

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 93052 / September 17, 2021

Admin. Proc. File No. 3-18612

In the Matter of the Application of

SCOTTSDALE CAPITAL ADVISORS
CORPORATION, JOHN J. HURRY, TIMOTHY B.
DIBLASI, and D. MICHAEL CRUZ

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION — REVIEW OF DISCIPLINARY
PROCEEDING

FINRA member firm and persons associated with firm appeal from a FINRA disciplinary proceeding finding that the firm was responsible for the unregistered sale of securities not subject to an exemption from registration in violation of Section 5 of the Securities Act of 1933; that the firm's owner engaged in conduct inconsistent with just and equitable principles of trade; and that the firm, its president, and its chief compliance officer failed to exercise reasonable supervision. FINRA imposed fines on the firm, the president, and the chief compliance officer, barred the owner from association with a member firm, and suspended the president and chief compliance officer from such association for two years. *Held*, FINRA's findings of violations and imposition of sanctions are set aside.

APPEARANCES:

Kevin J. Harnisch, Michael J. Edney, Ryan E. Meltzer, and Vijay N. Rao of Norton Rose Fulbright US LLP for Applicants.

Alan Lawhead and Jante Turner for FINRA.

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Last brief received: November 30, 2018

Scottsdale Capital Advisors Corporation (“Scottsdale”), John J. Hurry, Timothy B. DiBlasi, and D. Michael Cruz (together, “Applicants”) appeal from a FINRA disciplinary action. FINRA found that (i) Scottsdale participated in the unregistered sale of securities not subject to an exemption from registration and thus violated Section 5 of the Securities Act of 1933 and FINRA Rule 2010; (ii) Hurry violated FINRA Rule 2010 by engaging in unethical conduct related to his creation, management, and control of a foreign broker-dealer; (iii) Scottsdale and DiBlasi violated NASD Rule 3010¹ and FINRA Rule 2010 by failing to establish and maintain supervisory systems, including written supervisory procedures (“WSPs”), that were reasonably designed to prevent the sale of unregistered, nonexempt securities; and (iv) Scottsdale and Cruz violated NASD Rule 3010 and FINRA Rule 2010 by failing to adequately supervise Scottsdale’s due diligence process for accepting unregistered securities for deposit and sale.

FINRA fined Scottsdale \$1.5 million; barred Hurry from associating with any FINRA member firm in any capacity; and suspended DiBlasi and Cruz from associating with any FINRA member firm in any capacity for two years and fined them each \$50,000.

Upon our independent review of the record and for the reasons set forth below, we have determined to set aside FINRA’s findings of violations and the imposition of sanctions.

I. Background

Scottsdale, a registered broker-dealer located in Scottsdale, Arizona, has been a FINRA member firm since May 2002. Scottsdale’s principal business is the deposit and liquidation of microcap securities for its customers.² As FINRA recognized, Scottsdale has been disciplined previously for, among other things, selling securities in unregistered transactions and having inadequate procedures and WSPs to prevent and detect the unregistered sale of securities, though the charges at issue here do not relate to that prior conduct.

We have stated previously that transactions in microcap securities present a risk of abuse because information about the issuers of such securities can be extremely hard to find, which makes these securities more susceptible to fraud.³ As a result, we have cautioned broker-dealers

¹ FINRA Rule 3110, effective December 1, 2014, superseded NASD Rule 3010. *See Regulatory Notice 14-10*, 2014 FINRA LEXIS 17, at *1-14 (Mar. 2014).

² The term “microcap securities” applies to companies with low or “micro” capitalizations; the total value of the company’s stock would typically be less than \$250 or \$300 million. *See* <https://www.sec.gov/reportspubs/investor-publications/investorpubsmicrocapstock.htm>.

³ *ACAP Fin., Inc.*, Exchange Act Release No. 70046, 2013 WL 3864512, at *2 (July 26, 2013), *pet. denied*, 783 F.3d 763 (10th Cir. 2015) (Gorsuch, J.); *accord Ronald S. Bloomfield*, Exchange Act Release No. 71632, 2014 WL 768828, at *2 (Feb. 27, 2014), *pet. denied*, 649 F. App’x 546 (9th Cir. 2016); *Publication or Submission of Quotations Without Specified Information*, Exchange Act Release No. 89891, 2020 WL 5763379, at *2 (Sept. 16, 2020).

to be alert to the possibility of an illegal, unregistered distribution of lower-priced stock and that customers might attempt to mislead them regarding the legality of a sale.⁴

A. Scottsdale, its Affiliated Entities, and its Procedures

1. Scottsdale

Hurry founded Scottsdale. Scottsdale's sole equity shareholder is a holding company, Scottsdale Capital Advisors Holding LLC, which is in turn owned by a family trust for which Hurry and his wife are the trustees and the beneficiaries. In addition to his ownership interest in Scottsdale, Hurry is registered with the firm in several capacities. Between December 2013 and June 2014, the relevant period here, Hurry served as a director of Scottsdale but it is undisputed that he had limited day-to-day involvement with the firm.

During the relevant period, Cruz was Scottsdale's president, chief legal counsel, and assistant corporate secretary. Cruz stepped down as president of Scottsdale in 2015. He currently serves as the general counsel of Scottsdale's holding company. Cruz drafted the procedures that Scottsdale used to review deposits for compliance with Securities Act Section 5 and, during the relevant period, he supervised the deposit due diligence process.

DiBlasi is Scottsdale's Chief Compliance Officer ("CCO") and has been since October 2013. According to his uncontested testimony, DiBlasi was responsible during the relevant period for coordinating the process for updating Scottsdale's general WSPs, overseeing the filing of updates and revisions to Forms BD and Forms U4, surveilling email, policy and procedure testing, and maintaining the firm's Anti Money Laundering ("AML") program. Notably, he did not oversee compliance related to stock deposits and ensuring that the deposits met the requirements of Section 5. Because Section 5 compliance involved specialized expertise outside of DiBlasi's training and experience, Scottsdale placed the responsibility for Section 5 compliance during the relevant period with Cruz, Scottsdale's president, who is an attorney.

2. Cayman Securities Clearing and Trading

FINRA's allegations in this case concern five deposits of securities at Scottsdale made through a foreign broker-dealer, Cayman Securities Clearing and Trading, Ltd. ("Cayman Securities"). Hurry formed Cayman Securities in early 2013. According to Hurry, he did so primarily for tax-related reasons. Hurry testified that Scottsdale's clearing broker, Alpine Securities Corporation ("Alpine"), which Hurry also indirectly owned, sought to avoid certain

⁴ *ACAP Fin., Inc.*, 2013 WL 3864512, at *2; *Bloomfield*, 2014 WL 768828, at *2; *see also Transfer Agent Regulations*, Exchange Act Release No. 76743, 2015 WL 9311555, at *58 (Dec. 22, 2015) ("The need to prevent unregistered securities distributions is particularly acute in the microcap market, where OTC issuers may not be subject to certain of the Commission's disclosure requirements and there is an increased potential for fraud and abuse because potential investors have few, if any, resources for obtaining meaningful disclosure or conducting independent research on microcap issuers.").

tax withholding obligations for sales by foreign persons. Alpine decided, therefore, to limit its business dealings to foreign financial institutions that were qualified intermediaries and had thus agreed to take on these tax withholding obligations. Hurry established Cayman Securities to be the conduit through which Scottsdale (and subsequently Alpine) would receive securities deposits from foreign persons. After Hurry formed Cayman Securities, it went through the process of becoming a qualified intermediary with the IRS, which included retaining KPMG to assist with the mandatory qualified intermediary audit process. Hurry testified that another reason he created Cayman Securities was that its location in the Cayman Islands allowed the income generated by the firm to be tax deferred until it was repatriated into the United States.

In late 2013, Hurry hired Greg Ruzicka, an attorney who had done legal work for Hurry but who had no securities industry experience, to run Cayman Securities' day-to-day operations. In early 2014, Hurry hired an experienced reviewer from Scottsdale, Craig D'Mura, to help Ruzicka review deposits at Cayman Securities. D'Mura resigned after only six weeks on the job, but he was at Cayman Securities at the time most of the deposits at issue were made.

3. Scottsdale's Review Process

Because Scottsdale's principal business is liquidating microcap securities, much of its work involves reviewing deposits of securities to determine if they can be resold consistent with the registration requirements of Securities Act Section 5. The vast majority of Scottsdale's depositors claim that their securities can be resold without registration under Securities Act Rule 144. For this reason, Scottsdale has a dedicated "Rule 144 team" that reviews potential deposits.

During the relevant period, Henry Diekmann led the Rule 144 team and reported directly to Cruz. The entire team consisted of approximately five or six individuals—several of whom were lawyers—or about one third of Scottsdale's staff. Following review by the Rule 144 team, Cruz personally reviewed and approved deposits from foreign financial institutions, such as Cayman Securities, because such deposits were seen as involving a heightened level of risk.

The Rule 144 team followed processes and procedures Scottsdale adopted, including a stand-alone procedures manual Cruz drafted entitled "OTC Restricted Stock: Deposits, Resales and Transfers of OTC Securities" ("Section 5 Procedures Manual"). The manual was 18 pages (not including tables and appendices) and was separate from Scottsdale's general WSPs. It provided general guidance as well as specific "due diligence steps" that personnel were to follow when reviewing a potential deposit.

In addition to the Section 5 Procedures Manual, the Rule 144 team used other forms and checklists to assist in the review process. It used a Deposited Securities Checklist to document the due diligence steps taken during the review, and clients were asked to complete and sign the Deposited Securities Request and Securities Deposit Agreement for each deposit. In addition, Scottsdale required the beneficial owner of the securities to sign a Beneficial Ownership Declaration that attested that the owner was "the exclusive beneficial owner of the Security" and that "No other person or entity whatsoever has any right, title, or interest, legal, equitable, contingent or otherwise, in or to the Security." The Beneficial Ownership Declaration form also included check boxes to determine whether the beneficial owner was an affiliate of the issuer and

asked the owner to “describe the details” of his or her acquisition of the securities, including when they were acquired and whether they were acquired from someone who may be an affiliate.

Generally, before approving a deposit of securities at Scottsdale, a Rule 144 team member would conduct due diligence by following the Deposited Securities Checklist and gathering relevant information into Due Diligence Packages for each deposit. This information included documents evidencing the origin and transfer history of the shares; legal opinions; the Beneficial Ownership Declaration; search results from the Commission’s website and FINRA’s OFAC⁵ Search Tool; and internet searches on the individuals and entities in the chain of custody. The reviewer also looked for recent promotional activity related to the shares to be deposited.

For deposits from foreign financial institutions, Cruz reviewed the Due Diligence Packages after the Rule 144 team member’s review. He would ask follow-up questions of the team member before deciding to approve or reject the deposit, and the reviewer might have follow-up questions and requests for additional information from the sellers. Scottsdale rejected approximately 46% of the deposit requests it received from Cayman Securities.

B. The Relevant Deposits

This appeal involves five deposits of approximately 83 million total shares of three microcap issuers: one deposit on February 7, 2014 of 20 million shares and two deposits on March 12, 2014 of 20 million shares each of Neuro-Hitech, Inc. (“NHPI”); a deposit on February 6, 2014 of 9.318 million shares of Voip-Pal.com (“VPLM”); and a deposit on June 5, 2014 of 13.28 million shares of Orofino Gold Corporation (“ORFG”). There is no evidence that Hurry was involved in approving or facilitating any of the five deposits. The depositors all claimed that subsequent sales were exempt from Section 5’s registration requirement under Section 4(a)(1) because they fell within the safe harbor provided by Rule 144.

1. NHPI

According to company disclosures, NHPI has been in the business of developing and marketing pharmaceuticals, including a drug that completed a Phase II FDA clinical trial, since 2006. More recently, NHPI expanded its business lines to include oil and gas exploration. NHPI was previously registered with the Commission and filed reports with the Commission between June 2005 and August 2009. During the relevant period it was not filing reports with the Commission and was traded on the OTC Pink market.

The NHPI shares relevant to this case began as a convertible note dated May 1, 2012 between Thomas Collins and NHPI for \$10,000 for consulting services Collins had provided the company. The note was due on July 1, 2012. Upon NHPI’s default, Collins had the right to obtain (based on a conversion price of \$0.0001 per share) up to 100 million shares of NHPI. Collins subsequently exercised his right to 90 million shares in November 2013.

⁵ FINRA offers an automated method of searching the U.S. Department of Treasury’s Office of Asset Control Sanction Program Listing of persons and organizations subject to sanctions, embargos, and other restrictions.

In the fall of 2013, Collins received loans in the form of three convertible notes of \$50,000 each from Sky Walker, Inc., Ireland Offshore Securities, and Swiss National Securities, with Collins giving each a pledge of 20 million NHPI shares as collateral (reflecting a conversion price of \$0.0025 per share). Collins subsequently defaulted on the notes and 20 million shares each of NHPI were thereafter transferred to Sky Walker, Ireland Offshore Securities, and Swiss National Securities to satisfy his obligation.⁶

Sky Walker, Ireland Offshore Securities, and Swiss National Securities were all customers of Unicorn International Securities, LLC (“Unicorn”), a foreign financial institution located in Belize. After Cayman Securities asked to deposit the NHPI shares on behalf of Unicorn and its customers with Scottsdale, Scottsdale went through its due diligence process and obtained relevant documentation and legal opinions regarding the origin of the shares and their owners. The beneficial ownership declarations identified Sky Walker’s president as the beneficial owner of Sky Walker’s shares, Ireland Offshore Securities’ control person as the beneficial owner of Ireland Offshore Securities’ shares, and Swiss National Securities’ president as the beneficial owner of Swiss National Securities’ shares. After receiving approval for the deposits from Scottsdale, the shares were deposited on February 7, 2014, and March 12, 2014. Between February 26, 2014, and May 7, 2014, Scottsdale sold all 60 million shares of NHPI that had been deposited, with the sellers receiving \$264,711.70 in net proceeds and Scottsdale earning \$4,727.68 in commissions on the sales.

2. VPLM

According to company disclosures, VPLM provides Voice-over-Internet-Protocol (“VoIP”) services and has a variety of VoIP patent applications. During the relevant period, its shares traded on the OTC Pink market, and it currently trades on OTCQB. As of July 2012, Locksmith Financial, a company owned by VPLM’s former CEO Richard Kipping, had outstanding loans to VPLM totaling \$58,636. In August 2013, VPLM and Locksmith memorialized an agreement to settle VPLM’s debt in exchange for Locksmith receiving 29.32 million shares of VPLM. On August 23, 2013, Locksmith sold those shares to VHB International for \$0.008186 per share.

VHB International was a customer of Montage Securities, a foreign financial institution based in Panama. Montage Securities sought to deposit 9.318 million shares of VPLM on behalf

⁶ There is some dispute between the parties regarding the dates of certain documents relevant to the transfer of the NHPI shares from Collins to the three note holders. Collins exercised his option to receive NHPI shares in a conversion agreement dated November 15, 2013. The three promissory notes and stock pledge agreements between Collins and Sky Walker, Ireland Offshore Securities, and Swiss National Securities were dated September 1, 2013. For each transaction there was a Note Satisfaction Agreement dated September 16, 2013, approximately two months before Collins defaulted and before he obtained the NHPI shares. The evidence in the record shows that the shares were transferred from Collins to the note holders in late November. For this reason, Applicants contend that the date on the note satisfaction agreements was a typographical error—that it should have read *November* 16, 2013.

of VHB International with Scottsdale through Cayman Securities. Scottsdale conducted due diligence on the deposit, including identifying Victor Hugo Bretel as the shares' beneficial owner. Because Bretel had previously made deposits with Scottsdale, it already had a copy of his Bolivian passport. After Scottsdale's approval, the shares were deposited on February 6, 2014. Scottsdale sold 7.81 million shares between February 20, 2014, and June 6, 2014, with net proceeds to VHB International of \$1.4 million and commissions to Scottsdale of \$22,172.92.

3. ORFG

According to company disclosures, ORFG entered the mining industry in 2009.⁷ ORFG was previously registered with the Commission and made several periodic filings between July 2008 and April 2013, when it terminated its registration and status as a reporting company under the Exchange Act. During the relevant period, ORFG traded on the OTC Pink market.

The ORFG shares at issue here originated from a \$600,000 convertible note between Casey Forward and ORFG dated September 1, 2012. The note had a maturity date of June 1, 2013, and contained a conversion option that expired in September 2013, which allowed Forward to convert the debt into ORFG stock at \$0.0025 per share. In January 2014—after the note came due and the conversion option had expired—Forward entered into an agreement with Anything Media in which he assigned the company a \$50,000 portion of his note in exchange for 20,000 shares of Preferred B stock of Anything Media. As part of the deal, ORFG agreed to modify to the terms of the note to provide a lower interest rate and a right of conversion at either (i) a 55% discount from the lowest trade price in the 120 days before the exercise of the conversion or (ii) a mutually agreeable price. In April 2014, Anything Media exercised its conversion option as to a \$9,000 portion of the note and sold the resulting 15 million shares of ORFG to Media Central Corporation, a Belizean company, for \$0.005 per share.

Media Central was a customer of Unicorn, which sought to deposit 13.28 million shares with Scottsdale through Cayman Securities. Scottsdale conducted due diligence on the deposit and identified Geovanni Moh as the beneficial owner of the ORFG shares. As part of its due diligence, Scottsdale noticed that promotional activity for ORFG had been conducted by a company in Florida with a similar name to Media Central. Given the similarity between the names of the two companies, Scottsdale engaged in additional due diligence to assure itself that they were not the same or affiliated companies. It obtained a new legal opinion on this issue from a different attorney, a passport and utility bill from Moh in Belize, and other information. Scottsdale approved the deposit, which was made on June 5, 2014. Between June 11, 2014 and June 30, 2014, Scottsdale sold 6.4 million of the ORFG shares that Media Central deposited, resulting in net proceeds of \$91,408.43 and \$1,911.07 in commissions for Scottsdale.

C. Procedural History

On May 15, 2015, FINRA's Department of Enforcement ("Enforcement") filed a Complaint against Applicants alleging three causes of action. The First Cause of Action alleged that Scottsdale violated FINRA Rule 2010 "by engaging and participating" in the sale of

⁷ In 2014, after the relevant period, the company changed its name to Bakken Energy Corp.

“unregistered securities transactions not subject to an exemption from the registration requirements”—specifically the sale of shares of NHPI, VPLM, and ORFG—in “contravention of Section 5.” The First Cause of Action further alleged that Hurry violated FINRA Rule 2010 “by being a necessary participant and substantial factor in the foregoing sales of unregistered securities transactions” in “contravention of Section 5.” The Second Cause of Action alleged that Scottsdale and DiBlasi violated NASD Rule 3010 and FINRA Rule 2010 by failing “to establish and maintain a supervisory system, including WSPs, reasonably designed to achieve compliance with Section 5 for sales of microcap stocks.” The Third Cause of Action alleged that Scottsdale and Cruz violated NASD Rule 3010 and FINRA Rule 2010 by failing “to conduct reasonable inquiries” into the sales of the microcap stocks that allegedly violated Section 5.

After a 12-day hearing that included testimony from multiple fact witnesses as well as an expert witness from each side, a Hearing Panel found that Applicants engaged in the violations alleged in the Complaint. The Hearing Panel fined Scottsdale \$1.5 million; barred Hurry from associating with any FINRA member firm in any capacity and assessed—but in light of the bar did not impose—a \$100,000 fine; and suspended DiBlasi and Cruz from associating with any FINRA member firm in any capacity for two years and fined them each \$50,000.

Upon Applicants’ appeal, FINRA’s National Adjudicatory Council (“NAC”) affirmed most of the Hearing Panel’s findings of violations. With regard to Hurry’s liability, although the Hearing Panel had found that Hurry was a “necessary participant and substantial factor” in the unregistered sale of securities in violation of Section 5, the NAC determined that Hurry’s conduct was unethical under FINRA Rule 2010 “regardless of whether Hurry was a necessary participant and substantial factor in the unlawful sales of NHPI, VPLM, and ORFG.” The NAC affirmed the Hearing Panel’s imposition of sanctions.

Applicants appealed to the Commission, and Hurry moved to stay FINRA’s bar against him pending his appeal. Hurry argued that the NAC premised his violations on “a new, post hoc theory of liability.” Hurry’s motion to stay the bar was granted on the ground that Hurry had “at least raised serious legal questions about the NAC’s findings.”⁸

II. Analysis

In reviewing FINRA’s disciplinary action, we must determine whether Applicants engaged in the conduct FINRA found, whether that conduct violated the statutory provisions or rules specified in FINRA’s determination, and whether those provisions and rules are, and were applied in a manner, consistent with the purposes of the Exchange Act.⁹ We base our findings on an independent review of the record and apply a preponderance of the evidence standard.¹⁰

⁸ *Scottsdale Capital Advisors Corp., et al.*, Exchange Act Release No. 83783, 2018 WL 3738189, at *4 (Aug. 6, 2018) (Order Granting Stay).

⁹ 15 U.S.C. § 78s(e)(1).

¹⁰ *See Richard G. Cody*, Exchange Act Release No. 64565, 2011 WL 2098202, at *1, 9 (May 27, 2011), *aff’d*, 693 F.3d 251 (1st Cir. 2012).

A. First Cause of Action: Alleged Violations of Securities Act Section 5

1. FINRA has the authority to discipline its members and their associated persons for violations of Section 5 of the Securities Act.

As a threshold matter, Applicants argue that “FINRA does not have the statutory authority to administer discipline with respect to the Securities Act, including Section 5.” But we have repeatedly held that a “broker violates [FINRA] Rule 2010 . . . by engaging in the unregistered offer and sale of securities without an exemption from registration in violation of Section 5.”¹¹ As we recently explained, a violation of Rule 2010, which requires members to observe “high standards of commercial honor and just and equitable principles of trade,” may be “based on any conduct, not simply conduct that violates the Exchange Act.”¹² Thus, a violation of Section 5 by a person under FINRA’s jurisdiction also violates Rule 2010 because the rule “‘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.”¹³ Accordingly, we reject Applicants’ contention that FINRA lacks the authority to discipline its members and their associated persons for violations of Section 5.

2. FINRA’s finding that Hurry violated FINRA Rule 2010 must be set aside.

Enforcement’s Complaint charged Hurry with violating Section 5 and thereby FINRA Rule 2010, but the NAC did not find that Hurry violated Section 5. Indeed, FINRA concedes in this appeal that Hurry’s conduct was “not a direct violation of Section 5 of the Securities Act.” Rather than a violation of Section 5, the NAC found that “Hurry’s creation, management, and control of Cayman Securities was unethical conduct that violated FINRA Rule 2010 because Cayman Securities operated to insulate Scottsdale Capital Advisors from regulatory scrutiny.” Because we agree with Hurry that the NAC’s theory of liability was fundamentally different than the one FINRA pursued throughout its proceedings, and that it was unfair for the NAC to impose liability on him under the circumstances, we set aside FINRA’s finding of liability and the resulting sanction with respect to Hurry.¹⁴

¹¹ *Merrimac Corp. Sec., Inc.*, Exchange Act Release No. 10662, 2019 WL 3216542, at *6 (July 17, 2019); *see also KCD Financial Inc.*, Exchange Act Release No. 80340, 2017 WL 1163328, at *4 (Mar. 29, 2017) (collecting authorities); *Fuad Ahmed & Success Trade Sec., Inc.*, Exchange Act Release No. 81759, 2017 WL 4335036, at *18 (Sept. 28, 2017) (“Because Respondents violated Section 5, they also violated FINRA Rule 2010.”).

¹² *KCD Financial Inc.*, 2017 WL 1163328, at *4.

¹³ *Id.* (quoting *Protective Grp. Sec. Corp.*, Exchange Act Release No. 34547, 1994 WL 455492, at *6 (Aug. 18, 1994)).

¹⁴ Because we set aside Hurry’s liability with respect to his conduct at Cayman Securities, Applicants’ motion for leave to adduce additional evidence related to Greg Ruzicka is moot.

The Exchange Act requires FINRA to “bring specific charges,” “notify” the respondent of the charges, and give the respondent “an opportunity to defend against” the charges.¹⁵ Although “a complaint need not specify all details regarding a case against a respondent,” in order for proceedings to be fair a respondent should “‘underst[an]d the issue’ and ‘[be] afforded full opportunity’ to justify its conduct during the course of the litigation.”¹⁶ As a result, we have consistently set aside findings of violations based on uncharged theories of liability.¹⁷

The only charge against Hurry in FINRA’s Complaint came under the First Cause of Action, which was titled “Unregistered Securities—Sales Of.” The specific allegations against Hurry in the Complaint were that his conduct made him a “necessary participant and substantial factor” in Scottsdale’s allegedly violative unregistered sales of securities and thus liable himself for violating Section 5. Nowhere in the Complaint did FINRA suggest that Hurry’s conduct independently violated Rule 2010 separate from a Section 5 violation.

Before the Hearing Panel—in its pre- and post-hearing briefs as well as during the hearing—Enforcement consistently prosecuted its case against Hurry as an alleged violation of Section 5. Prior to the hearing, Hurry moved for summary disposition of the charges against him on the basis that the undisputed evidence showed that he was not a necessary participant or substantial factor in the subject transactions. Enforcement countered that it could “prove that Hurry was a necessary participant and substantial factor in the microcap stock liquidations at issue” and that “genuine issues of material fact regarding Hurry’s role in the liquidations preclude summary disposition.” The Hearing Officer agreed with Enforcement and denied Hurry’s motion on the ground that “Hurry’s level of involvement” was in dispute.

At the hearing, Enforcement continued to argue that Hurry was a necessary participant and substantial factor in the alleged violations and urged the panel to find Hurry “liable under Section 5.” But neither witness testimony nor documentary evidence showed that Hurry had any involvement in the transactions that FINRA alleged violated Section 5. As a result, the Hearing

¹⁵ 15 U.S.C. § 78o-3(h)(1).

¹⁶ *Wanda P. Sears*, Exchange Act Release No. 58075, 2008 WL 2597567, at *3 (July 1, 2008) (quoting *Aloha Airlines, Inc. v. CAB*, 598 F.2d 250, 262 (D.C. Cir. 1979)).

¹⁷ *Sears*, 2008 WL 2597567, at *3-4 (setting aside FINRA’s finding that applicant made unauthorized trades in certain customers’ accounts because the complaint did not include allegations of unauthorized trades in those accounts and thus the respondent “lacked adequate notice” that such trades would be a basis for liability); *Paulson Inv. Co., Inc.*, Exchange Act Release No. 19603, 1983 WL 32198, at *4 (Mar. 16, 1983) (setting aside NASD’s findings of violations where the “complaint did not charge applicants with any of these deficiencies” and the Commission was “unable to conclude that applicants were subsequently given adequate notice of these additional allegations, or a proper opportunity to defend themselves against them”). See also *James W. Browne*, Exchange Act Release No. 58916, 2008 WL 4826020, at *10-11 (Nov. 7, 2008) (setting aside NASD’s finding of violation where the complaint’s theory of liability was inconsistent with the evidence and thus the Commission could “not know how [the applicant’s] defense of the [charge in the complaint] might have changed or been augmented if Enforcement had given [him] notice with more specific charges” of its theory of liability).

Panel questioned whether “the ‘necessary participant/substantial factor’ test [was] appropriate here.” Nevertheless, it concluded that “Hurry was a necessary participant and a substantial factor in the transactions.” In the appeal before the NAC, Enforcement continued to argue that Hurry was a necessary participant and substantial factor and that this rendered him liable.

In its decision, however, the NAC did not rely on the theory that Hurry violated Rule 2010 because he was a necessary participant and substantial factor in a Section 5 violation. Instead, the NAC examined whether Hurry’s conduct in establishing and managing Cayman Securities “was unethical, regardless of whether Hurry was a necessary participant and substantial factor in the unlawful sales of NHPI, VPLM, and ORFG.” Finding that his conduct was “unethical,” the NAC concluded that Hurry violated Rule 2010.

But this theory of Hurry’s Rule 2010 liability—untethered from any alleged violation of Section 5—was first articulated in the NAC’s decision. Under the circumstances, Hurry was deprived of a fair opportunity to rebut the theory under which he was held liable, including through the development of the factual record during the hearing.

FINRA attempts to justify its liability finding by arguing that it charged Hurry with a violation of Rule 2010 and not a violation of Section 5. Although it is true that Hurry’s alleged liability in this proceeding was based on a violation of Rule 2010, it is also true that throughout the proceedings FINRA alleged that Hurry had violated Rule 2010 *because* he had violated Section 5. Whether Hurry’s conduct independently violated Rule 2010 outside the context of a Section 5 violation is an issue that we decline to address because Hurry was never afforded a meaningful opportunity to counter that theory of liability in the proceedings before FINRA.

FINRA also argues that its “complaint put the issue of Hurry’s creation, management, and control of Cayman Securities squarely in contention.” But in the Complaint and throughout the proceedings before FINRA, the contention was always that Hurry’s activities with Cayman Securities made him a necessary participant and substantial factor in a Section 5 violation—not that these activities were an independent basis for a Rule 2010 violation. Accordingly, the finding that Hurry violated Rule 2010 must be set aside because he was not afforded a sufficient opportunity to counter the new theory of liability set forth in the NAC’s decision.¹⁸

3. FINRA’s finding that Scottsdale violated Section 5 must be set aside.

The NAC found that Scottsdale “violated FINRA Rule 2010 because the Firm acted in contravention of Section 5 of the Securities Act and sold millions of shares of unregistered

¹⁸ *James L. Owsley*, Exchange Act Release No. 32491, 1993 WL 226056, at *3-4 (June 18, 1993) (setting aside NASD’s fraud findings where violations were not “based on the allegations in its complaint,” which charged that applicant made false representations, but on information applicant failed to disclose, “none of which was charged in the complaint,” because NASD could not find liability “on matters that have not been charged and which respondents have not had a fair chance to rebut,” particularly when respondents have “effectively refuted” the charges in the complaint).

microcap securities without the benefit of a registration exemption.” Specifically, the NAC found that Scottsdale failed to establish either (1) that its customers’ resales qualified for the Rule 144 safe harbor (and thus the exemption under Section 4(a)(1) of the Securities Act was available); or (2) that Scottsdale’s facilitation of its customers’ resales qualified for the exemption under Section 4(a)(4) of the Securities Act. In reaching this conclusion, however, the NAC failed to correctly state and apply the appropriate legal standards and thereby failed to “clearly explain the bases for its conclusions” in a manner that would allow us to “discharge properly our review function.”¹⁹ Because of this, we are unable to discern whether FINRA has discharged its obligation of establishing a violation for which it can impose sanctions. Accordingly, we will set aside the Section 5 liability findings against Scottsdale and the resulting Rule 2010 violation.

a. The governing legal standards

Securities Act Section 5(a) prohibits the sale of securities through use of the mails or interstate commerce unless a registration statement is in effect with respect to the transaction or an exemption from registration is available.²⁰ Scottsdale does not dispute that FINRA has made a *prima facie* case of a Section 5 violation because (1) Scottsdale directly or indirectly sold or offered to sell securities; (2) through the use of interstate commerce; (3) when no registration statement was filed or in effect.²¹ Once FINRA has established a *prima facie* violation, Scottsdale must show that it is entitled to an exemption from the registration requirements.²²

Scottsdale claims two possible exemptions: (1) that the customers’ transactions at issue were exempt from registration under Section 4(a)(1) because they qualified for the Rule 144 safe harbor; and (2) that Scottsdale could claim the exemption under Section 4(a)(4) for its facilitation of its customers’ transactions.²³ Securities Act Section 4(a)(1) “is intended to exempt routine trading transactions between individual investors with respect to securities already issued and not to exempt distributions by issuers or acts of other individuals who engage in steps necessary to such distributions.”²⁴ It exempts “transactions by any person other than an issuer, underwriter, or dealer.”²⁵ An “underwriter” is one “who has purchased from an issuer with a view to . . . the distribution of any security, or participates or has a direct or indirect participation in any such

¹⁹ *David B. Tysk*, Exchange Act Release No. 80135, 2017 WL 782153, at *2 (March 1, 2017).

²⁰ 15 U.S.C. § 77e(a).

²¹ *SEC v. Big Apple Consulting USA, Inc.*, 783 F.3d 786, 806-807 (11th Cir. 2015).

²² *Id.* at 807.

²³ *See* 15 U.S.C. § 77d(a)(1), (a)(4); 17 C.F.R. § 230.144.

²⁴ *Rodney Schoemann*, Securities Act Release No. 9076, 2009 WL 3413043, at *7 (Oct. 23, 2009), *aff’d*, 398 Fed. Appx. 603 (D.C. Cir. 2010).

²⁵ 15 U.S.C. § 77d(a)(1).

undertaking.”²⁶ The Commission has promulgated Securities Act Rule 144, which creates a non-exclusive safe harbor by identifying certain conditions under which a person will be deemed not to be an “underwriter” for purposes of Section 4(a)(1).²⁷ In order to rely on the Rule 144 safe harbor, a non-affiliate who acquires from the issuer or an affiliate of the issuer restricted securities of an issuer not subject to Exchange Act reporting requirements, and which is not a “shell company,” must, among other requirements, hold the security for at least one year.²⁸ A “failure to qualify for the Rule 144 safe harbor does not automatically prevent a transaction from qualifying for the broader Section 4[a](1) exemption.”²⁹

Section 4(a)(4) provides an exemption for “brokers’ transactions executed upon customers’ orders on any exchange or in the over-the-counter market but not the solicitation of such orders.”³⁰ A broker-dealer may not rely on the Section 4(a)(4) exemption if, after reasonable inquiry, the broker-dealer knows or has reasonable grounds to believe that the selling customer’s part of the transaction is not exempt from Section 5 of the Securities Act, such as when the customer is an underwriter with respect to the securities or the transaction would be part of a distribution of securities of the issuer.³¹ Accordingly, a broker-dealer must conduct a “reasonable inquiry” into the facts surrounding a proposed unregistered sale of securities before selling the securities.³² A broker-dealer “‘must make whatever inquiries are necessary under the circumstances to determine that the transaction is . . . not part of an unlawful distribution.’”³³ “The amount of inquiry called for necessarily varies with the circumstances of particular cases.”³⁴ A “searching inquiry is called for” when a broker-dealer encounters facts or

²⁶ 15 U.S.C. § 77b(a)(11). For purposes of the definition of the term “underwriter” in 15 U.S.C. § 77b(a)(11), an “issuer” also includes “any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.”

²⁷ See Preliminary Note to Rule 144, 17 C.F.R. § 230.144.

²⁸ See 17 C.F.R. § 230.144(a)(3)(i), (b)(1)(i), (d)(1)(i), (i).

²⁹ *SEC v. Platforms Wireless Corp.*, 617 F.3d 1072, 1090 (9th Cir. 2010).

³⁰ 15 U.S.C. § 77d(a)(4). The exemption is only available to the broker and does not extend to the customer, who would need to have her own exemption. See *Rule 154*, Securities Act Release No. 4818, 1966 WL 85228, at *2 (Jan. 21, 1966).

³¹ See *Wonsover v. SEC*, 205 F.3d 408, 415 (D.C. Cir. 2000).

³² *World Trade Fin. Corp. v. SEC*, 739 F.3d 1243, 1248 (9th Cir. 2014) (“[A] broker is not merely an ‘order taker,’ and must conduct a reasonable inquiry into the circumstances surrounding the transaction before the broker may claim the protection of the . . . exemption.”); accord *Wonsover*, 205 F.3d at 415; *Midas Secs., LLC*, Exchange Act Release No. 66200, 2012 WL 169138, at *11 (Jan. 20, 2012).

³³ *World Trade Fin. Corp.*, 739 F.3d at 1249 (quoting *Robert G. Leigh*, Exchange Act Release No. 27667, 1990 WL 1104369, at *4 (Feb. 1, 1990)).

³⁴ *Wonsover*, 205 F.3d at 415 (quoting *Distribution by Broker-Dealers of Unregistered Securities*, Exchange Act Release No. 6721, 1962 WL 69442, at *2 (Feb. 2, 1962)).

circumstances that “raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters.”³⁵

b. FINRA incorrectly applied the legal standards.

We find the NAC incorrectly applied these legal standards. The NAC conflated the analysis under Section 4(a)(1) and Rule 144 with the analysis under Section 4(a)(4). The NAC stated that Scottsdale “failed to conduct a searching inquiry that is required under Rule 144 and Section 4(a)(4)” and that “as a consequence . . . the Firm is unable to satisfy its burden of proof for the more technical aspects of Rule 144.” But contrary to what the NAC stated, whether the sales satisfied the “technical” requirements of Rule 144 did not depend on whether a broker-dealer conducted a “searching inquiry.” “The purpose of Rule 144 is to provide objective criteria for determining that the person selling securities to the public has not acquired the securities from the issuer for distribution.”³⁶ Contrary to the NAC’s analysis, Scottsdale could have met its burden to establish an exemption from registration by showing that its customers’ sales satisfied the Rule 144 safe harbor without regard to the inquiry required under Section 4(a)(4).

In its brief, FINRA attempts to justify the NAC’s conflation of the Rule 144 and Section 4(a)(4) standards by noting that Rule 144(f) and (g) reference Section 4(a)(4) and the reasonable inquiry requirement. But the NAC’s decision did not reference subsections (f) and (g) of Rule 144. And Rule 144(f) and (g) are inapplicable to sales by non-affiliates of the issuer and the execution of customer orders in furtherance of those sales, respectively.³⁷ Although the applicability of the Rule 144 exemption may depend on whether the broker-dealer after reasonable inquiry is aware of circumstances indicating that the selling customer’s part of the transaction is not exempt from Section 5 of the Securities Act, this is the case only where the customers are affiliates. Scottsdale submitted evidence, such as the beneficial ownership declarations, that its customers were not affiliates. The NAC did not explain the relevance of the reasonable inquiry or searching inquiry requirement to the Rule 144 analysis in light of this evidence. Instead, the NAC appeared to hold that the lack of a searching inquiry by Scottsdale was itself sufficient to show that Scottsdale’s customers were not non-affiliates of the issuers—again confusing the Rule 144 and Section 4(a)(4) analyses.

We have recognized, citing Exchange Act Section 15A(h)(1), that FINRA’s “determination to impose a disciplinary sanction must be supported by a statement setting forth, among other things, the violative act or practice engaged in by the member or person and the

³⁵ *Distribution by Broker-Dealers of Unregistered Securities*, 1962 WL 69442, at *1-2; see also *World Trade Fin.*, 739 F.3d at 1248 (endorsing this standard); *Geiger v. SEC*, 363 F.3d 481, 485 (D.C. Cir. 2004) (same); *Kane v. SEC*, 842 F.2d 194, 199 (8th Cir. 1988) (same).

³⁶ *Revisions to Rules 144 and 145*, Securities Act Release No. 8869, 2007 WL 4270700, at *7 (Dec. 6, 2007).

³⁷ 17 C.F.R. § 230.144(b).

sanction imposed and the reason therefore.”³⁸ Accordingly, it is important that FINRA clearly explain the basis for its conclusions. If FINRA fails to do so, applicants are impaired in their ability to defend themselves before us.³⁹ Here, Scottsdale could not be expected to defend itself before us against FINRA’s finding that it violated Section 5 in light of the NAC’s flawed articulation of the standards governing the Rule 144 and Section 4(a)(4) exemptions.⁴⁰

As a result, we conclude that it is appropriate to set aside FINRA’s finding that Scottsdale violated Securities Act Section 5.⁴¹ In doing so, we make no finding as to whether the sales at issue qualified for an exemption from registration. Rather, we find that due to the manner in which FINRA applied the governing legal standards it failed to discharge its duty to fairly and adequately explain the basis for the finding that Scottsdale committed a violation. So, to be clear, nothing about this case alters our view about the role broker-dealers should play in preventing unregistered distributions or the need to prevent recidivism.⁴² We have long made combating abuses in the microcap market one of our top priorities,⁴³ and we will continue to do so. But, on this record, we simply cannot sustain FINRA’s finding of liability.⁴⁴

B. Second Cause of Action: Alleged Supervisory Violations Related to WSPs

The NAC’s decision found that Scottsdale and DiBlasi violated NASD Rule 3010 and FINRA Rule 2010 by failing to establish and maintain supervisory systems, including WSPs,

³⁸ *Donald R. Gates*, Exchange Act Release No. 36109, 1995 WL 497444, at *2 (Aug. 16, 1995) (citing Exchange Act Section 15A(h)(1), 15 U.S.C. 78o-3(h)(1)).

³⁹ *Id.*

⁴⁰ *See, e.g., Jonathan Feins*, Exchange Act Release No. 37091, 1996 WL 169441, at *2 (Apr. 10, 1996) (noting that because the Commission was “unable to discern from the . . . decision why the [SRO] found violations” it “cannot determine if the sanctions imposed . . . are justified”).

⁴¹ Although we might otherwise have remanded to FINRA for it to clarify its findings, we decline to exercise our discretion to do so here given the significant flaws we have identified in the application of legal standards and FINRA’s changing theories of liability in the case. *See Sharemaster*, Exchange Act Release No. 83138, 2018 WL 2017542 at *8 n.56 (Apr. 30, 2018) (“Although we might otherwise have remanded the matter to FINRA in order to allow it to attempt to provide the explanation . . . we decline to do so here in light of the . . . unique facts and circumstances of this particular proceeding.”).

⁴² *See supra* notes 3-4 and accompanying text.

⁴³ *Publication or Submission of Quotations Without Specified Information*, Exchange Act Release No. 41110, 1999 WL 95487, at *2 (Feb. 25, 1999) (stating that the Commission “has made combating microcap fraud one of its top priorities”).

⁴⁴ *Cf. In re Smith*, 999 F.3d 452, 454 (6th Cir. June 9, 2021) (stating that courts must apply the law “regardless of whether a court likes the results of that application in a particular case”).

that were reasonably designed to achieve compliance with Section 5.⁴⁵ NASD Rule 3010 provides that “[e]ach member firm shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules,” and that such system shall include “[t]he establishment and maintenance of written procedures.” Specifically with respect to the registration provisions of the Securities Act, “we have emphasized that all registered broker-dealers should establish minimum standard procedures to prevent and detect violations of the federal securities laws and to ensure that the firm meets its continuing responsibility to know both its customers and the securities being sold.”⁴⁶ The standard for supervision under Rule 3010 is reasonableness, which is “determined based on the particular circumstances of each case.”⁴⁷ We find that a preponderance of the evidence does not show that Scottsdale and DiBlasi violated Rule 3010.

1. The record does not support FINRA’s finding that DiBlasi violated Rule 3010.

To find that DiBlasi violated Rule 3010, we must find “that he had supervisory authority over” the area of the alleged supervisory failures.⁴⁸ A preponderance of the evidence does not show DiBlasi had supervisory authority over Scottsdale’s Section 5 compliance procedures. Accordingly, we set aside FINRA’s liability findings and sanctions with regard to DiBlasi.

All of the witnesses at the hearing testified consistently that DiBlasi had no responsibility for Section 5 compliance, the Rule 144 review team, or the attendant procedures. DiBlasi testified that he “never had responsibility for the stock deposit procedures” and confirmed that he was never “responsible for maintaining, writing[,] or updating the firm’s procedures for Rule 144 [/] Section 5 compliance.” Instead, he testified that this was Cruz’s responsibility.

Every witness who was asked about the issue corroborated this testimony. Cruz testified that he (Cruz) drafted the Section 5 Procedures Manual and oversaw compliance in this area, that DiBlasi never “had any responsibility for updating” the Section 5 Procedures Manual, and that DiBlasi never “had any role in the Rule 144 review process.” Diekmann confirmed this understanding by testifying that DiBlasi had no role in the Rule 144 review process. Jay Noiman, who preceded DiBlasi as CCO and was director of sales and trading during the relevant period, testified that Cruz was responsible for “putting together the policies and procedures for Rule 144 compliance” and “would take the lead” on those issues when they arose.

⁴⁵ A violation of NASD Rule 3010 also violates FINRA Rule 2010. *See Meyers Assocs. L.P.*, Exchange Act Release No. 86193, 2019 WL 2593825, at *10 (June 24, 2019).

⁴⁶ *World Trade Fin.*, Exchange Act Release No. 66114, 2012 WL 32121, at *11 (Jan. 6, 2012) (internal quotation marks omitted).

⁴⁷ *Robert Marcus Lane*, Exchange Act Release No. 74269, 2015 WL 627346, at *13 (Feb. 13, 2015) (quoting *Pellegrino*, 2008 WL 5328765, at *10 n.26).

⁴⁸ *Wedbush Secs., Inc.*, Exchange Act Release No. 78568, 2016 WL 4258143, at *8 (Aug. 12, 2016).

The NAC decision states, and FINRA maintains before the Commission, that Cruz testified DiBlasi was responsible for updating the Section 5 Procedures Manual. But Cruz's testimony makes clear that Cruz believed Diekmann, and not DiBlasi, had this responsibility.

FINRA also points to two documents in the record that it contends show DiBlasi was responsible for the Section 5 WSPs and is thus liable for a supervisory failure related to them. But the two documents do not bear the weight that FINRA places on them.

The first document is Scottsdale's general Firm Rules and Procedures manual dated May 2013. The May 2013 procedures manual provided that the "CCO is responsible for establishing procedures reasonable [sic] designed to ensure: the stock certificate is validly issued and owned by the customer; and the resale of such security is made in reasonable reliance on an exemption from the registration requirements, as applicable." But the undisputed testimony at the hearing was that, even before DiBlasi became CCO in October 2013, this provision was being revised to reflect "the longstanding practice" at the firm that Cruz, and not the CCO, was responsible for the Section 5 compliance procedures. Indeed, a May 2014 update to the procedures manual placed the responsibility for Section 5 compliance procedures on the "General Principal." And Cruz had assumed the responsibilities of the General Principal at that time.⁴⁹

The second document is Appendix B to the Firm Rules and Procedures. Appendix B contained a chart that outlined in general terms the activities and supervisory duties of Scottsdale personnel. In both versions of Appendix B in the record (from May 2013 and November 2013), the responsibility for "Written Supervisory Procedures," i.e., to "[e]stablish, maintain and update, as required, the firm rules and procedures," fell to DiBlasi. Although FINRA insists that Appendix B thus proves that DiBlasi had responsibility for all of the firm's WSPs, including the Section 5 compliance procedures, the May 2014 revisions to the general procedures clarified that Section 5 compliance procedures were *not* the responsibility of the CCO. In any case, the documents on which FINRA relies do not outweigh the consistent and uniform testimony at the hearing that even before the May 2014 revisions there was never any confusion at the firm that Cruz, and not DiBlasi, was responsible for the Section 5 compliance procedures and that DiBlasi was never responsible for establishing and maintaining the Section 5 compliance procedures.

Because the evidence shows that another official at the firm, Scottsdale's president, had responsibility for overseeing the relevant activities of establishing and maintaining Scottsdale's Section 5 compliance procedures, we set aside the finding that DiBlasi violated Rule 3010.⁵⁰

⁴⁹ The May 2014 procedures define the "General Principal" as the firm's "Management Committee," which consisted of Cruz, DiBlasi, Noiman, and Elizabeth Arndt. But the Management Committee was dissolved in early 2014, with its responsibilities assumed by Cruz, Scottsdale's president. Although the May 2014 procedures created some confusion by referencing a Management Committee that no longer existed, the consistent and uncontested testimony of multiple witnesses was that there was never any confusion at Scottsdale that Cruz—and not the CCO—was responsible for the procedures for Section 5 compliance.

⁵⁰ *Thaddeus J. North*, Exchange Act Release No. 84500, 2018 WL 5433114, at *9 (Oct. 29 2018) (stating that we have dismissed proceedings "against an individual with compliance

2. The record does not support FINRA’s finding that Scottsdale violated Rule 3010.

A preponderance of the evidence also does not show that Scottsdale’s WSPs themselves were unreasonable in violation of Rule 3010. The NAC’s decision provides two principal bases for finding a Rule 3010 violation. First, the NAC faults the WSPs for failing to clearly establish who was responsible for the firm’s Section 5 compliance review process. Although the May 2013 WSPs needed updating on this topic, Scottsdale made the required revisions to its WSPs in the next scheduled update in May 2014. There, Scottsdale removed the CCO from having Section 5-related compliance responsibilities. The evidence also shows that throughout the relevant period there was no confusion within the firm that Cruz, Scottsdale’s president who served as the General Principal following the dissolution of the Management Committee, was the individual responsible for supervising the Section 5 compliance review process.⁵¹ In light of this evidence, we do not find that Scottsdale’s supervisory system was unreasonable.

Second, the NAC’s decision claims the WSPs were deficient because they “do not discuss the concept of nominees.” From our review of the relevant procedures, however, it appears that they were designed to ascertain the beneficial owner of the securities to be sold. As a result, the procedures appear to address the concern that a nominee (and not the beneficial owner) would be used, even if they do not use the word “nominee.”⁵²

C. Third Cause of Action: Alleged Supervisory Violations Related to Due Diligence

The NAC found that Scottsdale and Cruz violated NASD Rule 3010 and FINRA Rule 2010 by failing to supervise properly the firm’s microcap liquidation business.⁵³ As discussed above, Rule 3010 requires members to “establish and maintain” a system of supervision that is “reasonably designed to achieve compliance with applicable securities laws and regulations.” In addition, “[t]he duty of supervision includes the responsibility to investigate ‘red flags’ that suggest that misconduct may be occurring and to act upon the results of such investigation.”⁵⁴

responsibilities” where “another official at the firm had responsibility for overseeing the relevant activities and the respondent was never asked to evaluate the relevant regulatory issues”).

⁵¹ Cf. *World Trade Fin.*, 2012 WL 32121, at *11 (noting that knowledge by firm personnel of the procedures is a factor in assessing whether supervision was reasonable). The errant reference in the May 2014 WSPs to the defunct Management Committee does not support a finding that the WSPs were unreasonable in violation of Rule 3010.

⁵² Cf. *IFG Network Secs., Inc.*, Exchange Act Release No. 54127, 2006 WL 1976001, at *13 (July 11, 2006) (holding that the Division of Enforcement failed to establish that the respondents’ supervision was unreasonable despite the Division’s theory that an alternative “review policy” would have been better designed to prevent violations).

⁵³ We agree with FINRA, and Applicants do not dispute, that “Cruz had supervisory responsibility for Scottsdale Capital Advisor’s microcap liquidation business.”

⁵⁴ *ACAP*, 2013 WL 3864512, at *8.

We have repeatedly emphasized that “[a]ssuring proper supervision is a critical component of broker-dealer operations,”⁵⁵ and that “[t]he presence of procedures alone is not enough. Without sufficient implementation, guidelines and strictures do not ensure compliance.”⁵⁶

The NAC found a violation of Rule 3010 on two bases. First, the NAC found that, although selling customers may “tack” their holding period to the holding period of their predecessors to satisfy Rule 144’s holding period requirement provided that “the securities sold were acquired from the issuer solely in exchange for other securities of the same issuer,”⁵⁷ Cruz failed to analyze reasonably whether the instruments from which deposited shares originated were securities. On this record, we cannot sustain liability under this theory.

Cruz testified to the effect that his review of the relevant materials in the Due Diligence Packages led him to conclude that the NHPI, VPLM, and ORFG debt obligations were securities capable of tacking. The Hearing Panel reached the conclusion that the NHPI and ORFG notes were not securities *sua sponte*, and the NAC did not explain its findings that Cruz failed to analyze whether the instruments were securities in light of Cruz’s testimony. Under these facts, FINRA has not established a violation of Rule 3010. Cruz’s legal conclusion regarding whether the instruments were securities may or may not have been correct.⁵⁸ But FINRA did not establish that Cruz’s analysis was unreasonable and therefore constituted a failure to supervise.

Second, the NAC found that Scottsdale and Cruz rubber-stamped the deposits’ approval and that Scottsdale’s due diligence efforts were simply “papering the file” without any genuine effort to address and resolve red flags. But the record does not support this finding.

Cruz and Diekmann testified extensively about their review of the relevant deposits, their thinking about whether certain issues were or were not red flags, and about how they resolved their concerns. They acknowledged that in hindsight there were sometimes mistakes in the process—a wrong search term used or a document that may have warranted an additional inquiry—but on the whole their testimony suggested a process reasonably designed to ascertain whether an exemption was available, including by addressing material red flags. Other evidence in the record, such as the Due Diligence Packages, also suggested such a process.

For example, when Scottsdale discovered in the review of the ORFG deposit that promotional activity was being conducted by a Florida company with a similar name to the customer seeking to deposit the shares, it engaged in additional due diligence. It obtained a new legal opinion from a different attorney who made the assurance, after interviewing the owner of the Florida company, that the company had no affiliation with Media Central. Scottsdale also obtained (i) organizational documents from Media Central to verify that it was incorporated in

⁵⁵ *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 WL 5328765, at *10 (Dec. 19, 2008).

⁵⁶ *Merrimac Corp. Sec., Inc.*, 2019 WL 3216542, at *16 (quoting *Rita H. Malm*, Exchange Act Release No. 35000, 1994 WL 665963, at *4 n.17 (Nov. 23, 1994)).

⁵⁷ 17 C.F.R. § 230.144(d)(3)(ii).

⁵⁸ We do not reach a conclusion on whether the instruments in question were securities.

Belize and therefore was not the same entity as the Florida promoter; (ii) a passport and utility bill from Media Central's beneficial owner to confirm that he was living in Belize; (iii) a letter from Media Central confirming that it was not engaged in any promotional activity; and (iv) a representation from ORFG that it had not engaged Media Central "to directly or indirectly promote or maintain a market for [ORFG's] securities," and that the company had no knowledge of Media Central engaging any third parties to provide such services. In the absence of evidence to the contrary, the steps Scottsdale took are inconsistent with FINRA's finding that Scottsdale was simply "papering the file" without any genuine effort to address and resolve red flags.

Because Scottsdale has chosen to operate in an area with heightened risk—the microcap securities market—it must be particularly alert to potential violations of the securities laws.⁵⁹ But Rule 3010's supervisory standard is one of reasonableness, and on this record the evidence does not establish that Scottsdale's and Cruz's supervision of the due diligence process was unreasonable.⁶⁰ Accordingly, we will set aside FINRA's finding that Scottsdale and Cruz violated Rule 3010 by failing to supervise properly the firm's microcap liquidation business.

An appropriate order will issue.⁶¹

By the Commission (Chair GENSLER and Commissioners PEIRCE, ROISMAN, LEE, and CRENSHAW).

Vanessa A. Countryman
Secretary

⁵⁹ See *supra* notes 3-4 and accompanying text.

⁶⁰ Cf. *Arthur James Huff*, Exchange Act Release No. 29017, 1991 WL 296561 (Mar. 28, 1991) (dismissing the Division of Enforcement's allegations of supervisory violations where, even though the supervisor's "performance of his assignment was less than exemplary" and a "more thorough investigation" by the supervisor might have revealed misconduct, the standard is "reasonable supervision under the attendant circumstances," which standard the supervisor met).

⁶¹ Because our decisional process would not be significantly aided by oral argument, Applicants' motion for oral argument is denied. Rule of Practice 451, 17 C.F.R. § 201.451.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 93052 / September 17, 2021

Admin. Proc. File No. 3-18612

In the Matter of the Application of

SCOTTSDALE CAPITAL ADVISORS
CORPORATION, JOHN J. HURRY, TIMOTHY
B. DIBLASI, and D. MICHAEL CRUZ

For Review of Disciplinary Action Taken by

FINRA

ORDER SETTING ASIDE DISCIPLINARY ACTION

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

ORDERED that the findings of violations and the sanctions imposed by FINRA in this action against Scottsdale Capital Advisors Corporation, John J. Hurry, Timothy B. DiBlasi, and D. Michael Cruz be, and hereby are, set aside.

By the Commission.

Vanessa A. Countryman
Secretary