

COMMONWEALTH OF VIRGINIA  
STATE CORPORATION COMMISSION

AT RICHMOND, JUNE 3, 2014

COMMONWEALTH OF VIRGINIA, *ex rel.*

STATE CORPORATION COMMISSION

v.

CASE NO. SEC-2013-00029

INDEPENDENT FINANCIAL GROUP, LLC,  
Defendant

SETTLEMENT ORDER

The Division of Securities and Retail Franchising ("Division") of the State Corporation Commission ("Commission") conducted an investigation of Independent Financial Group, LLC ("IFG" or "Defendant"), pursuant to § 13.1-518 of the Virginia Securities Act ("Act"), § 13.1-501 *et seq.* of the Code of Virginia ("Code"). Based on its investigation, the Division alleges as follows:

(1) IFG agents James Crawford ("Crawford") and Neal M. Woodard ("Woodard") (collectively "Agents"), who reside and do business in the Commonwealth of Virginia ("Virginia"), failed to receive adequate training in the sale of publicly registered non-traded real estate investment trusts ("REIT(s)"), which are a subset of investments commonly referred to as "alternative investments." IFG's Agents in Virginia made material misrepresentations and untrue statements of fact in the offer and sale of these securities in violation of § 13.1-502 (2) of the Act. Specifically, these Agents improperly marketed alternative investments, designated as high risk securities, to some of their retail brokerage clients in Virginia as lower to moderate risk securities. IFG also failed to implement adequate compliance procedures to monitor the Agents' sale of these securities. As a consequence, in selling these high risk securities to IFG's Virginia clients, IFG's Agents recommended the purchase of, and sold these securities in, high and

14061  
CLERK'S OFFICE  
CONTROL CENTER  
2014 JUN -3 A 9:23

unsuitable concentrations in violation of 21 VAC 5-20-280 A (3) of the Commission's Rules Governing Broker-dealers, Broker-dealer Agents and Agents of the Issuer, 21 VAC 5-20-10 *et seq.* ("Rules").

(2) Pursuant to Rule 21 VAC 5-20-260 B, a broker-dealer must exercise diligent supervision over the securities activities of all of its agents. By failing to adequately train these Agents and by failing to implement adequate compliance procedures to track and monitor the alternative investment sales activities of these Agents, IFG violated Rules 21 VAC 5-20-260 B and 21 VAC 5-20-260 D. Also, pursuant to Rule 21 VAC 5-20-260 A, a broker-dealer is responsible for the acts, practices, and conduct of its agents in connection with the sale of securities, including the violations of § 13.1-502 (2) of the Act by misrepresentations regarding the risks associated with alternative investments to IFG clients. Also, IFG violated Rule 21 VAC 5-20-280 A (3) for clearing trades made by Crawford and Woodard that were unsuitable.

*Defendant and Its Agents' Backgrounds*

(3) IFG is a broker-dealer registered (CRD #7717) to offer and sell securities within Virginia. Its principal offices are located in San Diego, California, and it maintains affiliated offices in Virginia.

(4) Crawford is a broker-dealer agent registered (CRD #1327638) to offer and sell securities within Virginia. From March 2012 through December 2012 ("relevant time period"), Crawford was a registered agent of IFG. During the relevant time period, Crawford offered and sold securities through IFG out of an affiliated office in Harrisonburg, Virginia.

(5) Woodard is a broker-dealer agent registered (CRD #5461015) to offer and sell securities within Virginia. During the relevant time period, Woodard offered and sold securities through IFG out of an affiliated office in Harrisonburg, Virginia.

(6) During their time as agents with IFG, Crawford and Woodard offered, as part of a total investment strategy, a class of securities referred to as "alternative investments" to IFG clients, which included investments tied to real estate such as REIT. Crawford and Woodard presented these alternative investment strategies to some of their clients who they believed met the general suitability requirements to purchase such investments.

*Background on Alternative Investments Sold by the Defendant*

(7) A REIT is a complex investment generally involving a company that owns income-producing real estate or assets related to real estate. REITs provide a way for individual investors to earn a share of the income produced through commercial real estate ownership by purchasing interests or shares in the REIT. The income-producing real estate assets owned by a REIT may include office buildings, shopping malls, apartments, hotels, resorts, self-storage facilities, warehouses, and mortgages or loans on real estate. A REIT is distinguishable from other real estate companies in that a REIT must acquire and develop its real estate properties primarily to operate them as part of its own investment portfolio over an extended period of time, as opposed to reselling those properties after they have been developed.

(8) REITs may be registered with the Securities and Exchange Commission ("SEC") and can be traded publicly on exchanges. These are known as publicly traded REITs. There are also, however, REITs that are non-publicly traded. Non-publicly traded REITs also are registered with the SEC, but they are illiquid, long-term investments designed to produce income, with an ultimate goal of appreciation when the REIT either sells its portfolio of real estate or undergoes a

public offering. Additionally, for tax and regulatory purposes, a real estate fund must meet certain specific criteria to be qualified as a REIT. Almost all REITs offered by Woodard and Crawford to their IFG clients were publicly reporting non-publicly traded REITs. Although not publicly traded, these REITs have reporting requirements provided under Section 13(a) or 15(d) of the Securities Exchange Act, 15 U.S.C § 78a, *et seq.*

(9) In almost every case, the REITs offered by Crawford and Woodard were newly formed entities with limited operating history. However, these newly formed entities were sponsored by companies that had been doing business syndicating and managing REITs for many years. The sponsoring companies had principals, managers and board members with experience managing such investments and investment funds for the benefit of retail and institutional investors. These REITs typically had a projected holding period of five to seven years and in some cases could not be redeemed, sold or liquidated during this time period.

#### *Risks Associated with Alternative Investments*

(10) Nearly all illiquid alternative investments offered by Crawford and Woodard involved a high degree of risk and were speculative in nature. These products were expressly designated as such in the disclosure documents for these investments.

(11) Other significant risks associated with these products, in particular REITs, as generally expressed in the disclosure documents, and summarized here, included the following:

- In instances where the REITs were not publicly traded, there was a substantial barrier to their resale and any resale would likely occur at a discount from the purchase price.
- Though the REIT companies were managed by companies in the business of managing real estate and syndicating REIT investments, the REITs associated with these investments were in every case early stage companies and had limited operating histories making future performance difficult to predict and largely speculative.

- The general risks involved in ownership of real estate created no guarantees of any return on investment and loss of investment throughout the life of the investment.
- There was no guarantee of income distributions from the REITs.
- REITs were permitted to use offering proceeds to pay distributions to investors and to borrow funds for a variety of purposes, including to pay distributions.
- Certain REITs had the ability to incur debt for operations from the equity in the property purchased which could lead to an inability to pay distributions to shareholders and could facilitate a possible decrease in the value of the investment.
- REITs depended on the management expertise of an outside advisor to manage the fund and to select the properties associated with the REIT.
- There were conflicts of interest between the outside REIT advisors and their other affiliated funds including significant conflicts in allocating time among the funds they managed and other similar programs they sponsored.
- For REITs, if the issuer failed to raise the maximum amount of offering proceeds, it could result in the REIT issuer not investing in a diverse portfolio of properties making the value of the investment variable based on the performance of a more limited number of properties in the portfolio.
- The REITs in many cases were not pre-qualified as REITs and could have potentially failed to meet the tax requirements to qualify as a REIT causing payment of additional taxes and reducing funds available to make distributions and also the value of the fund in general.

*Internal Compliance and Suitability Standards for Selling Alternative Investments at IFG*

(12) The alternative investments offered and sold by the IFG agents were typically classified as non-conventional investments ("NCIs") within the brokerage industry, in part, because they were non-publicly traded and illiquid in nature.

(13) Because NCIs can be complex and not easily understood, an agent could not rely solely on a client's financial status as the basis for recommending an NCI for purchase. In fact,

the National Association for Securities Dealers ("NASD") issued a notice to member firms, of which IFG was a member, in 2003. NASD Notice to Members 03-71 ("Notice") expressly cautioned agents that NCIs with particular risks might only be suitable for a very narrow band of investors capable of evaluating and being financially able to bear those risks.

(14) Although IFG's Compliance Manual discusses suitability, IFG did not adequately apply the standards in the Notice to the sale of non-publicly traded REITs in its compliance manual, nor did IFG make certain that Crawford and Woodard were aware of the particulars set forth in the Notice prior to engaging them as registered representatives of the firm. IFG required that investors confirm their suitability for direct participation programs and that investors complete a Direct Participation Program Suitability Questionnaire before a purchase request was cleared. IFG reviewed the transaction, including the suitability information provided and the financial status of the investor, prior to approval of the purchase of alternative investments by its customers. Crawford and Woodard completed and submitted to IFG the required forms in connection with their non-traded REIT transactions.

(15) In recommending the purchase of alternative investments, IFG agents were required to use care to ensure that the concentration of alternative investments within a client's investment portfolio was suitable for the client, in part, because of the liquidity and other risks associated with these investments. In general, firms within the retail brokerage industry have compliance guidelines for determining suitable concentration levels of non-publicly traded and illiquid alternative investments for individual clients based on a client's investment profile.

(16) IFG did not impose on its agents specific guidelines regarding concentration in NCIs, except to the extent that there were product-specific concentration guidelines provided by certain states.

*IFG Agents' Misrepresentations of Risk Associated with Alternative Investments*

(17) Crawford and Woodard marketed themselves to clients as specialists in alternative investments and routinely offered these products to some of their clients as "alternatives" to traditional securities publicly traded over national exchanges. Crawford and Woodard offered these products to their customers as part of an investment strategy they believed added diversity to a portfolio beyond holding only traditional exchange-traded securities. Almost all alternative investments offered and sold by Crawford and Woodard were non-publicly traded products. Crawford and Woodard derived the majority of their commissions from the sale of these products.

(18) On several occasions, despite Crawford and Woodard informing their clients that they could lose their principal investment, Crawford and Woodard understated the material risks associated with the alternative investments they sold to some of their clients and minimized the possibility of a total loss. Specifically, Crawford and Woodard misled some of their clients to believe that these high-risk and speculative securities carried a lower risk than what was expressed in the disclosure documents for these products due to the fact that they were being purchased toward the end of their offering period.

(19) In some cases, Crawford downplayed the risks represented in the disclosure documents for these products, as referenced above, when the documents were provided to some of their clients. In many cases, he referred to the high risk language and express risk factors in these documents as "boilerplate," contrary to IFG's compliance guidance and regulatory requirements cautioning against the minimization of risks associated with these types of products.

(20) As a general practice, when selling REITs, Crawford and Woodard employed an investment strategy whereby they usually offered and sold REITs to clients at the end of an offering period for each particular REIT. Crawford and Woodard represented to their clients that by purchasing REITs at the tail end of an offering period, some of the risks as expressed in the offering documents were mitigated because the REIT fund was close to raising or had raised all the money it intended and had also purchased a substantial book of properties from which to draw income. Crawford and Woodard also represented to clients that by adding this type of real estate investments to their portfolios, the total portfolio risk became generally safer and less volatile than one containing only traditional securities such as stocks and mutual funds. Although in general it is recognized that diversification may be a means of mitigating risk, the way that Crawford and Woodard presented this risk mitigation to certain customers understated the actual risk of investing in the REITs.

(21) Representing that the risks disclosed in the offering documents were reduced as a result of employing this strategy was improper. At no time did the risk factors as referenced in the disclosure documents change. The risk factors expressly referenced in the disclosure documents remained during, and well after, the offering period ended for the REITs in question. Simply approaching or reaching the target maximum funds during the offering period and even purchasing properties within a REIT did not mitigate all of the operational risks of the fund or the tax consequences for those REITs over the life of the investment. As stated previously, nearly all alternative investments offered by Crawford and Woodard were offered by established companies in early-stage funds with limited or no operational history. The offering period for these products typically represented only a 10- to 18-month period, and reaching the target



offering amount during this time period did not eliminate the risks associated with the investment, as stated in the disclosure documents.

(22) For example, fluctuations in the value of real estate over time would have had a dramatic influence on the value of a REIT as it would impact any real estate investment, and reaching the target offering amount did nothing to mitigate this risk. The performance of the businesses in leased REIT properties and their ability to continue meeting their lease obligations was also a factor unrelated to the amount of offering proceeds collected. These risks and others, as expressed above in paragraph (12), continued throughout the life of these investments and some of them were minimized by Crawford and Woodard.

*The Defendant's Failure to Conduct an Adequate Suitability Determination*

(23) On several occasions, Crawford and Woodard also failed to make an appropriate suitability determination when recommending the alternative investments they sold to IFG clients. In some cases, Crawford and Woodard relied too heavily on a client's financial status and net worth in recommending the purchase of alternative investments and improperly placed some IFG clients into high concentrations of alternative investments. In other cases, Crawford and Woodard considered the mitigated risk of a particular REIT to be sufficiently reduced so as to be appropriate to sell in large concentrations to clients who were unaccredited investors.

(24) Crawford and Woodard considered placement in alternative investments, in particular REITs, as an option for IFG clients even before they had completed the necessary steps to determine suitability and made their decision to steer clients into alternative investments based in large part on the amount of money their clients had.

(25) Crawford and Woodard also placed some of their clients into inappropriately high concentrations of high risk alternative investments in relation to their net worth exclusive of

home, furnishings and automobiles ("net worth exclusive") and liquid net worth. Considering net worth exclusive and liquid net worth was an important extra component in determining the suitability of these particular investments because of the illiquidity risks they carried.

(26) Out of 31 transactions conducted during the relevant time period, IFG cleared five trades for Crawford and Woodard's clients that made the total concentration of high risk alternative investments in their portfolio in excess of 25% of their net worth exclusive. Out of these five transactions, four trades were cleared by IFG for clients having less than \$1 million in assets including their personal residence. This is an important factor to consider in determining suitability and is generally used as a benchmark within the brokerage industry to gauge the level of an investor's financial sophistication and ability to comprehend complex investments such as NCIs.

(27) Out of these 31 transactions during the relevant time period, IFG also cleared seven trades for clients whose net worth was less than \$1 million and whose total concentration of high risk alternative investments in their portfolios was in excess of 20% of their liquid net worth.

(28) Based on the conduct as described above, the Division alleges that IFG Agents violated § 13.1-502 (2) of the Act by making materially untrue statements or omissions of fact in the offer and sale of securities through Crawford and Woodard. The Division further alleges that IFG allowed Crawford and Woodard to violate Rule 21 VAC 5-20-280 A (3) by recommending to some of their clients the purchase of alternative investments without reasonable grounds to believe that the recommendation was suitable for their clients based upon reasonable inquiry concerning their client's investment objectives, financial situation, risk tolerance and needs, and any other relevant information known by the broker-dealer.

(29) The Division further alleges that IFG failed to adequately train Crawford and Woodard and failed to implement adequate compliance procedures to track and monitor the alternative investment sales activities of Crawford and Woodard, in violation of Rules 21 VAC 5-20-260 B and 21 VAC 5-20-260 D.

If the provisions of the Act are violated, the Commission is authorized by § 13.1-506 of the Act to revoke a defendant's registration, by § 13.1-519 of the Act to issue temporary or permanent injunctions, by § 13.1-518 A of the Act to impose costs of investigation, by § 13.1-521 A of the Act to impose certain monetary penalties, by § 13.1-521 C of the Act to order a defendant to make rescission and restitution, and by § 12.1-15 of the Code to settle matters within its jurisdiction.

The Defendant neither admits nor denies these allegations but admits to the Commission's jurisdiction and authority to enter this Settlement Order ("Order").

As a proposal to settle all matters arising from these allegations, the Defendant has made an offer of settlement to the Commission wherein the Defendant will abide by and comply with the following terms and undertakings:

(1) The Defendant will pay to the Treasurer of the Commonwealth ("Treasurer"), contemporaneously with the entry of this Order, the amount of Thirty Thousand Dollars (\$30,000) in monetary penalties.

(2) The Defendant will pay to the Treasurer, contemporaneously with the entry of this Order, the amount of Five Thousand Dollars (\$5,000) to defray the costs of investigation.

(3) The Defendant acknowledges that it is responsible for the acts, practices, and conduct of its Agents in connection with securities transactions while they were acting as registered representatives affiliated with the firm, and in doing so, the Defendant agrees it shall enhance its

compliance measures and supervision policies to more closely and diligently supervise the securities activities of its Virginia agents, especially in connection with monitoring the offer and sale of alternative investments.

(4) The allegations and recitation of investigative findings in this Order are expressly limited to the conduct of Crawford and Woodard during the relevant time period and for specified transactions. The Division's allegations do not extend to actions of other IFG registered representatives or other transactions and the effect of this Order is not intended to reach conduct governed by other states, or matters regulated by the Financial Industry Regulatory Authority or the SEC.

(5) If Crawford and Woodard remain affiliated with IFG, the Defendant will conduct two (2) separate training sessions with both Crawford and Woodard within one (1) year from the date of entry of this Order to ensure that their presentation of investment opportunities to clients is complete, balanced and consistent with IFG's standards and regulatory requirements. Upon such training being completed, IFG will submit an affidavit to the Division attesting to Crawford and Woodard having completed such training and the dates upon which such training was completed. If Crawford and Woodard's affiliation with IFG ends prior to the obligation to either conduct the training or report, IFG will notify the Division that such termination has taken place.

(6) The Defendant will not violate the Act in the future.

Accordingly, IT IS ORDERED THAT:

(1) The offer of the Defendant in settlement of the matter set forth herein be, and it is hereby, accepted.

(2) The Defendant fully complies with the aforesaid terms and undertakings of this settlement.

(3) This Order concludes the investigation by the Commission and any other action that the Commission could commence against the Defendant under applicable law on behalf of the Commonwealth as it relates to the violations described in this Order, up to and including activity occurring through the date of this Order.

(4) This Order is not intended to serve as the basis for a disqualification under Section 3(a)(39) of the Securities Exchange Act of 1934 or under 17 CFR 230.506(d), and such disqualification should not arise as a consequence of this Order.

(5) The Commission shall retain jurisdiction in this matter for all purposes, including the institution of a show cause proceeding, or taking such other action it deems appropriate, on account of the Defendant's failure to comply with the terms and undertakings of the settlement.

AN ATTESTED COPY hereof shall be sent by the Clerk of the Commission to:  
Edward S. Zusman, Esquire, Counsel for Defendant, Markun, Zusman, Freniere & Compton, LLP, 465 California St., Suite 500, San Francisco, California 94104; and a copy shall be delivered to the Commission's Office of General Counsel and Division of Securities and Retail Franchising.

COMMONWEALTH OF VIRGINIA  
STATE CORPORATION COMMISSION  
AT RICHMOND,

COMMONWEALTH OF VIRGINIA, *ex rel.*

STATE CORPORATION COMMISSION

v.

CASE NO. SEC-2013-00029

INDEPENDENT FINANCIAL GROUP, LLC,  
Defendant

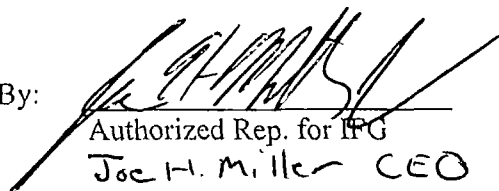
ADMISSION AND CONSENT

Independent Financial Group, LLC ("Defendant"), admits to the jurisdiction of the State Corporation Commission ("Commission") as to the parties and subject matter hereof and, neither admitting nor denying the allegations made herein by the Division of Securities and Retail Franchising, hereby consents to the form, substance and entry of the foregoing Settlement Order ("Order").

The Defendant further states that no offer, tender, threat or promise of any kind whatsoever has been made by the Commission or any member, subordinate, employee, agent or representative thereof in consideration of the foregoing Order.

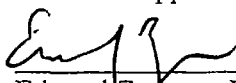
Date: 5-21-2014

By:

  
Authorized Rep. for IFG

Joe H. Miller CEO

Seen and Approved by:

  
Edward Zugman, Esquire  
Counsel for IFG