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FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. RESPONDENT 1, and RESPONDENT 2, Respondents.	Disciplinary Proceeding No. 2014040501801 Hearing Officer – DRS

ORDER DENYING RESPONDENTS' MOTION FOR SUMMARY DISPOSITION

A. Introduction

On December 18, 2015, Respondents moved for summary disposition on the First and Second Causes of Action in the Complaint ("Motion"). Those causes of action charge Respondents with engaging in a fraudulent scheme and making fraudulent material misrepresentations and omissions in connection with the sale of units of joint venture interests in an oil and gas private placement offering.

According to the Complaint, Respondent 1 acted as the placement agent and broker for the sale of units issued by the Respondent 1 Joint Venture ("Joint Venture") to 88 investors. The Joint Venture, organized as a general partnership under Texas law, sold the units through its Managing Venturer, Respondent 1 Exploration, Inc. ("CEI"). Respondent 2 owned and controlled both Respondent 1 and CEI. Respondents represented to investors that Respondents would purchase for the Joint Venture's benefit interests in an existing oil and gas well and three other wells that had not yet been drilled (collectively, the "Prospective Wells"). The investors were to benefit from the Joint Venture's share of the oil and gas revenue generated from these four wells.[1]

[1] Complaint ("Compl.") ¶¶ 1, 17–20, 109, 130.

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The gravamen of the fraud charges is that, unbeknownst to the investors, Respondents allegedly schemed to charge them the maximum well completion assessment, irrespective of whether the third Prospective Well was ever drilled or whether an attempt was made to complete it. (In fact, according to the Complaint, the third Prospective Well was never drilled and no attempt was made to complete it).[2] Additionally, Respondents allegedly schemed to have the Joint Venture transfer the unearned and wrongfully assessed fees to CEI and to allow CEI to improperly retain those fees. The Complaint alleges that Respondents made misrepresentations and omissions to further the scheme. Further, Respondents allegedly overcharged the customers $560,000 for unearned well completion assessments and misused the fraudulently obtained investor funds by transferring them to CEI.

Based on this alleged conduct, the First Cause of Action charges Respondents with violating Section 10(b) of the Securities Exchange Act of 1934, SEC Rule 10b-5 thereunder, and NASD Conduct Rules 2110 and 2120. The Second Cause of Action alleges, as an alternative to the First Cause of Action, that Respondents violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, thereby violating NASD Conduct Rule 2110.

In their Motion, Respondents contend that these charges are predicated upon the sale of a security. And, they argue, based on the undisputed material facts, the units sold to the customers are not securities, as a matter of law. Thus, they request that the Hearing Panel dismiss these charges.[3] The Department of Enforcement opposed the Motion on January 29, 2016, arguing that there is a genuine issue of material fact about whether the units are securities, thereby precluding the grant of summary disposition ("Opposition").[4] Finally, on February 12, 2016, Respondents filed a reply to the Opposition ("Reply").

As explained below, I deny the Motion because Respondents failed to demonstrate that there is no genuine issue with regard to any material fact and that they are entitled to summary disposition as a matter of law.

[2] Compl. ¶¶ 3, 21, 36.

[3] The Motion also lists Respondents' other affirmative defenses, but does not seek summary disposition based on them.

[4] Enforcement also asserts that Respondents' other affirmative defenses do not provide a basis for summary disposition because none of them are defenses to "an Enforcement action for violations of the anti-fraud provisions of the federal securities laws." Opp. at 6. But as noted above, Respondents did not move for summary disposition on the basis of their other affirmative defenses.

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B. Standards Governing Summary Disposition

FINRA Rule 9264(e) authorizes a Hearing Panel to grant a "motion for summary disposition if there is no genuine issue with regard to any material fact and the Party that files the motion is entitled to summary disposition as a matter of law."[5] Subsection (e) further provides that "the facts alleged in the pleadings of the Party against whom the motion is made shall be taken as true, except as modified by stipulations or admissions made by the non-moving Party, by uncontested affidavits or declarations, or by facts officially noticed pursuant to Rule 9145." Additionally, all reasonable inferences must be drawn in favor of the non-moving party,[6] and "if there is a disagreement over what inferences can be reasonably drawn from the facts even if the facts are undisputed," summary disposition must be denied.[7]

Finally, subsection (e) states that while "[t]he Hearing Officer may promptly deny or defer decisions on any motion for summary disposition, . . . only the Hearing Panel . . . may grant a motion for summary disposition, except the Hearing Officer may grant motions for summary disposition with respect to questions of jurisdiction."

In deciding the instant motion for partial summary disposition, I was guided by the federal summary judgment rule, Rule 56 of the Federal Rules of Civil Procedure,[8] and the principles delineated in the related case law. Accordingly, it is the movant's responsibility to inform the adjudicator "of the basis for its motion" and to identify "those portions of 'the pleadings, depositions, . . . and admissions on file, together with the affidavits, if any,' which it believes demonstrates the absence of a genuine issue of material fact."[9] Once the movant has done so, the non-moving party must "come forward with 'specific facts showing that there exists a *genuine issue*' for hearing."[10]

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[5] A motion for summary disposition may be made with respect to, among other things, "any or all causes of action in the complaint. . . ." FINRA Rule 9264(a).

[6] OHO Order 15-07 (2013036217601) (Apr. 2, 2015) at 4–5, https://www.finra.org/sites/default/files/OHO-Order-15-07-ProceedingNo.2013036217601.pdf; OHO Order 07-37 (2005001919501) (Oct. 16, 2007) at 10, http://www.finra.org/sites/default/files/OHODecision/p037809.pdf (citing *Frank P. Quattrone*, Exchange Act Release No. 53547, 2006 SEC LEXIS 703, at *18 n.24 (Mar. 24, 2006)).

[7] OHO Order 15-07 (2013036217601) at 5 (quoting *Ideal Dairy Farms, Inc. v. John Labatt, Ltd*., 90 F.3d 737, 743 (3d Cir. 1996)).

[8] *Dep't of Enforcement v. Respondent*, No. C020500006, 2007 NASD Discip. LEXIS 13, at *12 (NAC Feb. 12, 2007) (citing *Dep't Enforcement v. U.S. Rica Fin., Inc*., No. C01000003, 2003 NASD Discip. LEXIS 24, at *12 n.3 (NAC Sept. 9, 2003)).

[9] *Id*. (citing *Celotex Corp. v. Catrett*, 477 U.S. 317, 323 (1986)).

[10] *Id*. (citing *Matsushita Elec. Indus. Co. v. Zenith Radio Corp*., 475 U.S. 574, 587 (1986)).

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C. Discussion

To establish the fraud claims alleged in the Complaint, Enforcement must prove, among other things, that Respondents' misconduct involved a security.[11] The definitions of "security" under the Exchange Act and the Securities Act do not include joint venture interests.[12] But the definitions include "investment contracts," and the Complaint alleges that the units of Joint Venture interests are investment contracts and, hence, securities.[13] The issue presented by the Motion is whether the units are not investment contracts as a matter of law.

The term "investment contract" is not defined under the federal securities laws. However, the U.S. Supreme Court in *SEC v. W.J. Howey Co.*,[14] described an investment contract as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." Further, the Court explained, an investment contract, and thus a security, exists when there is (1) an investment of money; (2) in a common enterprise; (3) with an expectation of profits to come solely from the efforts of the promoter or a third party.[15] The Court instructed that this test should be construed broadly to afford the investing public a full measure of protection.[16]

Respondents do not assert that the units fail the first two *Howey* elements. Instead, they maintain that because the units are interests in a general partnership, they fail the third *Howey* element. Indeed, ordinarily, general partnerships "are not considered to be securities under the federal securities laws. In a true general partnership, general partners control significant decisions of the enterprise, and therefore do not ordinarily rely on the efforts of promoters or third parties."[17] Nevertheless, if investors are prevented from making these significant decisions,

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[11] "It is well established that the federal securities laws only apply to the purchase or sale of 'securities' as defined therein." *SEC v. Infinity Group Co.*, 212 F.3d 180, 186 (3d Cir. 2000). NASD Rule 2120 also only applies to securities transactions. *See Dep't of Enforcement, v. Brookstone Securities, Inc.*, No. 2007011413501, 2015 FINRA Discip. LEXIS 3, at *69 (Apr. 16, 2015) (finding that the rule "prohibits members and their associated persons from effecting any transaction in, or inducing the purchase or sale of, a *security* 'by means of any manipulative, deceptive or other fraudulent device or contrivance.'") [Emphasis added].

[12] *See* Section 3(a)(1) of the Exchange Act and Section 2(a)(1) of the Securities Act. "The definitions of a security under the Securities Act and Exchange Act are virtually identical and may be considered the same." *Dep't of Enforcement v. Akindemowo*, No. 2011029619301, 2015 FINRA Discip. LEXIS 58, at *21 (NAC Dec. 29, 2015) (citing *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975)), *appeal docketed*, No. 3-17076 (SEC Jan. 29, 2016).

[13] Compl. ¶¶ 107–123.

[14] 328 U.S. 293, 298–99 (1946). *See also Akindemowo*, 2015 FINRA Discip. LEXIS 58, at *22.

[15] *Howey*, 328 U.S. at 298–99. *See also Akindemowo*, 2015 FINRA Discip. LEXIS 58, at *22.

[16] *Howey*, 328 U.S. at 298–99. *See also Dep't of Enforcement v. De Vietien*, No. 2006007544401, 2010 FINRA Discip. LEXIS 45, at *16 (NAC Dec. 28, 2010).

[17] *Guevara*, 54 S.E.C. 655, 660 (May 18, 2000**),** *pet. for review denied***,** 2005 U.S. Dist. LEXIS 17255 (E.D. Pa. Aug. 17, 2005).

it is appropriate to "look through form to the substance of the investment arrangements to determine whether the interests involved are securities."[18]

The test for determining whether an investment in a general partnership constitutes a security was set forth in *Williamson v. Tucker*,[19] and has been adopted by the SEC[20] and the National Adjudicatory Council ("NAC").[21] In *Williamson*, the Fifth Circuit found that a general partnership could be an investment contract, and thus a security, if the investor established any of the following:

> (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.[22]

The NAC has noted that because "the three *Williamson* factors are presented in the disjunctive, . . . satisfaction of one factor is sufficient to conclude that the interest in question is a security."[23] Consequently, to prevail on their Motion, Respondents must demonstrate that there is no genuine issue of fact regarding any factor and that they are entitled to disposition as a matter of law on all of them. Conversely, the Motion fails if there is a genuine issue of material fact regarding any of these factors.

1. **Respondent's Arguments**

Respondents argue that there is no genuine issue of any material fact regarding any of the *Williamson* factors and that, as a matter of law, the units are not securities. Therefore, they submit, the fraud claims must be dismissed. Specifically, they argue that (1) the Joint Venture agreements incorporated Texas partnership law and granted the investors "sweeping managerial control";[24] (2) the Joint Venture operated as a true general partnership, not just in form; (3) the

[18] *Id.*

[19] 645 F.2d 404 (5th Cir. 1981), *cert. denied*, 454 U.S. 897 (1981).

[20] *Guevara*, 54 S.E.C. at 660.

[21] *DBCC for District No. 9 v. Guevara*, No. C9A970018, 1999 NASD Discip. LEXIS 1, at *8–9 (Jan. 28, 1999), *aff'd*, 54 S.E.C. 655, 660 (2000), *pet. for review denied*, 2005 U.S. Dist. LEXIS 17266 (E.D. Pa. Aug.17, 2005). *See also De Vietien*, 2010 FINRA Discip. LEXIS 45, at *22.

[22] *Williamson*, 645 F.2d 404, 424. These factors are not exhaustive. *Id*. at 424 n.15.

[23] *Guevara*, 1999 NASD Discip. LEXIS 1, at *9 n.5.

[24] Motion ("Mot.") at 12.

venturers had "both the means and incentive to participate in the management of" the Joint Venture;[25] (4) the venturers "are collectively sophisticated and capable of managing their substantial partnership powers;"[26] and (5) the venturers cannot show they "are so dependent on some unique entrepreneurial or managerial ability of Respondent 1 that they could not replace it or otherwise exercise meaningful partnership or venture powers."[27]

2. Enforcement's Arguments

By contrast, Enforcement argues that the purported Joint Venture powers granted to the investors were illusory. For example, according to Enforcement, the investors had no meaningful way to exercise those powers because the investors did not know, and lacked contact information for, each other. Also, because day-to-day operations control was vested in CEI, and because of the drilling and completion features in the project, investors had no practical ability to replace CEI until all of the wells were drilled. As a result, Enforcement submits, they had to rely solely on Respondents for all information and guidance regarding their investment.[28] Further, Enforcement argues, the investors were so inexperienced that they were not capable of meaningfully exercising their purported Joint Venture powers.[29] And, finally, Enforcement claims that the investors were so dependent on Respondent 2's and CEI's unique entrepreneurial and managerial ability that they could not replace CEI as the Managing Venturer or otherwise

[25] Mot. at 17.

[26] Mot. 18.

[27] Mot. 21.

[28] Opp. 25–26.

[29] Opp. at 27. In applying the *Williamson* factor regarding investor experience, some courts have focused on the investors' experience in the type of business at issue. *See, e.g.*, *Long v. Shultz Cattle Co*., 881 F.2d 129, 134 n.3 (5th Cir. 1989) (cited approvingly in *Affco Invs. 2001 LLC v. Proskauer Rose L.L.P*., 625 F.3d 185, 190–91 (5th Cir. 2010)); *Bailey v. J.W.K. Properties, Inc*., 904 F.2d 918, 924 n.13 (4th Cir. 1990); *SEC v. Shields*, 744 F.3d 633, 647 (10th Cir. 2014); *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 762 (11th Cir. 2007); *Albanese V. Florida Nat'l Bank*, 823 F. 2d 408, 412 (11th Cir.1987). Other courts, however, have stressed the investors' general business experience. *See, e.g.*, *Holden v. Hagopian*, 978 F.2d 1115, 1121 (9th Cir. 1992); *Koch v. Hankins*, 928 F.2d 1471, 1476 (9th Cir. 1991); *SEC v. Schooler* No. 3:12-cv-2164-GPC-JMA, 2014 U.S. Dist. LEXIS 58034 (S.D. Cal. Apr. 25, 2014). *See also SEC v. Kinlaw Securities Corp*., No. 93; CV-2010-T (N.D. Tex. Jul. 22, 1990) (unreported decision relied upon by Respondents). Neither the SEC nor the NAC have adopted a single approach. *See Guevara*, 54 S.E.C. at 661–62 (considering both general and business-specific experience); *Guevara*, 1999 NASD Discip. LEXIS 1, at *13 (same); *Dep't of Enforcement v. Baxter*, No. C07990016, 2000 NASD Discip. LEXIS 3, at *20 n.16 (NAC Apr. 19, 2000) (noting that in applying *Williamson*, it would "need to consider . . . the investors' general business experiences. . ."); *De Vietien*, 2010 FINRA Discip. LEXIS 45, at *24 (finding that membership interests in a Florida LLC were securities based, in part, on the investors' lack of experience in real estate or the Florida real estate market). In ruling on the Motion, I do not reach the issue of whether general, as opposed to venture-specific, business experience is the relevant type of experience under *Williamson*.

exercise meaningful partnership or Joint Venture powers. On this last point, Enforcement argues that the Joint Venture Agreement made it "entirely impracticable" for the investors to exclude Respondent 2 and CEI from management, at least until the three Prospective Wells were completed.[30]

3. Respondents Failed to Show that There are No Genuine Issues with Regard to any Material Fact Concerning Whether the Units are Securities

Based on the Complaint, the Motion, Opposition, and Reply, as well as the supporting exhibits, and applying the summary disposition standards set forth above, I find that there are numerous genuine issues of material fact (or, at least conflicting inferences from the facts) relating to the third element of the *Howey* test and, specifically, to each of the *Williamson* factors. These genuine issues of material fact include the following:

1. Whether the Joint Venture operated as a true general partnership under Texas general partnership law, as opposed to, for example, a limited partnership?

2. Whether the partnership and the managerial rights purportedly granted to investors were illusory because, for example, the investors lacked the practical ability to exercise their purported partnership rights and because the Joint Venture Agreement contains limitations on their authority?

3. Whether CEI, in the context of the Joint Venture, has unique expertise?

4. Whether the investors had the practical ability to replace CEI as the Managing Venturer or were they essentially locked into using CEI?

5. Whether the venturers were so inexperienced and unknowledgeable in business affairs that they were incapable of intelligently exercising their Joint Venture powers?

6. Whether the investors had the opportunity to play any role in the management and operation of the Joint Venture, and did they do so? Or, was their role passive and primarily limited to providing funds to the Joint Venture?

[30] Opp. at 28.

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In conclusion, Respondents failed to demonstrate that there are no genuine issues with regard to any material fact regarding whether the units are securities. And, therefore, Respondents are not entitled to summary disposition on the basis that the units are not securities.

The Motion is **DENIED.**

SO ORDERED.

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David R. Sonnenberg
Hearing Officer

Dated: March 4, 2016