

BEFORE THE NATIONAL ADJUDICATORY COUNCIL
FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of

Department of Enforcement,

Complainant,

vs.

Eric S. Smith
Troy, MI,

Respondent.

DECISION

Complaint No. 2015043646501

Dated: September 18, 2020

Respondent fraudulently misrepresented and omitted material facts in connection with the sale of securities and failed to register as a general securities representative and principal despite engaging in conduct requiring registration. Held, findings affirmed and sanctions affirmed in relevant part.

Appearances

For the Complainant: Kathryn S. Gostinger, Esq., Roger J. Kiley, Esq, Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: Robert Knuts, Esq.

Decision

Eric S. Smith appeals an Extended Hearing Panel (“Hearing Panel”) decision. The Hearing Panel found that Smith fraudulently made material misrepresentations and omissions of fact in offering documents, in willful violation of the federal securities laws and FINRA rules. The Hearing Panel barred Smith from associating with any FINRA member in any capacity for this misconduct and ordered that he pay, jointly and severally with his firm, \$130,000 in restitution to four investors.

The Hearing Panel also found that Smith actively engaged in the conduct of his firm’s securities business in the capacities of a general securities principal and representative without being registered, in violation of NASD and FINRA rules. In light of the bar for Smith’s fraud, the Hearing Panel assessed, but did not impose, additional sanctions for Smith’s registration violations.

After a thorough review of the record, we affirm the Hearing Panel's liability findings and the bar and restitution ordered for Smith's fraud. We, however, modify the Hearing Panel's assessed sanctions for Smith's registration violations. For acting as an unregistered principal, we increase the fine from \$50,000 to \$75,000 and the suspension in all capacities from one year to two years. For acting as an unregistered general securities representative, we affirm the Hearing Panel's recommended \$50,000 fine and one-year concurrent suspension in all capacities. Like the Hearing Panel, we decline to impose the sanctions for the registration violations in light of the bar imposed for Smith's fraud.

I. Background

Smith founded the financial services company, Consulting Services Support Corporation ("CSSC") in 1998. CSSC is not a FINRA member. Smith is CSSC's chairman, chief executive officer, and majority owner. Prior to founding CSSC, Smith practiced law in private practice and later worked for a broker-dealer named North American Financial, as its chief operating officer. Smith has never registered with FINRA.

CSSC is the parent company of several wholly owned subsidiaries, including CSSC Brokerage Services, Inc. ("CSSC BD"), as well as a registered investment advisor ("RIA") and an insurance business. CSSC BD's registered representatives became affiliated with all the various CSSC entities through an affiliation agreement that Smith required. CSSC and its subsidiaries, including CSSC BD and RIA, occupied the same office suite in Troy, Michigan. CSSC BD leased office space from CSSC.

CSSC BD became a FINRA member in 2006 and terminated its registration in 2018. As part of CSSC BD's application for FINRA membership, Smith attested that he was exempt from registration pursuant to NASD Rule 1060 because he would not be actively engaged in the management of the firm's securities business. Keith Frye, who Smith knew from North American Financial, was the initial president and chief compliance officer ("CCO") of CSSC BD. After Frye left the firm, Smith appointed Jennifer LaRose and Alex Martin as CSSC BD's co-presidents, and he also made LaRose its CCO.¹

The conduct at issue in this case occurred from 2010 through 2015, while CSSC BD was a FINRA member.

II. Procedural History

During a routine examination of CSSC BD in 2015, FINRA's Department of Member Regulation found that Smith appeared to be acting as a general securities representative and principal of the firm without being registered. Around this time, a former CSSC employee,

¹ Smith also knew LaRose and Martin from their time working at North American Financial. Martin worked for CSSC RIA before joining CSSC BD as a registered representative. LaRose joined CSSC BD in 2006 as a general securities principal.

Donald Southwick, complained to FINRA that two of his customers had not received interest and principal payments for certain investments offered through CSSC BD. One of these customers also complained to FINRA directly. These matters were referred to FINRA's Department of Enforcement ("Enforcement") for further investigation.

After concluding its investigation, Enforcement began disciplinary proceedings on August 4, 2017, when it filed a five-cause complaint alleging that Smith and CSSC BD engaged in misconduct for which FINRA should impose sanctions. The first three causes of action involve a bridge loan note offering that Smith issued in 2015 ("2015 Bridge Loan Note Offering") to address CSSC's deteriorating financial condition. Cause one alleged that Smith and CSSC BD fraudulently misrepresented or omitted material facts in connection with the 2015 Bridge Loan Note Offering, in willful violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 10b-5, and FINRA Rules 2020 and 2010.² Enforcement pleaded the second and third causes of action as alternatives to cause one. Cause two alleged that Smith and CSSC BD acted negligently when they made the fraudulent misrepresentations and omissions, in violation of Sections 17(a)(2) and (a)(3) of the Securities Act of 1933 ("Securities Act"), and FINRA Rule 2010. Cause three alleged that Smith and CSSC BD violated FINRA Rule 2010 because they failed to adhere to just and equitable principles of trade by making unethical misrepresentations and omitting to disclose material facts to investors.

Causes four and five of the complaint involve Smith's active involvement in CSSC BD's securities business without maintaining the proper securities registrations. Enforcement alleged that Smith and CSSC BD violated NASD Rules 1021 and 1031 and FINRA Rule 2010 by failing to register Smith as a general securities representative and principal of CSSC BD.

In their answer, CSSC BD denied all involvement in the 2015 Bridge Loan Note Offering, and Smith denied making any false statements or omissions in the 2015 Bridge Loan Note Offering documents. Smith and CSSC BD also denied violating the registration rules, asserting that FINRA does not have jurisdiction over Smith and therefore he was never required to be registered as a representative or a principal. As discussed in detail below, we agree with the Hearing Panel's findings that FINRA has jurisdiction over Smith to bring this disciplinary action against him and that Smith was required to register.

After conducting an eight-day hearing, the Hearing Panel found that Smith and CSSC BD engaged in the alleged misconduct. For knowingly or recklessly misrepresenting and failing to disclose material facts in connection with the sales of securities, in willful violation of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, as alleged in cause one, the Hearing Panel barred Smith from associating with any FINRA member firm in any capacity. The Hearing Panel suspended CSSC BD from participating in private securities offerings in all capacities for one year and fined the firm \$100,000. The Hearing Panel also ordered that Smith

² The conduct rules that apply in this case are those that existed at the time of the conduct at issue.

and CSSC BD be held jointly and severally liable for paying \$130,000 in restitution to four affected investors.

For Smith's acting in the capacities of a principal and a representative 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 Hearing Panel assessed, but declined to impose, any additional sanctions in light of the bar already imposed. For CSSC BD's failure to register Smith as a representative and principal, the Hearing Panel fined the firm \$20,000.

Smith timely appealed the Hearing Panel's decision. CSSC BD did not appeal, and the Hearing Panel's decision is final with respect to the firm.

III. Facts

A. CSSC's Efforts to Raise Cash Through Offerings in 2010 and 2014

In the wake of the 2008 financial crisis, CSSC's revenues dropped because of a reduction in investment advisory fees earned by its RIA subsidiary. Smith and CSSC undertook multiple efforts to raise cash to bolster CSSC's faltering financial condition. In 2010, Smith and CSSC issued a convertible debenture bond offering ("2010 Bond Offering"), hoping to raise \$5 million to satisfy financial obligations. The offering raised only \$2.45 million. In 2014, Smith and CSSC began offering "bridge loan notes" ("2014 Bridge Loan Note Offering") to garner additional funds to cover operational losses. This offering raised approximately \$1.1 million. That amount proved insufficient as CSSC continued losing money. To address CSSC's ongoing financial decline, Smith initiated CSSC's issuance of the 2015 Bridge Loan Note Offering, which is the subject of the first three causes of action in Enforcement's complaint.

1. The 2010 Bond Offering and Smith's Role

It was Smith's decision to conduct the 2010 Bond Offering. The intended use of the proceeds was to retire short-term debt of \$1.4 million, including \$480,000 in short-term promissory notes that were due. CSSC also needed money to pay \$160,000 in deferred salaries and \$140,000 in legal fees. The offering document stated that the bonds were unsecured, had a five-year maturity date, offered an annual interest rate of eight percent, and permitted buyers to convert the bonds to CSSC common stock.

The offering document stated that CSSC had "no plans to use the services of registered representatives to act as agents of [CSSC] in selling the Bonds," and no brokerage commissions or fees would be paid to them. Because it was assumed that CSSC BD would not be marketing or selling the 2010 Bond Offering, the firm established no parameters for its registered representatives' marketing or selling of this investment. CSSC BD's representatives, however, did sell the 2010 Bond Offering to their customers, and Smith provided these representatives with the offering documents in order to do so. CSSC BD's representatives also introduced Smith directly to their customers for him to sell the 2010 Bond Offering directly to those customers.

For example, Martin introduced customer SK to the 2010 Bond Offering, but Smith finalized the \$375,000 investment. Southwick also introduced Smith to several his CSSC BD customers, who then invested in the 2010 Bond Offering. These customers included: JM who was approximately 88 years old at the time she invested \$300,000; DN who invested \$400,000; PK who invested \$100,000; DG who invested \$200,000; and SM who invested \$20,000. Some investors in the 2010 Bond Offering used funds from their CSSC BD accounts to invest in the 2010 Bond Offering.

From March 2010 through March 2014, CSSC and Smith raised a total of \$2.45 million through the 2010 Bond Offering.

2. The 2014 Bridge Loan Note Offering and Smith's Role

After conducting the 2010 Bond Offering, CSSC's business continued to struggle; the firm lost approximately \$803,000 in 2012 and \$883,000 in 2013. CSSC could not meet its day-to-day obligations without additional outside funding. As CSSC had done in the past, it deferred payments of salaries, commissions, and advisory fees to employees and affiliates. To cover ongoing losses, CSSC conducted the 2014 Bridge Loan Note Offering. This offering consisted of one-year, unsecured promissory notes bearing simple interest at eight percent. Buyers were promised 1,000 shares of CSSC common stock from Smith's holdings for every \$100,000 invested.

Smith made Southwick aware of the 2014 Bridge Loan Note Offering, and Southwick then sold it to his customers, including SM and JM, who also had invested in the 2010 Bond Offering. Smith specifically asked Southwick whether JM, who had invested \$300,000 in the 2010 Bond Offering, would also invest in the 2014 Bridge Loan Note Offering. Southwick testified that Smith told him not to recommend the investment, but rather to make his customers "aware" of the offering and to tell them he would "see if it could be made available," which Southwick referred to as his "script." CSSC and Smith raised approximately \$1.1 million in the 2014 Bridge Loan Note Offering, including \$550,000 from JM, who was approximately 90 years-old at the time.³ JM initially invested \$100,000 in the 2014 offering, but made subsequent investments after Smith asked Southwick whether JM would invest more. Southwick "made her aware" that more notes were available, which led to her additional \$450,000 investment.

CSSC and Smith raised most of the money in the 2014 Bridge Loan Note Offering from Southwick's CSSC BD customers. While Southwick received no compensation for these sales, Smith expressed their importance to him. Southwick knew the offering's success was integral to whether Smith could pay Southwick his salary as CSSC continued to suffer financial difficulties.

³ In April 2017, Southwick settled a disciplinary action with FINRA. Southwick consented to findings that he made unsuitable recommendations to his customers to invest in the 2010 Bond Offering and 2014 Bridge Loan Note Offering without conducting reasonable due diligence and by relying upon a sales script that CSSC provided. Southwick was suspended from FINRA membership for six months in all capacities.

B. CSSC's Ongoing Financial Instability in Advance of the 2015 Bridge Loan Note Offering

CSSC's financial problems persisted into 2015 following the 2014 Bridge Loan Note Offering. Indeed, CSSC had a net loss of \$944,000 in 2014. Smith was keenly aware of the company's financial struggles at the time of the 2015 offering.

For example, in December 2014, American Express started declining charges on the CSSC company credit card after four successive months in which the company's payments were more than thirty days past due. Smith and Southwick were traveling on business at the time, and Smith was worried that he and Southwick might be "stranded" because American Express was declining the charges that they had incurred. While traveling, Smith emailed CSSC's assistant controller, MD, about the immediacy of the financial strain facing CSSC. MD informed Smith that CSSC BD "desperately needs to be paid the \$20,000 that it is owed from the RIA for December." MD highlighted that CSSC BD was "only \$874 over the notification threshold" when it would fall below its minimum net capital requirement. MD explained that because CSSC BD owed CSSC more than \$83,000 for the December 2014 rent, CSSC BD would fail to maintain its required level of net capital unless CSSC offset the rent with other revenue. Smith acknowledged that CSSC already had "missed payroll" and that offsetting the rent payment would leave CSSC unable to make payroll again. MD further explained to Smith that she was unable to make an \$11,000 past due payment that Smith had asked her to send Ken Wheeler, a CSSC affiliate with CSSC BD and RIA, who needed the funds to pay insurance premiums.

In addition, in February 2015, CSSC's auditor alerted Smith that the company's accumulated deficit had surpassed \$10 million at the end of 2014. The auditor also questioned whether CSSC BD could continue as a going concern and noted that CSSC BD would have been net capital deficient without the monthly \$20,000 "stipends" it received from CSSC RIA. The auditor noted that CSSC's group of entities suffered losses of \$803,000, \$883,000, and \$944,000 in 2012, 2013, and 2014, respectively. The auditor highlighted that CSSC "continues to experience difficulty in meeting its day-to-day obligations without significant outside funding."

In May and June 2015, principal began to become due to investors in the 2010 Bond Offering and the 2014 Bridge Loan Note Offering. When Smith began the 2015 Bridge Loan Note Offering, CSSC owed \$635,000 to investors in the prior offerings. Smith knew that CSSC was unable to pay these investors. Smith, however, believed that CSSC would be current on its obligations to these investors by August 2015, and he did not disclose in the 2015 Bridge Loan Note Offering materials CSSC's inability to pay its investors in these prior offerings.

At the end of June 2015, CSSC BD's co-president, Martin, recognized CSSC's need for cash and extended to CSSC a loan of \$50,000 at eight percent interest to be paid back in 30 days. CSSC, however, did not repay Martin when the principal became due. In August 2015, Martin demanded at least partial payment from CSSC. While CSSC repaid Martin approximately \$7,500 by August 10, 2015, the balance remained unpaid as of the date of the hearing in this matter.

C. The 2015 Bridge Loan Note Offering

Smith sought to address CSSC's financial woes by issuing more debt securities, in the form of the 2015 Bridge Loan Note Offering. The terms of this offering were essentially the same as those of the 2014 Bridge Loan Note Offering, including Smith's promise to give investors 1,000 shares of his own CSSC stock for every \$100,000 invested.⁴ The offering documents, which Smith drafted and disseminated, consisted of a "Confidential Report" and an "Important Memorandum," each of which went through several iterations. Smith's omissions and misrepresentations in the 2015 Bridge Loan Note Offering documents form the basis of the Hearing Panel's findings that Smith committed fraud.

1. Smith's Failure to Disclose CSSC's Inability to Pay Prior Investors

Smith failed to disclose in the 2015 Bridge Loan Note Offering documents that CSSC was unable to pay substantial sums to the investors in the 2010 Bond Offering and 2014 Bridge Loan Note Offering. When Smith commenced the 2015 Bridge Loan Note Offering in June 2015, CSSC owed more than \$200,000 to the 2010 investors and \$300,000 to the 2014 investors. Smith admittedly was aware that CSSC was unable to pay those investors what they were owed. Smith acknowledged in his hearing testimony that, when he was soliciting investments in the 2015 Bridge Loan Note Offering, he was aware of CSSC's financial condition at the time and that he knew CSSC was unable to pay interest and principal to investors in the 2010 Bond Offering and 2014 Bridge Loan Note Offering.

⁴ Regarding the stock, the 2015 Bridge Loan Note terms stated that investors

will also receive 1,000 shares of CSSC common stock for every \$100,000 loaned (and proportionally more and less for greater and lesser loan amounts). These shares will **not** be coming from the Company, but from the personal holdings of Eric Smith, CSSC's Founder, Chairman, and Chief Executive Officer. He is giving these shares as an expression of his gratitude for the important help being provided by these loans. Although the value of CSSC's common stock has not been professionally evaluated, the latest Company transaction involving such shares occurred on April 30, 2012, when 11 CSSC Bondholders converted their Bonds to common stock at \$20 per share.

Although these bridge loan Notes are not "convertible," the Company is currently planning an offering of CSSC common stock to provide an opportunity for the holders of CSSC debt instruments, including these bridge loan Notes and CSSC Bonds (from a prior offering), to acquire CSSC common stock in exchange for all or part of their CSSC Bonds or bridge loan Notes. The Company plans to initiate this new Offering sometime within the third quarter of 2015.

2. Smith Misrepresented Facts Related to Project X

In November 2014, CSSC affiliate and registered representative Wheeler was looking for novel investment ideas to present to SB, a wealthy client and cardiologist who had a large network of contacts with other physicians. Wheeler, who also was an estate planner in Florida, provided estate planning services for SB. Wheeler approached Southwick for advice on what investments he might recommend. Southwick suggested he could “build a bank” in which SB could invest. Southwick had a background in commercial banking and previously had participated in the creation of a nationally chartered special purpose bank. Southwick understood SB to have enough wealth to provide the necessary capital to enable a new bank to obtain regulatory approval.

Wheeler told Southwick that SB had expressed “extreme excitement” and was “very interested in building a bank.” SB insisted on keeping the project confidential, and they referred to the undertaking as “Project X.” Wheeler informed Southwick that he alone would handle contact with SB.

Southwick told Smith about Project X soon after he and Wheeler began discussing it. Wheeler made clear that he did not want Smith participating in Project X, but Southwick continued to inform Smith about what was happening. Southwick explained that the Office of the Comptroller of the Currency (“OCC”), as well as other bank regulators, would have to approve the bank’s charter. Southwick contacted a lawyer with whom he had worked to establish a special purpose bank in 1996 to ask for legal guidance. On November 9, 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.

On November 11, 2014, Southwick made a presentation regarding Project X to CSSC affiliates in a weekly meeting held at CSSC’s office in Michigan, and Southwick shared all this information with Smith. In the presentation, Southwick described Project X in broad terms and provided a lengthy list of tasks that would have to be completed to form a national bank. 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. Southwick testified that all of this information, including a consulting fee for CSSC of \$1 million “initially paid up front with [equity firm] funds,” was “[p]rospective” and there were “no [p]lans or agreements,” “assets under management,” or any “entity created.”

Southwick and Wheeler both testified that, at the time, they understood that chartering the bank would be a long and arduous process and that success was far from assured. Southwick explained that virtually everything with Project X was suppositional, “not firm.” Southwick had no idea if bank regulators would allow CSSC or the private equity firm to share ownership in the bank; he had no information on whether OCC would approve the project; he had not spoken to any of the OCC representatives; and had not yet attempted to contact individuals at the private equity firm nor made a proposal to them. Importantly, no consulting agreement ever existed. Southwick testified that sometime around March 2015, he contacted the private equity firm, and it was not interested in Project X. According to Southwick, getting approval for the bank would be a “huge, monumental task,” and would take one to two years.

Notwithstanding the tentative and inconclusive status of Project X, Smith featured it prominently in the offering materials for the 2015 Bridge Loan Notes Offering. In the June 15, 2015 Confidential Report, Smith represented that **“CSSC is being paid a \$1 million consulting fee for its work on the design and formation of this new Bank, the payment of which will ensure CSSC’s profitability in 2015.”** He further wrote:

One-half of that fee has now been earned and should be received very soon. The remainder will be due and payable when this new bank opens its doors for business, an event we expect to occur prior to the end of the 3rd quarter of 2015. For each additional bank of this type that CSSC helps to create, CSSC will receive an additional consulting fee, declining by \$200,000 for each new bank created, with consulting fees ending with the 5th such Special Purpose Bank formed. CSSC expects to receive the full consulting fee for the first Bank during 2015, plus at least one half of the consulting fee for the second Special Purpose Bank amounting to \$400,000 during 2015, for a total bank design-related consulting fee-income to CSSC of \$1.4 million in 2015.

Smith went on to state in the offering materials that CSSC’s receipt of the \$1.4 million consulting fees “should ensure that 2015 is not only profitable, but also that it will be the most profitable year in CSSC’s history.”

In the July 12, 2015 Important Memorandum, Smith highlighted the special purpose bank as foremost among several CSSC’s “important new initiatives.” Specifically, in the section “Important Disclosures in the Accompanying ‘Confidential Report,’” Smith again represented that **“CSSC is being paid a \$1 million consulting fee for its work on the design and formation of this new Bank, the payment of which will ensure CSSC’s profitability in 2015.”** He added that this project would **“likely make 2015 CSSC’s most profitable year so far.”**

Wheeler testified that contrary to Smith’s representations in the offering documents as of June 2015, the special purpose bank was far from being in the final stages. The project organizers were “nowhere close” to creating a special-purpose bank. CSSC had no arrangement in place to be paid a consulting fee for the project nor was there work done or contemplated toward a second bank. Wheeler described Smith’s representations about Project X in the offering materials as “delusional.” When asked at the hearing whether he believed, at the time of the 2015 Bridge Loan Note Offering, that the bank would be opening its doors for business in the third quarter of 2015, Wheeler answered, “Absolutely not.” Wheeler explained that they first had to form the financial services entity and prove the concept to the regulators. They then had to apply for the bank’s charter, which may not have been granted. Wheeler surmised that they “were looking probably at a year or more in June of 2015 to accomplish all of that.”

When Smith made these representations in the offering documents, he was aware of challenges involved with Project X coming to fruition. At the hearing, Smith admitted that he knew when he drafted the offering documents that only three banks in the previous five years had received national charters. Smith also admitted he never reviewed or approved any

consulting agreement. He also never saw any evidence of an agreement by which CSSC would be paid a \$1 million consulting fee. And despite his representation in the offering documents that “[o]ne-half” of the \$1 million fee “had been earned and should be received very soon,” Smith admitted “[w]e did not know exactly the triggering event of when the payment” would be made. Smith testified that it was his “expectation” that CSSC would be paid based on what Southwick had told him. Smith admitted, however, that he never received any documentation from Southwick evidencing that CSSC would be paid any fee. Smith also had no conversations with the private equity firm purportedly involved with Project X about the payment of the consulting fee.

3. Smith Misrepresented CSSC’s Business with the South Dakota Trust Company

In the June 15, 2015 Confidential Report, Smith claimed that he and Southwick were working on establishing an “important new strategic alliance with South Dakota Trust Company (‘SDTC’).” Smith claimed that CSSC was helping SDTC create a range of new investment funds for which CSSC “will be the investment advisor” and for which CSSC “will earn a fee based on a percentage of the assets under management.” Smith also claimed he was forming “a client referral relationship with SDTC” whereby SDTC clients “would be referred to CSSC for a range of financial services that SDTC does not currently offer.” Smith further asserted in the Confidential Report:

With over \$80 Billion of investment assets of wealthy families across the country in SDTC administered trust accounts, the revenue and profit potential from client referrals to CSSC could be quite substantial. . . . [T]he Company [CSSC] expects to have both of these potentially important new revenue sources up and running before the end of calendar year 2015.

These representations, however, were largely baseless. In March 2015, based on an introduction provided by a CSSC affiliate who was on SDTC’s board of directors, Southwick and Smith had met with representatives of SDTC to discuss a possible referral agreement. At the meeting, SDTC emphasized that CSSC was not to disclose the prospective relationship to avoid jeopardizing SDTC’s relationships with other investment professionals. As of June 2015, Smith knew there was no client referral agreement in place between CSSC and SDTC and that CSSC was not about to become the advisor for any SDTC funds. Nevertheless, Smith disregarded SDTC’s request for confidentiality and touted the prospective relationship with SDTC in the offering documents for the 2015 Bridge Loan Note Offering.

In July 2015, a planned follow-up meeting with SDTC’s chief executive officer never materialized.⁵ And, in reality, CSSC never became the investment advisor to any SDTC funds, nor did it enter into a client referral agreement with SDTC.

⁵ Southwick unsuccessfully attempted to meet with SDTC representatives until Smith fired him in September 2015.

4. Smith Misrepresented the Status of CSSC's Business with the City of Jacksonville

Smith also misrepresented in the June 15, 2015 Confidential Report the status of CSSC's business with Jacksonville, Florida. Smith stated in the Report:

We are currently in the final stages of being engaged as Special Reviewing Consultant with regard to the investment management of Jacksonville's nearly \$1 billion in short-term operating funds. . . . In addition to the revenue this case will generate, it will also increase our reportable assets under management by nearly \$1 billion — a very significant credentialing plateau.

Southwick was primarily responsible for pursuing the city as a client. When Smith made this representation in June 2015, CSSC had not yet sent the city a proposal. When it did so on July 27, 2015, the proposal was confined to CSSC's providing a quarterly performance review of the city's investment portfolio, not managing its investments. For providing this review, CSSC proposed a \$15,000 quarterly fee. The city did not agree to CSSC's proposal.

Even after Smith terminated Southwick in September 2015, Smith continued falsely representing to investors in an "October 2015 Important Update" offering document that CSSC had a pending engagement with Jacksonville that would result in an additional \$1 billion in assets under management, and that the engagement was expected to begin by the end of 2015. In fact, as Smith acknowledged at hearing, the city of Jacksonville never engaged CSSC to serve as a reviewing consultant. Even if the city had accepted the proposal, CSSC's acting as "special reviewing consultant" would not have increased its assets under management at all, let alone by \$1 billion.

D. Investors in the 2015 Bridge Loan Note Offering

Smith personally solicited between 15 and 25 people to invest in the 2015 Bridge Loan Note Offering and succeeded in raising \$130,000 from four of them: TL, Thomas Scotto, BB, and Gavin Clarkson.⁶ Scotto and Clarkson were registered representatives of CSSC BD.

TL and Scotto were the first two investors in the 2015 Bridge Loan Note Offering and made their investments in August 2015, after receiving the offering materials that included the July 12, 2015 version of the Important Memorandum to potential investors. On September 9, 2015, Smith revised the Important Memorandum and Confidential Report related to Project X. Smith stated in the revised documents that progress on Project X had been "unexpectedly interrupted," the revenue he previously had represented as already having been earned "may not materialize until 2016, if at all," and that the interruption, caused by a "plan to deprive" CSSC of

⁶ Investors BB and TL are identified in Enforcement's Schedule of Abbreviations and References filed with its complaint in this matter.

“an expected \$2.15 million,” meant that the special purpose bank revenue “now appears unlikely to take place within the 4th quarter of 2015. Consequently, it now appears unlikely that, unless other revenue sources are secured, 2015 will be profitable and the best year in the Company’s history.” Despite these revisions made a few days earlier, Smith, on September 12, 2015, sent investor BB a package of materials that included the June 15, 2015 Confidential Report, which described the likely receipt of revenue from Project X, as follows: **“CSSC is being paid a \$1 million consulting fee for its work on the design and formation of this new Bank, the payment of which will ensure CSSC’s profitability in 2015.”**

In October and November 2015, Smith sent emails to Clarkson soliciting him and his connections to invest in the 2015 Bridge Loan Note Offering. Although Smith attached updated offering materials to the emails, including the disclosure that Project X had been “unexpectedly interrupted and revenue from it now is doubtful in 2015,” the materials continued to make other false claims about projected large increases in revenues to CSSC related to the SDTC and engagement with the city of Jacksonville. Smith’s emails to Clarkson also failed to disclose that CSSC was unable to pay the investors from the 2010 Bond Offering and the 2014 Bridge Loan Note Offering.

1. Investor TL

JC, who was affiliated with CSSC, referred Smith to TL. On July 21, 2015, Smith emailed TL promoting the 2015 Bridge Loan Note Offering. The email, with the subject line “CSSC’s ‘Bridge Loan Note’ Offering - explanation/package,” stated that Smith was sending TL “the complete package” of offering documents. Smith represented that the offering was a “great deal” that “really was originally designed for friends and family and for those doing business with CSSC.” Smith told TL that he had been “introducing this to one person at a time” but had “recently changed that approach” and now was “expanding the range of those to whom this is being made available.” Smith represented to have “successfully placed” \$1.35 million in notes and hoped to complete the \$3 million offering by placing \$1.65 million “within the next 30 days.” Smith said he was “not anticipating doing anything like this (individual offerings) again.” Smith invited TL to meet him later that week in New York City, where they discussed the 2015 Bridge Loan Note Offering. Smith stayed in contact and spoke again with TL about the offering by phone in August 2015.

On August 17, 2015, Smith followed-up with TL via email. To that email Smith attached the July 12, 2015 Important Memorandum to prospective investors, which Smith described as “[a] summary discussion of why we are seeking bridge financing, the new initiatives and changes being implemented, and important financial information/disclosures.” TL had asked Smith whether he would rescind the offer of promised CSSC stock if TL 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. On August 24, 2015, TL invested \$50,000 in the 2015 Bridge Loan Note Offering.

Smith did not send the stock certificate to TL until November 2015. TL complained to JC in email about the delay, indicating that he had been waiting for weeks for Smith to send him the paperwork. TL told JC that his “trust has been seriously shaken” and that he would refuse to

accept delivery of the certificate and wanted a refund from Smith. JC did not respond and forwarded the email to Smith. Smith informed TL that he had “no present ability” to refund his investment and promised he would “be paying off the Notes at the earliest opportunity.” Smith highlighted that TL’s investment was “earning interest at 8%” and Smith had gifted him CSSC common stock. TL has not been repaid his \$50,000 investment.

2. Investor Scotto

Scotto, a CSSC registered representative and an employee of CSSC RIA, previously had invested \$215,000 in bond and note purchases with CSSC. Smith made Scotto aware of the 2015 Bridge Loan Note Offering to enable him to solicit prospective investors. In July 2015, Smith sent Scotto an email directing him to replace the June 2015 version of the “Important Memorandum” in the offering documents that Smith sent earlier with the updated July 12, 2015 version.⁷ Smith directed Scotto to send the updated memorandum to anyone to whom he had given the earlier version. Smith explained that the June memorandum “did not give an accurate or balanced view of what we are doing and why . . . someone might consider it beneficial (to them) to participate in the Offering.” He also 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.”

In response to Smith’s email, Scotto sent \$20,000 of his personal funds to CSSC on August 31, 2015. Smith claimed during the hearing that the \$20,000 was not an investment in the 2015 Bridge Loan Note Offering but was instead a short-term loan to CSSC. In an email exchange on November 18, 2015, between CSSC’s controller, DW and Smith, however, DW informed Smith that Scotto’s \$20,000 was one of several “notes” that “[t]erms have not been specified for.” In response, Smith wrote that Scotto’s funds were “in the Bridge Loan Note Offering.” Scotto has not been repaid his \$20,000 investment.

3. Investor BB

In September 2015, Smith solicited BB, a college classmate, to invest in the 2015 Bridge Loan Note Offering and encouraged BB to solicit other investors in the offering. Smith emailed BB on September 12, 2015, with the subject line “FW: CSSC’s ‘Bridge Loan Note Offering’ - explanation/package.” In the email, Smith referred to a conversation he and BB had earlier that day and referenced their prior discussion that the offering was not “applicable in [BB’s] case.” Smith stated that they should “consider some alternatives” for BB to become “involved” in the offering. Smith attached to this email various offering documents, including the June 15, 2015 version of the “Confidential Report.” Smith encouraged BB to let him know if he thought the offering would be a “fit” for him or “others that you believe we should consider including that would be good for us to ‘have in the family.’”

⁷ The record does not detail their prior conversations.

On September 29, 2015, BB sent \$10,000 to Smith. Smith indicated to CSSC's controller that BB's investment was a "6 month Note." BB has not been repaid his \$10,000 investment.

4. Investor Clarkson

In October 2015, Smith solicited Clarkson to invest in the 2015 Bridge Loan Note Offering. Clarkson was a licensed investment advisor and broker who had been registered with affiliates of CSSC since 2012. 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 had revised four days earlier, and a promissory note and certificate. Smith encouraged Clarkson to invest personally and to solicit his contacts for investments. Smith knew that Clarkson also worked with Native American tribes attempting to facilitate release of tribal funds held by the Bureau of Indian Affairs. Smith referenced CSSC's "current short-term cash needs," and stated that he hoped the 2015 offering "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." Smith told Clarkson that it would be "good [to] have some new folks 'on the team'—especially in the tribal world, and if you are the one recommending them."

On November 2, 2015, Smith sent Clarkson another email with updates to "two of the principal [offering] documents" that Smith had revised that day, and asked Clarkson to "dispose of the earlier versions in the package(s)" and "replace with these." Smith emailed wiring instructions to Clarkson on November 12, 2015, and wrote that he would soon "resend the rest of the disclosure package." In a subsequent email sent 14 minutes later, Smith attached the 2015 Bridge Loan Note Offering documents and the wiring instructions. The following day, Clarkson invested \$50,000. In an email to CSSC's controller, Smith characterized Clarkson's investment as a "6 month Note." Clarkson has not been repaid his \$50,000 investment.

IV. Discussion

We affirm the Hearing Panel's findings that Smith engaged in fraud when he failed to disclose material facts and made material misrepresentations in connection with the 2015 Bridge Loan Notes Offering. We further affirm the findings that Smith acted in the capacities of a general securities representative and principal without being registered. We discuss the violations in detail below.

A. Smith Committed Fraud When He Omitted and Misrepresented Material Facts

Exchange Act Section 10(b) makes it "unlawful for any person, directly or indirectly . . . [t]o use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention" of Commission rules. 15 U.S.C. § 78j(b). Exchange Rule 10b-5(b) makes it unlawful for any person "directly or indirectly" to "make any untrue statement of a material fact or omit to state a material fact necessary in order to make the

statements made . . . not misleading.”⁸ 17 C.F.R. §240.10b-5(b). Thus, under Section 10(b) and Rule 10b-5, “one who elects to disclose material facts must speak fully and truthfully, and provide complete and non-misleading information with respect to the subjects on which he undertakes to speak.” *Louis Ottimo*, Exchange Act Release No. 83555, 2018 SEC LEXIS 1588, at *31 (June 28, 2018) (internal quotation marks omitted). “That duty is a general one, and arises whenever a disclosed statement would be misleading in the absence of the disclosure of additional material facts needed to make it *not* misleading.” *Id.* (internal quotation marks omitted).

A violation of Section 10(b) and Rule 10b-5 constitutes a violation of FINRA’s antifraud rule, FINRA Rule 2020, which prohibits FINRA members and their associated persons from effecting “any transaction in, or induc[ing] the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.” *William Scholander*, Exchange Act Release No. 77492, 2016 SEC LEXIS 1209, at *15 (Mar. 31, 2016), *aff’d sub nom. Harris v. SEC*, 712 F. App’x 46 (2d Cir. Oct. 25, 2017). Proof of scienter is required to establish a violation of each of the foregoing provisions.⁹ *See Dept. of Enforcement v. Luo*, Complaint No. 2011026346206, 2017 FINRA Discip. LEXIS 4, at *20 (FINRA NAC Jan. 13, 2017). Such conduct also violates FINRA Rule 2010. *Scholander*, 2016 SEC LEXIS 1209, at *14-15.

Enforcement alleged, and the Hearing Panel found, that Smith committed securities fraud when he failed to disclose and made material misstatements of fact when he solicited investors to purchase the 2015 Bridge Loan Notes. Enforcement’s fraud allegations stemmed from: (1) Smith’s failure to disclose CSSC’s inability to pay previous investors in CSSC’s 2010 Bond and 2014 Bridge Note Loan Offerings; and (2) Smith’s representations related to Project X and CSSC’s business with the SDTC and the city of Jacksonville. We agree with the Hearing Panel that Smith committed securities fraud.

⁸ Smith, as the drafter of the 2015 Bridge Loan Notes Offering documents with the ultimate authority over these documents and their contents, was the maker of the misstatements and omissions contained within them for purposes of liability under Exchange Act Rule 10(b)-(5)(b). *See Janus Capital Grp., Inc. v. First Derivative Traders*, 564 U.S. 135, 142-43 (2011).

⁹ Section 10(b) and Rule 10b-5 include jurisdictional elements that prohibit fraud by “any means or instrumentality of interstate commerce.” *See* 15 U.S.C. § 78j; 17 C.F.R. 240.10b-5. Smith’s conduct in this case occurred by means or instrumentality of interstate commerce, such as communicating through telephone calls, email, or the U.S. mail service, thereby satisfying the interstate commerce requirement. *See Grubbs v. Sheakley Grp., Inc.*, 807 F.3d 785, 803 (6th Cir. 2015) (“[T]he very act of sending an e-mail creates the interstate commerce nexus necessary for federal jurisdiction.”); *SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 865 (S.D.N.Y. 1997) (determining that the jurisdictional requirements of the federal antifraud provisions are interpreted broadly and are satisfied by intrastate telephone calls or the use of the U.S. mail), *aff’d*, 159 F.3d 1348 (2d Cir. 1998).

1. The 2015 Bridge Loan Notes Were Securities

We agree with the Hearing Panel's determination that the 2015 Bridge Loan Notes were securities. The offering documents describe the 2015 Bridge Loan Notes as unsecured with a 12-month maturity, earning eight percent interest, with an additional "gift" of CSSC common stock. The Exchange Act defines a "security" to include "any note," except notes with maturities of less than nine months. 15 U.S.C. § 78c(a)(10); *see Reves v. Ernst & Young*, 494 U.S. 56, 65-66 (1990). The Supreme Court in *Reves* adopted the "family resemblance" test, along with four factors, to consider in determining whether a note is a security under Section 3(a)(10) of the Exchange Act. 494 U.S. at 66-67. The *Reves* four factors determine whether the transaction nonetheless involves a security by evaluating: (1) the motivations of the buyer and seller (i.e., whether the seller is raising money for general use of a business enterprise and whether the buyer is interested in the profit the note is expected to generate); (2) the plan of distribution (i.e., whether the note is an instrument in which there is a common trading for speculation or investment); (3) the reasonable expectation of the investing public; and (4) the existence of another regulatory scheme that makes oversight by federal securities laws unnecessary. *Id.* Under the *Reves* test, a note is presumed to be a security. *Id.* That presumption may be rebutted only by demonstrating that the note bears a strong resemblance to one of the enumerated categories of instrument that are deemed as non-securities when considering the four factors of the *Reves* test.¹⁰ *Id.* at 66-67. If a note is not sufficiently similar to the enumerated categories of non-securities, the family resemblance test requires an examination, based on the same four factors, of whether another category should be added. *Id.*

The 2015 Bridge Loan Note Offering documents show that CSSC issued the short-term notes to raise capital for its general business operations and that the notes were crafted to appeal to investors seeking profit. The 2015 Bridge Loan Note Offering Confidential Report stated that CSSC was "covering its operating deficits" with the note proceeds. In the "Important Memorandum," Smith wrote that "funds raised will be used to smooth out Company cash flows and cover any operating deficits until the revenue expected from" pending "new initiatives begins to be received."

Furthermore, the evidence reflects that Smith drafted the offering documents to emphasize the potential profit to note purchasers. Indeed, 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 potential investors. The 2015 Bridge Loan Notes provided its holders an attractive interest rate of eight percent; thus, the investing public reasonably would view them as "securities." *See Stoiber v. SEC*, 161 F.3d 745, 750 (D.C. Cir. 1998) (explaining that notes

¹⁰ The categories of notes that are not securities are notes that are: (1) delivered in consumer financing; (2) secured by a mortgage on a home; (3) short-term notes secured by a lien on a small business or some of its assets; (4) evidencing a character loan to a bank customer; (5) short-term notes secured by an assignment of accounts receivable; or (6) which simply formalize an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized). *Id.* at 65.

with a favorable interest rate indicate that profit was the lender's primary goal). In addition, the notes were uninsured and not subject to the federal banking laws and therefore would otherwise escape federal regulatory oversight if they were deemed non-securities. Based on these considerations, we conclude that the 2015 Bridge Loan Notes were securities. The notes did not bear a strong family resemblance to the notes listed as non-securities, and there is no basis for adding a new category considering the *Reves* factors.

While Smith conceded that customer TL invested \$50,000 in the 2015 Bridge Loan Note Offering, he asserted that Scotto, Clarkson, and BB merely loaned money to CSSC. In evaluating the 2015 Bridge Loan Notes under the *Reves* factors, however, we conclude that the notes were securities that Smith offered to TL, Scotto, Clarkson, and BB, who were investors in the securities offering. Smith offered the notes for investment purposes and not in commercial or consumer contexts with a standard maturity date of one year from purchase. While Smith was willing to shorten the maturity date to less than one year for some note holders, he did so only after investors negotiated a shorter term for the notes' maturity in exchange for their investment. For example, Smith testified that Scotto said he would participate in the offering, but needed his principal returned by the end of the year. Smith accommodated Scotto by agreeing to "[d]o it differently." Thus, 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. It was only after Smith solicited Scotto with emails and sent him the package of offering documents for prospective investors that Scotto sent Smith \$20,000. As the Hearing Panel found, these circumstances show that Smith solicited Scotto to invest in the 2015 Bridge Loan Note Offering, and Scotto invested in the offering only after negotiating a shorter term for maturity than the standard one year.

Similarly, with respect to BB, Smith in September 2015 sent BB the offering materials for the 2015 Bridge Loan Note Offering, including the June 15, 2015 version of the "Confidential Report." Smith stated in an accompanying email that if BB wished "to get involved," Smith would "consider some alternatives," and invited BB to let Smith know if he decided "to get involved." 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" and that he was interested in receiving CSSC stock to have "a stake in the company." Smith again agreed to vary from the original terms and shorten the offering's standard one-year maturity, referring to it as a "6 month Note," in order to obtain BB's \$10,000. Like he did with Scotto, Smith solicited BB to invest in the 2015 Bridge Loan Note Offering and obtained BB's investment only after modifying the offering's standard terms. Smith also encouraged BB to introduce the offering to his connections in investment banking and venture capital circles to obtain more investors.

While Smith admitted in his hearing testimony that he solicited Clarkson to invest in the 2015 Bridge Loan Note Offering, Smith contends that Clarkson instead made a shorter-term loan. Smith, however, sent the 2015 Bridge Loan Note Offering documents and wiring instructions to Clarkson hoping he would purchase a Bridge Loan Note and solicit other potential investors among his Native American tribal contacts. In October 2015, Smith emailed Clarkson that he was "finishing the placement of the remaining \$1.6 million available in our current Bridge Loan Note Offering," and described it as "a great opportunity" that he hoped would "be a good 'fit'" for Clarkson and his "tribal connections—that you and/or some of them will be able

to take advantage of the opportunity.” Smith’s willingness to make individual modifications to the terms of the offering to obtain certain investors does not alter that the 2015 Bridge Loan Note Offering was a securities offering under the Exchange Act and *Reves* analysis. *See* 15 U.S.C. § 78c(a)(10); *Reves*, 494 U.S. at 65-66.

In addition, CSSC records describe the note transactions in terms of investments rather than loans in a document titled, “Bridge Loan note holders.” In this document, TL and Scotto were listed by name as “Bridge Loan note holders,” with the amounts of their investments, August 2016 maturity dates of their notes, and total interest due at eight percent upon maturity for each investor. Investor BB’s name appears on another CSSC document titled, “Other note holders,” and lists his \$10,000 investment with a September 2016 maturity date, which was one year after his investment, and \$799.99 interest due at maturity.

As the Hearing Panel found, other evidence supports the conclusion that the four transactions at issue were purchases of securities in the 2015 Bridge Loan Note Offering rather than short-term unaffiliated loans to CSSC. In November 2015, when 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. Smith then identified Scotto’s and TL’s funds as “in the Bridge Loan Note Offering,” and BB’s and Clarkson’s funds as “6 month Note[s].”

2. Smith’s Omissions and Misstatements of Fact Were Material

The information that Smith omitted to disclose and misstated in the 2015 Bridge Loan Note Offering documents was material. Whether information is material “depends on the significance the reasonable investor would place on the . . . information.” *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988). Information is material “if there is a substantial likelihood that a reasonable [investor] would consider it important in deciding how to [invest] . . . [and] the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” *Id.* at 231-32 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

When soliciting investments in the 2015 Bridge Loan Notes, Smith failed to disclose that CSSC was unable to pay the investors in CSSC’s 2010 Bond Offering and 2014 Bridge Loan Note Offering. Smith does not dispute that he failed to disclose CSSC’s inability to satisfy its pre-existing debt obligations. He in fact admitted that when he was soliciting investments in the 2015 Bridge Loan Note Offering, he was aware of CSSC’s deteriorating financial condition at the time and knew CSSC was unable to pay interest and principal to investors in the 2010 and 2014 offerings. Indeed, when Smith was soliciting investors in the 2015 offering, CSSC owed a combined \$635,000 to the 2010 and 2014 investors. A reasonable investor would have considered the fact that CSSC was unable to pay investors in its prior debt offerings an important factor when evaluating whether an investment in the 2015 Bridge Loan Note Offering was prudent. *See SEC v. Todd*, 642 F.3d 1207, 1221 (9th Cir. 2011) (holding a company’s financial condition is material to investments); *Dep’t of Enforcement v. McGee*, Complaint No. 2012034389202, 2016 FINRA Discip. LEXIS 33, at *33 (FINRA NAC July 18, 2016), *aff’d*, 2017 SEC LEXIS 987 (Mar. 27, 2017), *aff’d*, 733 F. App’x 571 (2d Cir. 2018); *see, e.g., Aubrey*

v. Barlin, No. A-10-CA-076-SS, 2011 U.S. Dist. LEXIS 15332, at *23 (W.D. Tex. Feb. 16, 2011) (finding “the omitted facts material, as any reasonable investor would want to know if the entity to which they were loaning money was already defaulting on its prior obligations”). This omission was material.

Smith also made false material representations regarding CSSC’s anticipated revenue from Project X, SDTC, and the city of Jacksonville. Smith misrepresented the status of these significant revenue events in the 2015 offering documents and concluded that 2015 likely would be CSSC’s most profitable year so far. For example, he stated that CSSC was being paid \$1.4 million in consulting fees for its work on the design and formation of Project X, and that the payment “will ensure CSSC’s profitability in 2015.” Smith also stated without support that CSSC had already earned \$500,000 from this project. Smith claimed that CSSC would be the investment advisor for a range of new investment funds that CSSC was helping SDTC create, that CSSC would earn a fee based on a percentage of the assets under management, and that CSSC was forming “a client referral relationship” with SDTC for a range of financial services that SDTC does not currently offer. Smith claimed that “the revenue and profit potential from client referrals to CSSC could be quite substantial.”

As of June 2015, Smith knew that CSSC had not earned anything from Project X, that there was no client referral agreement in place between CSSC and SDTC, and that CSSC was not about to become the advisor for any SDTC funds. Smith further misrepresented in the offering documents that CSSC would increase its assets under management by nearly \$1 billion through its engagement with the city of Jacksonville. These statements, which were demonstrably false when Smith made them, were at the heart of his sales pitch to potential investors. “[T]he materiality of information relating to financial condition, solvency and profitability is not subject to serious challenge.” *SEC v. Murphy*, 626 F.2d 633, 653 (9th Cir. 1980); *see also SEC v. USA Real Estate Fund 1, Inc.*, 30 F. Supp. 3d 1026, 1034 (E.D. Wash. 2014) (“False claims of substantial unearned revenue, or the substantial overstatement of revenue, are ‘material’ to reasonable investors.”); *Dep’t of Enforcement v. Gomez*, Complaint No. 2011030293503, 2018 FINRA Discip. LEXIS 10, at *44 (FINRA NAC Mar. 28, 2018) (“The truth that Praetorian and the Praetorian G entities did not own pre-IPO shares of Groupon or Zynga, and that U.S. Coal had no plans to pursue an IPO, would have undoubtedly been material to the investors Gomez solicited. Gomez’s false statements to the contrary significantly altered the total mix of information available to these investors and any reasonable investor.”). The statements that Smith included in the 2015 Bridge Loan Note Offering documents about CSSC’s financial prospects related to Project X, SDTC, and the city of Jacksonville were information that “altered the total mix of information made available” to the investors for the 2015 offering, and any reasonable investor would consider this information important to an investment decision in the offering. *See Basic*, 485 U.S. at 231-32; *Ottimo*, 2018 SEC LEXIS 1588, at *33.

Smith argues that the Hearing Panel erroneously decided materiality “as a matter of law,” and failed to consider evidence of whether any of the specific investors relied on the information in making their investment decisions. Moreover, he states that one investor, Scotto, continued “loaning” CSSC money in 2015 despite having “loaned” CSSC money earlier that the firm had not yet repaid. The Commission and the courts, however, have rejected arguments mirroring

Smith's, and we do so here. As the Supreme Court has explained in the context of deciding materiality as a matter of law:

The determination [of materiality] requires delicate assessments of the inferences a reasonable shareholder would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact. Only if the established omissions are so obviously important to an investor, that reasonable minds cannot differ on the question of materiality is the ultimate issue of materiality appropriately resolved as a matter of law by summary judgment.

TSC Indus., 426 U.S. at 450 (internal quotation marks omitted).¹¹ The Hearing Panel, as the trier of fact, decided materiality correctly as a mixed question of law and the relevant facts of this case. *See id.* Relevant precedent also does not require that Enforcement present evidence of an individual investor relying upon a misstatement or omission when deciding to invest. “[T]o be material, a fact need not be outcome-determinative—that is, it need not be important enough that it would necessarily cause a reasonable investor to change his investment decision.” *SEC v. Meltzer*, 440 F. Supp. 2d 179, 190 (E.D.N.Y. 2006). And the reasonableness of an investor’s reliance is not an element of a FINRA enforcement action for fraud. *See Dep’t of Enforcement v. Kaweske*, Complaint No. C07040042, 2007 NASD Discip. LEXIS 5, at *21 n.16 (NASD NAC Feb. 12, 2007). The “reaction of individual investors is not determinative of materiality, since the standard is objective, not subjective.” *Ottimo*, 2018 SEC LEXIS 1588, at *38; *see also Kenny Akindemowo*, Exchange Act Release No. 79007, 2016 SEC LEXIS 3769, at *17 (Sept. 30, 2016) (finding misstatements material “because a reasonable investor would want to know how their funds were actually being used”).

Smith further contends that the “total mix of information” that he provided to prospective investors included “stark warnings” of CSSC’s “financial losses and its then-current inability to pay its debts from operating revenues.” Smith overstates these purported disclosures, which do not serve to counteract his omissions and misstatements. “Materiality is not judged in the abstract, but in light of the surrounding circumstances.” *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 866 (5th Cir. 2003); *see also ZPR Inv. Mgmt. v. SEC*, 861 F.3d 1239, 1251-52 (11th Cir. 2017) (explaining that it is “well-established principle that a statement or omission must be considered in context”), *cert. denied*, 138 S. Ct. 756 (2018); *United States v. Rigas*, 490 F.3d

¹¹ Smith also objects to Enforcement’s failure to call an expert to offer testimony on materiality. Smith, however, could have filed his own motion before the Hearing Officer to permit expert testimony. *See* FINRA Rule 9242(a)(5). Regardless, expert testimony is not necessary for the Hearing Panel or the NAC to assess what Smith omitted and disclosed to investors and whether those disclosures were false and misleading in light of the circumstances of this case. *See Fuad Ahmed*, Exchange Act Release No. 81759, 2017 SEC LEXIS 3078, at *79 (Sept. 28, 2017) (“Rather, the relevant evidence concerned the representations that Respondents made in offering the STI notes. Both FINRA and the Commission . . . have the expertise to evaluate such evidence without expert testimony.” (internal quotation marks omitted)).

208, 231 (2d Cir. 2007) (“Analysis of the misrepresentations must be in the context in which they were made.”).

While the 2015 Confidential Report referred to CSSC’s ongoing financial difficulties, it did so in the context of how CSSC was overcoming those struggles through its new initiatives including Project X, its business with SDTC, and its business with the city of Jacksonville. The “warnings” that Smith highlights were boilerplate risk-disclosure language in the 2015 Important Memorandum, which stated, “[m]aking an unsecured loan to a company that is experiencing current cash flow shortfalls involves a significant amount of risk,” “that there was no guarantee that the loan would be repaid with interest when due,” “[l]oans of this type should be made only by those financially able and willing to accept the risk that all or part of the loan could be lost.” Smith’s warnings, however, were offset by his statement that, “we believe that the measures described and discussed in the accompanying Confidential Report (which you are urged to read) will restore the Company to sustainable and growing profitability, and could result in significant appreciation in the value of CSSC’s common stock.” Here, Smith’s numerous falsehoods and his omission of key financial information that CSSC was unable to pay its prior investors were made to portray the 2015 Bridge Loan Note Offering as an ostensibly profitable investment. *See, e.g., Gould v. Am. Hawaiian S.S. Co.*, 331 F. Supp. 981, 997 (D. Del. 1971) (finding aggregate effect of numerous falsehoods most clearly evidenced materiality).

The NAC moreover rejected arguments like Smith’s in *Department of Enforcement v. Escarcega*, Complaint No. 2012034936005, 2017 FINRA Discip. LEXIS 32 (FINRA NAC July 20, 2017). The NAC found unpersuasive Escarcega’s argument that because he provided written material that described risks of an investment in detail, such as the prospectus, any alleged misrepresentations that he made cannot be considered material in the context of the total mix of information. *Id.* at *36-37; *see also Dep’t of Enforcement v. Brookstone Sec., Inc.*, Complaint No. 2007011413501, 2015 FINRA Discip. LEXIS 3, at *81 (FINRA NAC Apr. 16, 2015) (rejecting respondents’ argument that a broker’s misrepresentations are rendered immaterial when written risk disclosures are made available to customers).

We conclude that the information that Smith failed to disclose and misrepresented was material.

3. Smith Acted with Scienter

We also find that Smith acted with scienter when he omitted material facts and made material misrepresentations to investors. Scienter is defined as “a mental state embracing intent to deceive, manipulate, or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Scienter is established if a respondent acted intentionally or recklessly. *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n.3 (2007). Scienter includes recklessness, which is defined as conduct that is “an extreme departure from the standards of ordinary care . . . which presents a danger [of deceiving investors that] is either known to the [respondent] or is so obvious that the [respondent] must have been aware of it.” *Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 639 (D.C. Cir. 2008) (internal quotation marks and emphasis omitted). Recklessness may be inferred from circumstantial evidence suggesting an obvious risk of misleading investors that is so great that it is simply implausible that a respondent did not know

about it. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390-91 n.30 (1983); *Vernazza v. SEC*, 327 F.3d 851, 860-61 & n.8 (9th Cir. 2003).

In the case of a material omission, “scienter is satisfied where . . . the [respondent] had actual knowledge of the material information.” *Brookstone*, 2015 FINRA Discip. LEXIS 3, at *78-79. Smith knew when he drafted the 2015 Bridge Loan Note Offering documents that CSSC was experiencing extreme financial difficulties. In March 2015, CSSC’s controller informed Smith that \$635,000 was coming due to prior investors by the end of June 2015. Smith knew that CSSC was unable to pay these investors but failed to disclose that fact in the 2015 offering documents that he drafted.

We also find as additional evidence of scienter that Smith had disclosed in the 2010 Bond Offering documents that short-term notes CSSC issued in 2009 had become due, and it was “fortunate” to secure agreements to exchange the notes for new notes. Smith disclosed in the 2010 offering documents that “serious consequences,” including CSSC being unable to continue as a going concern, could result if the note holders did not continue to agree to similar exchanges. Smith included no similar language in the 2015 offering documents. While Smith stated in the 2015 documents that CSSC had conducted previous offerings, he did not disclose that those investors were not being paid. This omission served to mislead new investors and furthered Smith’s self interest in obtaining much needed capital infusions from these investors.¹² *See, e.g., Warwick Capital Mgmt., Inc.*, Investment Advisers Act Release No. 2694, 2008 SEC LEXIS 96, at *29 (Jan. 16, 2008) (“His self-interest in providing inaccurate information about Warwick is apparent.”). The evidence unquestionably reflects that Smith knew these adverse facts and intentionally withheld them.

Smith also misled investors about the status of Project X and CSSC’s purported agreements with SDTC and the city of Jacksonville. Affirmative statements concerning the purchase or sale of a security come with the “ever-present duty not to mislead.” *See Basic*, 485 U.S. at 240 n.18. Smith lacked a reasonable basis for his statements concerning these initiatives and the circumstances reveal it was implausible that he did not know or was extremely reckless in not knowing the truth when he made these statements. *See Gebhart v. SEC*, 595 F.3d 1034, 1041 (9th Cir. 2010) (“Scienter may be established, therefore, by showing that the [respondents] knew their statements were false, or by showing that [respondents] were reckless as to the truth or falsity of their statements.”).

¹² In further support of Smith’s scienter, we note that Smith initiated the 2015 Bridge Loan Note Offering in the wake of extreme financial pressure on CSSC. For example, in December 2014, American Express had been declining charges on the CSSC company credit card for nonpayment, and Smith was worried that he and Southwick might be “stranded” while traveling as a result. In February 2015, CSSC’s auditor alerted Smith that the company’s accumulated deficit had surpassed \$10 million at the end of 2014. The auditor also questioned whether CSSC BD could continue as a going concern. The auditor highlighted that CSSC “continues to experience difficulty in meeting its day-to-day obligations without significant outside funding.”

Smith represented in the multiple iterations of the 2015 Bridge Loan Note Offering documents that CSSC was set to receive \$1.4 million in total consulting fees in 2015 from Project X alone, consisting of \$1 million for creating the first bank and \$400,000 for creating the second bank. Smith represented that Project X would make 2015 the “most profitable year in CSSC’s history.” Smith stated 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 this would be accomplished prior to the third quarter of 2015. Smith represented that CSSC then was slated to be paid additional fees for replicating the banks. None of this was remotely accurate.

Smith made these representations without reviewing or approving a consulting agreement or reviewing an application to bank regulators for the special purpose bank. And the evidence shows that Smith knew (or was extremely reckless in not knowing) that there was no consulting agreement in place when he made these statements. For example, in July 2015, a wealthy potential investor LC, with whom Smith was trying to place \$1.6 million in 2015 Bridge Loan Notes, insisted that Smith produce a copy of a written commitment reflecting that CSSC would be providing financial services for the special purpose bank. On July 28, Smith wrote to LC that the “bank is nearing completion,” and the document confirming that CSSC would provide “the investment advisory and brokerage platform” would be executed “very soon since meetings with the [prospective] investors began, financial services introductions have already been set.” Smith then asked Southwick for the documentation. When Southwick said he did not have any, Smith had Southwick, in Smith’s presence, call the lawyer who Southwick knew was advising on the project and ask him for the agreement. The lawyer replied that there was no agreement, and that the financial services entity had not been formed. On July 31, 2015, Smith informed LC “that the document that establishes that CSSC will be providing the investment advisory and brokerage platform for the . . . banks, has not yet been signed.” Despite knowing that there was no agreement, Smith continued to assure LC that written confirmation of the commitment was forthcoming: “I was told that they expected that agreement to be finalized and executed within the next 7-14 days.”¹³

Moreover, both Southwick and Wheeler testified there was no work being done yet on a second special purpose bank. Wheeler also had no knowledge of a \$1 million consulting fee owed to CSSC. Southwick, when asked whether Smith’s representations regarding the purported \$1.4 million consulting fees were accurate, repeatedly answered, “No.” In short, Smith’s representations regarding the status of Project X and its imminent beneficial effects on CSSC’s finances were uniformly baseless.

CSSC BD’s co-presidents, LaRose and Martin, also testified about that status of Project X. LaRose first learned the details of Project X around August 2015 when Southwick submitted an outside business activity approval form to her when there were discussions of doing a capital raise for the initiative. LaRose referred to Project X as “a fluid project,” which was not

¹³ In September 2015, LC informed Smith that he would “pass” on the 2015 Bridge Loan Note Offering and requested that Smith not contact him again.

sufficiently underway for her to even review it as an outside business activity for Martin, who was supposed to take a significant position in the financial services company that would provide brokerage and advisory services to the banking clients. Martin testified that when Smith asked him in the spring of 2015 if he had seen any documentation regarding the Project X consulting fee, he told Smith he had not seen anything.

Smith contends that he relied on Southwick for updates on Project X and that Southwick misled him about the progress and imminent earning of consulting fees. Smith's claims are unpersuasive and do not negate his scienter. Smith first made the representations about Project X in the June 2015 offering documents without any confirmation of their truth. After Southwick could not produce any documentation that Smith requested in July 2015 to provide to LC, Smith knew from his and Southwick's conversation with the lawyer on Project X that no agreement existed. Nonetheless, Smith continued to misrepresent the status of Project X to investors. Contrary to his assertions, Smith must have known that, when he made his misrepresentations, his actions presented an unacceptable danger of misleading investors. *See Alvin W. Gebhart*, Exchange Act Release No. 58951, 2008 SEC LEXIS 3142, at *35 (Nov. 14, 2008) ("A respondent's asserted good faith belief is not plausible if he ignores facts that place him on notice of a risk of misleading clients."), *aff'd*, 595 F.3d 1034 (9th Cir. 2010). In addition, Southwick's employment contract precluded him from committing CSSC to "any project, contract or engagement" without "conferring in advance with" Smith and "securing his prior advice and consent." Smith also cannot shift to others his responsibility to refrain from committing fraud. *See Dane S. Faber*, 57 S.E.C. 297, 309-10 (2004) (rejecting argument that respondent did not possess the scienter necessary to establish liability for fraudulent misrepresentations and omissions when respondent argued that he relied on information provided by his firm).

We have no difficulty in finding that the requisite scienter existed here considering Smith's statements to investors about the supposed consulting agreement and its purported financial benefits to CSSC when there was no actual consulting agreement in place. It is simply implausible that Smith, who is CSSC's chairman, chief executive officer, majority owner, and a lawyer, did not know that he was deceiving investors. *See Vernazza*, 327 F.3d 851 at 860-61 & n.8. These circumstances go beyond mere recklessness and indicate a deliberate intent to defraud investors. *See John Edward Mullins*, Exchange Act Release No. 66373, 2012 SEC LEXIS 464, at *38 (Feb. 10, 2012) (finding that circumstantial evidence in the record lends further support to the conclusion individual acted with intent).

We also find Smith acted with scienter regarding his statements in the 2015 Bridge Loan Note Offering documents about CSSC's business with SDTC and the city of Jacksonville. Smith knew that CSSC had formed no "strategic alliance" with SDTC or client referral relationship and that there was no agreement in place for CSSC to be the investment advisor for SDTC's new investment funds. Instead, Smith had direct knowledge that discussions with SDTC had stalled. Likewise, in June 2015, when Smith first represented that CSSC was in the final stages of engagement with the city of Jacksonville to manage its \$1 billion in assets, CSSC had not sent the city such a proposal. When Smith drafted a proposal for the city in July 2015, CSSC's role was limited to providing a performance review of the city's investment portfolio—a service that did not increase CSSC's assets under management at all—for a \$15,000 quarterly fee. And as Smith acknowledged, the city never engaged CSSC.

We conclude that Smith failed to disclose material information and made material misrepresentations in connection with the offer and sale of the 2015 Bridge Loan Notes and he did so with scienter. As a result, Smith violated Exchange Act Section 10(b), Exchange Act Rule 10b-5, and FINRA Rules 2020 and 2010.¹⁴

4. Smith Acted Willfully and Is Statutorily Disqualified

We also affirm the Hearing Panel’s findings that Smith acted willfully when he made material misrepresentations and omissions with scienter, in violation of the Exchange Act and the rules promulgated thereunder. “A willful violation under the federal securities laws simply means ‘that the person charged with the duty knows what he is doing.’” *Robert D. Tucker*, Exchange Act Release No. 68210, 2012 SEC LEXIS 3496, at *41 (Nov. 9, 2012) (quoting *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000)); *see also Mathis v. SEC*, 671 F.3d 210, 216-18 (2d Cir. 2012) (explaining that “willfulness” does not require awareness that one “is violating one of the Rules or Acts,” and holding that a person may be subject to statutory disqualification under Section 3(a)(39) as long as he “intentionally submitted an application to register with a FINRA member knowing that the application contained material false information”); *Allen Holeman*, Exchange Act Release No. 86523, 2019 SEC LEXIS 1903, at *38 (July 31, 2019) (requiring “subjective intent” for a willful violation), *appeal docketed*, No. 19-1251 (D.C. Cir. Nov. 26, 2019).

Smith knew that CSSC was unable to pay investors in CSSC’s prior offerings but failed to disclose this key fact in the 2015 Bridge Loan Note Offering documents. He also was at least extremely reckless when he represented the imminent finalization of lucrative contracts with SDTC and the city of Jacksonville and that CSSC had earned a \$500,000 consulting fee through Project X. Consequently, Smith is subject to statutory disqualification. *See* Exchange Act Section 3(a)(39)(F) (incorporating by reference Exchange Act Section 15(b)(4)(D), which together provide that a person is subject to statutory disqualification if he has willfully violated any provision of, among other things, the Exchange Act and its rules and regulations); FINRA By-Laws, Article III Section 4 (providing that a person is subject to statutory disqualification if he is disqualified pursuant to Exchange Act Section 3(a)(39)).

B. Smith Acted as an Unregistered General Securities Representative and Principal

We also find that Smith violated FINRA’s registration rules because he acted as an unregistered general securities representative and principal while associated with CSSC BD, as alleged in causes four and five of Enforcement’s complaint. Smith has argued throughout these proceedings that FINRA lacks jurisdiction to bring this enforcement action against him, asserting that he was not a “person associated with a member.” We disagree.

¹⁴ We decline to make any findings with respect to the alternative allegations in causes two and three of the complaint related to violations of Sections 17(a)(2) and (a)(3) of the Securities Act and FINRA Rule 2010.

1. Smith Was an Associated Person Who Acted as an Unregistered General Securities Representative

NASD Rule 1031 provides that any person engaged in the securities business of a FINRA member firm and functioning as a “representative” must register with FINRA. NASD Rule 1031(b) defines a representative as a person “associated with a member . . . who [is] engaged in the investment banking or securities business for the member including the functions of supervision, solicitation or conduct of business in securities.” FINRA 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.” FINRA By-Laws, Art. I (rr). “FINRA has jurisdiction to discipline all associated persons of a member firm,” including Smith. *See Ottimo*, 2018 SEC LEXIS 1588, at *49; *see also Stephen Grivas*, Exchange Act Release No. 77470, 2016 SEC LEXIS 1173, at *14 n.15 (Mar. 29, 2016) (“There is no dispute that FINRA has jurisdiction over a registered representative associated with a member firm or that FINRA has jurisdiction to discipline associated persons.” (citing 15 U.S.C. § 78o-3(b), (h); FINRA By-Laws Articles V and XIII)); *Keilen Dimone Wiley*, Exchange Act Release No. 76558, 2015 SEC LEXIS 4952, at *11 (Dec. 4, 2015) (finding that FINRA has jurisdiction to discipline a person associated with a member firm and that an associated person’s “unethical business-related conduct, even while performing insurance-related activities, falls under FINRA’s jurisdiction”), *aff’d*, 663 F. App’x 353 (5th Cir. 2016).

Under FINRA’s By-Laws, “investment banking or securities business” includes “the business, carried on by a broker . . . of underwriting or distributing issues of securities.” FINRA By-Laws, Art. I(u). The Commission has interpreted the definition of associated person broadly, and has held that “FINRA has the authority to discipline associated persons who engage in misconduct in connection with their management of an investment fund where the misconduct is ‘business-related . . . , even if that management was not of a FINRA member firm.’” *Ottimo*, 2018 SEC LEXIS 1588, at *49-50. Even clerical staff are included in the category of an associated person if their duties are part of the conduct of a firm’s securities business. *See, e.g., Stephen M. Carter*, 49 S.E.C. 988, 989 (1988) (employee who worked as a “dealer cashier” was an associated person because he received checks and securities and entered them in the firm’s computer system, prepared firm checks for signature in payment of customer balances, prepared deposit slips, and furnished account balances and other information to customers).

Smith asserts that he was not associated and “never knowingly consented to FINRA jurisdiction.” Regardless of Smith’s intentions, the evidence shows that he was associated with CSSC BD. In July 2006, as part of CSSC BD’s new member application form (“Form NMA”), Smith acknowledged that he was exempt from registration, and therefore an associated person, under NASD Rule 1060 when he stated:¹⁵

¹⁵ NASD Rule 1060 stated:

(a) The following persons associated with a member are not required to be registered with the Association:

[Footnote continued on next page]

I understand that I will be permitted to be exempt from NASD securities registration requirements, without having to register either as a registered representative or as a principal, so long as I am not actively engaged in the management of the Firm's (CSSC Brokerage Services, Inc.) securities business, including the supervision, solicitation, conduct of business or the securities training of persons associated with the Firm. I understand that I will not be permitted to become active in the Firm's securities business until such time as I have completed the registration as both an appropriately registered representative and principal as outlined in NASD Rules 1020-1032.

We find that Smith participated in the firm's securities business, evidencing that he was associated. "[O]ne whose functions are part of the conduct of a securities business is an associated person engaged in that business." *Bruce Zipper*, Exchange Act Release No. 84334, 2018 SEC LEXIS 2709, at *14 (Oct. 1, 2018) (internal quotation marks omitted). Smith contends that he did not conduct any securities business on behalf of CSSC BD and his participation in any securities sales was solely to raise money for CSSC as its chairman and chief executive officer. We reject Smith's unrealistic view of his activities. It is undisputed that Smith solicited CSSC BD's customers to invest in CSSC's debt offerings and sold these securities to some of these customers. Smith also created and distributed the offering documents to CSSC BD customers directly and through the firm's brokers, including Southwick for whom Smith prepared scripted solicitations. Southwick also introduced Smith to CSSC BD's customers for purposes of soliciting their investments in CSSC's offerings. *See Dep't of Enforcement v. Hedge Fund Capital Partners, LLC*, Complaint No. 2006004122402, 2012 FINRA Discip. LEXIS 42, at *24-25 (FINRA NAC May 1, 2012) (contacting potential investors and marketing hedge funds to them constituted investment banking or securities business requiring FINRA registration).

[Cont'd]

- (1) persons associated with a member whose functions are solely and exclusively clerical or ministerial;
- (2) persons associated with a member who are not actively engaged in the investment banking or securities business;
- (3) persons associated with a member whose functions are related solely and exclusively to the member's need for nominal corporate officers or for capital participation; and
- (4) persons associated with a member whose functions are related solely and exclusively to:
 - (A) effecting transactions on the floor of a national securities exchange and who are registered as floor members with such exchange;
 - (B) transactions in municipal securities;
 - (C) transactions in commodities; or
 - (D) transactions in security futures, provided that any such person is registered with a registered futures association.

We also find that Smith's activities are part of the conduct of a securities business and made him not only an associated person, but that his active participation required FINRA registration. "Activities requiring registration are a subset of those that constitute 'associating' with a FINRA member firm." *Dep't of Enforcement v. Dakota Sec. Int'l, Inc.*, Complaint No. 2016047565702, 2019 FINRA Discip. LEXIS 11, at *16-17 (FINRA NAC Mar. 18, 2019), *appeal docketed*, SEC Admin. Proceeding No. 3-19138 (Apr. 5, 2019). By engaging in these activities without proper FINRA registration, Smith violated NASD Rule 1031.

The functions of a registered representative include communicating with members of the public to determine their interest in making investments, discussing the nature or details of particular securities or investment vehicles, recommending the purchase or sale of securities, and accepting orders for the purchase or sale of securities. *Dist. Bus. Conduct Comm. v. Gallison*, Complaint No. C02960001, 1999 NASD Discip. LEXIS 8, at *52 (NASD NAC Feb. 5, 1999). Smith claims that he "had precluded CSSC-BD from becoming involved in the private offerings made by CSSC-Parent." But the evidence shows that Smith orchestrated and directed the involvement of CSSC BD brokers and their customers in CSSC's private offerings. For example, Martin introduced CSSC BD customer SK to the 2010 Bond Offering, but Smith finalized the \$375,000 investment. Smith also specifically asked Southwick whether CSSC BD customer JM, who had invested \$300,000 in the 2010 Bond Offering, would also invest in the 2014 Bridge Loan Note Offering. Smith directed Southwick not to recommend the investment outright, but rather to make his customers "aware" of the offering and to tell them he would "see if it could be made available." Smith solicited CSSC BD customers to invest in CSSC's offerings, disseminated the offering documents to CSSC BD brokers whom he directed to sell the securities, and obtained customer introductions from CSSC BD brokers in order to solicit the customers personally. Smith's activities fell within the definition of a representative and required appropriate registration. *See Zipper*, 2018 SEC LEXIS 2709, at *14; *Michael F. Flannigan*, 56 S.E.C. 8, 17-18 (2003) (affirming finding that firm and its president violated FINRA's registration rules by permitting unregistered individuals to solicit customers and confirm indications of interest for an initial public offering); *First Capital Funding, Inc.*, 50 S.E.C. 1026, 1028-30 (1992) (finding that member firm and its president violated FINRA's registration rules by permitting an unregistered individual to send pre-qualification forms with information regarding an investment to potential investors and that firm was "engaged at least in an 'attempt to induce' the purchase or sale of securities").

We affirm the Hearing Panel's finding that Smith participated in CSSC BD's securities business as a general securities representative and therefore violated NASD Rule 1031 and FINRA Rule 2010 by acting in this capacity without registration. "FINRA is empowered to bring disciplinary actions and impose sanctions to enforce its members' compliance with federal securities laws, SEC regulations, and FINRA's own rules and regulations." *Birkelbach v. SEC*, 751 F.3d 472, 475 (7th Cir. 2014). Thus, FINRA has the authority to discipline Smith for violating the antifraud provisions of the securities laws and FINRA's registration rules—regardless of whether he believed he was not associated at the time of the misconduct. *See Ottimo*, 2018 SEC LEXIS 1588, at *49.

2. Smith Acted as an Unregistered Principal

In addition, Smith engaged in activities that required principal registration. NASD Rule 1021(a) requires that all individuals acting as principals register. The rule defines “principal” as an associated person who is “actively engaged in the management of the member’s . . . securities business, including supervision, solicitation, conduct of business or the training of persons associated with a member for any of these functions.” NASD Rule 1021(b). The definition of principal includes not only officers and directors of corporations who “actively engage[] in the management of the member’s investment banking or securities business,” but applies equally to others who engage in management or supervision. *NASD Notice to Members 99-49*, 1999 NASD LEXIS 24, at *2 (June 1999). An individual must register as a principal, when the individual is involved in the “day-to-day conduct of the member’s securities business and the implementation of corporate policies related to such business.” *Id.* (explaining that registration determination turns on the functions that an individual performs).

The evidence establishes that Smith was actively engaged in the management of CSSC BD’s securities business, which required Smith to register as a principal. *See, e.g., Gordon Kerr*, 54 S.E.C. 930, 938 (2000) (“[A] person acting in a supervisory capacity must be registered as a general securities principal.”). First, Smith recruited and hired registered representatives and officers of CSSC BD. Smith made the decisions to appoint LaRose and Martin as co-presidents of CSSC BD and elevate LaRose as the firm’s CCO. The NAC has found the selection and hiring of firm employees such as principals to reflect active management of a broker dealer. *Dep’t of Enforcement v. Harvest Capital Invs., LLC*, Complaint No. 2005001305701, 2008 FINRA Discip. LEXIS 45, at *26-27 (FINRA NAC Oct. 2008); *see also Kirk A. Knapp*, 50 S.E.C. 858, 861 (1992) (considering that the applicant hired individuals in determining that applicant acted in a principal capacity).

Smith was central to the hiring and firing of registered representatives at the firm. When individuals became registered representatives, they also affiliated with all the various CSSC entities because Smith required them to sign an affiliation agreement. For example, Smith recruited, hired, and negotiated employment terms for CSSC BD representatives Wheeler, Ken Bryant, and Southwick. LaRose testified that she never hired or fired a CSSC BD registered representative without first discussing it with Smith. The affiliation agreement gave Smith the authority to terminate the employment relationship if an employee willfully failed to comply with Smith’s directive. And it was Smith who fired Southwick. The hiring and firing of a firm’s personnel are activities that favor principal registration. *See Dennis Todd Lloyd Gordon*, Exchange Act Release No. 57655, 2008 SEC LEXIS 819, at *28-29 (Apr. 11, 2008) (determining that employee’s hiring and firing of firm’s registered representatives supports that employee acted as unregistered principal); *Richard F. Kresge*, Exchange Act Release No. 55988, 2007 SEC LEXIS 1407, at *50 (June 29, 2007) (finding that employee’s active involvement in firm’s hiring demonstrates that employee acted as unregistered principal).

And it was Smith who made financial decisions for CSSC BD, including directing the maintenance of its minimum net capital and controlling the payments of salaries and commissions to firm personnel. Smith controlled when CSSC BD would receive money from CSSC. LaRose testified that if an employee of the broker-dealer had a question about a salary

deferral, she directed the employee to Smith. When CSSC BD needed money in order to meet its net capital requirement, CSSC's assistant controller, MD communicated with Smith—not Martin or LaRose. She told Smith that CSSC BD “desperately needs to be paid the \$20,000 that it is owed from the RIA for December” and was “only \$874 over the notification threshold” when it would fall below its minimum net capital requirement. MD explained that because CSSC BD owed CSSC more than \$83,000 for the December 2014 rent, CSSC BD would fail to maintain its required level of net capital unless Smith offset the rent with other revenue. Smith told MD which bill payments to prioritize and Smith ensured that CSSC RIA diverted funds to enable the broker dealer to maintain minimum net capital. When the firm's auditors had concerns about whether CSSC BD could continue as a going concern, they contacted Smith. Control of a firm's finances is an activity that suggests that an associated person is actively engaged in a firm's securities business and should register as a principal. *See Kresge*, 2007 SEC LEXIS 1407, at *50 (finding that employee's “substantial role” in firm's finances supports that employee acted as unregistered principal); *Vladislav Steven Zubkis*, 53 S.E.C. 794, 799-800 (1998) (explaining that applicant's financial support of firm, including payment of firm expenses such as rent, telephone charges, and compensation of brokers, evidences need for principal registration); *Harvest*, 2008 FINRA Discip. LEXIS 45, at *27 (controlling firm checking account and making financial decisions for firm is an example of activities requiring principal registration). Smith also was involved in selecting CSSC BD's clearing firm. *Cf. Harvest*, 2008 FINRA Discip. LEXIS 45, at *27-28 (negotiating potential clearing agreements on behalf of firm was activity that demonstrated that an individual acted in a principal capacity).

LaRose and Martin as co-presidents answered directly to Smith and acted on behalf of CSSC BD at Smith's direction. *See Harvest*, 2008 FINRA Discip. LEXIS 45, at *27. Martin testified that his “hands-on work” as co-president was “fairly small.”¹⁶ Martin admitted that he “relied on other people to do a lot of the hands-on work,” and that “people might have” seen his role as “in title only.” Smith's wide-ranging involvement even included suitability reviews of CSSC BD customers' purchases of CSSC's offerings and the handling of broker dealer customer complaints. LaRose testified that when CSSC BD customer, SM, complained to the broker dealer about her investment in one of the CSSC offerings, LaRose consulted with Smith. Smith informed LaRose that SM's principal was due but unpaid and that he would speak with SM. LaRose informed SM that she should work with CSSC directly to resolve her complaint. Smith told LaRose that he had prepared a memo in anticipation of additional complaints that would be sent to the other broker dealer customers who had invested in CSSC's offerings.

Smith argues that he was engaged in these activities solely in his capacity as chairman and chief executive officer of CSSC. The evidence shows, however, that he was deeply involved in CSSC BD's securities business and does not support Smith's limited view of his activities. While, for example, an officer of a broker-dealer's parent corporation who sits on the board of directors of the broker-dealer and is not actively engaged in the management of the broker-dealer is considered an outside director and does not need to be registered, that is not the case here. The

¹⁶ In addition to co-president of the broker dealer, Martin was president of CSSC's insurance subsidiary and a senior consultant for CSSC RIA.

record shows that although Smith was not registered as a principal, he controlled CSSC BD and was actively engaged in the management of the firm's securities business. *See Dep't of Enforcement v. Gallagher*, Complaint No. 2008011701203, 2012 FINRA Discip. LEXIS 61, at *10-11 (FINRA NAC Dec. 12, 2012) (finding respondent acted as unregistered principal through his activities including hiring, firing, and supervision and his ownership and control of the broker-dealer's parent company).

Consequently, we find that Smith engaged in activities requiring principal registration, and that he violated NASD Rule 1021 and FINRA Rule 2010.

V. Sanctions

For Smith's fraudulent omission and misrepresentations of material facts, the Hearing Panel barred Smith and ordered that he pay \$130,000 in restitution (joint and several with CSSC BD) to the four investors in the 2015 Bridge Loan Note Offering. The Hearing Panel recommended, but declined to impose, additional sanctions for Smith's registration violations, in light of the bar. For the reasons set forth below, we affirm the bar and restitution order. We also assess, but do not impose, additional sanctions for Smith's violations of FINRA's registration rules.

A. Fraudulent Omissions and Misrepresentations of Material Facts

In assessing sanctions, we consider FINRA's Sanction Guidelines ("Guidelines"), including the Principal Considerations in Determining Sanctions and any other case-specific factors. Fraud violations are "especially serious and subject to the severest of sanctions under the securities laws." *See Marshall E. Melton*, 56 S.E.C. 695, 713 (2003). The Guidelines for intentional or reckless omissions or misrepresentations of material fact therefore recommend that we strongly consider barring an individual respondent, unless mitigating factors predominate.¹⁷

We conclude that there are numerous aggravating factors, and no mitigating factors, that support a decision to bar Smith for his fraud. Smith engaged in numerous acts of fraud over an extended period involving several investors who lost the entirety of their investments.¹⁸ By his own admission, Smith solicited a minimum of 15 people to invest in the 2015 Bridge Loan Note Offering. Of those, four people invested \$130,000 in the offering in which Smith misrepresented and failed to disclose the material facts. Smith intentionally failed to disclose the critical fact that CSSC owed prior investors hundreds of thousands of dollars that it could not repay.¹⁹ The

¹⁷ *See FINRA Sanction Guidelines* 89 (2019), http://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf [hereinafter *Guidelines*]. They also recommend a fine of \$10,000 to \$155,000. *Id.*

¹⁸ *See Guidelines*, at 7 (Principal Considerations in Determining Sanctions Nos. 8, 9, 11).

¹⁹ *See id.* at 8 (Principal Considerations in Determining Sanctions, No. 13).

evidence shows that Smith was desperate to raise funds for CSSC, which was struggling to pay its employees and remain viable.

In addition, Smith knew or was reckless in not knowing that his representations about CSSC's financial prospects resulting from Project X and CSSC's business with the SDTC and the city of Jacksonville were unfounded and would persuade investors to purchase the 2015 Bridge Loan Note Offering.²⁰ See, e.g., *Mitchell H. Fillet*, Exchange Act Release No. 75054, 2015 SEC LEXIS 2142, at *14-15 (May 27, 2015) (finding respondent acted recklessly, which served to aggravate sanctions, when drafting an offering term sheet knowing that it contained inaccurate descriptions subject to contingencies that had not yet occurred and failing to alert investors to the contingencies); *Gomez*, 2018 FINRA Discip. LEXIS 10, at *51 ("Under these circumstances, Gomez's "refusal to see the obvious, or to investigate the doubtful," gives rise to an inference of reckless misconduct."). Even after Smith fired Southwick in September 2015, Smith continued to solicit investors when it was obvious that his claims in the offering materials touting Project X and the purportedly pending engagements with SDTC and the city of Jacksonville were false.

In November 2015, one of the four investors, TL, requested a refund from Smith of his \$50,000 investment after he had not received documents related to his investment that he made in August 2015. TL stated that his "trust has been seriously shaken." Smith told TL that he had "no present ability" to refund his money and attempted to assuage TL's concerns by claiming without support that CSSC's assets "far exceed" CSSC's total debt. Smith's fraudulent omission and misrepresentations resulted not only in the potential for monetary gain, but \$130,000 in actual gain for Smith and CSSC for his sales to the four investors.²¹

We are also troubled by Smith's blaming of others for his own misrepresentations related to the 2015 Bridge Loan Note Offering.²² See also *John B. Busacca, III*, Exchange Act Release No. 63312, 2010 SEC LEXIS 3787, at *63 (Nov. 12, 2010) (aggravating for purposes of sanctions that representative blamed others for his own misconduct), *aff'd*, 449 F. App'x 886 (11th Cir. 2011); *Janet Gurley Katz*, Exchange Act Release No. 61449, 2010 SEC LEXIS 994, at *69 (Feb. 1, 2010) ("Katz cannot shift the blame for her violations to others or claim that others' misconduct somehow excuses her own misdeeds"), *aff'd*, 647 F.3d 1156 (D.C. Cir. 2011). Throughout these proceedings, Smith blamed Southwick and denied his own responsibility despite ample evidence of Smith's direct involvement and control over the offering. Smith ignored the high standards of conduct that FINRA expects in the sale of privately placed securities. See *FINRA Regulatory Notice 10-22*, 2010 FINRA LEXIS 43, at *4-5 (Apr. 2010). Smith defrauded investors and his "conduct demonstrates a fundamental unfitness for association in the securities industry." See *Akindemowo*, 2016 SEC LEXIS 3769, at *39.

²⁰ See *id.*

²¹ See *Guidelines*, at 8 (Principal Considerations in Determining Sanctions, No. 16).

²² See *id.* at 7 (Principal Considerations in Determining Sanctions, No. 2).

We also determine that restitution is an appropriate remedy in this case. Restitution may be appropriate when an “identifiable person” otherwise would unjustly suffer “quantifiable loss proximately caused by a respondent’s misconduct.”²³ “An order requiring restitution . . . seeks primarily to return customers to their prior positions by restoring the funds of which they were wrongfully deprived.” *Newport Coast Sec. Inc.*, Exchange Act Release No. 88548, 2020 SEC LEXIS 911, at *37 (Apr. 3, 2020). Although the Commission and courts have not adopted a single approach to proximate causation, we agree with the Hearing Panel’s determination that the losses suffered by the four investors in the form of the full amount of their investment in the 2015 Bridge Loan Note Offering were the foreseeable, direct, and proximate result of Smith’s fraud. *See id.*; *McGee*, 2016 FINRA Discip. LEXIS 33, at *79. Smith used CSSC BD as one way to obtain investors and the firm shared liability with Smith for the fraudulent misconduct. We therefore order Smith to pay restitution, jointly and severally, with CSSC BD, to the four investors in the amounts set forth below in footnote 24 plus prejudgment interest until paid in full.²⁴ *See Newport*, 2020 SEC LEXIS 911, at *38 n.112 (finding when “there are multiple parties liable for misconduct, it was appropriate to impose that obligation on respondents jointly and severally”).

Accordingly, we bar Smith from associating with any FINRA member in any capacity for violating Exchange Act Section 10(b), Exchange Act Rule 10b-5, and FINRA Rules 2020 and 2010 and order that he pay restitution to the four purchasers of the 2015 Bridge Loan Notes.

²³ *Guidelines*, at 4 (General Principles Applicable to All Sanction Determinations, No. 5).

²⁴ Prejudgment interest shall be paid at the rate established for the underpayment of income taxes in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a). *Guidelines*, at 11; *see McGee*, 2016 FINRA Discip. LEXIS 33 at *80. The restitution amount for each investor is as follows: TL, \$50,000, with interest accruing from August 24, 2015; Thomas Scotto, \$20,000, with interest accruing from August 31, 2015; BB, \$10,000, with interest accruing from September 29, 2015; and Gavin Clarkson, \$50,000, with interest accruing from November 13, 2015. If Smith is unable to locate an investor, he must provide Enforcement with proof that he has made a bona fide attempt to locate the investor. The Hearing Panel ordered that if Smith cannot locate an investor, Smith is to pay the restitution owed to FINRA as fine. We disagree with this approach and order instead that if investors cannot be located, unpaid restitution should be paid to the appropriate escheat, unclaimed property, or abandoned property fund for the states of the investors’ last known residences. *See Guidelines*, at 11.

B. Registration Violations

For registration violations, the Guidelines recommend imposing a fine of \$2,500 to \$77,000 and suspending the individual in any or all capacities for up to six months.²⁵ In egregious cases, the Guidelines recommend a lengthier suspension of up to two years, or a bar.²⁶ In assessing sanctions for registration violations, the Guidelines advise adjudicators to consider whether the respondent has filed an application for registration and the nature and extent of the unregistered respondent's responsibilities.²⁷

Smith's registration violations were egregious. Smith actively engaged in a multitude of activities as a principal and representative despite his lack of registration. Smith deliberately ignored the requirements of the registration rules.²⁸ Smith knew that he was required to register as a principal in order to manage CSSC BD's day-to-day securities business. Smith acknowledged in the Form NMA that he was exempt from registration *only if* he was not actively engaged in the firm's management. The record shows, however, that Smith was active in most every aspect of firm management: the hiring and firing of firm staff; appointing officers; overseeing and unilaterally controlling the firm's finances; channeling money from the RIA to the firm to maintain minimum net capital; responding to firm auditors about the broker dealer's ability to continue as a going concern; conducting suitability reviews; and responding to firm customer complaints. Smith appointed Martin and LaRose as co-presidents largely in name only when it was Smith who actively managed the firm and its employees. Smith's misconduct spanned the duration of the review period, occurring for more than five years.²⁹

Smith also acted as a representative without oversight when he directly, and through other CSSC BD representatives, solicited firm customers to invest in CSSC's debt offerings. These solicitations resulted in some firm customers investing in CSSC offerings and provided CSSC with much needed cash infusions. Thus, Smith had the potential for monetary gain from these investments that served to keep his business afloat.³⁰

As the Hearing Panel found, Smith chose not to register in order to conduct business through CSSC BD while attempting to avoid the appearance of doing so. At every turn, Smith has refused to accept any responsibility for his conduct.³¹ *See Hans N. Beerbaum*, Exchange Act

²⁵ *Guidelines*, at 45.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.* at 8 (Principal Considerations in Determining Sanctions, No. 13).

²⁹ *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 9).

³⁰ *Id.* at 8 (Principal Considerations in Determining Sanctions, No. 16).

³¹ *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 2).

Release No. 55731, 2007 SEC LEXIS 971, at *18 (May 9, 2007) (explaining respondent's "conduct and statements raise significant uncertainty about his willingness to comply with registration and other regulatory requirements in the future"). FINRA's "registration requirement provides an important safeguard in protecting public investors and strict adherence to that requirement is essential." *See Flannigan*, 56 S.E.C. at 17 (internal quotation marks omitted). We are particularly troubled by Smith's wide-ranging actions as an unregistered principal. As the Commission has observed, "the registered principal is the person at a broker-dealer to whom [FINRA] looks to ensure compliance with regulatory requirements." *Beerbaum*, 2007 SEC LEXIS 971, at *14 (internal quotation marks omitted); *see Douglas Conrad Black*, 51 S.E.C. 791, 794 (1993). And that "regulatory compliance is dependent, to a significant degree, on the qualifications of the principal, and those qualifications are assessed through the examination process," a process that Smith conveniently and impermissibly circumvented. *See Beerbaum*, 2007 SEC LEXIS 971, at *14.

Accordingly, we modify the Hearing Panel's sanctions for Smith's registration violations to reflect the seriousness and degree of Smith's activities as an unregistered principal.³² For acting as an unregistered principal, we fine Smith \$75,000 and suspend him in all capacities for two years. For acting as an unregistered representative, we fine Smith an additional \$50,000 and concurrently suspend him for one year in all capacities. In light of the bar for fraud, however, we decline to impose these additional sanctions for Smith's registration violations.

VI. Conclusion

We find that Smith fraudulently failed to disclose and misrepresented material facts to investors, in violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and FINRA Rules 2020 and 2010. We also find that Smith acted as an unregistered representative and principal, in violation of NASD Rules 1021 and 1031 and FINRA Rule 2010. Accordingly, we bar Smith from associating with any FINRA member in any capacity for his fraud and order that he shall pay to the affected investors as set forth in footnote 24 above, restitution totaling \$130,000, jointly and severally with CSSC BD. The bar is effective immediately upon issuance of this decision. In light of the bar, we assess but do not impose additional sanctions for Smith's registration violations. We also affirm the Hearing Panel's order that Smith pay hearing costs, jointly and severally with CSSC BD, of \$12,107.09 and impose appeal costs of \$1,283.

On behalf of the National Adjudicatory Council,

Jennifer Piorko Mitchell, Vice President and
Deputy Corporate Secretary

³² For acting as an unregistered principal, the Hearing Panel assessed a \$50,000 fine and a one-year suspension in all capacities. For acting as an unregistered general securities representative, the Hearing Panel assessed a \$50,000 fine and a one-year concurrent suspension in all capacities.