

THE STATE OF SOUTH CAROLINA
In The Court of Appeals

APPEAL FROM RICHLAND COUNTY
Court of Common Pleas

The Honorable Tanya A. Gee
Circuit Court Judge

Case No. 2014-CP-40-07917

Appellate Case No. 2015-001845

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SC Court of Appeals

John M. McIntyre and Silver Oak Land
Management LLC, ... Appellants,
v.
Securities Commissioner of South Carolina, ... Respondent.

FINAL REPLY BRIEF OF APPELLANTS

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Argument

I. The circuit court disregarded section 35-1-609 of the by relying on incompetent evidence to confirm the findings of the Securities Commissioner.

a. Appellants properly preserved their argument addressing the circuit court's failure to adhere to the standard mandated by section 35-1-609.

The Securities Commissioner alleges that Appellants failed to preserve this argument for appellate review because "Appellants failed to allege that evidence was incompetent" before the circuit court and "[t]here was no argument below that evidence was incompetent." {Resp. Br. p. 7}. This argument lacks merit. Appellants argued to the circuit court and the hearing officer that the evidence at issue was incompetent.

Before the hearing officer, the Securities Commissioner relied on the testimony of Sandra Matthews, Phil Hartman, Paul Finn, and James Paris in addition to the bank records of each LLC to support its position regarding the alleged violations of section 35-1-501 by Appellants.¹ {R. 290-91, 292, 301, 308-10, 310-11, 312, 314-15, 315-16, 317, 321-22, 324, 327, 332, 333, 337, 379, 600-02, 602, 604, 605, 606-07, 617-20, 685-86}. Appellants objected to the admissibility of the testimony and records introduced by the Securities Commissioner.

The hearing officer admitted the LLC bank records through the testimony of Mr. Silver. Appellants objected to the admission of those records on several grounds: authentication issues, hearsay, and improper admission of Mr. Silver's notes on the records. {R. 308-10, 317}. Appellants further objected to the decision to allow Mr. Silver to testify as an expert witness in

¹ Phil Hartman and James Paris offered no testimony relating to the specific factual scenarios identified by the circuit court as grounds for a finding of a violation of section 35-1-501 on page 13 of the order. Thus, their testimony cannot support the findings of the Securities Commissioner as set forth in Section V of Appellants' Brief.

regards to the bank statements. {R. 308-10, 310-11, 312, 314-15, 315-16, 317, 321-22, 324, 327, 332, 333, 337}.

The hearing officer admitted the investor questionnaires though the testimony of Ms. Matthews. {Oct. Trans. p. 438-439, R. 598-99}. Appellants likewise objected to the admission and testimony related thereto on hearsay and authentication grounds. {Oct. Trans. R. 600-02, 602, 604, 605, 606-07, 617-20, 685-86}. The hearing officer allowed Mr. Silver to testify as to the management of the LLCs or purported violations of the securities act. Appellants objected to the admission of such hearsay testimony. {Oct. Trans. R. 290-91, 292, 301, 308-10}. Appellants also objected to the hearing officer allowing Mr. Finn to base testimony off the improperly admitted bank records of the LLCs. {Oct. Trans. R. 308-10, 379}.

In short, Appellants objected to the competence of each piece of evidence and testimony introduced by the Securities Commissioner before the hearing officer. Thus, Appellants raised their competency of the evidence arguments contemporaneously with the introduction of the improper evidence and at the earliest opportunity, which was before the hearing officer. See State v. Buyers, 392 S.C. 438, 710 S.E.2d 55 (2011) (recognizing that an objection to the introduction of objectionable evidence must be made contemporaneously with the introduction of the evidence).

Moreover, Appellants continued to challenge the competency of the evidence introduced by the hearing officer at the judicial review hearing before the circuit court. Appellants specifically advised the circuit court that the findings of the Securities Commissioner were based on improperly admitted evidence before the circuit court:

- “[Appellants] objected on multiple occasions that the hearsay rule precluded evidence that was coming in” {April 2015 Trans. p. 15, R. 821}.

- “Subsequently, when the case resumed for three more days in October . . . the same issues were raised by [Appellants] with respect the state’s witnesses . . . was completely hearsay without any effort made to qualify it under one of the exceptions. And it was all ruled admissible on the basis that there was no firm and fast rules governing admissible evidence and what wasn’t. And those rulings are also in the record. That was by the hearing officer.” {April 2015 Trans. p. 15-16, R. 821-22}.
- “We asked to keep out all of this evidence.” {April 2015 Trans. p. 16, R. 822}.

Thus, Appellant advised the circuit court that the Securities Commissioner’s award was premised on incompetent and improperly admitted evidence.² Moreover, the circuit court rejected Appellants’ arguments on the admission of the evidence in confirming the award of the Securities Commissioner based on that evidence. The issue was preserved for appellate review.

It was incumbent on the circuit court to analyze the admission of the challenged evidence under the framework mandated by section 35-1-609.³ The circuit court failed do so and simply based its ruling on incompetent evidence. By failing to adhere to section 35-1-609 and verify whether the Securities Commissioner relied upon competent evidence, the circuit court erred as a matter of law. This Court should reverse based on this error of law. At a minimum, this Court should remand the matter to allow the circuit court to perform its threshold review of

² While Appellants’ argument on this issue could have been more artfully stated vis-à-vis section 35-1-609, our rules of preservation do not require the party to use the exact name of the legal doctrine, statute, or rule in order to preserve the argument for appellate review. See State v. Brannon, 388 S.C. 498, 697 S.E.2d 593 (2010) (finding the appellant preserved a Fourth Amendment argument without citing the rule because the appellant raised the general issue of whether an arrest was made to the circuit court).

³ Appellants did not have to argue that circuit court should apply section 35-1-609; it applied as a matter of law as the statute controlling the review by the circuit court. Once Appellants raised the issue of competency to the hearing officer and again to the circuit court, section 35-1-609 required the circuit court to review whether that evidence was in fact properly admitted.

whether the record before the Securities Commissioner contained competent evidence as required by section 35-1-609.

- b. The General Assembly required the circuit court to conduct a threshold review the competency of the evidence before the Securities Commissioners as mandated by section 35-1-609.**

In its brief, the Securities Commissioner argues that the circuit court had no obligation to perform its judicial review functions mandated by the General Assembly unless first requested by Appellants. {Resp. Br. p. 9}. Such an argument contradicts the duty imposed on the circuit court by the plain language employed by the General Assembly in section 35-1-609, which provides that:

A person aggrieved by a final order of the Securities Commissioner may obtain a review of the order in the Richland County Court of Common Pleas by filing in the court, within thirty days after entry of the order, a written petition praying that the order may be modified or set aside in whole or in part. The aggrieved person, upon filing a petition, may move before the court in which the petition is filed to stay the effectiveness of the Securities Commissioner's final order until such time as the court has reviewed the order. If the court orders a stay, the aggrieved person must post any bond set by the court in which a petition is filed. A copy of the petition must be served upon the Securities Commissioner, and the Securities Commissioner shall certify and file in court a copy of the filing and evidence upon which the order was entered. When these have been filed, the court has exclusive jurisdiction to affirm, modify, enforce or set aside the order, in whole or in part. **The findings of the Securities Commissioner as to the facts, if supported by competent, material, and substantial evidence, are conclusive.**

S.C. Code Ann. § 35-1-609 (2005) (emphasis added). With this final sentence of section 35-1-609, the General Assembly imposed a two-part obligation on the circuit court for review of a final order from the Securities Commissioner. First, the circuit court acts as the judicial reviewer of the administration of the Securities Act to determine “if” the Securities

Commissioner found facts “supported by competent . . . evidence.” Id. Second, after making that threshold determination as to whether competent evidence exists, the circuit court then determines whether substantial evidence supports the factual findings of the Securities Commissioner. Id.

This plain and unambiguous language defined the aim of the General Assembly to require the circuit court to conduct a threshold review the competency of the evidence before the Securities Commissioners. The Securities Commissioner’s argument improperly nullifies that express intent. See Gordon v. Phillips Utils., Inc., 362 S.C. 403, 406, 608 S.E.2d 425, 427 (2005) (holding that the cardinal rule of statutory interpretation is to determine the intent of the legislature above all else); Buist v. Huggins, 367 S.C. 268, 276, 625 S.E.2d 636, 640 (2006) (holding that words of a statute must be given their plain and ordinary meaning without resorting to subtle or forced construction to expand the statute’s operation). The circuit court was required to perform this threshold judicial review of the Securities Commissioner’s award. State v. Corey D., 339 S.C. 107, 120, 529 S.E.2d 20, 27 (2000) (recognizing that it is beyond a court’s “power to effect a change in the statutes enacted by the Legislature”); Buist, 367 S.C. at 276, 625 S.E.2d at 640 (holding that “if a statute’s language is plain, unambiguous, and conveys a clear meaning, the rules of statutory interpretation are not needed and the court has no right to impose another meaning”). The circuit court erred in failing to conduct that review before relying on the evidence to confirm the award. This Court should reverse based on this error of law. At a minimum, this Court should remand the matter to allow the circuit court to perform its threshold review of whether the record before the Securities Commissioner contained competent evidence as required by section 35-1-609.

II. The statutory power retained by the LLC members to remove the LLC manager precluded the LLC interests from qualifying as securities under the South Carolina test.

The Securities Commissioner avers that the “general presumption” (via an analogy to a limited liability partnership) that LLC interests constitute securities is sufficient to find these specific LLC interest are securities in this case. However, the Securities Commissioner offers no support for this claim. As the Securities Commissioner admits, the operating agreements (upon which the Securities Commissioner determined a security existed) are silent as to the procedures for “removal of the manager, thus, the statute is controlling.” {Resp. Br. p. 13}. Under that statute, section 33-44-404(b)(3)(i), and section 33-44-801, the members of the LLCs retained the power of the members to remove the manager of an LLC by simple majority vote as well as the power of the members to dissolve the LLC by vote over any objection by the manager. Such power overcomes any “general presumption” claimed by the Securities Commission.

Despite taking Appellants and the hearing officer to task in the final award for using an analogy to a another business type at the initial hearing, the Securities Commissioner creates this “general presumption” through an analogy to a limited liability partnership. {Resp. Br. p. 12-14}. The Securities Commissioner cites no case or authority to counter the recognition that retention of the ability to remove the manager or dissolve the LLC without manager consent fails the third prong of the Howey test and removes the interest from the purview of the Securities Act.

As all parties recognize, this matter hinged on the third prong of the Howey test. namely whether an expectation of profits to be derived primarily from the efforts of a person other than the investor existed here. Majors v. S.C. Securities Com’n, 373 S.C. 153, 163-67, 644 S.E.2d

710, 716-18 (2007) (relying upon Securities & Exchange Com'n. v. J.W. Howey Co., 328 U.S. 293 (1946)). That prong hinges on the control retained by the LLC members to affect the profits that each member receives from the LLC.

In the context of whether an LLC interest constitutes a security, the retention of the ability to remove the manager or dissolve the LLC without manager consent has been recognized to render the agreement something other than an investment contract under the Securities Act. Great Lakes Chem. Corp v. Monsanto Co., 96 F.Supp.2d 376 (D. Del. 2000). In that matter, the court noted that “the members of [the LLC] had no authority to directly manage [the LLC’s] business and affairs” pursuant to the operating agreement. Id. at 392. The analysis, however, did not stop there. Rather, the court recognized that the members “had the power to remove any [m]anager with or without cause, and to dissolve the company.” Id. The court found that such power meant the each member “was not a passive investor.” Id. The court then held that:

[The member’s] authority to remove managers gave it the power to directly **affect the profits it received from [the LLC]**. Thus, the court finds that [the member’s] profits from [the LLC] did not come solely from the efforts of others.

Id. (emphasis added). The court concluded that as a result the membership interests did not qualify as an investment contract under the securities act. Id.⁴

⁴ The Securities Commissioner alleges Great Lakes is inapplicable because the court there also addressed a control factor separate from the court’s holding related to the third prong of the Howey test. {Resp. Br. p. 14}. However, that argument is a red herring. The Great Lakes court directly addressed the third prong of the Howey test and concluded that the retention of the power to remove the manager and dissolve the LLC disqualified the interest from meeting the third prong of the Howey test. Great Lakes, 96 F.Supp.2d at 392. The fact that the court later distinguished the LLC interest on the other ground cited by the Securities Commissioner does not supplant the fact that the court held the control afforded to the members via statute (not the operating agreement) to remove the manager and dissolve the LLC rendered the securities act inapplicable. Thus, the Securities Commissioner’s attempt to distinguish Great Lakes fails. Moreover, despite the initial attempt to distinguish that case, the Securities Commissioner also

Thus, the members in each LLC retained (to the current day) ultimate control over the LLC despite the presence of a manager. That power vested each member with the authority to “affect the profits that [each] received” from the LLCs. As a result, the membership interests in the LLC could not qualify as securities under the South Carolina test. The Securities Commissioner and the circuit court erred in finding to the contrary. This Court should reverse and enter judgment in favor of Appellants.

III. The Securities Commissioner failed to cite any evidence that linked the allegedly improper conduct of Appellants to the time of the offer, sale, or purchase of the LLC interests as required by section 35-1-501.

Section 35-1-501 requires a finding that the conduct occur “in connection with the offer, sale, or purchase of a security” in order to violate the statute.⁵ The Securities Commissioner and the circuit court failed to make any finding that the conduct was connected in time to the offer, sale, or purchase of a membership interests in any of the LLCs at issue. Imposing penalties in the absence of such a temporal connection was error.

In its brief, the Securities Commissioner asks this Court to affirm (also without citing any evidence to support its claim) that the “activities it identified as fraudulent occurred in the connection with the offer and sale of the securities at issue.” {Resp. Br. p. 17}. Notably, the Securities Commissioner cites solely to its order and the circuit court order to support its claim

admits that the Great Lakes court “went on to find that the investment also failed the third prong of the Howey test” {Resp. Br. p. 14}. Thus, Great Lakes is analogous.

⁵ The circuit court upheld the Securities Commissioner’s findings of violations of the general fraud provision of the Securities Act codified as section 35-1-501 of the South Carolina Code. {Circuit Court Order p. 13, R. 99}. Specifically, the circuit court found that management activities occurring after the offer, sale, or purchase of the LLC membership interests supported a finding that Appellants violated section 35-1-501. {Id., R. 99 (listing facts in form of bullet points)}. This finding constituted error.

that the conduct was connected in time to the offer, sale, or purchase of a membership interests in any of the LLCs at issue. {Resp. Br. p. 17-18}. The Securities Commissioner does not cite **any evidence** from the record to support its position. Merely claiming evidence exists to support the circuit court's order does not establish such evidence exists in the record.

Moreover, the alleged "evidence" cited⁶ by the Securities Commissioner (via the findings in the award and circuit court order) actually support Appellants' position on this issue. Those actions all occurred post-offer, sale, or purchase of the LLC interests by the members. The Securities Commissioner introduced no evidence linking that conduct in the management of the LLCs to the time of the offer, sale, or purchase of any LLC interest. Rather, the Securities Commissioner's argument throughout was to ignore its burden to establish the temporal limitation mandated by the General Assembly in section 35-1-501 and instead argue that the management conduct caused harm to the LLCs so a violation should be assumed.

Such a position contradicts the unambiguous temporal requirements required before a violation of section 35-1-501 exists. That section provides that

It is unlawful for a person, **in connection with the offer, sale, or purchase of a security**, directly or indirectly:

- (1) to employ a device, scheme, or artifice to defraud;
- (2) to make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
- (3) to engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person.

⁶ See the list of alleged conduct cited on page 17 of the Securities Commissioner's brief.

S.C. Code Ann. § 35-1-501 (2005) (emphasis added). The plain language establishes that the statute limits its application to conduct occurring in connection with the offer, sale, or purchase of a security. By placing the “in connection with the offer, sale, or purchase of a security” language immediately after the “[i]t is unlawful for a person” language, the General Assembly signified its intent to modify, qualify, or limit violations to conduct occurring with the offer, sale, or purchase of a security. See, e.g., Total Environmental Solutions, Inc. v. S.C. Pub. Servs. Comm’n, 351 S.C. 175, 181-82, 568 S.E.2d 365, 369 (2002) (finding a subsequent phrase in the statute modified a preceding phrase and defined the scope of the statute). Such a grammatical construction demonstrates the limited scope of section 35-1-501 and requires a temporal connection between the conduct and the offer, sale, or purchase of a security. The Securities Commissioner’s position ignores “in connection with the offer, sale, or purchase of a security” language that qualifies the scope of the statute.

The Securities Commissioner and circuit court made no finding linking the conduct at issue to the offer, sale, or purchase of the LLC membership interest at issue in this matter. Rather, the Securities Commissioner and circuit court imposed liability under section 35-1-501 based on conduct occurring after the sale and purchase and related to the management of the LLCs. This Court should reverse.

IV. The Securities Commissioner’s position regarding the promulgation of rules contradicts the plain language of section 35-1-605.

The Securities Commissioner claims that because section 35-1-605 contains the word “may” then rules are not required to be promulgated, and therefore, Appellants’ due process rights cannot be infringed by the Securities Commissioner’s failure to promulgate rules for a

civil enforcement action.⁷ {Resp. Br. p. 19-20}. This argument cannot be reconciled with the language of section 35-1-605 that required that the Securities Commissioner could not initiate a civil relief action under the Securities Act until the Securities Commissioner promulgated the rules for such proceedings.

Section 35-1-605 provides in relevant part that

(a) The Securities Commissioner may:

(1) issue forms and orders and, after notice and comment, may adopt and amend rules necessary or appropriate to carry out this chapter and may repeal rules, including rules and forms governing registration statements, applications, notice filings, reports, and other records. . . .

S.C. Code Ann. § 35-1-605(a)(1) (emphasis added). The General Assembly qualified the conditional “may” relied upon by the Securities Commissioner with the emphasized text to mandate that the Securities Commissioner could not initiate a civil relief action under the Securities Act until the Securities Commissioner promulgated the rules for such proceedings. The highlighted text would be superfluous under the Securities Commissioner’s position. See, e.g., CFRE, LLC v. Greenville Cnty. Assessor, 395 S.C. 67, 74, 716 S.E.2d 877, 881 (2011) (“A statute should be so construed that no word, clause, sentence, provision or part shall be rendered surplusage, or superfluous”); Total Environmental Solutions, 351 S.C. at 181-82, 568 S.E.2d at 369 (finding a subsequent phrase in the statute modified a preceding phrase and defined the scope of the statute).

⁷ The Securities Commissioner claims this issue is not preserved for appellate review. This is incorrect. The circuit court first ruled directly on the merits of Appellants’ due process argument. {Order of Circuit Court p. 6-8; R. 92-94}. Any other ruling by the circuit court constituted dicta on this issue.

Under our well-settled rules of statutory construction, the use of “may” in the statute does not excuse a failure to promulgate rules. Rather, the inclusion of “may” must be read in conjunction with the “to carry out this chapter” language also included in section 35-1-605(a)(1) and leads to only one conclusion—the General Assembly allowed the Securities Commissioner to create the rules of a civil proceeding in the event the Securities Commissioner elected to implement such a proceeding. As a result, the permissive “may” referred to the condition precedent essential for the Securities Commissioner to implement the entire civil proceedings not just whether the Securities Commissioner will circulate rules after implementation. Thus, the circuit court’s finding misapprehended section 35-1-605(a)(1). The statute required rules to exist before the Securities Commissioner could pursue civil relief against Appellants.

The Securities Commissioner cited no authority to refute the how our rules of statutory interpretation require section 35-1-601 to be read to mandate that the Securities Commissioner could not initiate a civil relief action under the Securities Act until the Securities Commissioner promulgated the rules for such proceedings. Moreover, leading South Carolina scholars addressing the civil enforcement process confirm Appellants’ position. Gregory B. Adams, James R. Burkhard, et al., South Carolina Corp. Practice Manual, 2d., Ch. 16, p. 366 n. 8 (2005) (recognizing that the Securities Commissioner had not implemented regulations under section 35-1-605 but noting the Commissioner is to propose new regulations to implement the new Act”) (emphasis added). This Court should reverse.

V. Appellants’ properly preserved their argument that no substantial evidence existed to support the award because the Securities Commissioner based the award on inadmissible evidence.

The Securities Commissioner alleges that Appellants failed to preserve their arguments regarding admission of certain evidence. {Resp. Br. p. 21}. This argument is without merit.

As noted in Section I, supra, our rules of appellate preservation require an objection to evidence to be made contemporaneously with the introduction of the evidence. Appellants did so here.

Appellants objected to the admission of the bank records, investor questionnaires, the testimony related to those documents, the testimony from Mr. Silver regarding the management of the LLCs or purported violations of the securities act, and the testimony of Mr. Finn regarding the bank records. {Oct. Trans. R. 290-91, 292, 301, 308-310, 379, 600-02, 602, 604, 605, 606-07, 617-20, 685-86}. Appellants interposed each objection contemporaneously with the attempt to admit such evidence. {Id.}. The hearing officer overruled each objection. {Id.}. Thus, the issue is preserved for appellate review. See Buyers, 392 S.C. at ___, 710 S.E.2d at ___ (recognizing that an objection to the introduction of objectionable evidence must be made contemporaneously with the introduction of the evidence).

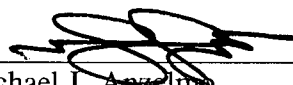
Moreover, Appellants continued to challenge the competency of the evidence introduced by the hearing officer at the judicial review hearing before the circuit court. Appellants specifically advised the circuit court that the findings of the Securities Commissioner were based on improperly admitted evidence before the circuit court. {April 2015 Trans. R. 821, 821-22, 822}. Thus, Appellant advised the circuit court that the Securities Commissioner's award was premised on incompetent and improperly admitted evidence. Moreover, the circuit court rejected Appellants' arguments on the admission of the evidence in confirming the award of the Securities Commissioner based on that evidence. The issue was preserved for appellate review.

Conclusion

The Securities Commissioner made several errors at the hearing and in the revised order. These errors have persisted due to similar (and new) missteps made by the circuit court. The circuit court did not analyze the evidence for competency purposes, as was required by section

35-1-609. In addition, the circuit court improperly found that the LLC interests were securities. Even assuming for purposes of argument that the interests are securities, the circuit court erroneously affirmed an order that contained no evidence linking any allegedly improper conduct to the offer, sale, or purchase of the LLC interests, as required by section 35-1-501. Further, the enforcement hearing was conducted in a seemingly random manner without reference to any applicable rules regarding procedure or evidence, which violated Appellants' due process rights. Finally, the Securities Commissioner's revised order was based on inadmissible evidence. Because of these errors, this Court should reverse the circuit court order upholding the order of the Securities Commissioner and enter judgment in favor of Appellants. In the alternative, this Court should remand this action to the circuit court as set forth in Section I, supra.

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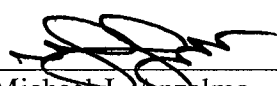
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CERTIFICATE OF COUNSEL

The undersigned certifies that this Final Reply Brief complies with Rule 211(b),
SCACR.

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