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SEC opinion reiterates strict position on general solicitations and affirms FINRA action against placement agent

By Theodore Ghorra, John C. Partigan and Vincent Cesare

The SEC opinion in *KCD Financial Inc.* (*SEC Opinion 34-80340, March 29, 2017*) affirms FINRA's fine and disciplinary action against KCD, a FINRA member broker-dealer, which sold securities in a private placement when no exemption from registration was available under Rule 506. This opinion makes clear that selling only to persons with whom the issuer or placement agent had a prior relationship will not cleanse a general solicitation under Regulation D. It also provides a cautionary tale for any placement agent involved in unregistered offerings.

Factual background

KCD is an independent broker-dealer with multiple offices, including a branch in Dallas that also did business under the name Westmount Realty Finance LLC (WRF). WRF had an "issuer side" tasked with putting together offerings and a "FINRA sales side" comprised of a "captive" team of registered representatives, which sold only those securities offered by WRF. The registered representatives in the Dallas branch office were supervised by KCD's De Pere, Wisconsin home office and its chief compliance officer (CCO).

In early 2011, WRF sponsored an offering of the WRF Distressed Residential Fund 2011, LLC (the Fund) of up to \$10 million to purchase distressed realty assets. The offering 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.

When the "issuer side" of WRF, assisted by WRF's securities attorney, completed its work on the PPM and other transaction documents for the Fund, they were sent, along with sales and marketing documents, to KCD. On March 15, 2011, the CCO signed a soliciting dealer agreement in which KCD agreed to solicit purchasers of membership interests in the 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 pre-existing investors, informing them that the new offering was available.

On April 26, 2011, before KCD's registered representatives had sold any interests in the Fund, two Dallas newspapers published and made available without restriction on their respective websites articles about the Fund, based on a press release issued by WRF. Shortly after these articles appeared, WRF's securities attorney, aware that WRF was relying on a Regulation D exemption, informed the company that the *Dallas Business Journal* article was a "breach of the prohibition against general solicitation." The attorney further warned WRF 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 WRF.

WRF's CCO was promptly informed of the attorney's concerns; however, the CCO did not direct the registered representatives to stop selling interests in the WRF Fund. Instead, the CCO and WRF's VP of Capital Markets decided to respond to the attorney's concerns by ensuring that only accredited investors who had prior business relationships with WRF or KCD could participate in the offering. Accordingly, if WRF's representatives discovered that a potential investor learned of the offering from a newspaper article, the representatives were instructed 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, WRF's VP of Capital Markets learned that the *Dallas Business Journal* article had been published on an unrestricted section of the WRC website, and he asked the technology team to remove the articles from the website. However, he did not follow up with this matter and during a FINRA examination of KCD in fall 2011, a FINRA examiner found that the articles were still posted on the WRC website. Sales of interests in the Fund continued until at least October 2011.

FINRA and SEC findings

KCD sought review by the SEC of FINRA's disciplinary action in which 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 (due to the general solicitation violation under its Rule 2010, which was compounded by the failure to properly supervise subsequent actions under its Rule 3110 once it was aware of the violation).¹ Based on these violations, FINRA censured KCD and imposed a fine of \$73,000.

Violation of prohibition on general solicitations

KCD admits in its submission to the SEC and FINRA that the offers and sales of the securities in question were not registered, but argued that the offers and sales were made pursuant to Rule 506(b) of Regulation D under the Securities Act of 1933, 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 argued unsuccessfully that its supervision of the offering was appropriate.

More specifically, the SEC found that the newspaper articles published on WRC's website were designed to arouse public interest in the Fund offering and therefore constituted an "offer" under the SEC's broad definition of the term. The articles were based on a press release issued by WRF,

¹ See SEC Decision at <https://www.sec.gov/litigation/opinions/2017/34-80340.pdf>; Section 5(a) of the Securities Act prohibits the sale of any security in interstate commerce "unless a registration statement is in effect." Also, 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."

the promoter of the Fund, and sought to draw attention to the Fund by casting the Fund's objective in a favorable light and predicting a bright future for the Fund.²

While KCD argued 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,” the SEC found that even if the articles were designed in part to alert potential sellers of distressed properties to the WRF Fund's possible interest, *that did not preclude the articles from also constituting offers.*

KCD further argued that no violation occurred because only accredited investors with prior relationships with KCD or WRF purchased interests in the offering. The SEC rejected this contention, stating that the dispositive issue pursuant to general solicitations was whether all *offerees*, and not just all purchasers, had a pre-existing substantive relationship with the issuer or its placement agent. As the newspaper articles constituted offers and were freely available to people who did not have a pre-existing relationship with the issuer or its placement agent, the SEC considered them prohibited general solicitations.³

The practical message from the SEC is that once WRF offered securities in the Fund to the general public by issuing a press release that was “designed to arouse public interest in the WRF Fund,” the press release and the resulting newspaper articles (further compounded here by the subsequent re-posting of the articles on an unrestricted part of WRF's website) constituted a general solicitation in violation of Rule 502(c). Once it engaged in this prohibited general solicitation, the Rule 506 exemption was no longer available to WRF for any subsequent sales of interests in the Fund—regardless of KCD's attempts to limit the sales only to (accredited) investors who did not see the newspaper articles or to (accredited) purchasers with whom KCD had a prior relationship.

An interlude: What About the JOBS Act?

For those readers questioning why the JOBS Act⁴ did not apply here,⁵ KCD's unregistered offering took place in 2011. *The JOBS Act exception to the general solicitation prohibition was not available before 2013.* Further, after 2013, issuers 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.

² See SEC Decision at <https://www.sec.gov/litigation/opinions/2017/34-80340.pdf>; 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. 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.

³ “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.” Publication on an unrestricted website *can also* constitute general advertising or general solicitation.

⁴ Section 201(a) of the Jumpstart Our Business Startups Act (a/k/a, the “JOBS Act”), Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313-14 (Apr. 5, 2012).

⁵ 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).

Failure to reasonably supervise the offer and sale of securities

NASD Rule 3010 (since superseded by Rule 3110) requires member firms (such as KCD) to establish and maintain a supervisory system “reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable NASD Rules.”

The SEC noted the established principle that “[t]he presence of procedures alone is not enough. Without sufficient implementation, guidelines and strictures do not ensure compliance.”⁶ As further noted in the SEC opinion, “Supervisors must respond with the utmost vigilance when there is any indication of irregularity, and take decisive action when they are made aware of suspicious circumstances. Whether supervision is “reasonable” depends on the particular circumstances of each case.”⁷

KCD had maintained the required written procedures for supervisors to oversee private offerings, which required those supervisors to perform reasonable due diligence and to check for compliance with Regulation D. As noted by the SEC, in spite of this, KCD failed to exercise reasonable supervision. Specifically, shortly after the publication of the news articles, WRF’s securities attorney notified the company of the breach of general solicitation prohibition, which, according to the SEC, “was more than a red flag; it was a red stop sign.”⁸ The SEC points out that, in spite of this, (i) WRF’s CCO never instructed the registered representatives to stop the unregistered sale of interests in the Fund, which the SEC states would have been the only acceptable response once the Rule 506 exemption was lost, and (ii) failing to remove the newspaper articles from the WRC website until the FINRA examiner brought it to the attention of the CCO was not a helpful fact.

Compounding the situation was that both of WRF’s CCOs testified that at the time they were unaware of what they were required to do after a general solicitation occurred. FINRA had concluded that, at the least, they were required to investigate their obligations, and their failure to do so was deemed unreasonable, a finding subsequently upheld by the SEC.⁹

Conclusion

For the reasons stated above, the SEC upheld FINRA’s fine of \$73,000 against KCD for the general solicitation violation and failure to properly supervise its employees in its private placement offering.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

- Theodore Ghorra, 212-940-3072, tghorra@nixonpeabody.com
- John C. Partigan, 202-585-8535, jpartigan@nixonpeabody.com

⁶ Rita H. Malm, Exchange Act Release No. 35000, 1994 WL 665963, at *4 n.17 (Nov. 23, 1994).

⁷ See SEC Decision at <https://www.sec.gov/litigation/opinions/2017/34-80340.pdf>.

⁸ See SEC Decision at <https://www.sec.gov/litigation/opinions/2017/34-80340.pdf>, at page 15.

⁹ 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).