FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, v. CSSC BROKERAGE SERVICES, INC. (CRD No. 141630), and ERIC S. SMITH, Respondents.	Disciplinary Proceeding No. 2015043646501 Hearing Officer–MC **EXTENDED HEARING PANEL DECISION** January 2, 2019

Respondents Eric S. Smith and CSSC Brokerage Services, Inc., knowingly made misrepresentations and omissions of material facts in connection with the sales of securities, in willful violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and in violation of FINRA Rules 2020 and 2010. Smith actively engaged in the conduct of the firm's securities business as a representative and a principal without being registered. For his misconduct, Smith is barred from associating with any member firm in any capacity. CSSC Brokerage Services, Inc. is suspended for one year and fined $120,000. Respondents are also ordered to pay restitution of $130,000 plus interest, and hearing costs.

Appearances

For the Complainant: Kathryn S. Gostinger, Esq., Roger J. Kiley, Esq., Christopher M. Burky, Esq., Mark A. Koerner, Esq., and Jeffrey D. Pariser, Esq., Department of Enforcement, Financial Industry Regulatory Authority.

For Respondent Eric S. Smith: Robert Knuts, Esq., Sher Tremonte LLP.

For Respondent CSSC Brokerage Services, Inc.: No appearance.

DECISION

I. Introduction

Respondent Eric S. Smith is the chairman, chief executive officer, and majority owner of Consulting Services Support Corporation ("CSSC"), a financial services company he founded in 1988. CSSC owns several subsidiaries, including a registered investment advisor and insurance services entity. Smith never registered with FINRA and CSSC is not a FINRA member, but its wholly owned brokerage subsidiary, Respondent CSSC Brokerage Services, Inc. ("CSSC B/D" or "Firm"), successfully applied for FINRA membership in 2006.

From 2010 through 2015 ("relevant period"), CSSC encountered significant financial problems. In 2010 Smith and CSSC issued a convertible debenture bond offering ("2010 Bond Offering"), hoping to raise $5 million to satisfy pressing financial obligations. The offering raised $2.45 million. In 2014 Smith and CSSC issued "bridge loan" notes ("2014 Bridge Loan Note Offering") to garner additional funds to cover operational losses. The offering raised approximately $1.1 million. It was not enough. CSSC continued to lose money.

In a further attempt to cope with CSSC's persistent financial deterioration, Smith issued another bridge loan note offering in 2015 ("2015 Bridge Loan Note Offering"). This offering is the subject of the first three causes of action in the Complaint filed by the Department of Enforcement. Those causes of action allege that Smith and CSSC B/D engaged in fraud when offering the 2015 Bridge Loan Notes to prospective investors. The fourth and fifth causes of action allege that Smith engaged in the Firm's securities business and involved himself in the Firm's day-to-day operations in the capacities of representative and principal without registering. Smith's failure to register, the Complaint alleges, caused him and the Firm to violate NASD registration rules and FINRA's ethical conduct rule.

In their Answer, Respondents deny that the Firm had any involvement in the 2015 Bridge Loan Note Offering, and deny any fraudulent conduct. They disclaim participation by Smith in the operation of CSSC B/D's business and deny he was obligated to register as a representative or principal, claiming instead that he was properly exempt from FINRA's registration requirements.

Smith also contests FINRA's jurisdiction over him, insisting that he never engaged in the securities business of CSSC B/D as a representative or principal, and therefore is not subject to FINRA's rules.

Finally, Smith claims that FINRA is estopped from proceeding against him. He bases this claim on the premise that because FINRA conducted examinations of CSSC B/D before 2015—without questioning his role in the Firm's securities business or management—it tacitly conceded that he was exempt from having to register. Thus, he argues, FINRA cannot now charge him for failing to register.

For the reasons given below, the Extended Hearing Panel finds that Respondents engaged in the fraudulent misconduct the Complaint alleges in the first three causes of action. We base this conclusion on the facts established at the hearing, the applicable law, and careful consideration of the parties' arguments at the hearing and in their briefs. We reject Smith's jurisdictional challenge as well as his estoppel claim. Finally, we conclude that the seriousness of Smith's misconduct requires imposing a bar on him and a one-year suspension and fine of $120,000 on CSSC B/D.

II. Respondents

Smith formed CSSC B/D, a wholly owned subsidiary of CSSC, as a Michigan corporation in 2001.[1] The Firm applied for membership as a broker-dealer with NASD in August 2006.[2] It leased space in CSSC's office suite in Troy, Michigan, which it shared with the parent company and its other subsidiaries on the same uncompartmentalized floor.[3] The Firm filed a Form BDW in June 2018, and FINRA terminated its registration in August 2018. Because CSSC B/D was a registered FINRA member when it engaged in the alleged misconduct and when Enforcement filed the Complaint, FINRA maintains jurisdiction over the Firm for the purposes of this disciplinary proceeding pursuant to Article IV of FINRA's By-Laws.

During the relevant period CSSC was the sole owner of CSSC B/D, as well as other subsidiaries, including CSSC Investment Advisory Services, Inc ("CSSC RIA" or "RIA").[4] FINRA's jurisdiction over Smith is discussed below.

III. Origin of the Investigation

FINRA's Member Regulation Department conducted a routine onsite examination of CSSC B/D's main office in Troy, Michigan, and two branch offices in March 2015. The examination led FINRA staff to request production of the offering documents for the 2010 Bond Offering. Because the offering benefitted CSSC, the staff also issued a request for CSSC's general ledgers.[5] The examination report concluded that Smith appeared to be acting as a registered representative and principal of CSSC B/D without being registered. The Firm responded to the findings in mid-September 2015.[6]

It was then that Don Southwick, a recently terminated employee of CSSC, but still a registered broker with the Firm, informed FINRA that two of his customers had complained to him that they had not received interest and principal payments for their investments in bond and

[1] Respondent Smith's Exhibit ("RX")-1, at 31.

[2] RX-1, at 1–22.

[3] Hearing Transcript ("Tr.") 65–66 (Smith).

[4] Tr. 86–87; RX-1, at 69.

[5] Tr. 826–29 (Kerr).

[6] Tr. 833 (Kerr).

bridge loan offerings.[7] One of the customers then contacted FINRA staff directly to complain.[8] These events led FINRA staff to issue additional document requests, to investigate further, and to file a complaint on August 4, 2017.

IV. The Complaint and Answer

The Complaint's first three causes of action focus on CSSC's 2015 Bridge Loan Note Offering. They allege that from June through December 2015, the Firm, through Smith, created and circulated offering documents to prospective investors containing omissions and misrepresentations of material facts.

More specifically, these three causes of action charge that Respondents, fully aware of CSSC's precarious financial condition, including its history of defaulting on principal payments to investors in previous offerings of securities, fraudulently failed to disclose in the 2015 Bridge Loan Note Offering documents that the company owed but could not pay principal due to investors in the 2010 Bond Offering and 2014 Bridge Loan Note Offering.[9] The alleged false representations included the following statements in the 2015 Bridge Loan Note Offering documents:

- CSSC had earned the first half of a million dollar consulting fee for working to form a new bank, and would be paid the balance before the end of the year;[10]
- CSSC had established a relationship with the South Dakota Trust Company ("SDTC"), a national trust company, to become the investment advisor of SDTC's funds, and would earn a substantial fee based on a percentage of assets under management;[11] and
- CSSC had a pending "engagement" with the City of Jacksonville, Florida, which would generate substantial revenue by bringing the Firm an additional $1 billion in assets under management.[12]

The first three causes of action are based on the same facts, alleging the same misrepresentations and omissions of material fact. They differ only in the legal elements required under different statutes and FINRA rules.

The first cause of action charges that Respondents knowingly or recklessly made material misrepresentations and omissions in connection with the sale of a security, in willful violation of

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[7] Tr. 834–35 (Kerr).

[8] Tr. 838–39 (Kerr).

[9] Complaint ("Compl.") ¶¶ 39–42.

[10] *Id.* ¶¶ 45–46.

[11] *Id.* ¶¶ 61–65.

[12] *Id.* ¶¶ 66–73.

Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Rule 10b-5 thereunder, and in violation of FINRA Rules 2020 and 2010.[13]

Enforcement charged the second and third causes of action as alternatives to the first. The second cause of action alleges that Respondents acted negligently when they made the fraudulent misrepresentations and omissions, violating Sections 17(a)(2) and (a)(3) of the Securities Act of 1933 ("Securities Act"), and thereby FINRA Rule 2010.[14] The third cause of action charges Respondents with violating the ethical requirements of FINRA Rule 2010, by failing to adhere to the just and equitable principles of trade that require fair dealing with customers.[15]

The fourth and fifth causes of action focus on Smith's alleged involvement in the securities business of the Firm without being properly registered during the relevant period. The fourth cause alleges that Smith acted as a representative when he solicited investments, starting in 2010 with the 2010 Bond Offering through 2015 with the 2015 Bridge Loan Note Offering. It charges that this activity required Smith to register as a representative, and that his failure to register caused him and the Firm to violate NASD Rule 1031(a) and FINRA Rule 2010.[16]

The fifth cause of action charges Smith with actively engaging in the management of the Firm's securities business without being registered as a principal. He allegedly engaged in this misconduct by, among other things, directing the payment of the Firm's expenses, including salaries, rent, and other costs of doing business; hiring all of the Firm's representatives and managers; supervising certain representatives; and conducting suitability reviews for investments in private offerings sold through the Firm. By these activities, Smith allegedly exercised control and management of the Firm, and he and the Firm violated NASD Rule 1021(a) and FINRA Rule 2010.[17]

In the Answer to the Complaint, CSSC B/D denies being involved in any way in the 2015 Bridge Loan Note Offering. It denies participating in the preparation or dissemination of any of the offering documents. CSSC B/D insists that CSSC, the parent company, handled all aspects of

[13] *Id.* ¶ 89.

[14] *Id.* ¶¶ 90–97.

[15] *Id.* ¶¶ 98–100.

[16] *Id.* ¶¶ 105–107.

[17] *Id.* ¶¶ 112–14.

the offering.[18] Respondents deny violating the registration rules, insisting that Smith was never required to be registered as a representative or a principal.[19]

Smith denies making any false statements or omissions in the 2015 Bridge Loan Note Offering documents. To the contrary he claims he had a reasonable, good-faith basis for believing that all of his representations were factually accurate when he made them.[20] Smith also challenges the allegation that the offering documents were misleading: the representations in them were appropriately qualified and limited. For example, he asserts that his offering documents used terms such as "pending" and "expected" to qualify the descriptions of agreements that "would generate" income to CSSC, alerting potential investors to the speculative nature of the investment. Smith maintains that the representations accurately characterized his then-reasonable expectations of pending initiatives that could have, but ultimately did not, come to fruition.[21] Smith argues the offering documents contained disclosures that sufficiently described CSSC's troubled financial condition, past and current losses, and warned of the risks of loss to potential investors.[22]

V. Smith's Jurisdictional Challenge

As noted, Smith insists that FINRA lacks jurisdiction over him and consequently the Panel must dismiss the Complaint in its entirety.

Because of the dispositive nature of this issue, we address it first. We begin by focusing on the facts alleged in the fourth and fifth causes of action concerning Smith's alleged involvement in the Firm's securities business in capacities requiring him to register both as a representative and as a principal. Enforcement's ability to prove the facts underlying these allegations determines whether Smith's jurisdictional challenge must be sustained or rejected.

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[18] Enforcement filed the Complaint on August 4, 2017. Counsel then representing both Respondents filed the Answer on their behalf on August 31. The Hearing Officer issued a Case Management Order on September 12. Enforcement provided discovery and the parties prepared for the hearing, set for two weeks, beginning on April 30, 2018. On February 27, 2018, Respondents' counsel filed a motion to withdraw. The Hearing Officer granted it on March 2. On March 15, present counsel filed his appearance on behalf of Respondent Smith only, representing that the Firm was unable to afford representation at the hearing. At his request, the extended hearing was postponed to June 18, 2018. No one appeared on behalf of the Firm at the hearing.

[19] Answer ("Ans.") ¶¶ 107, 114.

[20] *Id.* ¶ 57.

[21] *Id.* ¶¶ 66–68, 70–73.

[22] *Id.* ¶ 3.

A. Facts

1. CSSC B/D's New Member Application and Smith's Application for Exempt Status

Smith founded CSSC and is its chairman, CEO, and majority shareholder. CSSC is the parent company of CSSC B/D, a wholly owned subsidiary, as well as other wholly owned entities.[23] In August 2006, CSSC B/D filed a New Member Application Form ("Form NMA").[24]

The Form NMA refers applicants to NASD rules governing membership, registration, and qualification requirements.[25] It directs applicants to describe the "duties and responsibilities of any non-registered officers, directors, owners, and control persons." In addition, it requires applicants to submit attestations from associated persons who wish to be exempt from the requirement of registering. Such persons must affirm in writing that they "will not participate in the day-to-day securities operations of the Applicant or act in any capacity that would require that these individuals become registered." The Form NMA contains sample draft attestations.[26]

CSSC B/D's Form NMA provided no description of Smith's "duties and responsibilities."[27] With the Form NMA, Smith submitted a letter attesting that, pursuant to NASD Rule 1060, he was exempt from registering.[28] Smith specifically stated that he understood he would be "permitted to be exempt from NASD securities registration requirements, without having to register either as a registered representative or as a principal" as long as he was "not actively engaged in the management of the Firm's securities business, including the supervision, solicitation, [and] conduct of business." He concluded by acknowledging his understanding that he could not "become active in the Firm's securities business" without registering "as both an appropriately registered representative and principal as outlined in NASD Rules 1020-1032."[29]

In a memorandum written during the Firm's application process, CSSC B/D's then-president responded to FINRA's request for a "detailed description" of Smith's "duties and responsibilities" at CSSC and its subsidiaries. He wrote: "Mr. Smith has no role as an officer in any of the [CSSC's] subsidiaries . . . Mr. Smith has delegated the operation of all brokerage related activities to staff and has no intention or time to become involved in the day-to-day operations of that portion of the Company's business activities."[30] The memorandum did,

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[23] Tr. 54–57 (Smith).

[24] RX-1, at 1–22.

[25] RX-1, at 5.

[26] RX-1, at 5.

[27] RX-1, at 5.

[28] Tr. 58 (Smith); RX-1, at 81.

[29] RX-1, at 81.

[30] RX-3, at 2.

however, state that Smith had assumed "primary responsibility" for hiring new registered representatives.[31]

The extent to which Smith involved himself in the securities business of the Firm provides the basis for determining whether he should have registered as a principal and representative. We therefore now examine the evidence of his participation in the Firm's securities business.

2. The Offerings

a. The 2010 Bond Offering

By 2009, CSSC had experienced a number of financial adversities. In response, Smith set out to raise $5 million in much-needed cash. Through CSSC, he issued the 2010 Bond Offering to put the company on a sound financial footing. He hoped to use the funds raised to retire short-term company debts of $1,400,000; pay $100,000 to redeem a bond purchased by an investor in 2009; pay $160,000 in salaries owed to company employees; and pay $140,000 for legal expenses incurred defending lawsuits filed by former employees.[32]

The principal offering document, a self-described "Offering Circular," required minimum investments of $10,000. The bonds matured five years from the date of purchase, offered interest at eight percent per year, and permitted buyers to convert all or part of their bonds to CSSC common stock.[33]

The Offering Circular stated that CSSC did not intend to involve affiliated registered representatives as agents to sell the bonds, and no brokerage commissions or fees would be paid to them.[34] The Firm's co-presidents, Jennifer LaRose and Alex Martin, both testified that they understood this when the bonds were issued. Martin testified that CSSC B/D "was not intended to be involved in any way," and explained that was why he and LaRose did not set any guidelines for sales of the bonds by CSSC B/D's registered representatives.[35] LaRose, whom Smith made the Firm's Chief Compliance Officer as well as co-president,[36] testified that the Firm did not supervise the offering, did not review it for possible compliance issues, and did not conduct suitability reviews.[37] Martin testified that he believed the offering was "intended by design to not be a broker-dealer" offering.[38] Initially both Martin and LaRose thought Smith

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[31] RX-3, at 1.

[32] Complainant's Exhibit ("CX")-87, at 42.

[33] CX-87, at 1, 10.

[34] CX-87, at 1, 44.

[35] Tr. 1033 (Martin).

[36] Tr. 1207 (LaRose).

[37] Tr. 124–43 (LaRose).

[38] Tr. 1033–34 (Martin).

would be the only person soliciting investments in the offering on behalf of CSSC.[39] Later, however, they learned that the Firm's registered representatives helped Smith solicit their customers to purchase the bonds.[40]

According to Martin, registered representatives of CSSC B/D who wanted to present customers with copies of the Offering Circular would ask Smith for the documents.[41] For example, Martin testified that he arranged, "probably" through Smith, or CSSC's controller, or someone else at the company, to send the offering materials to his customer, SK.[42] Martin testified that Smith, not he, negotiated the terms of SK's bond purchases, and as a result, SK obtained a ten percent interest rate instead of eight percent.[43] Martin usually referred SK to Smith when the customer had questions.[44] Because Martin spoke with SK frequently, Martin sometimes asked Smith for answers to give SK about the offering.[45] SK invested $375,000 in the 2010 Bond Offering.[46]

LaRose knew that at least two other registered representatives offered the bonds to their customers. One registered representative, Ken Bryant, had a client interested in purchasing CSSC stock when none was available, so the client invested in the 2010 Bond Offering as a way to potentially obtain CSSC stock.[47] LaRose also found that some investors purchased bonds with funds from their brokerage accounts.[48] Another registered representative, Don Southwick, introduced the bonds to his clients,[49] who were customers of both the Firm and the RIA.[50] Southwick, who affiliated with CSSC in May 2012,[51] testified that Smith knew some of his clients had significant net worth, and told Southwick the bonds could be made available to them. Smith gave Southwick the bond offering documents to disseminate. The package included an

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[39] Tr. 1243 (LaRose), 1030, 1033 (Martin).

[40] Tr. 1243 (LaRose), 1033–34 (Martin).

[41] Tr. 1035, 1037 (Martin).

[42] Tr. 1036–38 (Martin).

[43] Tr. 1041–42 (Martin).

[44] Tr. 1038–39 (Martin).

[45] Tr. 1042–43 (Martin).

[46] Tr. 1039 (Martin).

[47] Tr. 1246–47 (LaRose).

[48] Tr. 1250–51 (LaRose).

[49] Tr. 1243 (LaRose).

[50] Tr. 434 (Southwick).

[51] Tr. 430, 433–34 (Southwick).

offering memorandum, a confidential memorandum, and financial reports. Southwick presented the offering to clients,[52] and personally introduced some of them to Smith.[53]

Southwick testified that Smith and a lawyer he employed supervised the 2010 Bond Offering.[54] Smith and the lawyer coached Southwick on specifically how to introduce the offering. According to Southwick, they instructed him to say that previously Smith had made the bonds available primarily to his family and friends, but if a client were interested, Southwick could ask Smith to make some bonds available for purchase. He was not supposed to describe the details of the offering, but direct clients to contact Smith. Some clients subsequently met personally with Smith, sometimes with Southwick present. Southwick does not recall Smith asking him any questions about the suitability of the bonds for his clients, and does not recall if anyone conducted suitability reviews.[55] Southwick obtained signed customer questionnaires from clients and submitted them to the lawyer or Smith, depending on who was available.[56]

Southwick personally introduced clients to Smith.[57] One, JM, who invested $300,000, was retired and approximately 88 years old when she first invested in the bonds.[58] Southwick introduced JM to Smith when she visited the Troy office.[59] The suitability review section of her customer questionnaire is unsigned.[60]

Other Southwick clients purchased the bonds: DN invested $400,000; JK and PK invested $100,000; DG invested $200,000; SM invested $20,000;[61] and VH invested $200,000. One, customer JK, used retirement funds from his IRA to invest $100,000.[62] Some withdrew funds from their CSSC B/D accounts to make their investments.[63]

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[52] Tr. 647–48 (Southwick).

[53] Tr. 648–49 (Southwick).

[54] Tr. 648 (Southwick).

[55] Tr. 672 (Southwick).

[56] Tr. 666–67 (Southwick).

[57] Tr. 648–49, 653–54 (Southwick).

[58] Tr. 670–71 (Southwick).

[59] Tr. 649, 653 (Southwick).

[60] CX-93, at 5.

[61] Tr. 674–80 (Southwick); CX-98, at 4–5.

[62] Tr. 665–66 (Southwick).

[63] Tr. 1250–51 (LaRose).

For some of Southwick's clients, Smith signed as the recipient of the questionnaire, and as having conducted a suitability review.[64] For others, the questionnaire did not have a signature indicating the completion of a suitability review.[65]

Southwick did not receive compensation for the bond purchases his customers made.[66]

From May 2010 through March 2014, Smith raised $2.45 million,[67] not enough to meet his goal of raising $5 million with the 2010 Bond Offering or to solve the company's financial problems. The CSSC group of entities experienced losses of approximately $803,000 in 2012 and $883,000 in 2013.[68]

b. The 2014 Bridge Loan Note Offering

To address these losses, Smith and CSSC sought to raise additional funds with their 2014 Bridge Loan Note Offering. Smith drafted an offering document titled "Important Memorandum," labeled "Confidential," and directed to "Those who may be considering Making a Bridge Loan to CSSC." The stated purpose of the memorandum was to explain why CSSC was "seeking bridge financing," and it purported to describe the continuing impact of the "catastrophic market downturn in 2008–2009" on CSSC's profitability, resulting in losses and delays in paying affiliated investment advisors and brokers.[69]

Terms of this offering were similar to the 2010 Bond Offering. Like the bonds, the notes were unsecured and yielded eight percent interest. Smith preferred investments—he called them "loans"—of at least $50,000 but would accept lesser amounts if "special circumstances" warranted it. Smith wrote that the offering was not available to the public, but restricted "almost exclusively to friends, family, and those with whom we are currently, or soon expect to be, doing business." This was why, Smith explained, he would gift shares of CSSC common stock to investors. For $100,000, Smith would gift an investor 1,000 shares from his "personal holdings"; investors of larger or smaller amounts would receive proportionately more or fewer shares.[70]

Smith discussed his plan to issue the 2014 Bridge Loan Notes with CSSC's controller, assistant controller, and Southwick. As he had with the 2010 Bond Offering, Smith asked Southwick if he knew of any potential investors.[71] Southwick did, and sold notes in this offering

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[64] Tr. 656–58; CX-90, at 5; CX-92, at 5.

[65] CX-91, at 5; CX-93, at 5.

[66] Tr. 666 (Southwick).

[67] CX-98, at 4–5.

[68] Tr. 301–02; CX-46, at 1.

[69] CX-106, at 1.

[70] CX-106, at 3–4.

[71] Tr. 681–82 (Southwick).

to three of his CSSC B/D clients.[72] Southwick received no compensation for the sales.[73] However, Smith made it clear to Southwick that the 2014 Bridge Loan Note Offering was important to provide CSSC with much-needed cash, and Southwick knew that the success of the offering would affect whether Smith could pay his salary.[74]

One customer Southwick approached was the elderly JM, who had earlier invested $300,000 in the 2010 Bond Offering. She made an initial investment of $100,000 in the 2014 Bridge Loan Notes Offering on June 6, 2014.[75] Smith later approached Southwick again about the possibility that JM would be willing to invest more.[76] Southwick testified that he again "made her aware" that the notes were still available.[77] JM subsequently made additional investments, increasing her total investment in the 2014 Bridge Loan Notes Offering to $550,000.[78]

Southwick claimed he did not actually *recommend* that his clients invest in the 2014 Bridge Loan Notes Offering. He testified that Smith told him specifically *not* to recommend the notes to customers but just to make customers "aware" of the offering. If they showed interest, then he was to say he would "see if it could be made available." Southwick referred to this as his "script" and testified that he "pretty much stuck to the script."[79] There were two other clients he "made aware" of the offering and in the end, Southwick's clients were responsible for providing most of the $1.1 million Smith raised through the offering.[80] In a FINRA action in April 2017, Southwick consented to a six-month suspension from association with any FINRA member firm in any capacity for making unsuitable investments in the 2010 Bond Offering and 2014 Bridge Loan Note Offering to his clients without conducting reasonable due diligence, and relying on a script provided by CSSC.[81]

The offering eased but did not cure CSSC's financial ills, or even cover previously delayed payments owed to affiliated brokers and advisors. In a November 19, 2014 memo to CSSC affiliates, Smith announced that although CSSC had been able to send brokerage

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[72] Tr. 683–85, 687, 692–93 (Southwick).

[73] Tr. 666 (Southwick).

[74] Tr. 686 (Southwick).

[75] Tr. 683–84 (Southwick); CX-106, at 12.

[76] Tr. 686 (Southwick).

[77] Tr. 686, 695 (Southwick).

[78] CX-98, at 6.

[79] Tr. 693–94 (Southwick).

[80] CX-98, at 6 (Customers JM, RR and M LLC, and SM). The Panel does not find that there is a distinction between Southwick as a broker, and Smith acting as a broker, "recommending" an investment and making customers "aware" of the opportunity to invest in the bond and note offerings. Under these facts, they clearly acted "to induce or attempt to induce the purchase" of a security under the terms of Section 15(a) of the Exchange Act. *SEC v. Martino*, 255 F. Supp. 2d 268, 283 (S.D.N.Y. 2003).

[81] Tr. 696–97; RX-78 (Southwick).

representatives and insurance affiliates their overdue checks, payments owed to investment advisors had "again been temporarily delayed." In an apparent effort to reassure them, Smith added that he was "pleased to report" that CSSC had obtained "capital commitments" large enough to end "the recurrent late payment."[82] A month later, on December 15, Smith recirculated the November memorandum with an addendum announcing that "[b]rokerage revenue sharing checks" had been mailed, but that payments owed to investment advisors and insurance affiliates had once more been delayed.[83]

c. Smith's Continued Attempts to Address CSSC's and the Firm's Financial Straits

Smith was keenly aware of how CSSC's poor cash flow affected its and its affiliated entities' operations in late 2014 and 2015. In December 2014, when Smith and Southwick were both traveling on business, Smith and CSSC's assistant controller, MD, exchanged email messages about the immediacy of the financial stresses facing CSSC. Smith noted that CSSC had "missed payroll," and he was worried that he and Southwick might be "stranded" because American Express was declining to accept charges Southwick had incurred on the road.[84]

MD responded with an update to Smith about some of the looming financial challenges. She said American Express declined the charges because CSSC's American Express account had been "over 30 days past due for the last 4 months."[85] She informed Smith that CSSC B/D "desperately needs to be paid the $20,000 that it is owed from the RIA for December."[86] She pointed out that CSSC B/D was "only $874 over the notification threshold" at which it would fall below its minimum net capital requirement. MD explained that because CSSC B/D owed CSSC more than $83,000 for December's rent, the Firm would fail to maintain its required level of net capital unless CSSC offset the rent with other revenue. That, however, would leave CSSC again unable to make payroll.[87] In the meantime, MD explained, she would also be unable to make an $11,000 past due payment Smith asked her to send Ken Wheeler, an affiliate with both RIA and brokerage clients, who urgently needed the funds to pay an insurance premium.[88]

Deferring payroll was nothing new for CSSC. As early as 2009–2010, Smith had delayed paying brokerage commission and advisory fee checks, sometimes for more than a year for the

[82] CX-34, at 2.

[83] CX-32.

[84] CX-40, at 5–6.

[85] Tr. 286–87 (Smith); CX-40, at 1.

[86] CX-40, at 2.

[87] Tr. 286–87 (Smith); CX-40, at 2.

[88] Tr. 293 (Smith); CX-40, at 2–3.

advisory fees.[89] CSSC's salaried employees, too, experienced delays in receiving their checks as well as their brokerage commissions and advisory fees.[90]

After completing the 2014 audit of CSSC and its affiliated entities, one of the auditors informed Smith that the audit raised questions about whether CSSC B/D would be "able to continue as a going concern."[91] The auditor summarized some of the "conditions that indicate there could be substantial doubt" about the Firm's future. One was CSSC B/D's financial dependence on the RIA. Although the Firm reported a net profit for the year, this was only because of a change to a compensation agreement by which the RIA provided the Firm with an additional $20,000 per month. Without this, CSSC B/D would have failed to meet its net capital requirement.[92]

Its financial support of the Firm was responsible for the RIA experiencing a net loss—$240,000—for the first time in 2014.[93] The auditor noted that CSSC's group of entities as a whole suffered losses of $803,000 in 2012, $883,000 in 2013, and $944,000 in 2014. He stated that CSSC's consolidated deficit exceeded $10 million as of December 31, 2014, and that CSSC "continues to experience difficulty in meeting its day-to-day obligations without significant outside funding."[94]

In March 2015 CSSC's inability to make interest and principal payments to holders of maturing notes was the focus of a discussion Smith had with CSSC's controller DW, Southwick, and MD.[95] By the start of July CSSC faced principal payments due totaling $655,000: $375,000 owed to 2014 Bridge Loan Notes investors,[96]and $280,000 owed to investors in the 2010 Bond Offering.[97] CSSC could not meet these obligations.

Recognizing CSSC's need for cash, Martin made a one-month loan to CSSC from his own funds of $50,000 at eight percent interest at the end of June 2015. He expected return of the principal in 30 days, but did not receive it.[98] By August 10 he had received only a partial payment of approximately $7,500.[99] Angry, he emailed Smith in late August asking if some of the funds from an "expected wire" to CSSC could be used to "further repayment" of his loan. In

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[89] Tr. 872–73 (Wheeler).

[90] Tr. 459 (Southwick), 1026–28 (Martin), 1191–92 (Caudill), 1248–49 (LaRose), 1325–28 (Bryant).

[91] CX-50, at 2–3.

[92] CX-50, at 2.

[93] CX-50, at 2.

[94] CX-50, at 3.

[95] Tr. 231 (Smith), 465, 681 (Southwick).

[96] CX-98, at 6.

[97] CX-98, at 4.

[98] Tr. 1088 (Martin).

[99] Tr. 1090 (Martin); CX-78.

the email, he noted that CSSC "affiliate payments have been withheld" leaving him "holding on by a thin thread."[100] Martin did not agree to roll over the loan, and at the time of the hearing, the remainder was still unpaid.[101]

In May and June 2015 principal payments were due to investors in the 2010 Bond Offering and 2014 Bridge Loan Notes Offering. By the end of June CSSC owed $260,000 to investors in the 2010 Bond Offering and $375,000 to investors in the 2014 Bridge Loan Note Offering.[102]

d. The 2015 Bridge Loan Note Offering

i. Smith Created the 2015 Bridge Loan Note Offering Documents

It was in this context that Smith decided to launch the 2015 Bridge Loan Note Offering, essentially a renewal of the 2014 offering. Smith created and disseminated numerous offering documents describing terms he crafted to attract investors. Like the 2014 Bridge Loan Note Offering, this one consisted of unsecured notes maturing one year from the purchase date, paying interest at eight percent. In addition, Smith promised to gift investors 1,000 shares of CSSC common stock for every $100,000 investment, or proportionally more or fewer shares depending on the amount of the bridge loan note purchased.[103]

Smith titled the initial offering document "Confidential Report." Dated June 15, 2015, he first produced it for a CSSC shareholders meeting, and later provided it to potential investors with other offering documents.[104] Smith testified that he supplemented it with what he called an "Important Memorandum" directed to "Those Considering Making a Bridge Loan to CSSC," dated June 22, 2015, which he updated with revisions.[105] The first revision, dated June 22, 2015,[106] was followed by revisions dated July 12,[107] September 9,[108] and November 2, 2015.[109]

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[100] CX-30.

[101] Tr. 1100 (Martin).

[102] CX-98, at 4, 6.

[103] CX-201, at 2.

[104] Tr. 199–200 (Smith); CX-202.

[105] Tr. 201–2 (Smith); CX-201.

[106] Tr. 201 (Smith); CX-201.

[107] Tr. 200 (Smith); CX-203.

[108] Tr. 200 (Smith); CX-204.

[109] Tr. 202 (Smith); CX-206.

ii. Smith Successfully Solicited Four Investors for the 2015 Bridge Loan Note Offering

By his own estimate, Smith personally solicited 15 to 25 people to invest in the 2015 offering.[110] He sent them offering materials that included the "Confidential Report" and the memoranda. Some of the potential investors were registered representatives with CSSC B/D and some were customers whom he had not met but whose names he obtained from representatives. He raised a total of $130,000 from four persons he solicited. Smith maintains that although he solicited their participation in the 2015 Bridge Loan Note Offering, three of them did not purchase one-year bridge loan notes from the offering, but instead merely made shorter term "loans" to CSSC.[111]

(a) Customer TL

The first of the four was customer TL. Smith obtained TL's name from JC, a colleague and mutual acquaintance.[112] On July 21, 2015, early in his promotion of the 2015 Bridge Loan Note Offering,[113] Smith sent an email to TL with the subject line "CSSC's 'Bridge Loan Note' Offering – explanation/package," explaining he was sending "the complete package" of offering documents.[114] Smith wrote that the offering "really was originally designed for friends and family and for those doing business with CSSC," and it was "a great deal." He wrote that he had been "introducing this to one person at a time" and now was "expanding the range of those to whom this is being made available" so he could include TL. Smith claimed to have "successfully placed" $1.35 million in notes and hoped to complete the offering by placing $1.65 million "within the next 30 days," after which he was "not anticipating doing anything like this (individual offerings) again."[115] Smith wrote that he was going to New York City and invited TL to meet. They met at a restaurant and discussed the bridge loan notes. Afterwards, they stayed in contact and spoke again about the 2015 Bridge Loan Note Offering by phone in August.[116]

On August 17, 2015, Smith sent another email to TL. He attached the July 12, 2015 memorandum to prospective investors. TL had asked whether Smith would rescind the gift of promised CSSC stock if he exercised an early payoff of the note. Smith assured TL that he would not, and promised to send a stock certificate and the Note by overnight mail. Smith's efforts were

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[110] Tr. 102 (Smith).

[111] Tr. 135, 137, 143 (Smith).

[112] Smith met JC in early March 2015 and hired him to implement what he referred to as a new approach in marketing financial services through commercial banks in such a way as to satisfy FINRA that the recommendations were suitable. In his June 2015 Confidential Report, Smith introduced JC as "An Important New Addition to the CSSC Team," touted his background, purported accomplishments, and ability to introduce CSSC to his "investment banker contacts," and noted that JC held several FINRA licenses. CX-58, at 24–26.

[113] Tr. 103–4 (Smith).

[114] Tr. 100–102 (Smith); CX-8.

[115] CX-8.

[116] Tr. 1377–81 (Smith).

rewarded on August 24, 2015, when TL invested $50,000 in the 2015 Bridge Loan Note Offering.[117]

It was not until November 2015 that Smith sent the stock certificate to TL. The delay annoyed TL, who emailed JC, complaining that he had been waiting for weeks for Smith to send him the paperwork. TL stated he would refuse to accept delivery of the certificate and wanted a refund because his confidence in Smith was shaken.[118]

In response, professing to be "shocked" by the tone of TL's complaint, Smith informed him that he had "no present ability" to refund TL's investment, although Smith promised he would "be paying off the Notes at the earliest opportunity." In the meantime, Smith pointed out, TL's note was "earning interest at 8%" and Smith had gifted him CSSC common stock.[119]

(b) Thomas Scotto

Smith's second successful solicitation was to Thomas Scotto, a CSSC employee and registered representative of the Firm. Smith urged Scotto to solicit other investors.[120] On July 13, 2015, Smith sent Scotto an email directing him to replace the "Important Memorandum" in the offering package Smith sent earlier with an updated version dated July 12, 2015.[121] Smith urged Scotto to send the updated memorandum to anyone to whom he had given the earlier version. He attached a copy of a PowerPoint presentation he thought "should provide a quick way to introduce us to prospective new investors and others that you think might be good fits for a relationship with us."[122]

Scotto previously invested $215,000 in bond and note purchases, and expressed a need for return of his principal by the end of October 2015. Scotto responded to Smith's new solicitation by investing $20,000. CSSC's general ledger reflects it was deposited on August 31.[123] Smith claims that the $20,000 was not a one-year bridge loan note purchase, but a short-term loan.[124]

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[117] CX-23, at 12; CX-27.

[118] CX-11, at 2.

[119] CX-11, at 1.

[120] Tr. 114 (Smith); CX-25, at 2.

[121] CX-3, at 1. Smith informed Scotto that the earlier version of the "Important Memorandum" did not provide "an accurate or balanced view" of the offering and did not make clear why "someone might consider it beneficial (to them) to participate in the Offering."

[122] CX-3, at 1.

[123] Tr. 115–19 (Smith); CX-23, at 12; CX-107.

[124] Tr. 116, 377 (Smith).

(c) Customer BB

Shortly after Scotto sent the $20,000 check, Smith solicited an investment in the 2015 Loan Note Offering from a college classmate, BB.[125] As with Scotto, Smith urged BB to solicit additional investors. On the afternoon of September 12, 2015, Smith emailed BB with the subject line "FW: CSSC's 'Bridge Loan Note' Offering – explanation/package," similar to the email he sent to TL the previous July.[126] In the email, Smith referred to a conversation he and BB had earlier that day and recapitulated their discussion about the offering not being "applicable" to BB's circumstances. Smith wrote that they would consider alternative ways for BB to become "involved" in the offering. The attachments consisted of the large package of offering documents including, among other documents, two "Confidential Reports" and an "IMPORTANT UPDATE." Smith urged BB to let him know if he—or "others that you believe we should consider including that would be good for us to 'have in the family'"—wanted to "get involved."[127]

Approximately two weeks later, BB sent $10,000 to Smith. In an email exchange between DW and Smith with the subject heading "Noteholders" DW informed Smith that BB's note was one of several that "[t]erms have not been specified for."[128] In response, Smith wrote that it was a "6 month Note."[129]

(d) Gavin Clarkson

The fourth investment in the 2015 Bridge Loan Note Offering described in the Complaint was made by Gavin Clarkson, a licensed investment advisor and broker registered with CSSC since 2012. Clarkson is an attorney who worked with Native American tribes attempting to facilitate release of tribal funds held by the Bureau of Indian Affairs.[130] Smith sent Clarkson an email on October 29, 2015, attaching the "Confidential Report," the "Important Update," a version of the "Memorandum to Those Considering Making a Bridge Loan" that Smith revised just four days earlier, and a promissory note and certificate. The email invited Clarkson personally to invest, and to solicit his tribal contacts for investments. Noting CSSC's "current short-term cash needs," Smith stressed his hope that the bridge loan notes "might indeed be a good 'fit' with you and possibly one or more of your tribal connections—that you and/or some of them will be able to take advantage of the opportunity" to invest.[131]

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[125] Tr. 1385 (Smith).

[126] CX-13.

[127] CX-13, at 1.

[128] CX-28.

[129] CX-27.

[130] Tr. 172–73, 1389–90 (Smith).

[131] CX-16.

Smith continued to communicate with Clarkson. Several days after sending the offering documents, on November 2, 2015, Smith sent Clarkson another email with updates to "two of the principal documents" in the package of offering materials he revised that day, asking Clarkson to "dispose of the earlier versions" and "replace with these."[132]

On November 12, 2015, Smith emailed wiring instructions to Clarkson and wrote that he would "resend the rest of the disclosure package."[133] Fourteen minutes later, Smith did so in an email attachment that included the 2015 Bridge Loan Note Offering documents and, again, the wiring instructions.[134] Clarkson invested $50,000 on November 13, 2015, and in an email to CSSC's controller, as with BB, Smith characterized it as a "6 month Note."[135]

B. Failure to Register

1. Registration as a Representative

a. The Standard

FINRA's By-Laws define an associated person as a "natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration."[136]

NASD Rule 1031(a) requires all persons engaged in a member firm's securities business who function as representatives to be registered. Its definition of representative includes all persons associated with a member firm who engage in "supervision, solicitation or conduct of business of securities." Soliciting, recommending, and accepting orders for the purchase of securities are indicia of engaging in the securities business of a firm. Communicating with potential investors to find out if they might make an investment, discussing the particulars of an investment, and recommending an investment, are all activities requiring registration as a representative.[137]

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[132] CX-17.

[133] CX-19.

[134] CX-18.

[135] CX-27.

[136] FINRA By-Laws, Art. I (rr).

[137] *Dep't of Enforcement v. Gallison*, No. C02960001, 1999 NASD Discip. LEXIS 8, at *51 (NAC Feb. 5, 1999) (functions of a representative include, but are not limited to, communicating with members of the public to ascertain interest in investing, recommending securities purchases, discussing the nature of investments, and accepting orders for securities purchases).

b. Discussion

Smith argues that he did not need to register as a representative because he did not engage in "any . . . securities business within or on behalf of CSSC-BD or any other firm."[138] Admittedly, he "participated in the sale of securities by CSSC-Parent, including a 2010 Bond Offering and the 2014-2015 Bridge Loan Note Offering."[139] He claims that when he sold those securities, he did so to raise money solely in his capacity as chairman and CEO of the parent company, not as a CSSC B/D broker. Smith adds there is no evidence he received any transaction-based compensation in connection with his selling of securities.[140]

In response, Enforcement points to the evidence that Smith was "instrumental in marketing and selling" the securities to customers of the Firm whom he and the Firm's brokers solicited.[141]

As reflected in the facts recited above, and admitted by Smith, he actively engaged in the solicitation of investments in all three offerings during the relevant period. Smith created and distributed offering documents to CSSC B/D's customers both personally and through the Firm's brokers. For example, Southwick introduced Smith to Firm customers and Smith scripted solicitations he and Southwick made to raise desperately needed funds for the parent company.

2. Registration as a Principal

a. The Standard

NASD Rule 1021 requires registration of principals, including sole proprietors and partners "actively engaged" in managing a member firm's "investment banking or securities business." Active engagement in a firm's management includes "supervision, solicitation, [and] conduct of business." NASD Rule 1021(a) requires that "all persons engaged or to be engaged in the investment or securities business of a member who are to function as principals shall be registered as such."

NASD Rule 1060, specifically cited by Smith in his attestation letter, allows exemptions from registration that are available to "persons associated with a member" under certain circumstances. Enforcement argues that by filing the attestation letter explicitly pursuant to NASD Rule 1060, Smith acknowledged he was an associated person. By the terms of the rule, one must be an associated person to qualify for an exemption. Furthermore, in his attestation letter Smith agreed to comply with the requirements of Rule 1060, and not actively engage in the

[138] Smith's Initial Post-Hr'g Br., at 12.

[139] *Id.* at 13.

[140] *Id.*

[141] Enforcement's Post-Hr'g Reply Br., at 4.

management of the Firm's securities business without first filing for the appropriate registrations.[142]

To determine whether a person functions as a principal, it is necessary to consider all relevant facts and circumstances bearing on whether the person influences the management of a firm's business affairs. Some indicators of acting in a principal capacity include

- hiring and firing personnel, supervising, controlling and holding an ownership interest in a firm's parent company;[143]
- making financial decisions for the firm, including controlling commission payments to registered representatives and payments to firm vendors;[144]
- presenting oneself as acting on behalf of the firm;[145] and
- being physically present at the firm's office with interaction in meetings with the firm's representatives and principals.[146]

b. Discussion

Smith disputes Enforcement's arguments that he acted as a principal and therefore should have been registered.[147] Smith denies Enforcement's assertion that by submitting his attestation letter with the Firm's Form NMA, he acknowledged he was an associated person subjecting himself to FINRA's jurisdiction. He argues that when he submitted the letter, he was merely complying with FINRA's requirement that an indirect partial owner of an applicant must submit an attestation pursuant to NASD Rule 1060.[148] He cites the lack of a contract empowering him to direct or manage the Firm and its personnel as evidence that he had nothing to do with the management or operation of the Firm.[149]

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[142] RX-1, at 81.

[143] *Dep't of Enforcement v. Gallagher*, No. 2008011701203, 2012 FINRA Discip. LEXIS 61, at *8–11 (NAC Dec. 12, 2012) (These factors "demonstrate . . . [respondent] actively engaged" in a firm's securities business and its day-to-day operations and "consequently, acted as an unregistered principal."); *Dep't of Enforcement v. Harvest Capital Invs., LLC*, No. 2005001305701, 2008 FINRA Discip. LEXIS 45, at *26–27 (NAC Oct. 6, 2008) (citing *Kirk A. Knapp*, 50 S.E.C. 858, 861 (1992) (hiring representatives and principals for a firm, after meeting and discussing scope of employment, are facts to consider in determining if person acted in a principal capacity)).

[144] *Gallagher*, 2012 FINRA Discip. LEXIS 61, at *8.

[145] *Id.*

[146] *Dist. Bus. Conduct Comm. v. Pecaro*, No. C8A960029, 1998 NASD Discip. LEXIS 13, at *19 (NBBC Jan. 7, 1998) (physical presence in firm's office, interaction with principals and representatives, and interactions with clients give appearance of being involved in firm's business).

[147] Smith's Initial Post-Hr'g Br., at 12–13.

[148] Smith's Rebuttal Br., at 14.

[149] *Id.* at 13.

Smith insists that he did not engage actively in the "day to day conduct" of CSSC B/D's "securities business and implementation of corporate policies related to such business."[150] Smith argues further that he did not directly or indirectly control the Firm because he did not own shares of CSSC B/D stock, was not an officer or director, and did not manage the operations of the Firm, but left its management to LaRose and Martin.[151]

As Enforcement notes, the language of NASD Rule 1060 states that associated persons are exempt from registering only if they "are not actively engaged in the investment banking or securities business."[152] Enforcement points out that in his attestation letter Smith explicitly echoed this when he acknowledged that he would be exempt from the registration requirement only "so long as I am not actively engaged in the management of the Firm's securities business, including the supervision, solicitation, conduct of business . . . associated with the Firm."[153]

Enforcement also rejects Smith's claim that he sold securities acting solely in his capacity as chairman and CEO of the parent company, and therefore beyond FINRA's jurisdiction and registration requirements. Enforcement cites a recent SEC decision rejecting a similar challenge to jurisdiction, holding that it did not matter whether the respondent acted in his capacity as a registered representative or as principal of a private fund advisor, because as an associated person he was subject to FINRA's jurisdiction.[154]

3. Smith's Participation in the Business of CSSC B/D

The evidence shows that Smith significantly involved himself in the Firm's day-to-day business operations and influenced the management of CSSC B/D's affairs.

Smith convened weekly meetings that all employees and affiliated persons sharing space in CSSC's office suite attended, including the Firm's registered representatives.[155] And, as previously noted, Smith was responsible for hiring all affiliates who became registered representatives. It was he who made Martin and LaRose co-presidents of the Firm and placed LaRose in the role of co-chief compliance officer in 2008.[156] It was Smith, not they, who recruited, hired, and negotiated details of terms of employment in the affiliation agreements for

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[150] *Id.* at 14–15 (quoting Notice to Members 99-49, NASD Regulation Provides Interpretive Guidance on Registration Requirements (June 1999)).

[151] Smith's Rebuttal Br., at 12–13.

[152] Enforcement's Post-Hr'g Reply Br., at 8 (quoting NASD Rule 1060(a)(2)).

[153] *Id.* (quoting RX-1, at 81).

[154] *Id.* at 9–10 (citing *Louis Ottimo*, Exchange Act Release No. 83555, 2018 SEC LEXIS 1588, at *49 (June 28, 2018)).

[155] Tr. 493, 578–80 (Southwick), 1165 (Caudill).

[156] Tr. 84 (Smith), 1207 (LaRose).

registered representatives Ken Wheeler,[157] Ken Bryant,[158] and Don Southwick.[159] The standard affiliation agreement provided that Smith could terminate the relationship upon a willful failure to comply with his directives.[160] When LaRose left the firm, Smith hired the new chief compliance officer.[161]

Smith exercised authority over the Firm in ways that are consistent with acting in principal capacities, while the Firm's co-presidents did not. For example, Martin conceded in his hearing testimony that people at the Firm may have viewed him as president "in title only," and the amount of "daily hands-on work" he did during his tenure as co-president was "fairly small."[162] When Smith introduced the 2010 Bond Offering, LaRose was unaware of anyone at the Firm reviewing the offering for suitability or compliance issues, even though registered representatives were soliciting customers to invest.[163]

Smith controlled the flow of money from CSSC's RIA to the Firm. It was he who decided to defer payment of salaries, brokerage commissions, and advisory fees,[164] and wrote memoranda in 2013 and 2014 to personnel explaining that their compensation would be deferred, promising better days were coming.[165] When DW and MD, CSSC's controller and assistant controller, needed to address the Firm's lack of operating funds and net capital issues, they did so with Smith, not LaRose and Martin. Smith, not the Firm's co-presidents, gave them directions. Smith told MD which bill payments to prioritize and informed DW he would ensure that the CSSC RIA diverted sufficient funds to the Firm to allow it to maintain its minimum net capital. Similarly, in February 2015, upon completion of the 2014 audit of CSSC B/D when the auditor had to alert the Firm that there was "substantial doubt about the BD's future" and uncertainty over whether it "will be able to continue as a going concern," he notified Smith. It was Smith who responded to the auditor to assuage his alarm, with the same optimistic recitation of his unfounded expectations of imminent profitability expressed in the 2015 Bridge Loan Note Offering documents. Smith informed the auditor:

> [W]e estimate that we could finish this quarter with a net profit of as much as $500,000. We are for instance expecting an installment payment of a portion of a

[157] Tr. 867–69 (Wheeler).

[158] Tr. 1320–24 (Bryant).

[159] Tr. 426–27, 438–39 (Southwick); CX-222.

[160] Tr. 94–96 (Smith); CX-223, at 8.

[161] Tr. 84–85 (Smith).

[162] Tr. 1025–26 (Martin).

[163] Tr. 1242–47 (LaRose).

[164] Tr. 1027 (Martin), 1247–49 (LaRose).

[165] CX-32; CX-33; CX-34.

$1 million consulting fee–the earned portion and expected payment being $500,000.

The remaining portion of the fee is expected to be earned and paid before the end of the third quarter of 2015. A second, nearly identical consulting engagement, with a total fee of $800,000 is expected to be commence [sic] later in 2015 and a portion of it may also be earned and paid in 2015. Even if corporate earnings from all other operations and operating expenses remained the same ([sic] and overall corporate operating expenses declined from the 1st to the 4th quarter in 2014, fees from this one engagement would be sufficient to make CSSC profitable.[166]

As noted above, Smith solicited and sold investments to CSSC B/D customers directly and through registered representatives.[167] When suitability reviews of CSSC B/D customer purchases of notes were conducted, it was Smith who conducted them.[168]

C. Conclusions

1. Smith Was an Associated Person of CSSC B/D

FINRA broadly defines the role of "associated person" consistent with its mission to protect the public interest[169] and FINRA "has jurisdiction to discipline all associated persons of a member firm."[170]

As Enforcement points out, Smith wrote in the attestation letter he filed with CSSC B/D's Form NMA that he understood he would "be permitted to be exempt" from having to register "so long as [he was] not actively engaged in the management of the Firm's securities business," including supervision and solicitation.[171] Thus, Smith implicitly acknowledged (i) he was associated with CSSC B/D and (ii) was subject to the requirement that he register if he actively engaged in the management of the Firm's securities business. As Rule 1060 clearly states, the exemption is available to persons associated with a firm; hence, Smith's application for exemption and his statement of his understanding of how he qualified for the exemption evidenced acknowledgement that he was a person associated with a FINRA member, and subject to FINRA's disciplinary jurisdiction.[172]

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[166] CX-50.

[167] Tr. 1087 (Martin), 1246 (LaRose).

[168] Tr. 73–77 (Smith).

[169] *Dep't of Enforcement v. Hedge Fund Capital Partners, LLC*, No. 2006004122402, 2012 FINRA Discip. LEXIS 42, at *31 (NAC May 1, 2012); *Dist. Bus. Conduct Comm. v. Paramount*, No. C3A940048, 1995 NASD Discip. LEXIS 248, at *12 (DBCC Oct. 20, 1995).

[170] *Ottimo*, 2018 SEC LEXIS 1588, at *49.

[171] RX-1, at 81; Enforcement's Post-Hr'g Reply Br., at 8.

[172] *Ottimo*, 2018 SEC LEXIS 1588, at *49.

2. Smith Acted in the Capacity of a Representative in CSSC B/D's Securities Business

It is not disputed that Smith solicited CSSC B/D customers to invest in CSSC's offerings during the entire relevant period. Smith wrote the offering documents, disseminated them to CSSC B/D brokers, solicited and sold bonds and bridge loan notes through them, and obtained introductions to offer securities personally. He negotiated the terms of sales, offered variations to individuals interested in participating but seeking shorter maturity periods, and even gave one investor a higher interest rate. The SEC has found that persons with far less involvement in a member firm's business than Smith's involvement with CSSC B/D's securities business were sufficiently engaged in the firm's securities business to require registration.[173] The evidence shows that Smith participated in CSSC B/D's securities business as a registered representative, was required to register as such, and is therefore subject to FINRA's jurisdiction.

3. Smith Acted in a Principal Capacity in CSSC B/D's Operation

The evidence establishes that Smith hired and designated Martin and LaRose as co-presidents of the Firm and that in important matters they were answerable directly to him. In addition, despite writing in his attestation letter that he would not do so, Smith exercised both direct and indirect control over CSSC B/D. His indirect control derived from his position as chairman, CEO, and owner of the Firm's parent company, the sole owner of the Firm. Smith demonstrated his direct control over the Firm by possessing and exercising sole authority to hire and fire, select principals, negotiate compensation of Firm personnel, allocate funds from the RIA to the Firm to maintain minimum net capital requirements, and direct registered representatives to solicit sales of bonds and bridge loan notes to Firm customers.

Smith even handled complaints that customers sent to LaRose at the Firm. SM was a customer of the Firm who sent LaRose a written complaint in October 2015. LaRose treated it as a complaint to the Firm, and informed SM that she was looking into it. LaRose took the complaint directly to Smith; he informed LaRose that the principal invested by SM was due but unpaid, and that he would deal with the customer.[174] LaRose wrote SM a second letter, telling her that she should work with CSSC to resolve her problem. Smith told LaRose "he had reached out" to the customer.[175] LaRose had no further contact with SM.[176] Smith then informed LaRose

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[173] *See, e.g.*, *Stephen M. Carter*, 49 S.E.C. 988, 989 (1988) (cashier for firm who performed primarily clerical duties such as receiving and recording checks and securities, but did not buy or sell securities to customers, was sufficiently engaged in the firm's securities business to make him an associated person under the By-Laws and subject to regulatory jurisdiction); *Ottimo*, 2018 SEC LEXIS 1588, at *49 (rejecting claim that FINRA lacked jurisdiction over respondent because he was acting as principal of private fund advisor and not in capacity of registered representative; holding that as an associated person of a member firm, he was subject to FINRA's jurisdiction).

[174] Tr. 1251–53 (LaRose).

[175] Tr. 1261–62 (LaRose).

[176] Tr. 1262 (LaRose).

that he prepared a memo to send to all investors in CSSC's offerings, including the Firm's clients, in anticipation of possible additional complaints.[177]

Thus, we find on the evidence presented that Smith participated in the conduct of the Firm's securities business in the capacity of a principal, and should have been registered as such.[178]

4. Both Smith and the Firm Violated FINRA Registration Rules

We also conclude that Smith and CSSC B/D share culpability for the violations of the registration rules. It is well established that member firms are responsible for misconduct by their agents.[179] Smith acted as an agent of the Firm by soliciting Firm customers to invest in the offerings he promoted. The Firm's co-presidents knew that Smith was acting as a representative by engaging in sales of securities with the Firm's customers during the relevant period.[180] They were also aware Smith acted in the capacity of a principal.

VI. The Fraud Allegations

A. Facts

As described above, Smith drafted and disseminated the 2015 Bridge Loan Note Offering documents to induce potential investors to purchase unsecured promissory notes maturing in twelve months, paying eight percent interest. In addition, for every $100,000 invested, he promised investors a "gift" of 1,000 shares of CSSC common stock from his personal holdings. The omissions and representations he made in the offering documents form the basis for the Complaint's allegations of fraud.

The offering documents Smith created contained, among other papers, an "Important Memorandum" directed to "Those Who May Be Considering Making a Bridge Loan to CSSC." The earliest version is dated June 22, 2015,[181] with later revisions dated July 12,[182] September

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[177] Tr. 1260–61 (LaRose).

[178] *Richard F. Kresge*, Exchange Act Release No. 55988, 2007 SEC LEXIS 1407, at *49–50 (June 29, 2007) (frequent presence in firm's office, attendance at meetings with registered representatives, playing a role in office finances, and active involvement in hiring demonstrate acting in capacity of unregistered principal).

[179] *Dep't of Mkt. Regulation v. Yankee Fin. Group*, No. CMS030182, 2006 NASD Discip. LEXIS 21, at *68, 77 (NAC Aug. 4, 2006) (holding firm responsible for failure to register person as representative and principal).

[180] Tr. 1243, 1246–47 (LaRose).

[181] CX-201.

[182] CX-203.

9,[183] October 25,[184] November 2,[185] and December 12, 2015.[186] There were also several versions of a "Confidential Report," dated June 15,[187] September 9,[188] and October 25, 2015.[189] In all iterations, the Important Memorandum and the Confidential Report contained the same allegedly material omissions and repeated similar allegedly material and false representations.

1. The Omissions

The original Important Memorandum and each revision contained a section titled "Risk Factors to be Considered." The section described in general terms the risks that attend "an unsecured loan to a company that is experiencing current cash flow shortfalls," with "a significant amount of risk," and warned that "there is no guarantee" that the expected "significant appreciation in the value of CSSC's common stock" would occur or "the loan will be repaid, with interest, when due."[190] These warnings of risk were appropriate. Smith, as noted earlier, claims they were sufficient to inform prospective investors of CSSC's financial challenges.

However, none of the 2015 offering documents disclosed that, at the time Smith created and began disseminating them, CSSC owed $260,000 in principal and interest to investors in the 2010 Bond Offering and $375,000 in the 2014 Bridge Loan Note Offering.[191]

Smith was clearly aware—even as he solicited investments in the 2015 Bridge Loan Note Offering—of CSSC's inability to pay what it owed to investors.[192] As Enforcement argues, Smith knew he was obligated to disclose this adverse information, having done so in the 2010 Bond Offering materials.[193] In them, he explicitly stated that CSSC had been unable to pay previously issued notes that came due in 2009.[194]

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[183] CX-204.

[184] CX-210.

[185] CX-206.

[186] CX-209.

[187] CX-202.

[188] CX-205.

[189] CX-211.

[190] CX-201, at 3.

[191] CX-98, at 4, 6.

[192] Tr. 265 (Smith).

[193] Enforcement's Post-Hr'g Br., at 8.

[194] CX-87, at 19.

2. The Misrepresentations

a. Project X

i. Southwick's Concept

In a November 19, 2014 memorandum to affiliated brokers, investment advisors, and insurance agents who had not received their RIA "revenue share" checks, Smith sought to explain delays in paying them. In the memorandum, Smith made vague references to infusions of cash that he anticipated receiving and believed would make CSSC profitable for the first time in years. Despite being unable to pay people their earnings, he stated, he was "pleased to report" an imminent "large revenue event . . . produced from our banking initiatives," large enough to cure the "recurrent late payment" of salaries, fees, and commissions. He wrote that he expected "to have these funds in hand . . . well before the close of the year."[195] Later, in February 2015, he explained another delay in paying CSSC RIA and insurance affiliates but further described "the anticipated receipt of the earned portion of a large consulting fee."[196] The "large revenue event" was a "consulting fee" for CSSC's work in creating a special purpose bank, which came to be referred to as "Project X."[197]

In the July 12, 2015 Important Memorandum he distributed early in soliciting investments in the 2015 Bridge Loan Note Offering, Smith touted the special purpose bank as chief among several "important new initiatives." In the section "Important Disclosures in the Accompanying 'Confidential Report,'" Smith wrote: "CSSC is being paid a $1 million consulting fee for its work on the design and formation" of the bank, "the payment of which in 2015 will ensure CSSC's profitability in 2015 and likely make 2015 CSSC's most profitable year so far."[198] In the "Confidential Report," revised in June 2015, accompanying the Important Memorandum, Smith made more detailed claims. He wrote that half of the $1 million consulting fee had already "been earned and should be received very soon." Smith went on to explain that he expected CSSC would receive the other half of the fee when the bank began operating, and that he expected to accomplish this "prior to the 3rd quarter of 2015." Then, Smith continued, CSSC was slated to be paid additional fees for replicating the banks. According to Smith, in 2015 he expected CSSC to be paid $1.4 million—$1 million for creating the first bank and $400,000, half the fee for creating the second bank—from Project X alone.[199]

Southwick conceived of Project X in the fall of 2014. CSSC affiliate and Firm broker Ken Wheeler had approached Southwick for advice on what investments he might recommend to SB, a wealthy, prominent Florida cardiologist who had a large network of contacts with other

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[195] CX-34, at 2.

[196] CX-35, at 2.

[197] Tr. 461–63 (Southwick).

[198] CX-9, at 2–3.

[199] CX-202, at 9–10.

Florida physicians. Wheeler had provided estate planning services for SB. Southwick suggested he could "build a bank" for SB to invest in.[200] Southwick had a banking background and had in 1996 participated in the creation of a nationally chartered special purpose bank. Southwick understood SB to have sufficient wealth to provide the necessary capital to enable the bank to obtain regulatory approval.[201]

According to Southwick, getting approval for the bank would be a "huge, monumental task," and would take one to two years.[202] He suggested calling it Health Pro Bank,[203] and pending its approval, Southwick proposed forming a financial advisory group, Health Pro Bank Financial Services, LLC ("HPB Financial Services"). The bank would affiliate with and generate revenue for CSSC by providing financial services, including insurance and investment recommendations, to SB's network of physicians. Then when the bank was chartered, the advisory group would provide bank customers with financial services, generating additional revenue for the bank and, in turn, CSSC. Southwick hoped he could take the concept to a reputable source of private equity that would invest in the bank, pay CSSC a consulting fee for creating the enterprise, and possibly take an ownership interest in the bank, although he did not know if regulators would approve that.[204]

Southwick testified that he contemplated the consulting fee would be "like a million dollars for the first bank that was up and running," and then CSSC would replicate the structure and charge a reduced consulting fee for each additional bank.[205]

Southwick hoped CSSC would also be able to share ownership of the bank, but did not know whether the bank regulators would approve.[206] He believed that even if the bank ultimately failed to receive a charter, HPB Financial Services would have established itself as a financial services provider for SB's network of physicians.[207]

Wheeler told Southwick that SB liked the idea,[208] had expressed "extreme excitement,"[209] and was "very interested in building a bank."[210] Because SB insisted on keeping

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[200] Tr. 478–480 (Southwick).

[201] Tr. 484 (Southwick).

[202] Tr. 486, 490–91, 505–6 (Southwick).

[203] Tr. 485 (Southwick).

[204] Tr. 494–96 (Southwick).

[205] Tr. 496 (Southwick).

[206] Tr. 496–97, 505 (Southwick).

[207] Tr. 507–8 (Southwick).

[208] Tr. 480 (Southwick).

[209] Tr. 482 (Southwick).

[210] Tr. 486–87 (Southwick).

the project confidential, at Wheeler's suggestion Southwick decided to call the endeavor "Project X." Wheeler also informed Southwick that he alone would handle contact with SB.[211]

Soon after his initial discussions with Wheeler, Southwick told Smith about Project X, and briefed him on the "progress" of the project thereafter.[212]

Southwick explained that the bank's charter would have to be approved by the Office of the Comptroller of the Currency ("OCC") as well as other bank regulators.[213] He contacted a lawyer from the Chicago law firm he had worked with to establish the special purpose bank in 1996, to ask for legal guidance in creating Health Pro Bank and HPB Financial Services. In early November 2014, Southwick informed Wheeler that he would soon send him "work product" from the law firm, the OCC, and a major private equity firm, that he hoped to involve in financing the bank.[214]

Southwick prepared several slides for a November 11, 2014 presentation to a weekly meeting of all of the CSSC affiliates in the Troy, Michigan office, to inform them about Project X, as well as other prospective sources of revenue for CSSC. The presentation described Project X as creating a nationally chartered private purpose bank that would produce consulting fees for CSSC, and provide an opportunity for CSSC to obtain equity in the bank. It identified lawyers from the law firm and individuals employed at the equity firm and OCC who would be involved.[215]

ii. Smith's Claims about Project X

In truth, as Southwick testified, virtually all of this was suppositional, "not firm."[216] He had no idea if bank regulators would allow CSSC or the equity firm to share ownership in the bank; no information on whether the project would receive OCC approval; had not spoken to and knew none of the OCC officials he listed, having obtained their names from public records; and had not yet attempted to contact individuals at the private equity firm or made a proposal to them.[217] A reference to $200 million in assets, and a consulting fee of $1 million "initially paid

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[211] Tr. 482–83 (Southwick).

[212] Tr. 486–87, 516 (Southwick).

[213] Tr. 490–93 (Southwick).

[214] Tr. 487–490 (Southwick); CX-225.

[215] Tr. 491–93 (Southwick); CX-224, at 9–12.

[216] Tr. 496 (Southwick).

[217] Tr. 496–99 (Southwick). Southwick testified that around early March 2015, prior to a meeting about Project X at the Chicago law firm, he spoke by telephone with a representative of the private equity firm and attempted to explain Project X, but the representative told him he was not interested. When Southwick called a second time, the representative hung up on Southwick. Tr. 527–28 (Southwick).

up front with [equity firm] funds" was, Southwick testified, "prospective" only—no consulting agreement existed.[218]

Nevertheless, starting with the June 15, 2015 revision of the Confidential Report, Smith represented to prospective investors that Southwick was "in the final stages of creating a '*Special Purpose Bank*' to exclusively serve the medical/dental/healthcare communities" and had "brought one of the largest law firms in the country together with a large private equity firm to work in conjunction with the Office of the Comptroller of the Currency." Smith claimed, "CSSC is being paid a $1 million consulting fee" for forming the bank, and "half of that fee has now been earned" with the rest "due and payable when the new bank opens its doors for business, an event we expect to occur prior to the end of the 3rd quarter of 2015." He wrote that CSSC would be paid an additional $400,000 for consulting services in establishing a second special purpose bank, and he expected CSSC to be paid "$1.4 million in 2015."[219]

In stark contrast, Wheeler testified that in June 2015 the special purpose bank was far from being in "the final stages" of being established. There was no arrangement for a consulting fee to be paid to CSSC for the project. Furthermore, there was no work done or contemplated for a second bank. Wheeler described Smith's characterizations as "delusional."[220]

At the hearing, Smith admitted that he never saw any evidence of an agreement by which CSSC would be paid a $1 million consulting fee, and he did not know what would have to be accomplished for CSSC to be paid half a million dollars. All he had was an "expectation" that CSSC would be paid, based on what Southwick told him.[221] And when he asked Southwick for evidence documenting the commitment that CSSC would be paid, Southwick never provided any.[222]

And Smith needed documentation. He was trying to place $1.6 million in 2015 Bridge Loan Notes with a wealthy potential investor who insisted that first Smith produce a copy of a written commitment by HPB Financial Services that CSSC would provide it with financial services.[223] In August Smith told Southwick he needed the documentation. When Southwick said he did not have it, Smith had Southwick, in Smith's presence, call the lawyer Southwick knew at the law firm and ask him for the agreement. The lawyer replied that there was no agreement, and that HPB Financial Services had not been formed.[224]

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[218] Tr. 503–4 (Southwick).

[219] CX-58, at 18–19.

[220] Tr. 896–900, 908 (Wheeler).

[221] Tr. 316–17 (Smith).

[222] Tr. 322–25 (Smith).

[223] Tr. 329–30, 332, 334 (Smith); CX-79; CX-81.

[224] Tr. 327–30 (Smith), 1117–18 (Martin).

Despite knowing this, Smith continued to assure his potential investor that written confirmation of the commitment was forthcoming. Smith wrote him that the "bank is nearing completion" and the document confirming that CSSC would provide "the investment advisory and brokerage platform" to HPB Financial Services would be executed "very soon since meetings with the perspective (sic) investors began, financial services introductions have already been set."[225] Finally, in September 2015, the investor informed Smith that he would "pass" on the investment opportunity, and asked, "please do not contact me again."[226]

In their testimony, the co-presidents of CSSC B/D indicated they had no inkling that CSSC was about to receive a million dollar consulting fee. LaRose referred to Project X as "a fluid project," not sufficiently underway for her to even review it as an outside business activity for Martin, who was supposed to take a significant position in HPB Financial Services.[227] Similarly, based on what Southwick, who was spearheading Project X, said in his presentations at weekly meetings, the undertaking was just the subject of "early-on discussions" and there was little talk of raising capital until August 2015.[228] According to Martin, in the spring of 2015 when Smith asked him if he had seen any documentation regarding the consulting fee, he told Smith he had not seen anything.[229]

As discussed above, the first two investors in the 2015 Bridge Loan Note Offering, TL and Scotto, made their investments in August 2015, after receiving offering materials that included the July 12 version of the memorandum to potential investors. The last two, BB and Clarkson, made their investments after Smith had fired Southwick on September 8, 2015. On September 9, Smith revised two of the offering documents, the Important Memorandum[230] and Confidential Report.[231] In them, Smith stated that progress on Project X had been "unexpectedly interrupted," the revenue he had represented as already having been earned "may not materialize until 2016, if at all,"[232] and that the interruption, caused by a "plan to deprive" CSSC of "an expected $2.15 million," meant that the special purpose bank revenue "now appears unlikely to take place within the 4th quarter of 2015."[233] Nonetheless, on September 12, Smith sent BB a package of materials that included the June 15 Confidential Report describing the likely receipt of revenue from Project X.[234] And on October 29, Smith sent an email to Clarkson continuing to

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[225] Tr. 332–34 (Smith).

[226] Tr. 208–10, 269 (Smith); CX-213, at 206.

[227] Tr. 1309–10 (LaRose).

[228] Tr. 1226–28 (LaRose).

[229] Tr. 1063 (Martin).

[230] CX-204.

[231] CX-205.

[232] CX-204, at 3.

[233] CX-205, at 6.

[234] CX-13, at 1, 10.

solicit him and his "tribal connections" to invest in the 2015 Bridge Loan Note Offering.[235] Although the updated offering materials accompanying the email included the disclosure that Project X had been "unexpectedly interrupted,"[236] they continued to make other false claims about projected large increases in revenues to CSSC.[237]

b. The South Dakota Trust Company

In the 2015 Confidential Report, Smith also touted "two new service offerings that we believe have tremendous revenue production potential in the months and years ahead."[238] He claimed that he and Southwick had "been active in the formation of an important new strategic alliance with South Dakota Trust Company." He stated that Southwick was helping SDTC create "new investment funds that are known as 'common and collective trust funds'" that "only a trust company can create and administer." He asserted, "CSSC will be the investment advisor" for the funds and "will earn a fee based on a percentage of the assets under management." He wrote that he personally was working on "the creation of a client referral relationship" by which SDTC would refer clients to CSSC to provide services. He asserted that CSSC expected to have the "new revenue sources" from this relationship "up and running" before the end of the year.[239]

On March 3, 2015, he and Southwick met in New York with representatives of SDTC. That meeting did not produce an agreement between SDTC and CSSC, and as of June 2015, no understanding—that CSSC would advise SDTC in administering new "common and collective trust funds" it helped SDTC to create—existed.[240] Southwick unsuccessfully pursued a follow-up meeting with SDTC representatives until Smith fired him.[241] Smith thus knew before he distributed the June 2015 Confidential Report that there was no basis for him to represent that CSSC was about to become the advisor for any trust funds at SDTC or was about to establish a client referral relationship with SDTC.[242]

c. The City of Jacksonville

Smith made representations in the 2015 Bridge Loan Note Offering documents about another project that he claimed was about to lead to important new revenue streams for CSSC. It was a "pending engagement with the City of Jacksonville, Florida." Smith represented that CSSC was "in the final stages of being engaged as a Special Reviewing Consultant with regard to the investment management of Jacksonville's nearly $1 billion in short-term operating funds."

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[235] CX-16, at 1.

[236] CX-16, at 8–9.

[237] CX-16, at 7–8.

[238] CX-58, at 20–21.

[239] CX-58, at 19.

[240] Tr. 630–35 (Southwick).

[241] Tr. 636–38 (Southwick).

[242] Tr. 132–33 (Smith).

Smith claimed that this engagement, about to be finalized, would increase CSSC's "reportable assets under management by nearly $1 billion." [243]

As with the other supposedly promising projects, it was Southwick who was primarily responsible for pursuing the possibility of obtaining the city as a client. His idea was for CSSC to review and monitor the city's investments, and he arranged to meet with a city official. He offered CSSC's services to manage one or more of the city's investment pools, or act as a consultant by analyzing the city's investment strategies and making recommendations. According to Southwick, the city showed some interest, but it was on a scale considerably less grand than Smith described in the offering documents. In his November 2014 slide presentation to CSSC's weekly staff meeting, Southwick estimated that CSSC might earn a quarterly fee of $40,000, not for managing assets but for providing limited consulting services.[244]

In April 2015 the city informed Southwick that it was not interested in CSSC's original proposal.[245] Southwick testified that he continued to pursue a relationship with the City of Jacksonville and kept Smith informed of his efforts.[246] In July 2015, Smith drafted a proposal to perform consulting services, not managing assets but evaluating the performance of the city's asset managers. The proposal called for the city to pay CSSC $15,000 per quarter, a level of compensation based on what the city indicated it was willing to pay. Southwick sent the proposal to the city on July 27, but received no response.[247] The deal never materialized.[248]

B. Conclusions of Law

1. Elements of Fraud in Violation of Exchange Act Section 10(b) Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010

To prove the allegations in the first cause of action that Smith and the Firm violated Exchange Act Section 10(b) and Rule 10b-5 thereunder, Enforcement must establish by a preponderance of the evidence that Smith and CSSC B/D, through Smith, made[249]

- a misrepresentation or omission of a material fact;
- in connection with the purchase or sale of a security;
- with scienter;

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[243] CX-58, at 21.

[244] Tr. 589–93 (Southwick).

[245] Tr. 597 (Southwick).

[246] Tr. 598–99 (Southwick).

[247] CX-246, at 12–13; Tr. 607–11, 614–15 (Southwick).

[248] Tr. 624 (Southwick).

[249] *Mitchell H. Fillet*, Exchange Act Release No. 75054, 2015 SEC LEXIS 2142, at *18 (May 27, 2015).

- using the instrumentalities of interstate commerce.[250]

To prove its allegations that Respondents committed fraud in violation of FINRA Rule 2020, also charged in the first cause of action, Enforcement must show by a preponderance of the evidence that Respondents effected transactions or induced the purchase or sale of a security by using a manipulative, deceptive, or fraudulent device. Proof of these violations also establishes violations of the ethical standards imposed by FINRA Rule 2010.[251]

a. Materiality of Omissions and Misrepresentations of Fact

Materiality must be determined by analysis of the particular facts of a case.[252] The standard for determining materiality of a fact is an objective one.[253] The test is whether there is a substantial likelihood that a reasonable investor would consider the misstated or omitted fact to be important in making an investment decision,[254] that is, whether it would alter the "total mix" of information available to evaluate the risk of a prospective investment.[255]

While Smith acknowledges this well-established definition of materiality,[256] he argues that Enforcement failed to prove that his alleged factual omissions and representations in the 2015 Bridge Loan Note Offering documents were material.[257] He contends that Enforcement must present evidence from the four persons who invested in the 2015 Bridge Loan Notes Offering[258] to establish the materiality of any representations or omissions. He insists that Enforcement's burden is to prove, through testimony of customers or experts, that those who received the offering materials "considered the alleged misstatements and/or omissions . . . to be a significant factor in their investment decisions." Smith complains that Enforcement did not present customer or expert testimony concerning the potential materiality of the omissions and misrepresentations.[259]

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[250] *SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1092 (9th Cir. 2010); *SEC v. Wolfson*, 539 F.3d 1249, 1256 (10th Cir. 2008) (citing *Geman v. SEC*, 334 F.3d 1183, 1192 (10th Cir. 2003)).

[251] A violation of a FINRA rule is inconsistent with just and equitable principles of trade; thus, it also violates Rule 2010. *See, e.g.*, *John Edward Mullins*, Exchange Act Release No. 66373, 2012 SEC LEXIS 464, at *44 n.45 (Feb. 10, 2012).

[252] *Basic Inc. v. Levinson*, 485 U.S. 224, 238–39 (1988).

[253] *Worlds of Wonder Sec. Litig.*, 1992 U.S. Dist. LEXIS 10503, at *12, 14 (N.D. Cal. July 9, 1992) ("Under the federal securities laws, materiality is determined by an objective standard: the hypothetical 'reasonable investor' is the yardstick used to measure materiality . . . and it is for the trier of fact to decide whether defendants' omissions were, in fact, material.") (citing *Basic*, 485 U.S. at 231).

[254] *United States v. Litvak*, 889 F.3d 56, 89 (2d Cir. 2018).

[255] *Basic*, 485 U.S. at 231–32 (1988) (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

[256] Smith's Rebuttal Br., at 3.

[257] Smith's Initial Post-Hr'g Br., at 13–14.

[258] Smith's Rebuttal Br., at 6–7.

[259] Smith's Initial Post-Hr'g Br., at 13–14; Smith's Rebuttal Br., at 3–4.

Smith's protestations are ill founded. Although Smith concedes that actual reliance by a customer is unnecessary, he seems to insist on the functional equivalent of proof of reliance by demanding "actual, competent evidence that the alleged misrepresentations or omissions were material."[260] But proof establishing materiality does not require testimony of individual customers that a representation or omission was important and substantially altered the total mix of information to be weighed.[261]

It is well established that statements and omissions relating to the financial condition of a company are material.[262] "False claims of substantial unearned revenue" are material.[263] In this case, Smith claimed in the 2015 Bridge Loan Note Offering materials with strong positive representations that, because of the consulting fee from Project X and the agreements with the City of Jacksonville and SDTC that were being "finalized," 2015 would be the most profitable year in CSSC's history. Smith knew potential investors would be reassured by these positive prospects and feel more confident that they would receive the promised interest and principal on maturity of the notes. But because Smith's predictions were unsubstantiated, and because he knew they had no sound factual basis, they were misrepresentations of material fact within the meaning of Section 10(b) and Rule 10b-5.[264]

Similarly, Smith's failure to disclose that CSSC had been unable to repay principal owed to investors in the prior bond and bridge loan offerings was a material omission in the 2015 Bridge Loan Note Offering documents, and violated his obligation to "disclose material adverse facts" known to him.[265]

The Panel concludes that reasonable investors would have considered the claims Smith, and through him the Firm, made about large, imminent expected revenues, and his omissions about CSSC's failure to make interest and overdue principal repayments to previous investors, to be material. Smith and the Firm breached their obligation to be truthful and not mislead potential investors.[266]

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[260] Smith's Rebuttal Br., at 3.

[261] *Dep't of Enforcement v. Jordan*, No. 2005001919501, 2009 FINRA Discip. LEXIS 15, at *17 n.7 (NAC Aug. 21, 2009) (citing *RichMark Capital Corp*., Exchange Act Release No. 48758, 2003 SEC LEXIS 2680, at *15 (Nov. 7, 2003), *aff'd*, 86 F. App'x 744 (5th Cir. 2004)).

[262] *SEC v. Todd*, 642 F.3d 1207, 1220–21 (9th Cir. 2011) ("Information regarding a company's financial condition is material to investment" and "how officers . . . describe revenue growth to investors is important.").

[263] *SEC v. USA Real Estate Fund 1, Inc.*, 30 F. Supp. 3d 1026, 1034 (E.D. Wash. 2014).

[264] *Marx v. Computer Sciences Corp.*, 507 F.2d 485, 489 (9th Cir. 1974) (citing *G & M, Inc. v. Newbern*, 488 F.2d 742, 745–46 (9th Cir. 1973) (prediction without sound factual or historical basis is actionable)).

[265] *Dep't of Enforcement v. McGee*, No. 2012034389202, 2016 FINRA Discip. LEXIS 33, at *25–26 (NAC July 18, 2016), *petition for rev. denied*, 733 Fed. Appx. 571 (2d Cir. 2018).

[266] *Ottimo*, 2018 SEC LEXIS 1588, at *31.

b. In Connection with the Purchase of Securities

Smith created and disseminated the 2015 Bridge Loan Note Offering documents to prospective investors with the specific purpose of attracting investments to raise funds for CSSC. Section 10(b) requires that fraudulent omissions and misrepresentations must be "in connection with" a securities transaction. The requirement is to be liberally construed, however. It is met when the evidence shows, as it does here, the omissions or misrepresentations are contained in documents disseminated to investors that are designed to persuade them to purchase a security.[267]

i. Smith's Characterization of the 2015 Bridge Loan Note Transactions

There is no dispute, and Smith concedes, that customer TL invested $50,000 in the 2015 Bridge Loan Note Offering, and was, as Smith wrote in an email to him about his investment, a "Note holder."[268] However, Smith argues that the other three participants in the 2015 Bridge Loan Note Offering—Scotto, Clarkson, and customer BB—did not invest in securities when they "participated" in the 2015 Bridge Loan Note Offering,[269] but simply loaned money to CSSC.[270]

In light of Smith's contentions, it is appropriate to examine the nature of the notes in the context of the definitions of securities in the securities acts and case law.

ii. Discussion

As discussed previously, the 2015 Bridge Loan Note Offering provided investors with the opportunity to purchase unsecured notes maturing in twelve months, earning an attractive eight percent interest, with an additional "gift" of CSSC common stock.[271]

The Securities Act declares "any note" maturing more than nine months after issuance to be a security, and the Exchange Act includes virtually "any note" as a security, unless the circumstances of the note's issuance or terms require a different result. This is consistent, as courts have observed, with the recognition that "the target of §§ 10(b) of the Exchange Act and 17(a) of the Securities Act is fraud."[272] The United States Court of Appeals for the Second Circuit has applied, and the Supreme Court has noted with approval, the presumption that a note with a term of more than nine months is a security.[273] The Supreme Court has stated, "the

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[267] *Wolfson*, 539 F.3d 1249, 1262–63 (citing *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 126 (2006)).

[268] Tr. 342–43 (Smith); CX-11, at 1.

[269] Tr. 149–53, 170–73 (claiming Clarkson did not invest in a bridge loan note) (Smith).

[270] Tr. 153 (Smith).

[271] CX-201, at 1; CX-203, at 1; CX-204, at 1; CX-206, at 1; CX-209, at 1; CX-210, at 1–2.

[272] *Exchange Nat'l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1137 (2nd Cir. 1976).

[273] *Reves v. Ernst & Young*, 494 U.S. 56, 65–66 (1990) (citing *Exchange Nat'l Bank of Chicago*, 544 F.2d at 1137).

Securities Acts define 'security' to include 'any note,'" giving rise to the presumption that every note is a security. The presumption is "not irrebutable," however. The Court has identified four factors ("*Reves* factors") relevant to assessing whether a note qualifies as a security under the Exchange Act.[274]

The first factor concerns the motives of the buyer and seller. If "the seller's purpose is to raise money for the general use of a business enterprise . . . and the buyer is interested primarily in the profit the note is expected to generate" it is "likely to be a 'security.'"[275] The second factor entails evaluation of the "plan of distribution," whether the note is traded for speculation or investment. The third factor encompasses the "reasonable expectations" of public investors. The fourth is whether there is some other regulatory protection of the investing public over the sales of the note that might make "application of the Securities Acts unnecessary."[276]

When soliciting investments in the 2015 Bridge Loan Note Offering, Smith made it clear that his purpose was to raise funds for the general use of CSSC. The 2015 Bridge Loan Note Offering "Confidential Report" stated that CSSC was "covering its operating deficits" with proceeds from the Offering,[277] and in the "Important Memorandum" he wrote that "funds raised will be used to smooth out Company cash flows and cover any operating deficits" until CSSC attained profitability from the pending "new initiatives" he touted.[278] Here, the evidence shows that Smith crafted the offering documents to emphasize the potential profit to purchasers of the notes. Smith acknowledged that he drafted the offering documents with the offer of an eight percent return and gifts of CSSC stock to make the offering attractive to investors.[279] The offering documents stressed the strong likelihood that CSSC's other ventures were about to bring in major revenue streams ensuring the company's ability to pay interest and principal to investors. The documents clearly appealed to investors seeking profit.

Notably, CSSC's records describe the transactions as investments. For example, a document titled "Bridge Loan note holders" includes the names of two of the four participants in the offering—TL and Scotto— as "Bridge Loan note holders," showing maturity dates in 2016, and the total of their interest due at eight percent on maturity.[280] A third participant, BB, appears

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[274] *Reves*, 494 U.S. at 65–66.

[275] *Id.* at 66 (noting that if "the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to evidence some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a 'security.'").

[276] *Id.* at 66–67.

[277] CX-58, at 12.

[278] CX-58, at 37.

[279] Tr. 104–6 (Smith).

[280] CX-89, at 2.

in a list of "Other note holders"[281] who invested in the bridge loan notes, listing his $20,000 note with a maturity date of August 30, 2016, at eight percent interest.[282]

At the hearing, Smith initially conceded the "Bridge Loan note holders" list shows holders, including Scotto and TL, of bridge loan notes with their maturity dates. He testified that the "Other Note holders" list did not identify note holders, but persons who had simply made "loans" to the company. Then he reversed his original concession and testified that Scotto was not a Bridge Loan Note purchaser, but was mistakenly listed as one.[283] However, as the discussion above establishes, it was only after Smith solicited Scotto with emails and sent him the package of offering documents for prospective investors in the 2015 Bridge Loan Notes that Scotto sent Smith his $20,000.[284]

Smith testified that when he solicited potential purchasers of the notes, some were interested but "needed the money more quickly" than the one-year term the offering permitted. For example, when he made Scotto aware of the 2015 Bridge Loan Note Offering, Scotto said he wanted to participate but would need the principal returned by the end of the year. Smith accommodated Scotto by agreeing to "[d]o it differently." In other words, Smith was willing to adjust the terms to satisfy those who wanted to participate in the offering but with terms that differed from its original terms.[285] These circumstances show that Smith solicited Scotto to invest in the 2015 Bridge Loan Note Offering, and Scotto did so after negotiating Smith into accepting a shorter term for maturity than the standard one year.

In July 2015, Smith sent TL offering materials with an email stating that he was "expanding the range" of people to whom he was making the 2015 Bridge Loan Note Offering available, so that TL could invest. Smith claimed he was "moving very rapidly" and expected to finish "within the next 30 days" after which the offering would no longer be available to individual investors. He arranged to meet with TL in New York.[286] When asked if he was soliciting TL, Smith characterized his actions as "giving him the information so he could evaluate it," although Smith conceded his goal was to get TL to invest.[287]

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[281] CX-89, at 3.

[282] Tr. 234–36 (Smith); CX-89, at 2. CX-89 is a three-page document, each page containing a list. The first page purports to be a list of CSSC debenture bond investors. The second is titled "Bridge Loan note holders." Scotto is listed three times, as holding a $75,000 note that came due in May 2015, a $50,000 note that came due in March 2016, and a $20,000 note that came due in August 2016. TL is listed as holder of a $50,000 note that also came due in August 2016. The third page is titled "Other note holders." Smith testified that this page identified "unsecured loans . . . not a part of the offering." Tr. 236.

[283] Tr. 235–37 (Smith).

[284] *See* discussion of Smith's solicitation of Scotto above at V. A. 2. d. ii. b.

[285] Tr. 406–8 (Smith).

[286] CX-8, at 1.

[287] Tr. 99–101 (Smith).

Similarly, although he wrote to customer BB that the 2015 Bridge Loan Note Offering was not "applicable" to him, in September 2015 Smith sent him the package of offering materials and stated in an accompanying email that if BB wished "to get involved," they would "consider some alternatives," and invited BB to let Smith know if he decided "to get involved."[288] According to Smith, when BB reviewed the offering documents, he said he wanted to participate, but asked if he could do so with only a $10,000 "loan." BB also was interested in receiving CSSC stock. As he did with Scotto, Smith again agreed to vary from the original terms of the offering. Moreover, he asked BB to introduce the offering to his connections in investment banking and venture capital circles.[289]

Smith concedes that he solicited Clarkson to invest in the offering.[290] He sent offering documents and wiring instructions to Clarkson hoping he would purchase a Bridge Loan Note and seek out other potential investors among the Native American tribes he knew. At the end of October 2015 he emailed Clarkson that he was "finishing the placement of the remaining $1.6 million available in our current Bridge Loan Note Offering," described it as "a great opportunity" that he hoped would be "a possible 'fit'" for Clarkson and his "tribal connections" to "take advantage of."[291]

As we do with Scotto, the Panel finds that Smith solicited TL, BB, and Clarkson to invest in 2015 Bridge Loan Notes and they did so, even though Smith allowed both Scotto and BB's notes to mature in less than a year.

Other evidence adds weight to the conclusion that the four transactions at issue were purchases of securities, not mere short-term loans. In November 2015, when DW, CSSC's controller, emailed Smith to inform him that "[t]erms have not been specified for the following notes," he included the notes at issue here: Scotto's $20,000, BB's $10,000, TL's $50,000, and Clarkson's $50,000 investments.[292] In response, Smith identified Scotto's $20,000 and customer TL's $50,000 as being "in the Bridge Loan Note Offering," and customer BB's $10,000 and Clarkson's $50,000 as "6 month Note[s]."[293] He did not contend at that time that they were just short-term loans to CSSC.

iii. Conclusion

Considering the entirety of the circumstances, the offering documents, together with the evidence of Smith's solicitations of BB, TL, Scotto and Clarkson, the Panel finds that Enforcement met its burden of proof: Smith made the material omissions and misrepresentations

[288] CX-13, at 1.

[289] Tr. 1388–89 (Smith).

[290] Tr. 136–37 (Smith).

[291] CX-16, at 1.

[292] CX-28.

[293] CX-27.

in the 2015 Bridge Loan Note Offering documents that solicited them to purchase securities. Applying the *Reves* factors, Smith offered the notes as securities with a maturity date of a year from purchase; intended to use the proceeds for the general needs of CSSC; and offered significant profit as the incentive for purchasing the notes, at a rate identical to prior offerings of securities that investors found attractive. While Smith was willing to shorten the maturity date for some note holders on request, doing so did not transform the transactions, as Smith contends, from securities transactions to short-term loans. The Panel concludes that the 2015 Bridge Loan Notes qualify as securities and that this is an appropriate case for the application of the Securities Acts, in the interest of protecting the investing public.

c. Scienter

Scienter is "a mental state embracing intent to deceive, manipulate, or defraud."[294] Scienter may be established by recklessness,[295] encompassing "a highly unreasonable misrepresentation or omission."[296] Recklessness is "an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[297]

i. Smith's Claims of Reasonable Reliance on Southwick

Smith denies that he possessed any deceptive intent. Rather, he claims that he reasonably relied on Southwick's reports to him that the project to establish the special purpose bank was progressing.[298] Smith insists there is no evidence that he knew Southwick's representations were false.[299] He points to a letter he wrote to the equity firm on September 25, 2015,[300] after firing Southwick, and emails sent to the law firm by a lawyer Smith hired,[301] as evidence of his good-faith reliance on Southwick.[302] In the equity firm letter, Smith asked to meet with representatives of the firm to explore pursuing Project X, asserting that the firm had already evaluated its viability and made a "substantial financial commitment to it."[303] The lawyer's emails to the law

[294] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

[295] *Fillet*, 2015 SEC LEXIS 2142, at *26.

[296] *Dep't of Enforcement v. Abbondante*, No. C10020090, 2005 NASD Discip. LEXIS 43, at *28 (NAC Apr. 5, 2005), *aff'd*, 58 S.E.C. 1082 (2006).

[297] *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990).

[298] Smith's Initial Post-Hr'g Br., at 3, 8, 14–15.

[299] *Id.* at 3; Smith's Rebuttal Br., at 8–9.

[300] RX-67.

[301] RX-68.

[302] Smith's Rebuttal Br., at 9.

[303] RX-67, at 2.

firm threatened legal action against the firm for improperly acting to prevent CSSC from profiting from Project X.[304]

ii. Discussion

In evaluating Smith's assertions, it is useful to review the context in which he wrote and promulgated the 2015 Bridge Loan Note Offering documents. Smith knew that CSSC owed investors hundreds of thousands of dollars in principal payments for bonds and notes that came due in mid-2015, and was struggling to pay the Firm's registered representatives and the RIA's advisors. He had reason to avoid disclosing CSSC's precarious financial condition to potential investors, and motive to make unfounded rosy projections of imminent new revenues. Smith needed to raise money to keep CSSC afloat.

As shown above, Smith made his representations about Project X without verifying the existence of the purported consulting agreement, or even asking to see a draft application to bank regulators for approval of a special purpose bank. It is also relevant that this is not a case of a single improvident aspirational representation. Here, Smith disseminated multiple revisions of the offering documents over a period of months, all containing the misrepresentations and omissions charged in the Complaint.

Given these facts, Smith's claim that he reasonably relied on Southwick's mischaracterizations of Project X's progress—particularly that CSSC was about to be paid $500,000 in earned consulting fees[305]—is unpersuasive. As Enforcement points out, Southwick's employment contract, written by Smith, forbade Southwick from committing CSSC "to any project, contract or engagement without conferring in advance" and obtaining approval from Smith.[306] When Southwick told Smith that half of the existing million dollar consulting fee had been earned, Smith had neither seen nor approved any "project, contract or engagement" of that nature. As shown above, although Smith asked Southwick for documentary evidence supporting the existence of the consulting fee, Southwick never produced any.

In addition, as Enforcement also points out, Smith cannot say he relied on Southwick's claims about the SDTC and City of Jacksonville consulting agreements. The facts recited above show that Smith had actual knowledge that CSSC was not in the final stages of reaching lucrative agreements with either SDTC or the City of Jacksonville and misrepresented the truth in every iteration of the offering documents.

Smith and Southwick met with SDTC personnel in March 2015,[307] and Smith exchanged emails with SDTC on July 13, 2015, stating "a referral agreement" and the issue of managing

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[304] RX-68.

[305] Tr. 310.

[306] Enforcement's Post Hr'g Reply Br., at 16–17.

[307] Tr. 630–32 (Southwick); CX-108.

funds were the subject of "discussions," not an actual agreement between SDTC and CSSC.[308] Yet Smith wrote in the June, September, and November 2015 offering documents that "CSSC will be the investment advisor of the common and collective trust funds it is helping to create [for SDTC], and CSSC will earn a fee based on a percentage of the assets under management."[309]

Similarly, Smith knew there was no basis to believe that CSSC had reached the final stage of completing a profitable agreement with the City of Jacksonville that would bring CSSC close to $1 billion in assets under management.[310] Smith had seen no documentation evidencing the existence of such an agreement. In fact, the City of Jacksonville had rejected the original proposal. The scaled-down proposal Smith personally drafted in July 2015 and sent to the City of Jacksonville had no provision for CSSC to acquire responsibility for a billion dollar valuation of assets under management. Rather, it called for a far humbler $15,000 quarterly fee if the City of Jacksonville agreed to have CSSC provide evaluations of the City's money managers.[311]

The Panel therefore concludes that Smith, and through him CSSC B/D, acted intentionally when he solicited investors in the 2015 Bridge Loan Note Offering and, in the offering documents, consciously did not disclose that CSSC owed but was unable to pay $655,000 in principal to investors in the 2010 Bond Offering and 2014 Bridge Loan Note Offering.

The Panel finds that Respondents made their affirmative misrepresentations about imminent revenue streams from consulting agreements while cognizant that no such agreements were nearing completion with the City of Jacksonville and SDTC. Moreover, Smith acted knowingly, or at a minimum recklessly, when he misled prospective investors to believe that CSSC was about to receive large cash infusions from an existing consulting agreement, for "Project X." All of these omissions and misrepresentations were material.

d. Smith Made the Omissions and Misrepresentations Using Instrumentalities of Interstate Commerce

Smith admits that he communicated "with investors and others principally by email and overnight courier."[312] Consistent with his admission, Smith provided the four investors in the 2015 Bridge Loan Note Offering with the misleading offering documents by email and overnight mail, and therefore utilized the instrumentalities of interstate commerce to make his fraudulent solicitations.

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[308] CX-109.

[309] CX-202, at 10; CX-205, at 4-5; CX-207, at 5–6.

[310] CX-202, at 12.

[311] Tr. 610–11 (Southwick); CX-246, at 12–13.

[312] Ans. ¶ 88.

e. CSSC B/D Is Liable for Smith's Fraudulent Misconduct

As shown above, Smith was the indirect owner and acted as both principal and registered representative in the securities business of CSSC B/D, and therefore he acted as an agent of the Firm. Member firms are responsible for the misconduct of their agents. Just as the Firm shares liability with Smith for failing to register as a principal and representative, it shares liability with him for the fraudulent misconduct charged in the Complaint's first three causes of action.[313]

f. Conclusion

For these reasons, the Panel finds that Enforcement has proven by a preponderance of the evidence that, as charged in the Complaint's first cause of action, Smith, and through him CSSC B/D, acted with scienter and willfully[314] violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, by intentionally or recklessly making untrue statements and omissions of material facts in connection with the sales of securities, specifically the 2015 Bridge Loan Note Offering, using instruments of interstate commerce to send offering materials and solicit registered representatives and customers of CSSC B/D and, by these acts, to induce the purchase of the 2015 Bridge Loan Notes by means of a manipulative, deceptive, fraudulent contrivance in violation of FINRA Rule 2020, thereby violating FINRA Rule 2010.

2. Elements of Fraud in Violation of FINRA Rule 2010 and Sections 17(a)(2) and (3) of the Securities Act

The allegations contained in the second cause of action, pleaded alternatively to the first cause, require Enforcement to prove by a preponderance of the evidence that respondents made material misrepresentations and omissions in violation of Sections 17(a)(2) and (3) of the Securities Act, thereby violating FINRA Rule 2010. As noted above, Section 17(a) makes it unlawful in the offer or sale of securities to use the mails or to communicate in interstate commerce to obtain money through an untrue statement of material fact or omitting to state a material fact needed to render statements made not misleading; or to engage in a course of business operating as a fraud or deceit on the purchaser. The signal difference between the charges in the first and second causes of action is that culpability for violation of Sections 17(a)(2) and (3) does not require proof of scienter.[315] All that is required is that a respondent negligently, rather than intentionally, misrepresent or omit to state a material fact.[316]

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[313] *Yankee Fin. Group*, 2006 NASD Discip. LEXIS 21, at *67–68; *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359, 361–62 (6th Cir. 1970).

[314] Willfulness in this context means intentionally committing the act that constitutes the violation. *See Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000). Willful violations of Section 10(b) of the Exchange Act give rise to statutory disqualification. *See* 15 U.S.C. § 78c3(a)(39)(F).

[315] *United States v. Aaron*, 446 U.S. 680, 697–99 (1980).

[316] *SEC v. Morgan Keegan & Co.*, 678 F.3d 1233, 1244 (11th Cir. 2012).

For the third cause of action, pleaded alternatively to the first and second causes, Enforcement must establish by a preponderance of the evidence that Respondents engaged in conduct inconsistent with just and equitable principles of trade by obtaining money from the public for the 2015 Bridge Loan Note Offering by means of material misrepresentations and omissions of fact regarding those investments.

Having found that Respondents possessed scienter when making the fraudulent solicitations for investments in the 2015 Bridge Loan Note Offering, the Panel concludes that Respondents also violated FINRA Rule 2010 by violating Sections 17(a)(2) and (3) of the Securities Act, requiring the lesser included element of negligence in making misrepresentations and omissions of material facts.

Thus, the Panel finds that Enforcement has met its burden of proving by a preponderance of the evidence that Respondents engaged in the fraudulent misconduct as alleged in each of the first three causes of action.

VII. Smith's Estoppel Claim

Smith argues that FINRA should be estopped from proceeding against him for failing to register as a principal or representative, arguing that he disclosed his ownership interest in CSSC and CSSC's ownership of the Firm when it filed its membership application in 2006. Based on the disclosures, his request to be exempt from registration requirements was granted.[317] Onsite examinations of CSSC B/D were completed in 2007 and 2011 and FINRA did not raise any questions about the roles he played as CEO and chairman of the parent company and his interactions with the Firm.[318]

Given these facts, Smith contends, FINRA should be equitably estopped from now asserting jurisdiction over him and pursuing disciplinary action for his failure to register.[319] Smith cites one federal case in support of his estoppel claim, relying on its finding that under federal case law a party may be estopped from seeking relief when it has made a misrepresentation of fact to another party, reasonably expecting the other party to rely on it, and the other party does so, to its detriment.[320] In essence, Smith claims that since FINRA approved the Firm's membership application without requiring him to register as a principal or representative, and failed to question his role in the Firm's business after conducting two routine examinations, FINRA may not now assume jurisdiction over him and sanction him for failing to register. Smith's contentions are without merit.

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[317] Smith's Initial Post-Hr'g Br., at 6.

[318] *Id.* at 7.

[319] *Id.* at 12.

[320] *Id.* at 12 (citing *Kosakow v. New Rochelle Radiology Assoc., P.C.*, 274 F.3d 706, 725 (2d Cir. 2001)).

The single case he cites is inapposite. FINRA made no misrepresentation to Smith, an essential prerequisite for triggering estoppel under the authority of the case.

Furthermore, two of the exhibits he filed in advance of the hearing are examination reports FINRA provided him after the two routine examinations, and both put him on notice that the examinations focused on specific aspects of the Firm's business and therefore should not be interpreted as relieving the Firm from complying with all applicable rules. The first states that the examination "sampled selected aspects" of the Firm's operations.[321] The second explained that the 2011 examination was "not an audit" and did not relieve Firm management from the obligation to conform to all "appropriate securities rules and regulations."[322]

In asserting his estoppel claim, Smith attempts to transfer responsibility for his failure to comply with FINRA's registration requirements from the Firm and himself, where it belongs, to FINRA, on the improper assumption that he did not need to register unless FINRA first discovered he was acting in registered capacities and told him so. The SEC has held that FINRA is not estopped from taking action later just because it did not do so immediately after an investigation, and a previous failure to sanction misconduct does not excuse a respondent's failure to comply with the requirements of applicable rules.[323]

VIII. Sanctions

A. Respondent Smith

1. Fraud – First Cause of Action

Characterizing Smith's intentional or reckless fraudulent omissions and misrepresentations in the sales of the 2015 Bridge Loan Notes charged in the first cause of action as egregious, Enforcement recommends imposing a bar. Enforcement cites as aggravating factors that Smith fraudulently solicited investments in the notes for prolonged period, from June through December 2015; obtained $130,000 from four investors and has not repaid them; was motivated by monetary gain; has not accepted responsibility for his actions; and apparently does not appreciate that his acts were wrongful.[324]

FINRA's Sanction Guidelines ("Guidelines") instruct adjudicators that the "overriding purpose of all disciplinary sanctions is to remedy misconduct and protect the investing public."[325] The Guideline pertaining to an individual's sales practice violations involving

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[321] RX-8, at 1.

[322] RX-14, at 3.

[323] *Dep't of Enforcement v. The Dratel Group, Inc.*, No. 2009016317701, 2015 FINRA Discip. LEXIS 10, at *43 (NAC May 6, 2015), *aff'd*, Exchange Act Release No. 77396, 2016 SEC LEXIS 1035 (Mar. 17, 2016) (citing *W.N. Whelen & Co.*, 50 S.E.C. 282, 284 (1990)).

[324] Enforcement's Post-Hr'g Br., 20–21.

[325] FINRA Sanction Guidelines at 10 (2018), http://www.finra.org/industry/sanction-guidelines.pdf.

fraudulent misrepresentations and omissions of fact recommends that adjudicators strongly consider imposing a bar.[326]

With these precepts in mind, the Panel finds there are significant aggravating factors under the Guidelines applicable to this case. First, the evidence that Smith acted intentionally is strong.[327] He knowingly concealed the fact that CSSC was unable to repay principal to participants in the 2010 Bond Offering and the 2014 Bridge Loan Note Offering. He knew his representations about the imminent finalization of lucrative consulting contracts with SDTC and the City of Jacksonville were unfounded, and he either knew or was reckless in not knowing that CSSC had not earned half of a million dollar consulting fee through Project X.

Second, Smith made his fraudulent solicitations to multiple potential investors over an extended period.[328]

Third, his goal was monetary gain for himself and CSSC.[329]

Fourth, despite the convincing evidence of the exclusive control he exercised over the creation and marketing of the 2015 Bridge Loan Note Offering, Smith strongly denies any personal responsibility.[330]

Finally, his fraudulent solicitations for the 2015 Bridge Loan Note Offering resulted in financial loss to investors whom he has not repaid.[331]

The Panel finds no mitigating factors present. We therefore bar Smith from associating with any FINRA member firm in any capacity for his fraudulent sales practices as alleged in the first cause of action.

In addition to imposing the bar, because the Panel has found that Smith's intentional and reckless fraudulent solicitations resulted in identifiable financial harm to four people, we order him to pay restitution to the purchasers of the 2015 Bridge Loan Notes, with interest.

2. Fraud – Second and Third Causes of Action

For the negligent fraudulent solicitations charged alternatively in the second cause of action, the applicable Guideline recommends a fine of $2,500 to $73,000, and consideration of suspension in any and all capacities for 31 calendar days to two years. This Guideline also

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[326] Guidelines at 89.

[327] Guidelines at 8 (Principal Consideration No. 13).

[328] Guidelines at 7 (Principal Consideration No. 9).

[329] Guidelines at 8 (Principal Consideration No. 16).

[330] Guidelines at 7 (Principal Consideration No. 2).

[331] Guidelines (Principal Consideration No. 11).

applies to the third cause of action, charging conduct inconsistent with just and equitable principles of trade in obtaining money by fraudulent means.[332]

In the Panel's view, many of the aggravating factors we considered in connection with the first cause of action are also relevant to the second and third causes of action. Even without the element of intentionality, the Panel finds Smith's misconduct egregious because he acted without regard to the interests of those he solicited to invest in the 2015 Bridge Loan Note Offering. This was evident in the cavalier manner in which he dismissed the request of investor TL, holder of a $50,000 note who, when his confidence in Smith was shaken, asked for a refund. Smith bluntly refused TL's request, saying "there is no present ability to provide you with a 'refund'" and continued to claim, without foundation, that there was little "if any" risk to Note holders because CSSC's assets "far exceed" its debts.[333] Smith's persistence in soliciting investors to purchase 2015 Bridge Loan Notes even after he fired Southwick on September 8, 2015, also illustrates disregard for his ethical obligations to investors. By then Smith had no doubt that Project X was a sham, and he knew there were no prospects of large scale profits from consulting agreements with SDTC or the City of Jacksonville. Yet Smith continued to solicit investors with offering materials touting the "Pending Strategic Relationship" with SDTC and the "pending engagement with the City of Jacksonville."[334] Subsequently investor BB purchased his six-month note on September 29 and Clarkson invested $50,000 in a six-month note on November 13, 2015.[335]

Having imposed a bar on Smith for the first cause of action, the Panel finds it unnecessary to impose additional sanctions for the second and third causes of action. Were we to impose sanctions for the negligence-based violations alleged in the second cause of action or the ethics-based allegations in the third cause of action, however, we would impose a bar upon Smith in all capacities, and order him to pay restitution with interest to the four investors in the 2015 Bridge Loan Note Offering.

3. Registration – Fourth and Fifth Causes of Action

For registration violations, the Guidelines recommend a fine of $2,500 to $73,000 and a suspension in any or all capacities for up to six months, or, in egregious cases, up to two years or a bar. The Principal Considerations in Determining Sanctions are whether a respondent has filed a registration application, and the nature and extent of the unregistered person's responsibilities.[336]

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[332] Guidelines at 89 n.3.

[333] CX-11, at 1.

[334] CX-18, at 8–9.

[335] CX-27.

[336] Guidelines at 45.

Enforcement seeks a bar for Smith's registration violations.[337]

The Panel concurs with Enforcement's characterization of Smith's registration violations as egregious. They occurred over the entire relevant period, from May 2010 through 2015.[338] During that time, Smith, acting in the capacity of a representative, solicited CSSC B/D customers—personally and through the Firm's brokers—to invest in a series of bonds and notes. He asked registered representatives to find interested investors among their customers, and then personally met with a number of them to solicit their investments, sometimes successfully, other times not.

Acting in the capacity of a principal, Smith involved himself in the management of CSSC B/D in several important ways. He determined how the co-presidents would manage the Firm. He held regular meetings attended by employees and affiliated persons, including registered representatives and registered investment advisors. He recruited new hires and set the terms of their employment. He decided whom to fire. He oversaw the finances of CSSC's subsidiaries, channeling funds from the RIA to the Firm to maintain minimum net capital for CSSC B/D. He responded to concerns of the auditors monitoring the Firm's finances. He responded to customer complaints.

In sum, the evidence leads the Panel to conclude that Smith chose intentionally not to register in an attempt, successful for years, to conduct business through CSSC B/D while avoiding the appearance of doing so.[339] Smith's claim of exemption from the registration requirements permitted him to act as a registered representative and a principal with no oversight while he made his solicitations to benefit himself and CSSC.[340] He has not accepted responsibility for failing to register.[341]

Having imposed a bar for Smith's fraudulent sales practices, the Panel finds it unnecessary to impose additional sanctions for his registration violations. Were we to do so, we would deem it appropriate to impose separate suspensions of one year in all capacities, and fines of $50,000 each, for his violations of the registration requirements as charged in the fourth and fifth causes of action.

B. CSSC B/D

1. Fraud – First Three Causes of Action

As noted above, CSSC B/D, through Smith, participated in the intentional fraudulent solicitations of securities charged in the first three causes of action. As with Smith, the Panel

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[337] Enforcement's Post-Hr'g Br., at 44.

[338] Guidelines at 7 (Principal Consideration No. 9).

[339] Guidelines at 8 (Principal Consideration No. 13).

[340] Guidelines at 8 (Principal Consideration No. 16).

[341] Guidelines at 7 (Principal Consideration No. 2).

finds that imposing appropriately remedial sanctions against the Firm for the first cause of action makes it unnecessary to impose additional sanctions for the second and third causes of action. We find that all of the aggravating factors applicable to Smith also apply to CSSC B/D. We are mindful, however, of Enforcement's observation that the Firm has no history of discipline or compliance issues, and the Firm's participation in Smith's fraudulent solicitations of the 2015 Bridge Loan Note Offering was not reflective of its compliance record.

Accordingly, the Panel agrees with Enforcement that the appropriately remedial sanctions for the Firm's fraudulent misconduct are a suspension from participating in private securities offerings for one year, and a fine of $100,000. In addition, the Firm shall pay restitution, jointly and severally with Smith, to the four investors in the 2015 Bridge Loan Note Offering, with interest.

Were we to impose sanctions for the second or third causes of action, we would, again in agreement with Enforcement's recommendations, impose a suspension from participating in private offerings for 90 days, and a fine of $73,000.

2. Registration – Fourth and Fifth Causes of Action

The Guidelines recommend a suspension of up to 30 business days and a fine of $2,500 to $73,000 for a firm's violations of registration requirements.[342] As with Smith, we find the length of time the Firm failed to register Smith to be an aggravating factor. An additional aggravating factor is that Smith, by recommending and selling the 2010 Bond Offering, the 2014 Bridge Loan Note Offering, and the 2015 Bridge Note Loan Offering, acted as an associate of the Firm. He had access to the Firm's customer base, which he exploited to make his fraudulent solicitations.

For these reasons, we concur with Enforcement's recommendation and impose a fine of $20,000 on CSSC B/D for the registration violations charged in the final two causes of action.[343]

IX. Order

For knowingly or recklessly misrepresenting and omitting to disclose material facts in connection with the sales of securities, in willful violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, as alleged in cause one, Respondent Eric S. Smith is barred from associating with any FINRA member firm in any capacity, and Respondent CSSC Brokerage Services, Inc., is suspended from participating in private securities offerings in all capacities for one year and fined $100,000.

For knowingly or recklessly misrepresenting and omitting to disclose material facts in connection with the sales of securities, in violation of Sections 17(a)(2) and (3) of the Securities

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[342] Guidelines at 45.

[343] Tr. 1447; Enforcement's Post-Hr'g Br., at 43-44.

Act of 1933, and FINRA Rules 2020 and 2010, the panel finds it unnecessary to impose any additional sanctions in light of the bar.

For actively engaging in the conduct of the Firm's securities business in the capacities of a principal and a representative, supervising registered representatives, and soliciting sales of securities without being registered, in violation of NASD Rules 1021 and 1031, and FINRA Rule 2010, as alleged in the fourth and fifth causes of action, the Extended Hearing Panel finds it unnecessary to impose any additional sanctions against Smith in light of the bar already imposed. For the Firm's failure to register Smith as a representative and as a principal, as charged in the fourth and fifth causes of action, we impose a fine of $20,000.

Respondents shall be jointly and severally responsible for paying restitution as ordered. We also order Respondents, jointly and severally, to pay the costs of this proceeding, $12,107.09, which includes the cost of the hearing transcript and a $750 administrative fee.[344]

If this decision becomes FINRA's final disciplinary action, Respondent Smith's bar shall become effective immediately, and Respondent CSSC's suspension shall become effective with the opening of business on Monday, March 4, 2019, and end at the close of business on March 3, 2020. Restitution, fines, and costs shall be payable on a date set by FINRA, but not sooner than 30 days after this decision becomes FINRA's final disciplinary action.[345]

Matthew Campbell
Hearing Officer
For the Extended Hearing Panel

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[344] Restitution is owed to the following persons, plus interest at the rate set forth in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), until the date that restitution is paid: customer TL, $50,000, with interest accruing from August 24, 2015; Thomas Scotto, $20,000, with interest accruing from August 31, 2015; customer BB, $10,000, with interest accruing from September 29, 2015; Gavin Clarkson, $50,000, with interest accruing from November 13, 2015. If Respondents are unable to locate a customer, the Firm must provide Enforcement with proof that it has made a bona fide attempt to locate the customer. Any restitution Respondents are unable to pay to a customer must be paid to FINRA (without interest) as a fine. Customers BB and TL are identified in Enforcement's Schedule of Abbreviations and References in its Complaint filed in this matter on November 14, 2017. Restitution shall be paid jointly and severally with the Firm.

[345] The Extended Hearing Panel considered and rejected without discussion all other arguments by the parties.

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