect as to those offers and sales and KCD failed to establish that the exemption from registration under Rule 506 of Regulation D, or any other exemption, was available. FINRA found that this conduct violated FINRA Rule 2010's prohibition against conduct inconsistent with just and equitable principles of trade. It also found that KCD's supervision of the sales of the WRF Fund was unreasonable because KCD failed to respond with reasonable supervisory steps after the securities attorney alerted KCD to the newspaper articles. FINRA censured KCD and imposed a $73,000 fine. This appeal followed.

III. Analysis

In reviewing disciplinary action by a self-regulatory organization ("SRO") like FINRA, we must determine whether the applicant engaged in the conduct found by the SRO, whether such conduct violates the SRO's rules as specified in the SRO's determination, and whether those rules are, and were applied in a manner, consistent with the purposes of the Securities Exchange Act of 1934.[6] We base our findings on an independent review of the record and apply a preponderance of the evidence standard to determine whether the evidence supports the SRO's findings.[7] As explained below, we find that KCD engaged in the conduct found by FINRA, that the conduct violated the rules that FINRA found violated, and that the rules are, and were applied in a manner, consistent with the purposes of the Exchange Act.

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

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

The Exchange Act authorizes FINRA to enact its own rules and enforce compliance with them.[8] FINRA Rule 2010, which we have long held is consistent with the purposes of the Exchange Act,[9] requires members to observe "high standards of commercial honor and just and equitable principles of trade." A violation of Rule 2010 may be based on any conduct, not simply conduct that violates the Exchange Act. To that end, we have sustained FINRA's findings that conduct unrelated to the purchase or sale of securities violates Rule 2010 and

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6 15 U.S.C. § 78(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 Exchange Act Section 15A(b)(2), 15 U.S.C. § 78*o*-3(b)(2).

9 *See, e.g., Rani T. Jarkas*, 2016 WL 1272876, at *10.

subjects a member to discipline.[10] And we have found on multiple occasions that a violation of the *Securities Act*, including a sale of unregistered securities in violation of Section 5, violates Rule 2010.[11] That is because Rule 2010 "appropriately encompasses the myriad types of misconduct that may injure public investors and the marketplace," such as sales of unregistered securities without an exemption from registration;[12] indeed, we have held that such unregistered sales "harm[] investors and the marketplace by depriving investors of the full disclosure that would have allowed them to make informed investment decisions."[13]

2. FINRA Enforcement established a prima facie case of a Section 5 violation.

Section 5(a) of the Securities Act prohibits the sale of any security in interstate commerce "unless a registration statement is in effect."[14] Section 5(c) of the Securities Act prohibits the offer to sell any security in interstate commerce "unless a registration statement has been filed as to such security."[15] FINRA's Department of Enforcement could establish a prima facie case that KCD violated Section 5 by showing that (1) KCD directly or indirectly sold or offered to sell securities (2) through the use of interstate commerce or the mails (3) when no registration statement was in effect or filed for those securities.[16] Section 5 imposes strict liability on those who offer or sell securities in unregistered offerings without an exemption from registration, so there is no scienter requirement.[17]

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[10] *See, e.g.*, *Brian L. Gibbons*, Exchange Act Release No. 37170, 1996 WL 254664, at *3 & n.17 (May 8, 1996) (finding that "providing misleading and inaccurate information to [an SRO] is conduct contrary to high standards of commercial honor and is inconsistent with just and equitable principles of trade," rejecting argument that conduct must involve "broker client situations" or "trading situations," and citing cases) .

[11] *See, e.g.*, *Midas Sec., LLC*, Exchange Act Release No. 66200, 2012 SEC LEXIS 199, at *46 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 Capital 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)).

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

[13] *Gordon Brent Pierce*, Exchange Act Release No. 71664, 2014 WL 896757, at *23 (Mar. 7, 2014), *petition denied*, 786 F.3d 1027 (D.C. Cir. 2015).

[14] 15 U.S.C. § 77e(a).

[15] 15 U.S.C. § 77e(c).

[16] *SEC v. Big Apple Consulting USA, Inc*, 783 F.3d 786, 806-07 (11th Cir. 2015).

[17] *SEC v. Calvo*, 378 F.3d 1211, 1215 (11th Cir. 2004).

Enforcement established a prima facie case because there is no dispute that KCD representatives offered and sold interests in the WRF Fund by means of interstate commerce or the mail when no registration statement was filed or in effect.

3. KCD failed to establish a Rule 506 exemption.

Once a prima facie case has been established, the burden shifts to the applicant to show that the offers and sales of securities are exempt from the registration requirement.[18] Registration exemptions are strictly construed "to promote full disclosure of information for the protection of the investing public."[19] Because "public policy strongly supports registration," the burden of proof rests with the party claiming the exemption to establish its availability.[20]

To establish that the offers and/or sales of the WRF Fund were exempt under Rule 506(b) of Regulation D at the time KCD representatives made the offers and sales, KCD must show, among other things, 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.[21] We find that KCD offered interests in the WRF Fund by means of a general solicitation. This rendered the exemption unavailable regardless of the number of accredited investors or the knowledge and experience of the purchasers who were not accredited investors.[22]

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

19 *Id.* at 115.

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

21 *See supra* notes 3-5 (discussing the prohibition against general solicitation for Rule 506(b) offerings as well as the requirements regarding purchasers).

22 *See, e.g.*, *Solicitations of Interest Prior to an Initial Public Offering*, Securities Act Release No. 7188, 1995 WL 385857, at *7 (June 27, 1995) (stating, with respect to Regulation D as it existed at the time of KCD's offering, that "under Rule 502(c) of Regulation D, any form of general solicitation or general advertising would preclude availability of the exemptions provided by Rules 505 and 506" and that if an issuer engaged in activity that "involved general advertising or other activities constituting general solicitation, it could not proceed directly to an offering relying on an exemption that precluded general solicitation, even if the parties expected to purchase in the exempt offering were accredited investors").

a. The newspaper articles posted on WRC's website 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."[23] The Supreme Court has recognized that "Congress expressly intended to define" this term "broadly."[24] Its definition "extends beyond the common law contract concept of an offer."[25]

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.[26] 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.[27]

We find that the Dallas Business Journal and Dallas Morning News articles published on WRC's website were designed to arouse public interest in the WRF Fund offering and therefore constituted offers. The articles were based on a press release issued by Westmount Realty Finance, the promoter of the WRF Fund, and sought to draw attention to the Fund. They cast the Fund's objective in a favorable light, stating that the United States was "experiencing record-level foreclosure activity" and predicting a bright future for the Fund. The articles emphasized the expertise of the Westmount Realty Fund principals, who "ha[d] been in the property business in the area for more than 25 years" and mentioned their anticipated alliance with "several operators that specialize in bulk acquisition of distressed residential properties." They also reported on Westmount Realty Finance's current involvement in the relevant market, stating that

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23 15 U.S.C. § 77b(a)(3). FINRA made no finding as to the nature of the security at issue. KCD does not dispute that interests in the WRF Fund were securities, and we find that those interests were investment contracts, and as such fell within the definition of a security. *See* Securities Act Section 2(a)(1), 15 U.S.C. §77b(a)(1) (defining "security" to include "any . . . investment contract"); *see also, e.g., Blair C. Mielke*, Exchange Act Release No. 75981, 2015 SEC LEXIS 3927, at *28 (Sept. 24, 2015) (defining "investment contract" as "'a contract, transaction, or 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 *W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946)); *Johnny Clifton*, Exchange Act Release No. 69982, 2013 SEC LEXIS 2022, at *32 (July 12, 2013) (same).

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

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

26 *Gearhart & Otis, Inc.*, Exchange Act Release No. 7329, 1964 SEC LEXIS 513, at *59 (June 2, 1964), *aff'd on other grounds*, 348 F.2d 798 (D.C. Cir. 1965).

27 *The Regulation of Securities Offerings*, Securities Act Release No. 7606A, 1998 SEC LEXIS 2858, at *227 n.276 (Nov. 13, 1998) (citing *Loeb, Rhoades & Co.*, Exchange Act Release No. 5870, 38 SEC 843, 1959 SEC LEXIS 413 (Feb. 9, 1959); *First Maine Corp.*, Exchange Act Release No. 5898, 38 SEC 882, 1959 SEC LEXIS 425 (Mar. 2, 1959)).

it had purchased "more than 350 distressed residential units" in just over a year and that it "continue[d] to see a steady stream of buying opportunities." Westmount adopted the articles by posting them on the WRC website, thereby rendering the content of the articles attributable to Westmount.[28]

KCD argues that the articles were "not even aimed at investors, but at owners of distressed residential properties from whom the WRF Fund sought to purchase investment properties." But even if the articles were designed in part to alert potential sellers of distressed properties to the WRF Fund's possible interest, that would not preclude the articles from also constituting offers.

KCD also argues that it did not use the articles to offer or sell securities because it took steps to insure that all sales were to accredited investors with whom the Firm had a prior relationship. But whether the purchasers were accredited or had a prior relationship to the Firm is irrelevant to whether or not the newspaper articles constituted a general solicitation for purposes of Regulation D.

b. The newspaper articles posted on WRC's website were a general solicitation.

"General advertising" and "general solicitation," as used in Rule 502(c), include "[a]ny . . . article, notice or other communication published in any newspaper, magazine, or similar media."[29] Publication on an unrestricted website can also constitute general advertising or general solicitation.[30] The articles published by the Dallas Morning News and Dallas Business Journal about Westmount Realty Finance constituted a general advertising and general solicitation under Rule 502(c)(1), since they were based on a press release issued by Westmount Reality Finance. The articles were published in the Dallas Morning News and Dallas Business Journal, and were posted on the newspapers' websites. Westmount Realty Finance also adopted them by posting them on the website of WRC. Since, as described above, the articles constituted offers and such offers were in the form of a general solicitation, KCD's offering of the interests in the WRF Fund on behalf of Westmount Realty Finance did not satisfy the requirements of Rule 502(c), and the offering did not qualify for the Rule 506 exemption.

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28 *See Use of Electronic Media*, Securities Act Release No. 7856, 2000 WL 502290, at *10 (Apr. 28, 2000).

29 17 C.F.R. §230.502(c)(1).

30 *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Securities Act Release No. 9415, 2013 SEC LEXIS 2004, at *8 (July 10, 2013) (citing *Use of Electronic Media for Delivery Purposes*, Securities Act Release No. 7233; *Use of Electronic Media*, Securities Act Release No. 7856 (Apr. 28, 2000)); *see also, e.g., SEC v. Rabinovich & Assocs.*, 2008 U.S. Dist. LEXIS 93595, at *13 (S.D.N.Y. Nov. 18, 2008) (recognizing general solicitation of purchases of securities "by means of . . . a website available to the general public").

c. KCD's arguments that the Rule 506(b) exemption was available despite the offer in the form of a general solicitation lack merit.

KCD argues that the Rule 506 exemption still applies because KCD did not generally solicit any of the actual investors in the WRF Fund (*i.e.*, all of the investors in the WRF Fund were accredited investors with whom KCD had a prior relationship). KCD relies on *Joseph P. Doxey*,[31] which, it says, suggests that if the issuer could show that it had a prior relationship with the investor, there would be no general solicitation violation despite the issuance of press releases regarding the issuer. *Doxey* stands for no such proposition. In *Doxey*, the Commission addressed allegations that a company's press releases contained material misstatements as well as separate allegations that the company violated the registration provisions. The Commission did not find that the press releases constituted an "offer" to sell securities; the Commission's discussion of the press releases in *Doxey* was limited to the separate allegations of fraud in that matter.

Rather, the Section 5 issue in the case was whether the company's offer and sale of securities to another company was made by means of a general solicitation. The Commission stated that a "pre-existing substantive relationship" between the CEO of the company offering and selling the securities and the sole owner of the company purchasing the securities "would be a means of demonstrating compliance with the limitation on the manner of offering found in Rule 502(c)." This statement reiterated the "well-known principle" that "a general solicitation is not present when there is a pre-existing, substantive relationship between an issuer, or its broker-dealer, and the *offerees*."[32] *Doxey* provides no support for the notion that the Rule 506(b) exemption is available despite press releases or, as here, newspaper articles posted on an issuer's unrestricted website that constitute an offer to sell securities in the form of a general solicitation as long as there was a pre-existing relationship with the *purchasers*.

KCD also relies on guidance the Commission issued in 1983.[33] But that guidance makes clear that whether the investors had a prior relationship to KCD or were all accredited is not the relevant inquiry. Under the guidance the Commission issued in 1983, 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."[34] Westmount Realty Finance *offered* securities in the WRF Fund to the general public by publishing the newspaper articles on an unrestricted part of WRC's website. Once it did so, it engaged in a general solicitation in violation of Rule 502(c) and the Rule 506

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31 Exchange Act Release No. 7773, 2016 SEC LEXIS 1665, at *27-28 (May 5, 2016).

32 *Use of Electronic Media*, 2000 WL 502290, at *12 (emphasis added).

33 *Interpretive Release on Regulation D*, Securities Act Release No. 6455, 1983 SEC LEXIS 2288 (Mar. 3, 1983).

34 *Id*. at *45-48 (setting forth two-part test to determine whether prohibition on general solicitation has been violated).

exemption was not available for any subsequent *sales* of the WRF Fund regardless of KCD's attempts to limit the sales only to investors who did not see the newspaper articles.[35]

KCD also argues that Commission guidance issued in 2007 supports its position. But the guidance the Commission issued in 2007 addressed only the narrow question of when a registration statement for a public offering constitutes a general solicitation or general advertising that would render the Section 4(2) exemption unavailable for a *concurrent* unregistered offering.[36] Here, there was no public offering for which a registration statement was filed and the question is whether the newspaper articles constituted a general solicitation of the unregistered private offering; we find that they did.

KCD further argues that a 2011 letter from former Chairman Mary Schapiro to Congressman Darrell E. Issa discussing a proposed private offering of Facebook by Goldman Sachs supports its position. According to KCD, Chairman Shapiro suggested in the letter that, despite the intense media scrutiny, Goldman Sachs would not have engaged in a general solicitation if it sold the unregistered securities only to investors who were not solicited by the media attention but rather were already clients of the firm.[37] KCD's reliance on this letter is misplaced.

The section of the letter KCD quoted occurs in a discussion concerning Commission guidance with respect to the scope of the ban on general solicitation and advertising. The Chairman prefaced the language KCD quotes with a reference to the 2007 guidance that she had cited in the previous paragraph. She was thus referring to sales to existing clients or those with a substantive, pre-existing relationship in the context of concurrent registered and private offerings. Again, that is not the situation here. The letter also noted that Goldman Sachs was "planning to *offer* . . . securities of Facebook to clients of Goldman Sachs" (emphasis added). As discussed above, a general solicitation may not be present where the *offerees* have a pre-existing relationship with the issuer or its broker; here, however, KCD does not argue that it had a pre-

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35 Under amendments to Rule 506 adopted to implement Section 201(a) of the Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313-14 (Apr. 5, 2012), an issuer who takes reasonable steps to verify that purchasers of an offering of securities are accredited investors and who sells the securities only to accredited investors may engage in general solicitation or general advertising and still claim an exemption under Rule 506(c). *See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, 2013 SEC LEXIS 2004; *see also* Rule 506(c), 17 C.F.R. § 230.506(c). This exception to the general solicitation prohibition was not available before 2013. And even after 2013, sellers may not take advantage of Rule 506(c) unless they take reasonable steps to verify the accredited investor status of the purchasers in the offering. KCD does not argue that Rule 506(c) applies, or was satisfied, here.

36 *Revisions of Limited Offering Exemptions in Regulation D*, Securities Act Release No. 8828, 2007 SEC LEXIS 1730, at *87-90 (Aug. 3, 2007). In the Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(c), Congress renumbered Section 4(2) as Section 4(a)(2).

37 Letter from Mary Schapiro to Darrell E. Issa, dated April 6, 2011, at 8, available at https://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf.

existing relationship with all offerees but rather with all *purchasers*. In any event, the Chairman's letter, which refers repeatedly to the Chairman's own views, does not purport to be an official statement of Commission policy.

Finally, KCD argues that a letter from Commission staff stating that the staff did not intend to recommend enforcement action against Westmount Realty Capital after an investigation that allegedly encompassed the WRF Fund offering suggests that the staff determined that the WRF Fund investors were accredited and had a pre-existing relationship with KCD or Westmount Realty Finance.[38] As discussed above, whether the investors were accredited or had such a pre-existing relationship was irrelevant because Rule 506 was not available where, as here, there was a general solicitation. In any case, staff letters advising that an investigation has been terminated without recommending enforcement action do not establish that no violations of the securities laws occurred.[39]

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Based on the foregoing analysis, we find that KCD engaged in the conduct that FINRA found and that its conduct violated FINRA Rule 2110 because it violated Securities Act Section 5. Because Exchange Act Section 15A(b)(6) requires that FINRA design its rules to "promote just and equitable principles of trade,[40] and because we have found that KCD's unregistered sale of securities without the benefit of an exemption from registration, in violation of Securities Act Section 5, was inconsistent with just and equitable principles of trade, we also find that FINRA Rule 2010 is, and was applied in a manner, consistent with the purposes of the Exchange Act.[41]

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[38] FINRA denied KCD's motion to introduce the letter and related documents during the appeal to the NAC, finding that the evidence was not material.

[39] *See Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations*, Securities Act Release No. 5310, 1972 SEC LEXIS 238, at *7-8 (Sept. 27, 1972) (stating that if the staff advises a person under inquiry that its formal investigation has been terminated, "such advice . . . must in no way be construed as indicating that the party has been exonerated" in part because the staff's decision not to recommend enforcement action at that time "may be based upon various reasons, some of which, such as workload considerations, are clearly irrelevant to the merits of any subsequent action"). Because the letter "must in no way" be construed as showing that KCD did not engage in violative conduct, and because KCD does not contend that the letter is relevant to any other issue, we find that the letter is not material and therefore deny KCD's motion to admit the letter and related documents on appeal. Rule of Practice 452, 17 C.F.R. § 201.452 (allowing the Commission to allow additional evidence on appeal if, among other things, that evidence is material).

[40] 15 U.S.C. § 78*o*-3(b)(6).

[41] *See Notice of Filing of a Proposed Rule Change*, Exchange Act Release No. 58095, 2008 SEC LEXIS 1558, at *2, 4-5 (July 3, 2008).

B. KCD failed to reasonably supervise the offer and sale of interests in the WRF Fund.

NASD Rule 3010 required member firms to establish and maintain a supervisory system "reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable NASD Rules."[42] It is well established that "[t]he presence of procedures alone is not enough. Without sufficient implementation, guidelines and strictures do not ensure compliance."[43]

The duty to supervise also "'includes the responsibility to investigate "red flags" that suggest that misconduct may be occurring and to act upon the results of such investigation.'"[44] "'[R]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review.'"[45] Supervisors must respond with the utmost vigilance when there is any indication of irregularity,[46] and take decisive action when they are made aware of suspicious circumstances.[47] Whether supervision is "reasonable" depends on the particular circumstances of each case.[48]

KCD's procedures required that supervisors oversee private offerings. The procedures required those supervisors to perform reasonable due diligence and to check for compliance with Regulation D. Despite these procedures, KCD failed to exercise reasonable supervision.

Shortly after the publication of the article in the Dallas Business Journal, Westmount Reality Finance's securities attorney, who had drafted the PPM and knew that Westmount Reality Finance was relying on a Regulation D exemption, contacted Gregory and told him that the article was a "breach of the prohibition against general solicitation." Gregory promptly informed Larson of the call. As the hearing panel found, this call warning that the publication of

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42 NASD Rule 3010 was later superseded in relevant part by FINRA Rule 3110.

43 *Rita H. Malm*, Exchange Act Release No. 35000, 1994 WL 665963, at *4 n.17 (Nov. 23, 1994).

44 *ACAP Fin., Inc.*, Exchange Act Release No. 70046, 2013 WL 3864512, at *8 (July 26, 2013) (quoting *Michael T. Studer*, Exchange Act Release No. 50534A, 2004 WL 2735433, at *6 (Nov. 30, 2004), *petition denied*, 260 F. App'x 342 (2d Cir. 2008)).

45 *Id*. (quoting *John B. Busacca, III*, Exchange Act Release No. 63312, 2010 SEC LEXIS 3787, at *48 & n.56 (Nov. 12, 2010), *petition denied*, 449 F. App'x 886 (11th Cir. 2011)); *see also*, *e.g.*, *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 WL 5328765, at *10 (Dec. 19, 2008) ("'Once indications of irregularity arise, supervisors must respond appropriately.'") (quoting *La Jolla Capital Corp*., Exchange Act Release No. 41755, 1999 SEC LEXIS 1642, at *21 (Aug. 18, 1999)).

46 *Consol. Inv. Servs. Inc.*, Exchange Act Release No. 36687, 1996 WL 20829, at *5 (Jan. 5, 1996); *Michael E. Tennenbaum*, Exchange Act Release No. 31984, 1982 WL 31984, at *6 (Jan. 19, 1982).

47 *George J. Kolar*, Exchange Act Release No. 46127, 2002 WL 1393652, at *4 (June 26, 2002).

48 *William J. Murphy*, Exchange Act Release No. 69923, 2013 WL 3327752, at *18 (July 2, 2013), *petition denied sub nom. Birkelbach v. SEC*, 751 F.3d 472 (7th Cir. 2014).

the article constituted a general solicitation "was more than a red flag; it was a red stop sign." KCD should have then directed its "prompt and full attention" to addressing the problem.[49] Yet neither Gregory nor Rastall (who succeeded Larson) instructed the registered representatives to stop the unregistered sale of interests in the Fund, which would have been the only acceptable response once the Rule 506 exemption was lost.

To the extent that KCD erroneously believed that it could continue to rely on the Rule 506 exemption by limiting the offering to certain investors, its supervisory responses were also unreasonable because KCD had no basis for this belief. KCD does not even assert that, at the time of the offering, it relied on the authorities that it cites here for its position that the Rule 506 exemption could still be available despite a general solicitation. Indeed, both Gregory and Rastall testified that at the time they were unaware of what they were required to do after a general solicitation occurred. At the least, they were required to investigate their obligations.[50] Their failure to do so was unreasonable.

We find that KCD engaged in the conduct that FINRA found and that its conduct violated NASD Rule 3010. Because we have "'long emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the federal regulatory scheme,'"[51] and because FINRA's application of Rule 3010 in this case was appropriate given the unreasonableness of the supervisory response here, we also find that NASD Rule 3010 is, and was applied in a manner, consistent with the purposes of the Exchange Act.

IV. Sanctions

Exchange Act Section 19(e)(2) requires us to sustain the sanctions FINRA imposed unless we find, with due regard for the public interest and the protection of investors, that they are excessive or oppressive or impose an unnecessary or inappropriate burden on competition.[52] As part of our review, we consider any aggravating or mitigating factors;[53] we also consider whether the sanctions are remedial or punitive.[54] While we are not bound by FINRA's Sanction Guidelines, we use them as a benchmark in conducting our review.[55]

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49 *Busacca*, 2010 SEC LEXIS 3787, at *38.

50 *See, e.g.*, *World Trade Fin. Corp. v. SEC*, 739 F.3d 1243, 1250 (9th Cir. 2014) (finding that ignorance of the law did not excuse failure to carry out supervisory duties).

51 *Robert Marcus Lane*, Exchange Act Release No. 74269, 2015 SEC LEXIS 558, at *62 (Feb. 13, 2015) (quoting *Order Granting Approval of a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook, as Modified by Amendment No. 1*, Exchange Act Release No. 71179, 2013 WL 6794111, at *32 (Dec. 23, 2013)).

52 15 U.S.C. § 78s(e)(2). KCD does not claim, and the record does not show, that FINRA's action imposed an unnecessary or inappropriate burden on competition.

53 *Saad v. SEC*, 718 F.3d 904, 906 (D.C. Cir. 2013).

54 *PAZ Sec., Inc. v. SEC*, 494 F.3d 1059, 1065 (D.C. Cir. 2007).

55 *See, e.g.*, *Plunkett*, 2013 WL 2898033, at *11.

For unregistered sales of securities, the Sanction Guidelines in effect when the NAC issued its decision recommended a fine of $2,500 to $73,000.[56] In egregious cases, they recommended a higher fine and suspension of the firm for up to 30 business days.[57] For a failure to supervise, the Guidelines recommended a fine of $5,000 to $73,000, plus limitations on the activities of the appropriate branch office for up to 30 business days, or a longer suspension or expulsion in egregious cases.[58] The Sanction Guidelines also recommended for both violations that disgorgement of any financial benefit derived from the misconduct be considered.[59]

In determining sanctions for the unregistered sales of securities, the Guidelines identified as principal considerations the share volume and dollar amount of the transactions involved; whether the respondent attempted to comply with an exemption from registration; whether the respondent had implemented reasonable procedures to ensure that it did not participate in an unregistered distribution; and whether the respondent disregarded red flags suggesting that an unregistered distribution had occurred.[60] In determining sanctions for a failure to supervise, the Guidelines similarly identified as principal considerations the nature, extent, and size of the underlying misconduct; the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls; and whether the respondent ignored "red flag" warnings that should have called forth additional supervisory scrutiny.[61] Additional relevant considerations include whether the respondent voluntarily and reasonably attempted, prior to detection and intervention by a regulator, to remedy the misconduct; whether the misconduct was the result of an intentional act, recklessness, or negligence; and whether the misconduct resulted in the potential for the respondent's monetary or other gain.[62]

A. The sanctions FINRA imposed are within the guidelines.

The censure and $73,000 fine that FINRA imposed are within the sanction guidelines for both the unregistered sale of securities and a failure to reasonably supervise. Here, KCD sold interests in the Fund totaling at least $2 million, and was compensated for its efforts. The violative offers and sales and the deficient supervision lasted for at least five months. Although KCD had procedures designed to keep it from participating in unregistered distributions, those procedures were not implemented in a way that led to meaningful supervisory action. And the phone call to Gregory from the securities attorney warning that the newspaper articles were a general solicitation was a major red flag. KCD's response to this red flag was entirely inadequate: no one sought authoritative advice about what should be done, the unregistered sales continued, and the attempts to have the articles removed from the WRC website were ineffective.

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56 Sanction Guidelines at 24 (March 2015).

57 *Id*.

58 *Id*. at 103.

59 *Id*. at 24 & n.1, 103 & n.2.

60 *Id*. at 24.

61 *Id*. at 103.

62 *Id*. at 6-7.

We agree with FINRA that KCD deserves some credit for its efforts to restrict sales of interests in the Fund to investors who had not learned about the offering from the articles. KCD also took this step on its own initiative, rather than in reaction to intervention by a regulator. Because KCD attempted to limit the impact of the general solicitation, we agree with FINRA that KCD's misconduct was reckless rather than intentional.

Under the circumstances, we find that FINRA's decision to impose a censure and a single $73,000 fine for these related violations was not excessive or oppressive. Indeed, FINRA could have ordered disgorgement or placed limitations on the firm for 30 days but did not. We further find that the sanctions are remedial because they will deter KCD and others from engaging in unregistered sales of securities and from failing to supervise such sales appropriately.

B. KCD has not shown that the sanctions are excessive or oppressive.

KCD argues that FINRA should have relied on the Sanction Guidelines that were in effect when this proceeding began rather than those adopted in March 2015, which increased the range of fines recommended for the violations from $5,000-$50,000 to $5,000-$73,000. KCD concedes that the March 2015 Sanctions Guidelines specifically state that they became "effective as of the date of publication, and apply to all disciplinary matters, including pending matters."[63] Nonetheless, it contends that it was unfair to characterize this matter as "pending" when the parties had filed their post-hearing briefs before the revised Sanction Guidelines were adopted.

KCD provides no support for this interpretation of "pending matters." The new guidelines were adopted before the hearing panel issued its decision. Indeed, KCD argued to the NAC that it should apply the earlier guidelines, which it could not have done if the proceeding was no longer pending. FINRA acted reasonably in rejecting this argument, finding that the proceeding was pending, and applying the revised guidelines. And as FINRA points out, the Guidelines in effect before the March 2015 revisions would have permitted a $100,000 total fine on KCD if FINRA had imposed separate fines for the Rule 2010 violation and the Rule 3010 rather than the unitary sanction it imposed here.

KCD argues further that the fine imposed is excessive because this matter involved at most a violation of Rule 502(c)'s ban against general solicitation rather than a more sweeping unlawful distribution of securities. It argues that the Commission regards general solicitations as having less of an impact on the public than do distributions, and accordingly merit lesser sanctions.[64] KCD's attempt to minimize the serious of its misconduct is inconsistent with the well-established principle that "'[t]he registration requirements are the heart' of the Securities Act,"[65] which was "designed 'to protect investors by promoting full disclosure of information

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63 Sanction Guidelines at 8.

64 KCD also attempts to downplay its misconduct by asserting that the FINRA examiner found that all WRF Fund sales were to customers for whom the investments were suitable. But the examiner looked at only a sample of customer records and reached no such conclusion.

65 *ACAP Fin., Inc.*, 2013 WL 3864512, at *7 (quoting *Pinter v. Dahl*, 486 U.S. 622, 638 (1988)).

thought necessary to informed investment decisions.'"[66] Violating Section 5 of the Securities Act by conducting unregistered sales of WRF Fund securities when the Rule 506 exemption was not available undermined the investor protection purposes of these provisions.

KCD also argues that lower sanctions were imposed in certain settled cases. Those cases were Commission administrative proceedings rather than FINRA disciplinary proceedings. In any event, it is well established that "comparisons to settled cases are inappropriate because respondents who offer to settle may properly receive lesser sanctions than they otherwise might have."[67] KCD cites a litigated case, *Midas Securities*,[68] and argues that it should not be fined an amount "commensurate" with the $80,000 fine imposed on the firm in that case because the firm was a recidivist responsible for distributing unregistered shares into the public markets, unlike the private offering here. But the $80,000 fine imposed on the firm was only one element of the sanctions in that case, which also included a $50,000 fine and a two-year suspension for the firm's president and CEO based on his failure to supervise the sale of unregistered securities and to establish adequate written supervisory procedures.

Finally, KCD argues that the lack of harm to customers should be treated as a mitigating factor. Although the Sanction Guidelines recognize injury to other parties, including the investing public, as a suitable consideration in determining sanctions,[69] KCD points to no authority in which the absence of harm to customers has been found to be a mitigating factor, and there is authority to the contrary.[70] In any event, to the extent a lack of demonstrated harm is relevant, here we find that it is outweighed by the seriousness of the misconduct.

An appropriate order will issue.[71]

By the Commission (Acting Chairman PIWOWAR and Commissioner STEIN).

Brent J. Fields
Secretary

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66 *Id*. (quoting *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953)).

67 *Michael C. Pattison, CPA*, Exchange Act Release No. 67900, 2012 SEC LEXIS 2973, at *47 (Sept. 20, 2012).

68 *Midas Sec., LLC,* 2012 WL 169138.

69 Sanction Guidelines at 6.

70 *See id*. (noting that "the presence of certain factors may be aggravating, but their absence does not draw an inference of mitigation"); *Howard Braff*, Exchange Act Release No. 66467, 2012 SEC LEXIS 620, at *26 (Feb. 24, 2012) (finding the absence of customer harm not mitigating).

71 We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 80340 / March 29, 2017

Admin. Proc. File No. 3-17512

In the Matter of the Application of

KCD FINANCIAL INC.

For review of Disciplinary Action Taken by FINRA

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY FINRA

On the basis of the Commission's opinion issued this day, it is ORDERED that the disciplinary action taken by FINRA against KCD Financial Inc. is hereby sustained.

By the Commission.

Brent J. Fields
Secretary